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Report on Public finances in EMU 2014

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Report on Public Finances in EMU
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EDITORIAL

The challenging economic times are not yet over. The economic recovery has not lived up to the expectations that existed earlier on the year and growth projections have been revised downwards in most EU Member States. Today, the risk of persistent low growth, close to zero inflation and high unemployment has become a primary concern. Six years on from the onset of the crisis, it is urgent to revitalise growth across the EU and to generate a new momentum for the economic recovery.

In this context, fiscal policy should be combined with initiatives at the EU level to boost investment and structural reforms in an integrated approach to tackle this challenge effectively. The Juncker plan, by putting forward an ambitious investment strategy, is expected to enhance aggregate demand and lessen supply side constraints in the EU. The Stability and Growth Pact, by ensuring fiscal responsibility while allowing for flexibility in the application of the rules, strikes the appropriate balance between addressing the fiscal challenges ahead and supporting the economic recovery. This report is the traditional annual contribution of the Commission's Directorate General for Economic and Financial Affairs to the policy debate in the domain of fiscal policy. It discusses economic and policy developments, implementation and advances in fiscal surveillance as well as improvements in the analytical framework applied to fiscal policy.

The aggregate fiscal picture for the EU and the euro area is now considerably more favourable, thanks to the commendably large consolidation efforts made in the past. As shown in Part I this has allowed Member States to slow the pace of adjustment. The aggregate fiscal stance is now expected to be broadly neutral in 2014 and 2015, both in the EU and the euro area. This will reduce one of the drags on growth and should therefore be welcomed.

Nevertheless, the contribution of each Member State's fiscal stance to the overall euro area average could be improved. Countries with high debt burdens need to show adequate progress and respect for their commitments under EU rules. At the same time, further consolidation by some euro area Member States could lead to an unwarranted overall fiscal tightening. Therefore, fiscal policies should be realigned across euro area countries with those having fiscal space taking advantage of it. This would help also to reduce the macroeconomic imbalances within the Euro area.

Member States still need to secure medium and long-term control over deficit and debt levels. As a contribution to the debate, the report suggests that this will crucially depend on Member States' ability to control expenditure trends. Part III shows that slippages in the implementation of medium-term budgetary plans across Member States are mainly attributable to expenditure ratios turning out higher than planned. In turn, Part IV suggests that decisive control of government expenditure is crucial to ensure a durable consolidation of public finances over the medium-term.

As part of the response to the crisis, the EU introduced a major overhaul of the EU system of economic governance. Budgetary surveillance in the EU and the euro area was largely reformed with the adoption of the legislative packages known as the Six Pack and the Two Pack, which precisely placed more emphasis on expenditure control and institutional arrangements that favour sound government finances. Part II presents some of the most salient features of the reformed EU fiscal framework, such as the rise of Independent Fiscal Institutions. As many such institutions have been created only very recently, their capability to make a difference in national fiscal policy outcomes has yet to be tested against the background of a challenging fiscal policy environment. Eventually it will be their ability to adapt to the specificities of their national framework while pursuing effectively the general goal of ensuring fiscal sustainability that will ensure their standing on the national scene and their reputation in the European and global fiscal landscape.

While the latest reforms have significantly bolstered the existing governance setup, the relationships between the various instruments of economic surveillance have also become more complex as acknowledged by the Six Pack and Two Pack review by the Commission published in November 2014. This poses challenges for communication with stakeholders and the general public. A transparent

implementation of the EU fiscal framework with proper involvement of national Parliaments and the European Parliament remains crucial in ensuring ownership, democratic legitimacy and accountability.

It is DG ECFIN's role and privilege to contribute to this endeavour with rigorous economic analysis and transparent policy advice, which are the aims of this report.

Marco Buti

Director General

Economic and Financial Affairs

SUMMARY

The recovery is fragile and the labour market outlook is particularly worrisome …

The EU's economic recovery remains fragile and subdued. Labour markets have improved only mildly and weak growth has compounded disinflationary trends. The persistence of high structural unemployment has become a serious concern in the EU because of its severe social consequences and because of its negative consequences for growth and the sustainability of public finances.

… while government deficits have been successfully reduced in the EU and the euro area.

Despite the low growth environment, the aggregate fiscal picture in both the EU and the euro area is now more favourable than in other major economies. The large consolidation efforts made over the last few years are bearing fruit. This year, the aggregate headline fiscal deficit for the EU is expected to be brought down to 3 % of GDP for the first time since 2008.In the euro area the government deficit should fall further below that threshold. Aggregate government debt is expected to peak as a proportion of GDP in 2015 at around 88 % and 95 % in the EU and the euro area respectively and then to start declining in 2016.

As shown in Part I, successful measures to improve public finances enabled several EU Member States (Belgium, the Czech Republic, Denmark, the Netherlands, Austria and Slovakia) to leave the EU's Excessive Deficit Procedure (EDP) in June this year. Only 11 Member States now remain subject to the EDP, compared to sixteen countries at the end of 2013.

In this context, fiscal responsibility should be combined with structural reforms and a boost in investment to support the recovery.

At the current juncture, fiscal policy should seek to strike an adequate balance between tackling historically-high debt levels and supporting the economic recovery. As outlined in the 2015 Annual Growth Survey, economic policy should be refocused along a strategy that relies on (i) structural reforms, (ii) initiatives at the EU level to boost investment and lessen supply side constraints and (iii) fiscal responsibility. While the EU has for some years been tackling all three areas, the Commission's recent Communication, an Investment Plan for Europe, represents a major new effort to boost investment.

The achievements to date resulted in a broadly neutral fiscal stance on aggregate …

Thanks to the progress achieved by Member States in recent years, the pace of fiscal consolidation has eased considerably. Analysis of the Draft Budgetary Plans submitted by euro area Member States in October this year confirms that the fiscal stance of both the EU and the euro area should be broadly neutral this year and next. While the absence of fiscal tightening at the aggregate level should be welcomed, fiscal policy seems to be insufficiently differentiated across Member States. Countries with high debt burdens need to show adequate progress and respect for their commitments under EU rules to ensure confidence. At the same time it would be appropriate that Member States with more fiscal space take measures to encourage domestic demand, with a particular emphasis on investment. Moreover, the quality of public finances should be raised by improving expenditure efficiency and prioritising productive investment in government spending; by making the tax system more efficient and supportive of investment.

… while fiscal challenges will remain especially hard for some Member States.

Fiscal policy challenges will likely remain substantial, particularly for the most indebted countries. The evidence presented in Parts III and IV suggests that effectively reducing high government debt levels will require effective management of public finances and expenditure control, as well as stronger growth brought about by structural reforms and increased investment.

Addressing these fiscal challenges will require strict implementation of medium- term budgetary plans...

Effective management of public finances requires medium-term budgetary planning, as a single-year perspective gives fiscal policymakers a poor basis for forming a credible budgetary strategy. The strain put on Member States' public finances by the crisis contributed to the strengthening of the multiannual dimension to fiscal planning under the European Semester. Thanks to the reforms of the EU's fiscal governance rules, many Member States have recently either introduced new medium-term budgetary frameworks (MTBFs), or significantly upgraded their existing ones.

However, an effective enforcement of MTBFs is essential if their benefits are to materialise, especially in the current context. Governments will only succeed in bringing down national debt levels if they meet the targets they lay out in their budgets. The track record of EU Member States in this respect is at best mixed. The evidence provided by the last seventeen years of Stability Programmes and Convergence Programmes shows that there tends to be a systematic deviation from budgetary targets, mainly because expenditure ratios turn out higher than planned. A careful focus on expenditure developments is therefore essential if MTBFs are to deliver their expected results.

…and concentrating the adjustment efforts on the expenditure side …

Government revenue-to-GDP ratios are already high in most EU Member States. Therefore, efforts on the revenue side should concentrate on enhancing the government's revenue structure to make it more growth-friendly. At the same time, as in the absence of discretionary measures government revenues typically follow GDP, controlling expenditure over the medium-term is crucial to control deficits and, ultimately, bring down current debt levels. Numerous academic studies have explored expenditure-based consolidations and the literature has tended to favour them arguing that they generate confidence effects and are less detrimental to growth over the medium-term. However, some evidence also suggests that cuts in expenditures may be temporary and limited to the duration of fiscal consolidation episodes. More generally, the actual impact of expenditure-based consolidations on medium- and long-term expenditure dynamics has been left relatively unexplored.

… in particular, on long-term expenditure commitments.

An analysis of past trends in the EU confirms that government expenditure is kept in check over the medium-term only when consolidation efforts concentrate on the spending side of the budget. Several episodes in EU Member States in the 1980s and 1990s in particular show that unsustainable expenditure trends are only reversed by tackling the most rigid, most persistent and least discretionary components of government spending, which typically constitute long-term expenditure commitments. In this respect,

spending reviews, which systematically scrutinise baseline expenditures, can help achieve fiscal consolidation targets and, more generally, to enhance the performance of government spending. This provides an additional argument in favour of expenditure control as the best means of successfully stabilising and reducing debt levels.

The EU's fiscal framework continues evolving …

In the context of the EU's fiscal framework, in which comparability and cross-country consistency is a major issue, efficient fiscal surveillance requires refining and updating the underlying analytical tools and measurements. Part II presents the most recent advancements in this framework, concerning (i) the measurement of policy actions — i.e. the effective action methodology; (ii) the definition of policy-relevant variables — i.e. the cyclically-adjusted balance, and (iii) fiscal statistics — i.e. the change to ESA 2010.

The statistical and methodological revisions often incite questions about their impact on surveillance decisions taken within the Stability and Growth Pact, especially since the recent reforms of the Pact have strengthened enforcement mechanisms.

… with the rise of independent fiscal institutions being amongst its most salient new features.

The rise of independent fiscal institutions is one of the most salient features of the recent evolution of the budgetary institutional setup in the EU. While such institutions have existed for a long time in some countries, the new EU rules have contributed to the rise of independent fiscal institutions, both in terms of their number and their competences. As many such institutions were created only very recently, their capacity to make a difference in national fiscal policy outcomes has yet to be tested against the background of a challenging fiscal policy environment. Yet their potential contribution to transparency and accountability should not be under-estimated.

The Six Pack and Two Pack review finds that the reformed framework has proven effective in strengthening budgetary surveillance.

The recent reform of the EU's fiscal governance has been instrumental in the strengthening of MTBFs and the rise of independent fiscal institutions. These and other developments are assessed in the recently adopted Communication from the Commission on the Economic governance review (the Six Pack and Two Pack review). The reformed framework is found to have been effective in guiding Member States in their efforts to consolidate public finances under difficult economic conditions. Since 2011, most Member States have attained or made appropriate progress towards their medium-term budgetary objectives while the intermediate headline and structural deficit targets under the EDP have enabled more precise and transparent policy advice and monitoring. Furthermore, the Six Pack and Two Pack review finds that the rules strike the right balance between sustainability and cyclical stabilisation requirements.

Part I

Current developments and prospects

1. CURRENT DEVELOPMENTS AND PROSPECTS

1.1. ECONOMIC DEVELOPMENTS AND PERSPECTIVE ON CONSOLIDATION

The EU recovery is not materialising as earlier expected. The momentum of the EU economy in 2014 has been slower than most forecasters had anticipated in spring. Recent indicators readings suggest slow growth in the EU and stagnation in the euro area will continue through the second half of the year.

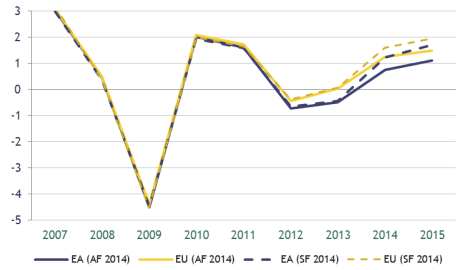
In the first half of 2014 a slowdown in GDP growth among the EU's major trading partners, aggravated by the rapidly deteriorating geopolitical situation, has affected the EU through slower-than-expected export growth and negative confidence effects. GDP growth forecasts have therefore been revised down to reflect not only the materialization of some of the risks identified in spring but also a reassessment of the underlying dynamics of domestic demand particularly investment, which has failed so far to emerge as an engine of growth.

GDP growth continues to be held back by the legacy of the global financial and economic crisis. The less favourable financing conditions and elevated uncertainty are weighing on the euro area private investment, while deleveraging pressures and fragile labour market conditions are weakening consumption. Disappointment over the pace of structural and institutional reform and the need to rebalancing are also weighing on growth, making the recovery more subdued and lowering actual and potential growth.

Economic activity, however, should gradually strengthen over the course of 2015 as the legacies of the crisis fade away and more supportive policies and financing conditions are in place. Positive factors such as improving labour market conditions, rising disposable incomes, improved financing conditions, diminishing financial fragmentation and lower deleveraging needs should lift growth in the EU and in the euro area. The mobilization of public funds at EU level proposed by the Commission to stimulate private investment in the real economy should further contribute to the recovery. Over time, a healthier banking sector, stronger growth in the rest of the world and the benefits of recently implemented structural reforms should accelerate growth further.

Disinflationary trends have continued across EU Member States this year, driven by the slack in the economy together with falling energy and food prices. As economic activity recovers gradually, inflation should increase. HIPC inflation in the euro area is now forecast to be 0.5% this year, but to rise to 0.8% in 2015. For the EU, inflation is forecast at 0.6% this year and then 1.0% in 2015.

Graph I.1.1: **Real GDP growth**



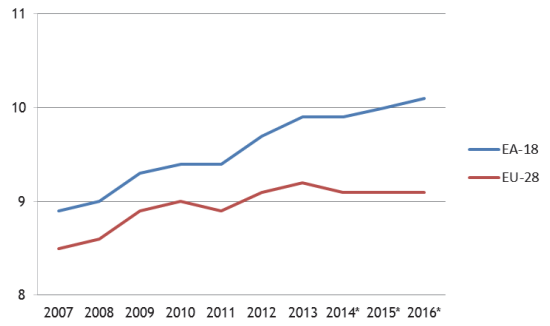
Source: Commission's 2014 spring and autumn forecasts

Graph I.1.1 presents forecasts for real GDP growth according to the Commission's 2014 autumn and spring forecasts. Annual GDP growth in the EU this year is projected to be 1.3%, while growth in the euro area is expected to be 0.8%. This is 0.3 and 0.4 percentage points (pp.) lower than projected in spring. The downward revision in growth appears relatively widespread across Member States, with only Ireland, the UK, Cyprus and Malta being projected substantial upward revisions to their growth forecasts in 2014, compared to earlier this year. Conversely, growth in the majority of other countries shows significant reductions.

As economic activity gradually strengthens over the course of 2015, real GDP growth in the EU is forecast to rise to 1.5% next year and 1.1% in the euro area.

These average growth figures mask sizeable differences across Member States however. Ireland stands out with a GDP growth of 4.6% projected for 2014 and 3.6% in 2015, followed by the UK, Malta, Luxembourg, Lithuania and Latvia where growth is expected at around 3% both in 2014 and

Graph I.1.2: **NAWRU in the EU and the euro area**



Source: Commission's 2014 autumn forecasts

2015. Conversely, four Member States are expected to register negative GDP growth in 2014, namely Italy (-0.4%), Finland (-0.4%), Croatia (-0.7%) and Cyprus (-2.8%), while growth is expected to turn positive next year in all four cases.

Among the remaining Member States, growth in Germany is expected to be 1.3% this year, 0.5 pp lower than anticipated in spring, as the economy broadly stagnated over the second half of 2014. Growth is expected to gradually pick up again in 2015 to 1.1% on the back of a robust labour market, favourable financing conditions, and strengthening external demand. France in turn is expected to register only very slow growth in 2014 (0.3%) and 2015 (0.7%) as a result of restrained domestic demand and a still subdued export performance. In Spain GDP growth is projected at 1.2% in 2014 and to increase in 2015 to 1.7%, supported by rising employment and easier financing conditions.

Overall weak economic growth has limited the labour market's recovery. The unemployment rate is expected to stand at 10.3% in the EU and 11.6% in the euro area in 2014, falling only slightly with respect to 2013. Differences across Member States remain sizeable with the highest unemployment rates registered in Greece and Spain (above 20%), followed by Croatia, Cyprus and Portugal. Among large Member States, the unemployment rate is set to fall this year and the next in Spain and the UK, reaching 23.5% and 5.7% in 2015 respectively; while it is set to increase and then remain stable in Italy and France, at 12.6% and 10.4% respectively. The unemployment rate will slightly decrease in Germany in 2014 and then remain at 5.1% in 2015.

Since economic growth is expected to gain momentum gradually, more meaningful labour market improvements should be visible in the coming years. By 2016, the end of the Commission's 2014 autumn forecasts' horizon, the unemployment rate in the EU is expected to decline to 9.5% in the EU and 10.8% in the euro area. This remains, however, still above pre-crisis levels by 1.3 pp. in the EU and by 2.2 pp. in the euro area (compared to the period 2004-2008). The overall slow decline in unemployment rates reflects cyclical factors such as the sluggishness of the recovery, but also the persistence of high structural unemployment. The latter is reflected in the rise of the NAWRU (Non Accelerating Wage Rate of Unemployment), which according to the common methodology agreed with Member States and used by Commission's staff estimates has been steadily increasing since 2009 in both the EU and the euro area as shown in Graph I.1.2. It is expected to continue rising in the euro area over the forecast horizon, though more moderately than during the crisis period and to stabilise in the EU.

High unemployment rates are a serious concern in the EU. Adverse labour market developments not only have severe social consequences, but also weigh on growth perspectives and on the sustainability of the public finances, as suggested when comparing the headline and structural balance figures for some Member States in Table I.1.1.

Turning to public finances, sustained consolidation have yielded a sizeable improvement of the budgetary positions in the EU and the euro area despite continuing low levels of growth in many economies. The deficit-to-GDP ratio in both the EU and the euro area are set to decrease further in 2014 and 2015, albeit more moderately than in previous years.

1.2. SHORT-TERM DEVELOPMENTS IN BUDGET DEFICITS

Table I.1.1 shows the budget balance for the 28 EU Member States from 2010 to 2015 on the basis of the Commission's 2014 autumn forecast.

Table I.1.1: **Budget balances in EU Member States (% of GDP)**

	Budget balance					Structural balance					Structural primary balance				
	2011	2012	2013	2014*	2015*	2011	2012	2013	2014*	2015*	2011	2012	2013	2014*	2015*
BE	-3.9	-4.1	-2.9	-3.0	-2.8	-3.6	-3.1	-2.7	-2.6	-2.2	-0.3	0.3	0.5	0.4	0.6
DE	-0.9	0.1	0.1	0.2	0.0	-1.3	0.0	0.6	0.7	0.6	1.2	2.3	2.6	2.6	2.4
EE	1.0	-0.3	-0.5	-0.4	-0.6	-0.2	-0.4	-1.1	-0.8	-0.7	-0.1	-0.2	-1.0	-0.6	-0.5
IE	-12.6	-8.0	-5.7	-3.7	-2.9	-8.0	-7.1	-4.8	-3.8	-3.3	-4.6	-2.9	-0.4	0.3	0.5
EL	-10.1	-8.6	-12.2	-1.6	-0.1	-5.7	0.1	3.1	2.0	1.6	1.6	5.1	7.1	6.3	5.8
ES	-9.4	-10.3	-6.8	-5.6	-4.6	-6.3	-3.6	-2.3	-2.2	-2.3	-3.8	-0.7	0.9	1.2	1.0
FR	-5.1	-4.9	-4.1	-4.4	-4.5	-5.0	-4.3	-3.3	-3.0	-2.9	-2.4	-1.7	-1.0	-0.9	-0.7
IT	-3.5	-3.0	-2.8	-3.0	-2.7	-3.3	-1.6	-0.8	-0.9	-0.8	1.4	3.5	4.0	3.8	3.7
CY	-5.8	-5.8	-4.9	-3.0	-3.0	-5.7	-5.5	-2.1	-0.8	-1.3	-3.5	-2.6	1.0	2.2	1.9
LV	-3.4	-0.8	-0.9	-1.1	-1.2	-1.1	-0.1	-1.0	-1.5	-1.6	0.8	1.6	0.4	0.0	-0.3
LU	0.3	0.1	0.6	0.2	-0.4	0.8	1.5	2.0	1.1	0.4	1.2	2.0	2.4	1.5	0.8
MT	-2.6	-3.7	-2.7	-2.5	-2.6	-3.1	-3.8	-2.7	-2.7	-2.9	0.1	-0.8	0.2	0.1	-0.1
NL	-4.3	-4.0	-2.3	-2.5	-2.1	-3.8	-2.2	-0.6	-0.5	-0.8	-2.0	-0.6	0.9	1.0	0.6
AT	-2.6	-2.3	-1.5	-2.9	-1.8	-2.5	-1.8	-1.3	-1.1	-1.0	0.3	0.9	1.3	1.4	1.5
PT	-7.4	-5.5	-4.9	-4.9	-3.3	-5.4	-2.3	-1.9	-1.3	-1.7	-1.1	2.6	3.0	3.7	3.3
SI	-6.2	-3.7	-14.6	-4.4	-2.9	-4.5	-1.8	-1.8	-2.5	-2.2	-2.6	0.2	0.7	0.8	1.0
SK	-4.1	-4.2	-2.6	-3.0	-2.6	-4.1	-3.4	-1.4	-2.1	-1.3	-2.5	-1.6	0.5	-0.3	0.4
FI	-1.0	-2.1	-2.4	-2.9	-2.6	-0.8	-1.1	-0.7	-1.1	-1.1	0.6	0.4	0.5	0.2	0.2
EA-18	-4.1	-3.6	-2.9	-2.6	-2.4	-3.6	-2.1	-1.2	-1.1	-1.1	-0.6	0.9	1.6	1.6	1.6
BG	-2.0	-0.5	-1.2	-3.6	-3.7	-2.0	-0.5	-1.3	-3.4	-3.4	-1.2	0.3	-0.5	-2.5	-2.5
CZ	-2.9	-4.0	-1.3	-1.4	-2.1	-2.6	-1.4	0.2	-0.7	-1.7	-1.3	0.0	1.5	0.6	-0.4
DK	-2.1	-3.9	-0.7	-1.0	-2.3	-0.6	-0.1	0.2	-0.2	-1.2	1.4	1.7	1.9	1.4	0.3
HR	-7.7	-5.6	-5.2	-5.6	-5.5	-7.1	-4.4	-3.6	-3.9	-4.1	-4.2	-1.2	-0.2	-0.1	-0.1
LT	-9.0	-3.2	-2.6	-1.2	-1.4	-3.8	-2.8	-2.2	-1.8	-1.6	-1.9	-0.8	-0.4	0.1	0.1
HU	-5.5	-2.3	-2.4	-2.9	-2.8	-4.2	-1.3	-1.3	-2.7	-2.8	0.0	3.3	3.3	1.4	1.1
PL	-4.9	-3.7	-4.0	-3.4	-2.9	-6.0	-4.0	-3.5	-2.9	-2.5	-3.4	-1.4	-1.1	-0.8	-0.4
RO	-5.5	-3.0	-2.2	-2.1	-2.8	-3.6	-2.5	-1.7	-1.7	-2.5	-1.9	-0.7	0.0	0.1	-0.7
SE	-0.1	-0.9	-1.3	-2.4	-1.8	0.0	0.0	-0.3	-1.5	-1.1	1.1	0.9	0.6	-0.7	-0.3
UK	-7.6	-8.3	-5.8	-5.4	-4.4	-5.8	-6.5	-4.4	-5.0	-4.5	-2.7	-3.6	-1.6	-2.3	-1.9
EU-28	-4.5	-4.2	-3.2	-3.0	-2.7	-3.8	-2.7	-1.7	-1.8	-1.8	-0.9	0.1	1.0	0.8	0.8

Source: Commission services
Note: The structural budget balance is calculated on the basis of the commonly agreed production function method (see European Commission (2004)).
* Figure from Commission services' Autumn 2014 forecast.

Large consolidation was implemented for three consecutive years over the period 2011-2013 both in the EU and the euro area. In fact, by 2013 the structural deficit in the EU had declined by 3 pp. of GDP compared to its 2010 level, standing at 1.7%. A similar consolidation effort was implemented throughout this period in the euro area, which overall structural deficit was brought down to 1.2% in 2013 from 4.2% in 2010.

These consolidation efforts resulted in considerable reductions of headline deficit across EU Member States. In particular, eighteen Member States recorded headline deficits below the 3% Treaty threshold in 2013, compared to only five three years earlier. The EU headline deficit came in at 3.2% of GDP in 2013, while in the euro area it came in at 2.9% of GDP.

As a result of the urgency and the size of these consolidation efforts, public investment has been particularly exposed to spending cuts across the EU. In fact, the share of government gross fixed capital formation in GDP is expected to be 20% lower in 2015 with respect to its 2010 levels, both in the EU and in the euro area. In particular, in 2015 government GFKF is expected to account for 2.9% of GDP in the EU and 2.7% of GDP in the euro area, compared to respectively 3.5% and 3.4% in 2010. Sixteen Member States have cut their public investment share in GDP by more than 10% over this same period. The collapse in public investment has been particularly acute in Ireland, Spain, Portugal, Cyprus, Italy, Latvia and Poland, as shown in Graph I.1.3.

The EU has repeatedly advocated a growth-friendly and differentiated fiscal consolidation

Box I.1.1: Communication from the Commission on an Investment Plan for Europe

The Investment Plan for Europe which has recently been put forward by the Commission is underpinned by three complementary strands: mobilising finance for investment, making finance reach the real economy and improving the investment environment. Its goal in the near term is to reverse downward investments trends and help boosting job creation and the economic recovery, without weighing on national public finances or generating new debt. Additionally, it ultimately aims at taking a decisive step towards meeting the long-term needs of the European economy.

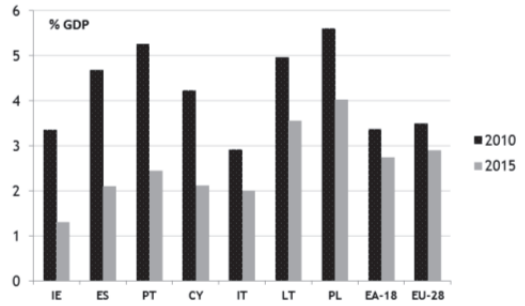
For that purpose, the first strand of the Plan is the mobilisation of at least 315 billion € of additional investment over the next three years. This will be done by establishing a new European Fund for Strategic Investments that will provide risk support for long-term investments and ensure increased access to risk-financing for SMEs and mid-cap companies. To establish this Fund a guarantee of 16 billion € will be created under the EU budget. Furthermore the EIB will commit 5 billion € to support the Fund. Member States, directly or through their National Promotional Banks, will have the opportunity to contribute to the Fund in the form of capital. Importantly, the Commission will take a favourable position towards such capital contributions to the Fund in the context of public finances surveillance under the Stability and Growth Pact.

The second strand of the Plan is to take targeted initiatives to make sure that the extra investment finance generated meets the needs of the real economy. This involves a new approach to the identification and preparation of investment projects across Europe: a credible project pipeline will be established, coupled with a technical assistance programme. This will facilitate that investments are channelled where they are most needed.

Finally, the third strand of the Plan consists of providing greater regulatory predictability, removing barriers to investment across Europe and further reinforcing the Single Market by creating optimal framework conditions for investment in Europe. The Investment Plan will contain an ambitious roadmap to make Europe more attractive for investment and remove regulatory bottlenecks.

All relevant measures should be adopted so that the new European Fund for Strategic Investments can be set up by mid-2015. By mid-2016, the European Commission and Heads of State and Government will take stock of the progress made and, if necessary, consider further options.

Graph I.1.3: **Recent developments in government Gross Fixed Capital Formation in selected EU countries**



Source: Commission services

strategy among Member States (see European Commission 2012, 2013 and 2014). ([1])

The recently launched Communication from the Commission on an Investment Plan for Europe ([2]) should not only avoid further expenditure cuts in areas that are expected to provide a greater contribution to economic growth, but also encourage greater investment especially by Member States with fiscal space available.

([1]) Communications from the Commission Annual Growth Survey 2013, 2014 and 2015.

([2]) Communication from the Commission to the to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and The European Investment Bank on an Investment Plan for Europe.

Table I.1.2: **Euro area - Government revenue and expenditures (% of GDP)**

	2010	2011	2012	2013	2014*	2015*
Total revenue (1)	44.3	44.9	45.9	46.5	46.7	46.7
Total expenditure (2)	50.4	49.0	49.5	49.4	49.4	49.1
Actual balance (3) = (1) - (2)	-6.1	-4.1	-3.6	-2.9	-2.6	-2.4
Interest (4)	2.7	3.0	3.0	2.8	2.7	2.7
Primary balance (5) = (3) + (4)	-3.4	-1.1	-0.6	-0.1	0.1	0.3
One-offs (6)	-0.8	0.0	-0.4	-0.1	0.0	0.0
Cyclically adjusted balance (7)	-5.0	-3.6	-2.5	-1.3	-1.1	-1.1
Cyclically adj. prim. balance = (7) + (	-2.3	-0.6	0.5	1.5	1.6	1.5
Structural budget balance = (7) -(6)	-4.2	-3.6	-2.1	-1.2	-1.1	-1.1
Change in actual balance:		2.0	0.5	0.7	0.3	0.2
- Cycle		0.6	-0.6	-0.5	0.1	0.3
- Interest		0.2	0.0	-0.2	-0.1	-0.1
- Cycl.adj.prim.balance		1.7	1.1	1.0	0.1	-0.1
- One-offs		0.8	-0.4	0.3	0.1	0.0
- Structural budget balance		0.7	1.4	0.9	0.1	0.0

Source: Commission services
Note: Differences between the sum and the total of individual items are due to rounding
* Figure from Commission services' Autumn 2014 forecast

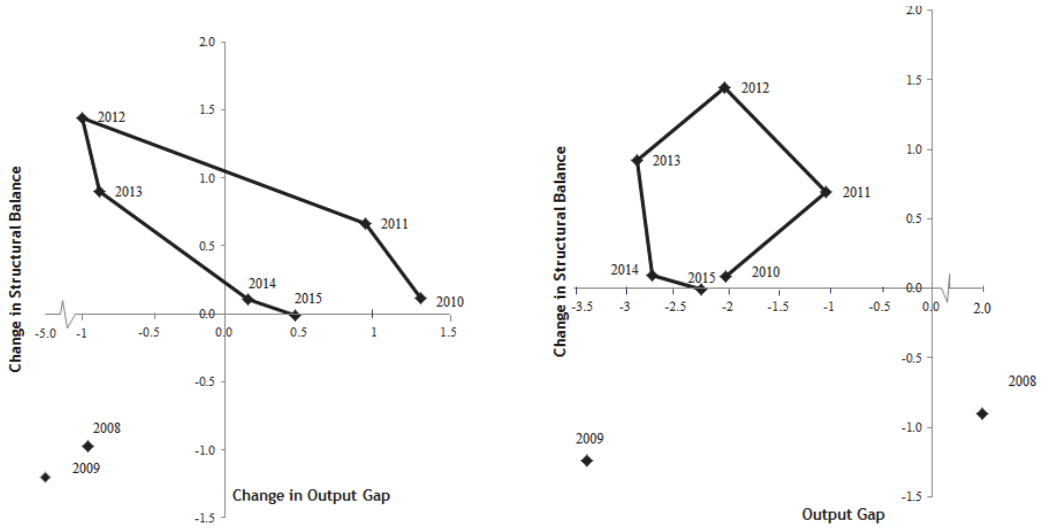
Looking ahead, a slowdown in headline deficit reduction is evident in 2014 and 2015. While both in the EU and the euro the headline deficit declined on average by 1.1 pp. of GDP per year between 2011 and 2013, it is now set to come down by 0.2. pp. in 2014 and in 2015. Thus, the EU headline deficit is expected at 3% and 2.7% of GDP respectively in 2014 and 2015, whereas it is expected at 2.6% and 2.4% of GDP in the euro area. The deceleration in deficit reduction is linked to both a decrease in the fiscal effort.

In fact, the process of budgetary consolidation is expected to come to a halt in 2014 as measured by a positive change in the structural balance. The structural deficit in the euro area is set to remain largely unchanged both in 2014 and 2015, which amounts to a broadly neutral fiscal stance as shown in Graph I.1.4. Similarly, the structural balance is expected to remain unchanged in 2014 and 2015 in the EU.

Across Member States, the fiscal effort in 2013 – as measured by the change in the structural balance – ranged from above 3 pp. in Cyprus and Greece, to a loosening of 1 pp. in Estonia, Bulgaria and Latvia. Ireland, Slovakia and the UK implemented substantial fiscal efforts around 2 pp. of potential GDP, followed by the Netherlands, the Check Republic and Spain, around 1.5 pp. The majority of Member States still implemented an effort between 0.5 pp. and 1 pp. in 2013.

The picture changes substantially for 2014 and 2015. Only seven Member States are forecast to implement any fiscal effort at all on average in these two years, the largest one at 0.7 pp. per year on average envisaged in Ireland. The fiscal effort is expected to be 0.5 pp. per year in Poland and between 0.3 and 0.2 pp. in Lithuania, Cyprus, Belgium, Estonia and France. Eight Member States are expected to carry out a neutral fiscal policy, with their structural balance remaining broadly unchanged throughout these two years (PT, AT, SK, DE, IT, ES, UK, NL and MT). In turn, the remaining twelve Member States are expected to loosen their fiscal policies in 2014 and 2015 on average. This loosening is expected to be around ¼

Graph I.1.4: **Fiscal stance in the euro area structural balance vs. euro area output gap level and change.**



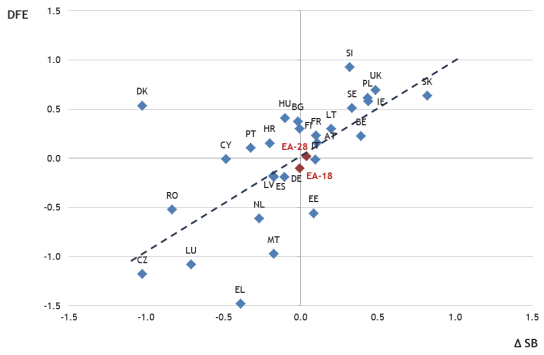
Source: Commission services

pp. per year in three Member States (FI, SI and HR) while a more considerable loosening of at least 0.5 pp. per year is envisaged in DK, EL, HU, LU, CZ and BG.

An alternative measure of the fiscal effort – the Discretionary Fiscal Effort or DFE – overall supports the above conclusions based on the change in the structural balance although with significant differences across countries. ([3])

Graph I.1.5 compares the expected fiscal effort in 2015 by Member State as measured by the change in the structural balance and the DFE. While for some countries –those above the forty five degree line– the DFE points to a larger effort than suggested by the change in the structural balance, for other Member States – those below the forty five degree line – it is the other way around. The difference between the two measures of fiscal effort is particularly noteworthy for Estonia, Malta and Luxembourg – the change in the structural balance overstating the fiscal effort compared to the DFE – and Slovenia, Denmark or Hungary – the change in the structural balance understating the fiscal effort compared to the DFE. Overall however, the DFE and the change in the structural balance point to a similar fiscal effort in 2015 in the euro area and the EU as a whole.

Graph I.1.5: **The DFE and the change in the Structural Balance in 2015 (% of GDP)**



Source: Commission services

While at the aggregate euro area level a broadly neutral fiscal stance may seem appropriate given the current cyclical conditions – which add up to an expected output gap of -3% in the euro area in 2014 and -2.3% in 2015 – the distribution of such fiscal stance across Member States may fail to meet crucial sustainability requirements, underscored by high and increasing debt ratios. At the same time, the fiscal space available in Germany is not planned to be used.

Graph I.1.6 brings together, on the one hand, Member States' structural position and debt levels and, on the other hand, the envisaged fiscal effort in 2015. Thereby it provides a snapshot of the expected degree of differentiation across Member States' fiscal policies.

According to Graph I.1.6 fiscal policy is expected to be somehow differentiated in 2015, although insufficiently so. Among the Member States with largest structural deficit and debt ratios only four are expected to implement at least some fiscal effort in 2015. It is the case of Ireland, France, Belgium and Portugal. However, the DFE confirms that their effort is expected to be below 0.5 pp of GDP, except in the case of Ireland where it is set to come in at 0.6 pp. On the other hand Spain and Italy are expected to implement a broadly neutral fiscal stance in 2015. Arguably, with the possible exception of Ireland, these Member States should implement larger fiscal efforts in 2015 to adequately ensure the sustainability of their public finances and respect their commitments under EU rules. However, further consolidation by some euro area Member States could lead to further fiscal tightening in the Eurozone as a whole, which seems unwarranted given the large and negative output gap still prevailing in the euro area.

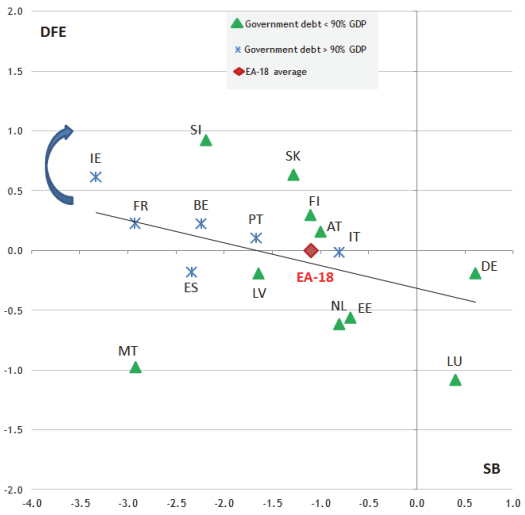
This suggests the need to realign fiscal policies across countries so that sustainability concerns are decisively addressed in the countries where these are present. At the same time, from an economic

([3]) The change in the structural balance may not always give an accurate picture of the underlying fiscal effort due, for example, to a different-than-normal response from revenue to economic growth. Another source of difficulties in interpreting the change in the structural balance as a proxy of the fiscal effort relates to its tendency to undergo revisions, in turn reflecting the difficulty of real time measurement of the output gap. An alternative measure of the fiscal effort can be obtained by adding up the amount of discretionary measures on the revenue side, and measuring the gap between spending and potential GDP growth on the expenditure side. See Part III of the 2013 Public Finance Report for more details on the computation of the DFE.

point of perspective it would be appropriate that Member States with more fiscal space – particularly Germany – take measures to encourage domestic demand, with a specific emphasis on investment.

In terms of Graph I.1.6, Member States' positions should pivot to become aligned with a steeper trend line.

Graph I.1.6: **Fiscal stance: dispersion around euro area average**



Source: Commission services
The graph compares the expected fiscal effort in 2015 by euro area Member State – as measured by the DFE in the vertical axis – with the starting fiscal structural position of each euro area Member State. The latter is measured by the level of the structural balance – in the horizontal axis – and complemented by information on debt-to-GDP ratios as provided by the different markers: Member States with debt ratios equal or above 90% are represented with asterisks; Member States with debt ratios below 90% are represented with triangles. The EA-18 average is represented with a diamond.
The trend line that fits the data shows that the larger the structural deficit, the larger the effort envisaged in 2015. However, the slope of the trend line is arguably very small, pointing to only limited fiscal policy differentiation across euro area Member States. A steeper trend line in the direction suggested by the blue arrow in the first quadrant, where Member States represented with asterisks would concentrate in the upper left side of the graph, would correspond to a more adequately differentiated fiscal stance across euro area countries.

1.3. DEVELOPMENTS IN DEBT

Average debt in the EU stood at 87.1% of GDP in 2013 – rising by 2.2 pp. relative to 2012 – and it is set to rise further to 88.1% in 2014 and stabilize at 88.3% in 2015.

Table I.1.3 shows the projected change in the government debt ratio between 2010 and 2015 by Member State and for the EU and euro area aggregates. Moreover it presents the decomposition of the overall change in the government debt ratio in terms of primary balance, the "snowball effect"([4]) and stock-flow adjustments. It shows that successive primary deficit, together with the snowball effect are expected to be the main drivers of debt accumulation in the EU in the period 2010-2015. In the euro area, however, the snowball effect explains the largest part of the change in the debt ratio, as a number of Member States with high starting levels of debt have faced both an increase in refinancing costs and more unfavourable GDP developments, both real and nominal.

Aggregate EU and euro area figures mask considerable variation across Member States in terms of both debt levels and their evolution over the past years. Regarding the latter, debt-to-GDP ratios have been on a broadly increasing path in all EU Member States since 2010, except for some noteworthy exceptions. These include Greece in 2012 following debt restructuring; Sweden, where debt declined in 2010 and 2011; Austria and Latvia, where debt decreased in 2011, 2012 and 2013; Denmark and Hungary in 2012 and 2013, and finally Germany, where debt declined in 2011 and 2013.

Heterogeneity in debt levels across Member States remains also large. Six Member States (Belgium, Ireland, Greece, Italy, Cyprus and Portugal) are expected to have debt above 100% of GDP by the end of 2014. In Greece, after a drop in 2012, the already very high debt ratio is expected to have increased further in 2014 reaching 175% of GDP. In Italy, where the debt-to-GDP ratio was already above 100% before the crisis, it has continued to rise and is forecast at 128% in GDP by 2014. Similarly, Belgium's debt increased above 100% in 2011 and has grown moderately since then and is projected at 104% of GDP in 2014. Conversely, debt-to-GDP ratios in Portugal and Ireland are

([4]) The snowball effect of debt stems from the interaction between the interest-growth rate differential and the debt level: if the difference between the interest paid on debt and the growth rate is positive –it will in general increase with debt – the dynamics of debt are explosive and an increase in primary balance is required to escape from the resulting cycle.

Table I.1.3: **Composition of changes in the government debt ratio in EU Member States (% of GDP)**

	Gross debt ratio						Change in debt ratio	Change in the debt ratio in 2010-15 due to:		
	2010	2011	2012	2013	2014*	2015*	2010-15	Primary balance	Interest &growth contribution	Stock-flow adjustment
BE	99.6	102.1	104.0	104.5	105.8	107.3	7.7	0.7	4.9	2.1
DE	80.3	77.6	79.0	76.9	74.5	72.4	-7.9	-10.1	-0.8	3.0
EE	6.5	6.0	9.7	10.1	9.9	9.6	3.1	0.0	-1.7	4.8
IE	87.4	111.1	121.7	123.3	110.5	109.4	22.0	13.1	3.4	5.5
EL	146.0	171.3	156.9	174.9	175.5	168.8	22.8	7.9	55.6	-40.6
ES	60.1	69.2	84.4	92.1	98.1	101.2	41.1	21.4	14.0	5.7
FR	81.5	85.0	89.2	92.2	95.5	98.1	16.6	11.2	4.9	0.5
IT	115.3	116.4	122.2	127.9	132.2	133.8	18.5	-8.8	21.5	5.8
CY	56.5	66.0	79.5	102.2	107.5	115.2	58.7	8.0	22.7	28.1
LV	46.8	42.7	40.9	38.2	40.3	36.3	-10.4	-0.4	-6.1	-4.0
LU	19.6	18.5	21.4	23.6	23.0	24.3	4.7	-2.8	-2.9	10.3
MT	67.6	69.8	67.9	69.8	71.0	71.0	3.4	-0.7	0.1	4.0
NL	59.0	61.3	66.5	68.6	69.7	70.3	11.3	7.3	4.4	-0.4
AT	82.4	82.1	81.7	81.2	87.0	86.1	3.7	0.0	0.0	0.0
PT	96.2	111.1	124.8	128.0	127.7	125.1	28.9	1.7	23.5	3.7
SI	37.9	46.2	53.4	70.4	82.2	82.9	45.0	18.9	9.8	16.2
SK	41.1	43.5	52.1	54.6	54.1	54.9	13.8	7.8	2.0	4.0
FI	47.1	48.5	53.0	56.0	59.8	61.7	14.6	4.4	1.5	8.7
EA-18	**83.9**	**86.5**	**91.0**	**93.3**	**94.7**	**95.0**	**11.0**	**1.5**	**7.1**	**2.4**
BG	15.9	15.7	18.0	18.3	25.3	26.8	10.8	7.0	2.0	1.9
CZ	38.2	41.0	45.5	45.7	44.4	44.7	6.6	4.9	1.9	-0.2
DK	42.9	46.4	45.6	45.0	44.1	45.1	2.3	1.5	4.2	-3.4
HR	52.8	59.9	64.4	75.7	81.7	84.9	32.1	12.3	16.5	3.3
LT	36.3	37.3	39.9	39.0	41.3	41.6	5.3	8.2	-2.1	-0.8
HU	80.9	81.0	78.5	77.3	76.9	76.4	-4.5	-5.5	6.0	-5.1
PL	53.6	54.8	54.4	55.7	49.1	50.2	-3.4	7.1	0.7	-11.2
RO	29.9	34.2	37.3	37.9	39.4	40.4	10.5	6.9	-1.1	4.7
SE	36.7	36.1	36.4	38.6	40.3	40.1	3.3	2.1	-1.1	2.2
UK	76.4	81.9	85.8	87.2	89.0	89.5	13.1	17.2	-1.2	-2.9
EU-28	**78.4**	**81.3**	**85.0**	**87.1**	**88.1**	**88.3**	**9.9**	**4.2**	**4.0**	**1.8**

Source: Commission services
Note: Differences between the sum and the total of individual items are due to rounding
* Figure from Commission services' Autumn 2014 forecast.

expected to have started decreasing in 2014 after reaching their peak in 2013 at 128% and 123% respectively. This decline in debt ratios is set to be remarkable in Ireland, by 13 pp, while more modest in the case of Portugal, by 0.3 pp.

Overall, the continuously rising debt-to-GDP ratios reflect the combined effect of high primary deficits, negative or very weak growth and high interest expenditure in some Member States. In particular, the large differential between the real interest rate and the real GDP growth continued to push up debt in Italy, despite the primary surpluses recorded since 2010. Negative GDP growth has aggravated the debt challenge in Spain, as well as in Greece, Portugal and Cyprus. Public interventions in the financial sector have also contributed to the rise in debt and to its heterogeneity across countries.

Looking ahead, debt is expected to continue decreasing in Ireland and Portugal in 2015, while it is set to start decreasing in Greece. Declines in debt ratios are expected in another six Member States (DE, EE LV, HU, AT and SE). On the contrary, debt ratios are projected to keep increasing in the remaining EU Member States, although at a considerably more moderate pace than in previous years. Spain's debt-to-GDP ratio, which was below 40% before the crisis, is expected to exceed 100% in 2015 thereby raising to seven the number of EU Member States with debt above that level. France is expected to register a debt-to-GDP ratio of 98.1% in 2015, while the UK, Austria, Croatia and Slovenia are expected to have debt ratios between 80 and 90% of GDP in 2015. Another four Member States will register debt ratios between 70 and 80% (HU, DE, MT and NL).

Table I.1.4: Government revenue and expenditures (% of GDP)

	Revenue						Expenditure					
	2010	2011	2012	2013	2014*	2015*	2010	2011	2012	2013	2014*	2015*
BE	48.4	49.3	50.7	51.5	50.9	50.7	52.3	53.2	54.8	54.4	53.8	53.4
DE	43.1	43.7	44.3	44.5	44.6	44.7	47.2	44.6	44.2	44.3	44.3	44.6
EE	40.6	39.1	39.5	38.4	38.4	38.9	40.4	38.0	39.7	38.9	38.9	39.5
IE	33.6	33.5	34.2	34.8	35.0	33.9	66.1	46.1	42.2	40.5	38.7	36.8
EL	41.0	43.6	45.2	47.0	46.9	45.9	52.1	53.7	53.8	59.2	48.5	45.9
ES	36.2	36.0	37.0	37.5	38.3	38.4	45.6	45.4	47.3	44.3	43.9	43.1
FR	49.6	50.8	51.8	53.0	53.5	53.5	56.4	55.9	56.7	57.1	57.9	58.1
IT	45.6	45.6	47.4	47.7	47.8	47.7	49.9	49.1	50.4	50.5	50.8	50.4
CY	37.7	37.0	36.3	36.5	39.1	38.5	42.5	42.8	42.1	41.4	42.1	41.5
LV	36.0	35.5	35.8	34.8	34.3	33.7	44.2	38.9	36.6	35.7	35.4	34.9
LU	43.3	42.6	43.5	44.5	44.1	43.5	43.9	42.3	43.4	43.8	44.0	44.0
MT	37.7	38.3	39.0	39.8	41.0	41.6	41.0	40.9	42.7	42.5	43.5	44.2
NL	43.2	42.7	43.5	44.5	44.8	44.6	48.2	47.0	47.5	46.8	47.3	46.8
AT	48.3	48.2	48.7	49.5	49.9	50.0	52.8	50.9	51.0	50.9	52.8	51.9
PT	40.6	42.6	43.0	45.2	44.6	44.4	51.8	50.0	48.5	50.1	49.5	47.7
SI	43.6	43.6	44.4	45.2	45.2	44.5	49.2	49.8	48.1	59.7	49.6	47.4
SK	34.5	36.4	36.0	38.4	38.0	37.9	42.0	40.6	40.2	41.0	40.9	40.5
FI	52.1	53.3	54.2	55.4	56.0	56.3	54.8	54.4	56.3	57.8	58.9	58.9
EA-18	44.3	44.9	45.9	46.5	46.7	46.7	50.4	49.0	49.5	49.4	49.4	49.1
BG	34.1	32.6	34.7	37.1	37.3	37.5	37.4	34.7	35.2	38.3	40.9	41.2
CZ	38.6	39.6	39.8	40.7	40.3	40.3	43.0	42.5	43.8	42.0	41.7	42.4
DK	54.3	54.8	54.9	55.9	55.9	53.7	57.1	56.9	58.8	56.7	57.0	56.1
HR	40.8	40.6	41.3	41.8	42.5	43.0	46.8	48.2	46.9	47.0	48.1	48.5
LT	35.4	33.5	33.0	32.8	34.6	33.4	42.3	42.5	36.1	35.5	35.8	34.8
HU	45.2	44.4	46.4	47.3	47.3	46.4	49.7	49.9	48.7	49.7	50.2	49.2
PL	38.2	39.0	39.1	38.2	38.2	38.6	45.9	43.9	42.9	42.2	41.6	41.5
RO	33.0	33.7	33.4	32.8	33.1	32.3	39.6	39.2	36.4	35.1	35.2	35.1
SE	52.0	51.4	51.7	51.9	50.5	50.7	52.0	51.4	52.6	53.2	52.9	52.5
UK	38.6	38.9	38.4	39.5	38.5	38.3	48.3	46.5	46.7	45.3	43.9	42.8
EU-28	43.5	44.0	44.6	45.3	45.2	45.0	49.9	48.5	48.9	48.5	48.2	47.8

Source: Commission services
Note: Differences between the sum and the total of individual items are due to rounding
* Figure from Commission services' Autumn 2014 forecast.

Together with Finland, which debt ratio is expected to come in at 62% in 2015, this will raise to seventeen the number of EU Member States with debt ratios above the 60% threshold in 2015.

1.4. COMPOSITION OF THE ADJUSTMENT

Fiscal consolidation in the EU between 2010 and 2013 was based on the one hand on revenue increases, which amounted to 1.8 pp. of GDP as shown in Table I.1.5, while expenditure decreased by 1.4 pp. also contributing to the budgetary adjustment. In the euro area the composition of consolidation was more tilted towards the revenue side, as expenditure fell by 1 pp. while revenues increased by 2.2 pp.

Table I.1.4 shows that, according to the Commission's 2014 autumn forecast the increase in the revenue-to-GDP ratio is expected to come to a standstill in 2014. After having increased at an average of 0.7 pp. per year between 2011 and 2013 the revenue ratio will remain broadly stable both in the EU and the euro area in 2014 and 2015.At the same time and similarly to what happened in 2013, expenditure is projected to decline by 0.1 and 0.3 pp. respectively in the euro area and the EU in 2014. The pace of reduction in expenditure ratios is expected to accelerate slightly in 2015 in both regions.

Across Member States, changes in the revenue ratio in the period 2013-2015 range from 2 pp. in Cyprus to -2.2 pp. in Denmark. A wider range emerges when comparing the changes in the expenditure ratio across Member States, from an increase of 3 pp. in Bulgaria to a decrease of more than 12 pp. in Greece. The picture remains broadly

Table I.1.5: **Government structural revenue and expenditures (% of GDP)**

	Structural Revenue						Structural Expenditure					
	2010	2011	2012	2013	2014*	2015*	2010	2011	2012	2013	2014*	2015*
BE	48.4	49.4	50.4	50.9	50.5	50.6	52.1	53.1	53.5	53.6	53.2	52.8
DE	43.1	43.7	44.3	44.5	44.6	44.7	45.2	45.0	44.3	43.9	43.8	44.0
EE	39.2	38.6	39.4	38.3	38.4	38.9	38.9	38.8	39.8	39.5	39.1	39.6
IE	33.7	33.5	34.2	34.9	35.0	33.8	42.5	41.5	41.3	39.6	38.8	37.1
EL	40.5	42.8	43.8	44.7	44.9	44.4	49.9	48.5	43.7	41.6	42.9	42.8
ES	36.3	35.9	36.7	37.5	38.5	38.5	43.3	42.2	40.3	39.9	40.7	40.8
FR	49.8	50.7	51.8	52.8	53.5	53.6	55.7	55.7	56.1	56.1	56.5	56.6
IT	45.4	45.3	47.4	47.6	47.7	47.8	48.7	48.6	49.0	48.4	48.6	48.6
CY	37.6	37.2	35.5	36.3	38.5	38.2	42.9	42.9	41.0	38.4	39.4	39.5
LV	35.7	35.3	35.7	34.8	34.3	33.8	37.9	36.4	35.8	35.9	35.8	35.4
LU	43.3	42.6	43.5	44.5	44.2	43.5	43.1	41.8	42.0	42.4	43.0	43.1
MT	37.2	37.8	38.8	39.8	40.9	41.6	41.5	40.9	42.6	42.5	43.6	44.5
NL	43.3	42.7	43.7	44.7	45.0	44.8	47.1	46.5	45.9	45.3	45.5	45.6
AT	48.4	48.2	48.6	49.2	49.8	50.1	51.3	50.7	50.5	50.5	51.0	51.1
PT	40.6	42.1	42.6	44.4	44.4	44.3	48.1	47.5	44.9	46.3	45.8	46.0
SI	43.5	43.6	44.2	44.7	44.9	44.5	48.1	48.0	46.0	46.5	47.5	46.7
SK	34.5	36.1	35.9	38.4	37.7	37.9	41.8	40.1	39.3	39.7	39.9	39.1
FI	52.1	53.3	54.2	55.3	55.9	56.2	53.1	54.1	55.2	56.1	57.0	57.3
EA-18	44.3	44.8	45.8	46.4	46.7	46.7	48.6	48.3	47.9	47.6	47.8	47.8
BG	34.0	32.6	34.7	37.2	37.5	37.4	36.5	34.6	35.1	38.5	40.9	40.8
CZ	38.4	39.5	39.8	40.8	40.3	40.3	42.5	42.1	41.2	40.6	41.0	42.1
DK	54.3	54.8	54.9	54.4	54.4	53.0	55.0	55.4	55.0	54.2	54.6	54.2
HR	40.8	40.6	41.3	42.0	42.4	43.0	46.1	47.7	45.7	45.5	46.3	47.1
LT	35.6	33.4	32.9	32.3	33.1	33.1	39.0	37.2	35.7	34.5	34.8	34.7
HU	44.4	43.8	45.8	47.3	47.5	46.4	47.8	48.0	47.0	48.6	50.2	49.3
PL	38.2	39.0	39.0	38.2	38.2	38.6	46.6	45.0	43.1	41.8	41.1	41.1
RO	32.8	33.6	33.2	32.8	33.0	32.3	38.8	37.1	35.7	34.5	34.7	34.8
SE	52.0	51.4	51.6	51.9	50.5	50.6	51.2	51.4	51.6	52.1	51.9	51.8
UK	39.1	39.3	38.8	39.8	38.6	38.3	46.5	45.1	45.3	44.2	43.6	42.8
EU-28	43.6	43.9	44.6	45.2	45.1	45.0	48.2	47.7	47.3	46.9	46.9	46.8

Source: Commission services
* Figure from Commission services' Autumn 2014 forecast.

the same when primary expenditure ratios are considered.

Looking further into the expected changes to the composition of public finances, it is worth noting that several Member States are projected to couple sizeable reductions in their expenditure ratios over the period 2013-2015 with some decrease in revenue ratios. It is the case of Belgium, Portugal, the UK, Ireland, Slovenia and Greece, which revenue ratios in 2015 are expected to come in between 0.6 and 1.2 pp. lower than their 2013 levels, while their expenditure ratios are expected to decline by considerably more, between 1 and 12 pp.

In turn, Spain is expected to adjust both on the revenue and the expenditure side in 2014 and 2015, as the revenue ratio is expected to increase by 1 pp. while the expenditure ratio is envisaged to decline by slightly more. Increases in both revenue and expenditure ratios are expected in Croatia, Malta, Finland, France and Austria.

Finally, Table I.1.5 suggests that government revenues could be mainly driven by cyclical developments in several Member States. In particular, while total and structural revenue-to-GDP ratios are expected to remain broadly stable in the EU and the euro area in 2014 and 2015, when turning to individual Member States Table I.1.5 suggests that the expected evolution in revenue ratios could be driven mainly driven by

cyclical factors in some cases. Across Member States, the largest expected contribution of cyclical revenues to the envisaged decline in revenue ratios is found in Denmark, Greece and Portugal. While in the former two countries structural revenues are also set to decrease in 2014 and 2015, no structural decrease in revenues is instead expected in Portugal. In most Member States however cyclical revenues are expected to remain unchanged in 2014 and 2015 and in only four of them are they expected to slightly increase (IE, HR, BG, UK).

Turning to expenditure, the Table suggests that the expected aggregate decline of expenditure ratios in the EU and the euro area could be attributable to cyclical factors. In fact, the structural expenditure ratio in the EU remains broadly stable while it slightly increases in the euro area. Similarly, the decrease in cyclical expenditure could be behind the expected reduction in expenditure ratios in Greece, Spain and Slovenia. Structural expenditure actually increases by around 1 pp of GDP in the period 2013-2015 in the former two, while it remains broadly unchanged in the case of Slovenia. The decrease in cyclical spending could be also behind the bulk of the expected decline in the overall expenditure ratio in Hungary, while it could explain about one third and one half of the decline in the ratios in respectively Ireland and the UK.

However, the comparison between total and structural ratios does not always allow drawing robust conclusions about the evolution of cyclically-adjusted revenue due, for example, to a different-than-normal response from revenue to economic growth. Likewise, the change in the conventionally measured cyclically-adjusted spending is not necessarily the best indicator of structural changes.

2. IMPLEMENTATION OF FISCAL SURVEILLANCE

The EU fiscal framework, as laid down by the Stability and Growth Pact (SGP), aims at ensuring budgetary discipline through two main requirements. First, Member States are required by the Treaty to keep their government deficit and debt positions below the reference values of 3% and 60% of GDP, respectively, and to prompt their correction if these two criteria are temporarily not fulfilled ([5]) ([6]). Second, they are required by the preventive arm of the SGP to achieve and maintain their medium-term budgetary objectives (MTO), which correspond to cyclically-adjusted targets for the budget balance, net of one-off and temporary measures ([7]). Country-specific MTOs are defined so as to secure the sustainability of public finances and allow the automatic stabilizers to work without breaching the deficit reference value in the Treaty.

2.1. THE EXCESSIVE DEFICIT PROCEDURE

The Excessive Deficit Procedure (EDP) ensures that Member States correct their excessive government deficit and debt positions, measured against the reference values of 3% and 60% of GDP, thus operationalizing the requirements set in the Treaty ([8]).

This section focuses on the implementation of the EDP since the last Report on Public Finances was published. The historical country-specific developments are summarized in Tables I.2.1-3 ([9]).

Currently, eleven Member States are still subject to the excessive deficit procedure, two of which are under an economic adjustment programme (Cyprus and Greece).

2.1.1. Euro area Member States

Table I.2.1 shows the steps taken under the EDP for the euro area countries.

In the case of **Cyprus**, the EDP has run in parallel to its economic adjustment programme. In the context of the EDP of Cyprus, on 6 September 2013, the Commission concluded that the country had taken action in compliance with the Council recommendation of 16 May 2013 to end the situation of excessive deficit. At the time, despite the headline deficit being expected not to be achieved in 2013 due to operations of extraordinary nature, the Commission considered that the underlying budgetary trends and the execution in the first semester of the year remained in line with the adjustment path established in the Council recommendation.

On 15 November 2013, the Commission adopted a communication in which **Spain**, **France**, **Malta**, the **Netherlands** and **Slovenia** were assessed to have taken effective action in compliance with the Council recommendation of 21 June 2013, or the decision to give notice, in the case of **Belgium**,

([5]) Article 126 TFEU lays down an Excessive Deficit Procedure which is further specified in Council Regulation (EC) No. 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", amended in 2005 and 2011, which represents the corrective arm of the SGP. Relevant legal texts and guidelines can be found at: http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm

([6]) In particular, a Member State is not compliant with the debt criterion if its general government debt is greater than 60% of GDP and is not sufficiently diminishing and approaching 60% of GDP at a satisfactory pace.

([7]) The preventive arm of the SGP is contained in Council Regulation (EC) 1466/97 "on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies", which was amended in 2005 and 2011. Together with Council Regulation (EC) 1467/97 and the new Directive on requirements for budgetary frameworks of the Member States (Directive (EC) 2011/85) and Regulation (EU) 1173/2011 on the effective enforcement of budgetary surveillance in the euro area, it forms the SGP.

([8]) The concept of "sufficiently diminishing" and "satisfactory pace" is crucial in the assessment of compliance with the debt criterion for Member States which debt is greater 60% of GDP as set out in footnote 6 above. These two concepts are defined in Regulation 1467/97 as being fulfilled if "the differential [of the debt] with respect to the reference value has decreased over the previous three years at an average of 1/20th per year as a benchmark". The Regulation then specified that "the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available." It further specifies that "the influence of the cycle on the pace of the debt reduction" should be taken into account

([9]) All the country-specific developments regarding the Excessive Deficit Procedure can be followed at: http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm.

Table I.2.1: **Overview EDP steps – Euro area Member States**

Steps in EDP procedure	Treaty Art.	Country															
		IE	FR	ES	LV	MT	BE	DE	IT	NL	AT	PT	SI	SK	CY	FI	MT
Starting phase																	
Commission adopts EDP-report = start of the procedure	126(3)	18.02.2009	18.02.2009	18.02.2009	18.02.2009	13.05.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	07.10.2009	12.05.2010	12.05.2010	21.05.2013
Economic and Financial Committee adopts opinion	126(4)	27.02.2009	27.02.2009	27.02.2009	27.02.2009	29.05.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.10.2009	27.05.2010	27.05.2010	21.06.2013
Commission adopts:																	
opinion on existence of excessive deficit	126(5)																
recommendation for Council decision on existence of excessive deficit	126(6)	24.03.2009	24.03.2009	24.03.2009	02.07.2009	24.06.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	11.11.2009	15.06.2010	15.06.2010	29.05.2013
recommendation for Council recommendation to end this situation	126(7)																
Council adopts:																	
decision on existence of excessive deficit	126(6)																
recommendation to end this situation	126(7)	27.04.2009	27.04.2009	27.04.2009	07.07.2009	07.07.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	02.12.2009	13.07.2010	13.07.2010	21.06.2013
deadline for correction of excessive deficit		***2013***	***2012***	***2012***	***2012***	***2010***	***2012***	***2013***	***2012***	***2013***	***2013***	***2013***	***2013***	***2013***	***2012***	***2011***	***2014***
Follow-up																	
Commission adopts communication on action taken		-	-	-	27.01.2010	-	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	15.06.2010	27.01.2011	27.01.2011	15.11.2013
Commission adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	11.11.2009	11.11.2009	11.11.2009		27.01.2010				29.05.2013		27.09.2012					
Council adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	02.12.2009	02.12.2009	02.12.2009		16.02.2010				21.06.2013		09.10.2012					
revised deadline for correction of excessive deficit		***2014***	***2013***	***2013***		***2011***				***2014***		***2014***					
Commission adopts communication on action taken		15.06.2010	15.06.2010	15.06.2010		06.01.2011	11.01.2012			15.11.2013					11.01.2012		
Commission adopts recommendation for Council decision establishing inadequate action	126(8)						29.05.2013										
Council adopts decision establishing inadequate action	126(8)						21.06.2013										
Commission adopts recommendation for a Council decision to give notice	126(9)						29.05.2013										
Council adopts decision to give notice	126(9)						21.06.2013										
Commission adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	03.12.2010	29.05.2013	06.07.2012								29.05.2013	29.05.2013		07.05.2013		
Council adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)	07.12.2010	21.06.2013	10.07.2012								21.06.2013	21.06.2013		16.05.2013		
new deadline for correction of excessive deficit		***2015***	***2015***	***2014***			***2013***					***2015***	***2015***		***2016***		
Commission adopts communication on action taken		24.08.2011	15.11.2013	14.11.2012			15.11.2013					*	15.11.2013		06.09.2013		
Commission adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)			29.05.2013													
Council adopts recommendation for NEW Council recommendation to end situation of excessive deficit	126(7)			21.06.2013													
new deadline for correction of excessive deficit				***2016***													
Commission adopts communication on action taken				15.11.2013													
Abrogation																	
Commission adopts recommendation for Council decision abrogating existence of excessive deficit	126(12)				29.05.2013	14.11.2012	02.06.2014	30.05.2012	29.05.2013	02.06.2014	02.06.2014			02.06.2014		29.06.2011	
Council adopts decision abrogating existence of excessive deficit	126(12)				21.06.2013	04.12.2012	20.06.2014	22.06.2012	21.06.2013	20.06.2014	20.06.2014			20.06.2014		12.07.2011	

Source: Commission services
Commission services
Note:*In line with Regulation (EU) No 472/2013 on the strengthening of economic and budgetary surveillance of Member States in the Euro area experiencing or threatened with serious difficulties with respect with their financial Stability (Two pack) the assessment of effective action is carried out in the context of the programme surveillance.

against the background of its autumn forecast, published earlier that month.

Then, on 20 June 2014, following recommendations issued by the Commission earlier that month, the Council adopted decisions abrogating the procedures of **Belgium**, the **Netherlands**, **Austria** and **Slovakia,** as the respective excessive deficits were judged to have been durably corrected in the precedent year.

Finally, on the basis of its 2014 autumn forecast, and in agreement with Regulation No. 473/2013, the Commission carried out a more detailed assessment of compliance with the SGP by euro area Member States not subject to an economic adjustment programme, based on the Draft Budgetary Plans submitted by these countries to the Commission by 15 October 2014. Regarding the Member States under EDP, the Commission was of the opinion that the Draft Budgetary Plans of **Spain**, **France, Malta** and **Portugal** posed a risk of non-compliance. The Commission therefore invited the authorities of these countries to take the necessary measures within the national budgetary process to ensure that the 2015 budget will be compliant with the Stability and Growth Pact.

2.1.2. Non-euro area Member States

Table I.2.2 shows the steps taken under the EDP for the non-euro area countries.

On 1 October 2013, Poland submitted a report on effective action as requested by the Council in its recommendation of 21 June 2013, according to which the general government deficit would miss the recommended headline deficit target in that year, and the overall fiscal effort had fallen short of the required additional effort. Therefore, on 10 December 2013, based on a recommendation issued by the Commission on 15 November, the Council established that Poland had not taken effective action and adopted a new recommendation to end the excessive deficit situation in a credible and sustainable manner by 2015. The Council established the deadline of 15 April 2014 for Poland to adopt the necessary measures to take effective action to comply with the recommendations and to report in detail its consolidation strategy.

Then, on 21 January 2014, based on a report submitted by the Commission on 15 November 2013, according to which **Croatia**'s general government deficit was projected to remain above the Treaty reference value of 3% of GDP in the 2013-15 period, the Council concluded on the

Table I.2.2: **Overview EDP steps – Non-euro area Member States**

Steps in EDP procedure	Treaty Art.	Country								
		HU	UK	PL	LT	RO	CZ	BG	DK	HR
Starting phase										
Commission adopts EDP-report = start of the procedure	126(3)	12.05.2004	11.06.2008	13.05.2009	13.05.2009	13.05.2009	07.10.2009	12.05.2010	12.05.2010	15.11.2013
Economic and Financial Committee adopts opinion	126(4)	24.05.2004	25.06.2008	29.05.2009	29.05.2009	29.05.2009	27.10.2009	27.05.2010	27.05.2010	29.11.2013
Commission adopts:										
opinion on existence of excessive deficit	126(5)									
recommendation for Council decision on existence of excessive deficit	126(6)	24.06.2004	02.07.2008	24.06.2009	24.06.2009	24.06.2009	11.11.2009	06.07.2010	15.06.2010	10.12.2013
recommendation for Council recommendation to end this situation	126(7)									
Council adopts:										
decision on existence of excessive deficit	126(6)									
recommendation to end this situation	126(7)	05.07.2004	08.07.2008	07.07.2009	07.07.2009	07.07.2009	02.12.2009	13.07.2010	13.07.2010	21.01.2014
deadline for correction of excessive deficit		***2008***	***fin. year 2009/10***	***2012***	***2011***	***2011***	***2013***	***2011***	***2013***	***2016***
Follow-up										
Commission adopts communication on action taken		-	-	03.02.2010	-	-	15.06.2010	27.01.2011	27.01.2011	02.06.2014
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	22.12.2004	24.03.2009		-	-				
Council adopts decision establishing inadequate action	126(8)	18.01.2005	27.04.2009		-	-				
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	16.02.2005	24.03.2009		27.01.2010	08.02.2010				
Council adopts NEW recommendation to end excessive deficit situation	126(7)	08.03.2005	27.04.2009		16.02.2010	16.02.2010				
new deadline for correction of excessive deficit		***2008***	***fin. year 2013/14***		***2012***	***2012***				
Commission adopts communication on action taken		13.07.2005		11.01.2012	21.09.2010	21.09.2010				
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	20.10.2005								
Council adopts decision establishing inadequate action	126(8)	08.11.2005								
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	26.09.2006	11.11.2009							
Council adopts NEW recommendation to end excessive deficit situation	126(7)	10.10.2006	02.12.2009							
new deadline for correction of excessive deficit		***2009***	***fin. year 2014/15***							
Commission adopts communication on action taken		13.06.2007	06.07.2010							
Commission adopts recommendations for Council decision establishing inadequate action	126(8)									
Council adopts decision establishing inadequate action	126(8)									
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	24.06.2009		29.05.2013						
Council adopts NEW recommendation to end excessive deficit situation	126(7)	07.07.2009		21.06.2013						
new deadline for correction of excessive deficit		***2011***		***2014***						
Commission adopts communication on action taken		27.01.2010								
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	11.01.2012		15.11.2013						
Council adopts decision establishing inadequate action	126(8)	24.01.2012		10.12.2013						
Commission adopts recommendation for NEW Council recommendation to end excessive deficit situation	126(7)	06.03.2012		15.11.2013						
Council adopts NEW recommendation to end excessive deficit situation	126(7)	13.03.2012		10.12.2013						
new deadline for correction of excessive deficit		***2012***		***2015***						
Commission adopts communication on action taken		30.05.2012		02.06.2014						
Abrogation										
Commission adopts recommendation for Council decision abrogating existence of excessive deficit	126(12)	29.05.2013			29.05.2013	29.05.2013	02.06.2014	30.05.2012	02.06.2014	
Council adopts decision abrogating existence of excessive deficit	126(12)	21.06.2013			21.06.2013	21.06.2013	20.06.2014	22.06.2012	20.06.2014	

Source: Commission services

existence of an excessive deficit and adopted a recommendation setting 2016 as the correction deadline. In addition, the Council set the deadline of 30 April 2014 for Croatia to take effective action and detail the envisaged consolidation strategy.

On 2 June 2014, the Commission assessed effective action taken by both Poland and Croatia against the background of its 2014 spring forecast, and adopted a communication on effective action taken in line with the Council recommendations of 10 December 2013 and of 21 January 2014, respectively.

On 20 June 2014, based on a recommendation adopted by the Commission, the Council decided to abrogate the excessive deficit procedures for **Czech Republic** and **Denmark** as these countries had durably corrected their excessive deficits in the year before.

2.2. THE EUROPEAN SEMESTER AND THE FISCAL COUNTRY-SPECIFIC RECOMMENDATIONS

Member States submitted the 2014 stability and convergence programmes (SCPs) in April this year thereby bringing their medium-term fiscal plans up to date. ([10])

([10]) For an overview of Member States' plans, see "The 2014 Stability and Convergence Programmes: An Overview", European Economy. Occasional Papers. 199. July 2014, available at:
http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op199_en.htm.

Member States in their programmes expected a return to growth in 2014. In fact, all Member States except Croatia anticipated positive real growth in 2014, and the aggregate output gap in both the euro area and the EU was expected to narrow from 2014 onwards, closing completely by 2017, the end of the programme period. These forecasts were in line with the Commission's 2014 spring forecast and with those set out in the 2013 SCPs, pointing to some stability and consensus in the underlying macroeconomic forecast. Moreover, the overall shift in the composition of growth towards a more prominent role of private consumption and investment than in the last years was planned to increase the tax-richness of output. Overall, the plans presented in the 2014 SCPs showed consolidation continuing for the fourth consecutive year, though at a slower pace (see below). Both at the euro area level and the EU, the aggregate general government deficit was expected to fall below 3% of GDP in 2014 and all Member States planned to register a headline deficit below the 3% threshold in 2017. Moreover, 2014 was expected to be the peak year for the debt-to-GDP ratio, which was then expected to start decreasing in 2015 and continue to do so until the end of the programme period.

The adjustment planned for the period 2014-17 also showed that the consolidation pace was expected to considerably decelerate to an average structural effort of around 0.3% of GDP per year both at the euro area and the EU level. Taking into account the currently high debt levels and the fact that in 2014 at least thirteen Member States were expected to be either under Excessive Deficit Procedure or still not at their MTOs, this average annual structural improvement pointed to an overall insufficient response to the existing fiscal challenges. However, this aggregate structural adjustment figure masked considerable differences across Member States, which had in general planned a differentiated fiscal consolidation strategy according to their respective fiscal positions.

In the aggregate, the 2014 SCPs planned to reduce revenues by about 0.5 pp. of GDP over the programme period and to reduce expenditure by five times as much, implicitly acknowledging the limited space for additional tax measures. In addition, the composition of the planned consolidation on the expenditure side in the EU and the euro area appeared also to be less biased against public investment than in the past.

Finally, the improvements in fiscal positions recorded in 2013 and planned for the programme period in most Member States were estimated to improve debt sustainability across the EU. Risks for short-term fiscal stress had been reduced in nearly all Member States. However, medium-term debt projections showed that even if the fiscal plans in the SCPs were fully implemented, additional fiscal consolidation measures in the order of 1.7 pp. of GDP on average would be needed over the period 2016-20 to bring debt down to 60% of GDP by 2030.

Based on the information provided in the 2014 SCPs (and national reform programmes), the Council on 8 July delivered country-specific opinions on the programmes and addressed country-specific recommendations (CSRs) as part of the 2014 European Semester. ([11]) In the area of fiscal policy, Member States were invited to comply with the requirements of the Stability and Growth Pact. The Member States under an Excessive Deficit Procedure were recommended to ensure the correction of the excessive deficits within the time limits allowed by fully implementing, and where necessary reinforcing, the planned budgetary strategies. The Member States in the preventive arm of the SGP were recommended to ensure sufficient progress towards, or stay at, their MTOs, with each recommendation providing guidance on the size of adjustment to be delivered in 2015. The Member States concerned by the debt rule were also recommended to ensure sufficient deficit reduction. Some general guidelines to achieve these goals included increasing the efficiency of public spending, preserving growth-enhancing categories of spending, improving coordination across sub-sectors of general government,

([11]) OJ C 247, 29.7.2014, pp.1-140.

Table I.2.3: **Overview EDP steps – Greece**

Steps in EDP procedure	Treaty Art.	Greece
Starting phase		
Commission adopts EDP-report = start of the procedure	126(3)	18.02.2009
Economic and Financial Committee adopts opinion	126(4)	27.02.2009
Commission adopts:		
opinion on existence of excessive deficit	126(5)	
recommendation for Council decision on existence of excessive deficit	126(6)	24.03.2009
recommendation for Council recommendation to end this situation	126(7)	
Council adopts:		
decision on existence of excessive deficit	126(6)	27.04.2009
recommendation to end this situation	126(7)	
deadline for correction of excessive deficit		***2010***
Follow-up		
Commission adopts recommendations for Council decision establishing inadequate action	126(8)	11.11.2009
Council adopts decision establishing inadequate action	126(8)	02.12.2009
Commission adopts Council recommendation for decision to give notice	126(9)	03.02.2010
Council decision to give notice	126(9)	16.02.2010
new deadline for correction of the excessive deficit		***2012***
Commission adopts communication on action taken		09.03.2010
Council adopts conclusions thereon		16.03.2010
Commission adopts recommendation for NEW Council decision to give notice	126(9)	04.05.2010
Council decision to give notice	126(9)	10.05.2010
new deadline for correction of the excessive deficit		***2014***
Follow-up - 1st review		
Commission adopts communication on action taken		19.08.2010
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	19.08.2010
Council decision amending the Council decision to give notice	126(9)	07.09.2010
Follow-up - 2nd review		
Commission adopts communication on action taken		09.12.2010
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	09.12.2010
Council decision amending the Council decision to give notice	126(9)	20.12.2010
Follow-up - 3rd review		
Commission adopts communication on action taken		24.02.2011
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	24.02.2011
Council decision amending the Council decision to give notice	126(9)	07.03.2011
Follow-up - 4th review		
Commission adopts communication on action taken		01.07.2011
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	05.07.2011
Council decision amending the Council decision to give notice	126(9)	12.07.2011
Follow-up - 5th review		
Commission adopts communication on action taken		26.10.2011
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	26.10.2011
Council decision amending the Council decision to give notice	126(9)	08.11.2011
Follow-up - Second Adjustment Programme		
Commission adopts communication on action taken		09.03.2012
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	09.03.2012
Council decision amending the Council decision to give notice	126(9)	13.03.2012
Follow-up - Second Adjustment Programme		
Commission adopts communication on action taken		30.11.2012
Commission adopts recommendation for Council decision amending the Council decision to give notice	126(9)	30.11.2012
Council decision amending the Council decision to give notice	126(9)	04.12.2012
new deadline for correction of the excessive deficit		***2016***

Source: Commission services

strengthening medium-term budgetary frameworks, increasing the efficiency of tax compliance. Annex 1 provides an overview of the country-specific opinions and recommendations in the area of fiscal policy that the Council issued in July.

2.3. CLOSING THE SURVEILLANCE CYCLE IN THE EURO AREA: DRAFT BUDGETARY PLANS

This autumn for the second time, euro area Member States submitted their draft budgetary plans (DBPs) for the forthcoming year to the Commission and to the Eurogroup. These plans summarise the content of the draft budgets that governments submitted to national parliaments. Sixteen euro area Member States sent the DBPs to the Commission by mid-October. ([12]) Greece and Cyprus, the remaining euro area countries under a macroeconomic adjustment programme, were not obliged to submit a plan, as the adjustment programme already provides for close fiscal monitoring.

Table I.2.4: **Overview of economic and budgetary aggregates in the EA-16 for 2014-15**

	2014			2015		
	2014 Stability Programmes	Draft budgetary plans	Commission's 2014 autumn forecast	2014 Stability Programmes	Draft budgetary plans	Commission's 2014 autumn forecast
Real GDP growth (% change)	1.3	1.0	0.8	1.7	1.5	1.1
HICP inflation (% change)	1.1	0.8	0.6	1.4	1.2	0.9
Headline deficit (% GDP)	-2.4	-2.6	-2.6	-1.8	-2.2	-2.4
Δ Structural Balance (p.p. GDP)	0.3	0.0	0.1	0.3	0.1	0.0
Debt (% GDP)	94.3	92.7	93.1	93.1	92.5	93.6
Cyclically-adjusted expenditure ratio (% potential GDP)	47.8	47.9	48.0	47.5	47.7	48.0
Cyclically-adjusted revenue ratio (% potential GDP)	46.9	46.7	46.8	46.7	46.5	46.8

Source: Commission services

A salient feature of this year's batch of DBPs is the confirmation that the relatively subdued recovery foreseen in the spring has slowed down. Based on the information provided in the plans, real GDP is now projected by Member States to expand by 1% in 2014 in the sixteen euro area countries concerned (EA-16), below the 1.3% expected at the time of the SPs. This is also reflected in 2015, where the forecast improvement in economic conditions, with GDP growth in the EA-16 picking up to 1.5%, is below the 1.7% projected in the SPs. The outlook for inflation has also been revised down by Member States due to falling energy and food prices but also reflecting the substantial slack in the economy. According to the DBPs, this year's inflation rate which is expected at 0.8% in the EA-16 (down from 1.1% expected in the spring) will mark the trough, followed by a slightly higher rate in 2015 (1.2%, down from 1.4% in the spring).

The Commission's 2014 autumn forecast projects real GDP growth to be 0.8% in 2014 and 1.1% in 2015. This is significantly lower than the aggregate growth rates stemming from Member States' plans, with Germany accounting for a significant part of the difference. ([13]) Regarding price developments, the Commission projects lower HICP inflation in both 2014 and 2015 (0.6% and 0.9%, respectively), with the largest negative gaps evident in Belgium, Germany, Estonia, France and Latvia. This is also reflected in the GDP deflator forecasts.

The overall fiscal position of the EA-16 as derived from the submitted plans is expected to continue to improve in 2014-15, though with a slowdown in the rate of progress. After returning below 3% of GDP in 2013 for the first time since 2008, the aggregate headline budget deficit for the EA-16 is expected to fall further to 2.6% of GDP in 2014 according to Member States' DBPs. This represents a deterioration compared with the target projected in the SPs, which had anticipated a

([12]) As set out in Regulation 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits of the Member States in the euro area. It is one of the two Regulations in the so-called Two-Pack which entered into force in May 2013.

([13]) The macroeconomic scenario underlying Germany's DBP is based on the spring issue of federal government's forecast published in April. However, given that further official statistics and worsened business cycle indicators became available after its publication, it describes a significantly more optimistic outlook for economic activity in 2014 and 2015 than the Commission's 2014 autumn forecast. The German Government has updated its own forecast since the submission of the DBP.

deficit of 2.4% of GDP. A slowdown in deficit reduction is also evident in 2015, with the aggregate headline deficit falling by 0.4 pp. to 2.2% of GDP, compared to a projected improvement of 0.6 pp. in the spring. This is linked to the worsening overall growth outlook for 2014-15. However, the higher deficit projection is also driven by a reduction in fiscal effort

Table I.2.5: **Overview of individual commission opinions on the Draft Budgetary Plans- Member States currently under the preventive arm of the SGP.**

Country	Overall compliance of Draft Budgetary Plan with Stability and Growth Pact		Overall compliance with the fiscal-structural reforms suggested in 2014 CSRs	
	Overall conclusion based on the Commission's 2014 autumn Forecast	Compliance with the Preventive Arm requirements in 2014/2015	Overall conclusion on progress towards fiscal-structural reforms	Main measures in DBP to address tax wedge CSRs
BE	Risk of non-compliance	2014: some deviation from the adjustment path towards the MTO; compliance with the debt benchmark at risk 2015: some deviation from the adjustment path towards the MTO; compliance with the debt benchmark at risk	Some progress	'Tax wedge' CSR Increase in personal income tax deduction. Reductions of employer social security contributions
DE	Compliant	2014: MTO overachieved; compliance with the debt benchmark 2015: MTO overachieved; compliance with the debt benchmark	Limited progress	'Tax wedge' CSR As of 2014, increase in personal income tax allowance and non-implementation of initially planned reduction in pension contribution rate to finance additional pension benefits. As of 2015, increase in long-term care contribution rate and reform of financing of healthcare insurance
EE	Broadly compliant	2014: some deviation from the adjustment path towards the MTO 2015: some deviation from the adjustment path towards the MTO	No progress	'Tax wedge' CSR Reduction of personal income tax rate and unemployment insurance contributions. Increase of basic allowance
IT	Risk of non-compliance	2014: allowed to deviate from the adjustment path towards the MTO due to exceptionally severe economic conditions; compliance with the debt benchmark at risk 2015: significant deviation from the adjustment path towards the MTO; compliance with the debt benchmark at risk	Some progress	'Tax wedge' CSR Exemption of labour costs from the taxable base of the regional tax on businesses. Permanent tax credit (recorded as social transfer in ESA2010) to low-wage employees, currently only financed for 2014. Exemption of employer social security contributions for three years for new hirings under open-ended contracts during 2015
LV	Broadly compliant	2014: no deviation from the adjustment path towards the MTO 2015: some deviation from the adjustment path towards the MTO based on no-policy change DBP	Limited progress	'Tax wedge' CSR No measures in DBP submitted by outgoing government. However, the Tax Policy Strategy for 2015-17 includes plans to increase minimum wage and untaxed minimum income
LU	Compliant	2014: MTO overachieved 2015: no deviation from the MTO	Some progress	No 'tax wedge' CSR
MT	Risk of non-compliance	2014: in EDP 2015: significant deviation from the adjustment path towards the MTO; compliance with the debt benchmark	Some progress	No 'tax wedge' CSR
NL	Compliant	2014: no deviation from the MTO; compliance with the debt benchmark 2015: no deviation from the MTO; compliance with the debt benchmark	Some progress	'Tax wedge' CSR Reform of employee tax credit, reducing burden on lower and middle incomes. Reduction of the personal income tax rate in the lowest tax bracket
AT	Risk of non-compliance	2014: some deviation from the adjustment path towards the MTO; compliance with the debt benchmark 2015: significant deviation from the adjustment path towards the MTO; compliance with the debt benchmark	Limited progress	'Tax wedge' CSR General announcement of reform to reduce the tax wedge to be decided in March 2015
SK	Compliant	2014: no deviation from the adjustment path towards the MTO 2015: no deviation from the adjustment path towards the MTO	Limited progress	No 'tax wedge' CSR
FI	Broadly compliant	2014: some deviation from the MTO 2015: some deviation from the adjustment path towards the MTO	Some progress	No 'tax wedge' CSR

Source: Commission services

Examining the planned fiscal effort in more detail, the DBPs, in the aggregate, do not provide evidence of consolidation efforts, as measured by a positive change in the structural balance, in 2014 and 2015. For both years, an improvement of 0.3 pp. had been anticipated by Member States in their SPs. A sizeable slowdown in structural deficit reduction is found in France (both in 2014 and 2015), Ireland (2014-15), Italy (2014), Portugal (2015) and Slovenia (2014). The lack of fiscal consolidation at the aggregate level is confirmed by using an alternative measurement of fiscal effort, which suggests an adjustment of just 0.2% of GDP in both 2014 and 2015. ([14])

For the euro area as a whole, the DBPs foresee only limited changes in the composition of public finances in 2015. While the revenue-to-GDP ratio is expected to remain broadly unchanged, the share of government expenditure in the EA-16 GDP is expected to decrease by 0.6 pp. However, about two thirds of the planned decrease in expenditure ratios in the EA-16 as a whole are attributable to cyclical factors, given positive 'denominator effects' linked to a narrowing output gap. In fact, the EA-16 cyclically-adjusted expenditure ratio is expected to recede by only 0.2 pp. of GDP in 2015, slightly below the 0.3 pp. reduction planned in spring. In turn, for the majority of Member States current plans imply larger cyclically-adjusted expenditure ratios in 2015 than envisaged in spring. Turning back to the revenue side, following up on several country-specific recommendations proposed by the Commission earlier this year and the subsequent discussions held by the Eurogroup, many DBPs refer to measures to address the tax burden on labour (henceforth tax wedge). Several horizontal insights regarding the tax wedge emerge from the DBPs. First of all, whereas the tax wedge has steadily increased in the majority of euro area Member States over the past few years, the current plans only include a very small number of measures that would increase the tax wedge further. By contrast, many Member States are planning or implementing measures aimed at reducing the tax wedge. In fact, almost all euro area Member States that are addressed a CSR in this area announce plans, with varying levels of detail.

Measures to lower the tax wedge are also foreseen by Member States with a relatively low tax wedge. Furthermore, many measures are targeted at lower

([14]) An alternative measure of the fiscal effort in the DBPs can be obtained by considering the amount of discretionary revenue measures net of the change in cyclically-adjusted expenditure ratio. This suggests a fiscal adjustment of 0.2% of GDP both in 2014 and 2015 for the EA-16. While these estimates are slightly higher than the changes in the structural balance (0.0% and 0.1% of GDP, respectively, in the two years), the downward revisions compared to the spring are of the same order of magnitude for both measures of effort.

income categories, by increasing the tax free allowance or by reducing taxes at low income levels or social contributions for low-wage earners. However, it should be noted that most tax wedge reforms remain relatively modest compared with the initial challenges.

Table I.2.6: **Overview of individual commission opinions on the Draft Budgetary Plans- Member States currently under the corrective arm of the SGP.**

Country	Overall compliance of Draft Budgetary Plan with Stability and Growth Pact		Overall compliance with the fiscal-structural reforms suggested in 2014 CSRs	
	Overall conclusion based on the Commission's 2014 autumn Forecast	Compliance with the Excessive Deficit Procedure in 2014/2015	Overall conclusion on progress towards fiscal-structural reforms	Main measures in DBP to address the tax wedge
ES	Risk of non-compliance	2014: headline target met 2015: in the absence of additional measures compliance not ensured	Some progress	'Tax wedge' CSR Reduction of personal income tax rates. Temporary reduction in social contributions on new contracts signed in 2014
FR	Risk of non-compliance	2014: risk of no effective action 2015: in the absence of additional measures compliance not ensured	Limited progress	'Tax wedge' CSR As of 2014, new tax credit for wages of up to 2.5 times the minimum wage. Reduction in employer social security contributions. Reduction in personal income tax for low wage earners
IE	Compliant	2014: effective action 2015: timely correction expected	Some progress	No 'tax wedge' CSR
PT	Risk of non-compliance	2014: risk of no effective action 2015: in the absence of additional measures compliance not ensured	Limited progress	No 'tax wedge' CSR
SI	Broadly compliant	2014: risk of no effective action 2015: timely correction expected	Limited progress	No 'tax wedge' CSR

Source: Commission services

At 92.6% of GDP in 2015, the aggregate debt ratio is planned to remain virtually unchanged from this year. This contrasts with the SPs which had projected that debt would start declining next year. The downward revisions to debt ratios in absolute terms from the SPs reflect the impact of statistical changes driven by the implementation of the new ESA 2010 system of national accounting, which more than compensate for the worsening growth and inflation outlook and fall-off in consolidation effort.

Based on the information provided in the DBPs and the autumn forecast, the Commission on 28 November delivered country-specific assessments of plans, in the form of Opinions and staff working documents.

The Commission, after having carried out consultations with certain Member States to request further information or to highlight some initial concerns related to the DBPs they submitted, did not found any DBP in serious non-compliance with the requirement of the SGP. In several cases, however, the Commission found that the planned fiscal adjustments fall short, or risk doing so, of what is required by the SGP. Tables I.2.3 and I.2.4 summarise the main findings.

Specifically, for Germany, Ireland, Luxembourg, the Netherlands and Slovakia, the DBPs were found to be compliant with the SGP provisions. For Estonia, Latvia, Slovenia and Finland, the DBPs were found to be broadly compliant with the SGP provisions. Finally, for seven Member States (Belgium, Spain, France, Italy, Malta, Austria and Portugal), the DBPs are found to be at risk of non-compliance.

ANNEX I. OVERVIEW OF COUNCIL COUNTRY-SPECIFIC RECOMMENDATIONS RELATING TO FISCAL POLICY

	Member State	Situation in spring 2014 as far as fiscal surveillance is concerned		Fiscal Country-Specific Recommendations		
	Applicable provisions of the SGP	**Other relevant information**	**CSR on fiscal adjustment**	**CSR on fiscal framework**	**CSR on taxation**	**CSR on pensions and health-care**
BE	• Preventive arm • Transition period debt rule	• MTO: 0.8% • Debt > 60% • Bad economic times in 2014 • Neither good nor bad economic times in 2015	Following the correction of the excessive deficit, reinforce the budgetary measures for 2014 in the light of the emerging gap of 0,5 % of GDP based on the Commission services 2014 spring forecast, pointing to a risk of significant deviation relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, significantly strengthen the budgetary strategy to ensure the required adjustment of 0.6 % of GDP towards the medium-term objective, which would also ensure compliance with the debt rule. Thereafter, until the medium-term objective is achieved, pursue the planned annual structural adjustment towards the medium-term objective, in line with the requirement of an annual structural adjustment of at least 0.5 % of GDP, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path.	Ensure a balanced contribution by all levels of government to the fulfilment of fiscal rules including the structural budget balance rule, through a binding instrument with an explicit breakdown of targets within a medium-term planning perspective.		
BG	• Preventive arm	• MTO: -1% • Debt < 60% • Neither good nor bad economic times in 2014 • Bad economic times in 2015	Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, strengthen the budgetary strategy to ensure that the medium-term objective is reached and, thereafter, maintained.	Ensure the capacity of the new fiscal council to fulfil its mandate.	Implement a comprehensive tax strategy to strengthen tax collection, tackle the shadow economy and reduce compliance costs.	
CZ	• Preventive arm	• MTO: -1% • Debt < 60% • Bad economic times in 2014 • Neither good nor bad economic times in 2015	Following the correction of the excessive deficit, preserve a sound fiscal position in 2014. Significantly strengthen the budgetary strategy in 2015 to ensure that the medium-term objective is achieved and remain at the medium-term objective thereafter. Prioritise growth-enhancing expenditure to support the recovery and improve growth prospects.	Adopt and implement measures to strengthen the fiscal framework, and in particular establish an independent fiscal institution to monitor fiscal policies, introduce fiscal rules for local and regional governments and improve coordination between all layers of government.		
DK	• Preventive arm	• MTO: -0.5% (overachieved in 2014 and 2015) •	Following the correction of the excessive deficit, continue to pursue a growth-friendly fiscal policy and preserve a sound fiscal position, ensuring that the medium-term budgetary objective continues to be adhered to throughout the period covered by the Convergence Programme.			
DE	• Preventive arm	• MTO: -0.5% (overachieved in 2014 and 2015) •	Pursue growth-friendly fiscal policy and preserve a sound fiscal position, ensuring that the medium-term budgetary objective continues to be adhered to throughout the period covered by the Stability Programme and that the general government debt ratio remains on a sustained downward path. In particular, use the available scope for increased and more efficient public investment in infrastructure, education and research.	Complete the implementation of the debt brake consistently across all Länder, ensuring that monitoring procedures and correction mechanisms are timely and relevant. Improve the design of fiscal relations between the federation, Länder and municipalities also with a view to ensuring adequate public investment at all levels of government.	Improve the efficiency of the tax system, in particular by broadening the tax base, in particular on consumption, by reassessing the municipal real estate tax base, by improving the tax administration and by reviewing the local trade tax, also with a view to foster private investment.	Make additional efforts to increase the cost-effectiveness of public spending on healthcare and long-term care. Ensure the sustainability of the public pension system by (i) changing the financing of new non-insurance/extraneous benefits ('Mütterrente') to funding from tax revenues, also in order to avoid a further increase of social security contributions, (ii) increasing incentives for later retirement, and (iii) increasing the coverage in second and third pillar pension schemes.
EE	• Preventive arm	• MTO: 0% • Debt < 60% • Neither good nor bad economic times in 2014 and 2015 •	Reinforce the budgetary measures for 2014 in the light of the emerging gap of 0.3 % of GDP based on the Commission services 2014 spring forecast, pointing to a risk of significant deviation relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, significantly strengthen the budgetary strategy to ensure that the medium-term objective is reached and, thereafter, maintained.	Complement the budget rule with more binding multi-annual expenditure rules within the medium-term budgetary framework and continue to enhance the efficiency of public spending.		
IE	• Corrective arm	• EDP deadline: 2015	Fully implement the 2014 budget and ensure the correction of the excessive deficit in a sustainable manner by 2015 through underpinning the budgetary strategy with additional structural measures while achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. After the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0.5 % of GDP each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path. Enhance the credibility of the fiscal adjustment strategy, effectively implement multi-annual budgetary planning and define broad budgetary measures underlying the medium-term fiscal targets.	Ensure the binding nature of the government expenditure ceiling including by limiting the statutory scope for discretionary changes.	To support fiscal consolidation, consideration should be given to raising revenues through broadening the tax base. Enhance the growth and environmental friendliness of the tax system.	
DK	• Preventive arm	• MTO: -0.5% (overachieved in 2014 and 2015) •	Following the correction of the excessive deficit, continue to pursue a growth-friendly fiscal policy and preserve a sound fiscal position, ensuring that the medium-term budgetary objective continues to be adhered to throughout the period covered by the Convergence Programme.			
EL	• Detailed recommendations are set out in the MoU					

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ES	• Corrective arm	• EDP deadline: 2016	Reinforce the budgetary strategy as of 2014, in particular by fully specifying the underlying measures for the year 2015 and beyond, to ensure the correction of the excessive deficit in a sustainable manner by 2016 through achieving the structural adjustment effort specified in the Council Recommendation under the Excessive Deficit Procedure. A durable correction of the fiscal imbalances requires a credible implementation of ambitious structural reforms to increase the adjustment capacity and boost growth and employment. After achieving the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0.5 % each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path.	Ensure that the new independent fiscal authority becomes fully operational as soon as possible and ensure a full implementation of the preventive, corrective and enforcement measures in the Budgetary Stability Organic Law at all levels of government, including on the elimination of public sector commercial arrears. Carry out by February 2015 a systematic review of expenditure at all levels of government to underpin the efficiency and quality of public spending going forward.	Adopt by the end of 2014 a comprehensive tax reform to make the tax system simpler and more conducive to growth and job creation, preservation of the environment and stability of revenues. To that end, shift revenues towards less distortive taxes, such as consumption, environmental (e.g. on motor fuels) and recurrent property taxes; remove inefficient personal and corporate income tax expenditures; consider lowering employers' social security contributions, in particular for low-wage jobs; continue to tackle the debt bias in corporate taxation; take measures to avoid that taxation hinders the smooth functioning of Spain's internal market. Step up the fight against tax evasion.	Continue to increase the cost-effectiveness of the healthcare sector, in particular by further rationalising pharmaceutical spending, including in hospitals and strengthening coordination across types of care, while maintaining accessibility for vulnerable groups.
FR	• Corrective arm	• EDP deadline: 2015	Reinforce the budgetary strategy, including by further specifying the underlying measures, for the year 2014 and beyond to ensure the correction of the excessive deficit in a sustainable manner by 2015 through achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. A durable correction of the fiscal imbalances requires a credible implementation of ambitious structural reforms to increase the adjustment capacity and boost growth and employment. After the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0.5 % of GDP each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path.	Step up efforts to achieve efficiency gains across all sub-sectors of general government, including by redefining, where relevant, the scope of government action. Set a clear timetable for the ongoing decentralisation process and take first steps by December 2014, with a view to eliminating administrative duplication, facilitating mergers between local governments and clarifying the responsibilities of each layer of local government. Reinforce incentives to streamline local government expenditure, by capping the annual increase in local government tax revenue while reducing grants from the central government as planned		In particular, take steps to reduce significantly the increase in social security spending as from 2015 as planned, by setting more ambitious annual healthcare spending targets, containing pension costs, and streamlining family benefits and housing allowances. Beyond the need for short-term savings, take steps to tackle the increase in public expenditure on health projected over the medium and long term, including in the area of pharmaceutical spending, and take additional measures when and where needed to bring the pension system into balance by 2020 in a sustainable manner covering all schemes, with a special focus on existing special schemes and complementary schemes.
HR	• Corrective arm	• EDP deadline: 2016	Fully implement the budgetary measures adopted for 2014. Reinforce the budgetary strategy, further specifying announced measures for 2015 and 2016, and considering additional permanent, growth-friendly measures in order to ensure a sustainable correction of the excessive deficit by 2016. At the same time, ensure that the structural adjustment effort as specified in the Council recommendation under the Excessive Deficit Procedure is delivered.	Align programme projections with ESA standards and Stability and Growth Pact requirements. Take measures to reinforce control over expenditure. By March 2015, carry out a thorough expenditure review. Reinforce the budgetary planning process, in particular by improving the accuracy of macroeconomic and budgetary forecasts and strengthening the binding nature of the annual and medium-term expenditure ceilings and improve the design of fiscal rules. By October 2014, ground in law the newly established Fiscal Policy Commission, strengthen its independence from all budgetary authorities, broaden its mandate, in particular with respect to the monitoring of all fiscal rules and the ex- ante and ex post assessment of forecasts, and ensure adequate resourcing.	Building on plans outlined in the National Reform Programme, present a concrete strategy to reform recurrent property taxation. Initiate a process of reporting and reviewing of tax expenditures. Improve tax compliance, in particular by further enhancing the efficiency of the tax administration; present an action plan to this end by the end of 2014.	
IT	• Preventive arm • Transition period debt rule	• MTO: 0% • Debt >60% • Bad economic times in 2014 and 2015	Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission services 2014 spring forecast and ensure progress towards the MTO. In 2015, significantly strengthen the budgetary strategy to ensure compliance with the debt reduction requirement and thus reaching the MTO. Thereafter, ensure that the general government debt is on a sufficiently downward path; carry out the ambitious privatisation plan; implement a growth-friendly fiscal adjustment based on the announced significant savings coming from a durable improvement of the efficiency and quality of public expenditure at all levels of government, while preserving growth-enhancing spending like R&D, innovation, education and essential infrastructure projects.	Guarantee the independence and full operationalization of the fiscal council as soon as possible and no later than September 2014, in time for the assessment of the 2015 Draft Budgetary Plan.		
CY	Detailed recommendations are set out in the MoU					

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LV	• Preventive arm	• MTO: -1% • (at MTO in 2014) • Debt < 60% • Good economic times in 2014 and 2015	Preserve a sound fiscal position in 2014 and strengthen the budgetary strategy as of 2015, ensuring that the deviation from the medium-term objective remains limited to the impact of the systemic pension reform.		Pursue efforts to further reduce the tax burden on low-income earners in the context of a shift towards more growth-friendly property and environmental taxes and by improving tax compliance and collection.	
LT	• Preventive arm	• MTO: -1% • Debt < 60% • Neither good nor bad economic times in 2014 and 2015	Reinforce the budgetary measures for 2014 in the light of expenditure growth exceeding the benchmark and the emerging gap of 0,3 % of GDP in terms of structural effort based on the Commission services 2014 spring forecast, pointing to a risk of significant deviation relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, strengthen the budgetary strategy to ensure the required adjustment of 0.5 % of GDP towards the medium-term objective. Thereafter ensure that the medium-term objective is adhered to.	Complement the budgetary strategy with a further strengthened fiscal framework, in particular by ensuring binding expenditure ceilings when setting the medium-term budgetary framework.	Further review the tax system and consider increasing those taxes that are least detrimental to growth, such as recurrent property and environmental taxation, while continuing to improve tax compliance.	
LU	• Preventive arm	• MTO: 0.5% • (overachieved in 2014) • Debt < 60% • Neither good nor bad economic times in 2014 and 2015	Preserve a sound fiscal position in 2014; significantly strengthen the budgetary strategy in 2015 to ensure that the medium-term objective is achieved and remain at the medium-term objective thereafter, in order to protect the long-term sustainability of public finances, in particular by taking into account implicit liabilities related to ageing.	Strengthen fiscal governance by speeding up the adoption of a medium-term budgetary framework covering the general government and including multi-annual expenditure ceilings, and by putting into place the independent monitoring of fiscal rules.	Further broaden the tax base, in particular on consumption.	
HU	• Preventive arm • Transition period debt rule	• MTO: -1.7% • (at MTO in 2014) • Debt > 60% • Bad economic times in 2014 • Neither good nor bad economic times in 2015	Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission 2014 spring forecast. In 2015, and thereafter significantly strengthen the budgetary strategy to ensure reaching the medium-term objective and compliance with the debt reduction requirements in order to keep the general government debt ratio on a sustained downward path	Ensure the binding nature of the medium-term budgetary framework through systematic ex-post monitoring of compliance with numerical fiscal rules and the use of corrective mechanisms. Improve the transparency of public finances, including through broadening the mandatory remit of the Fiscal Council, by requiring the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals.		

Source: Commission services

Part II

Recent development in fiscal surveillance

1. INTRODUCTION

Budgetary surveillance has experienced major changes over the last few years both at EU and national levels. The lessons from the economic and financial crisis were translated into a set of legislative reforms whose overreaching objective was to ensure prudent fiscal policy-making. A particular emphasis was placed on euro area Member States, due to the strong spillovers revealed by the crisis. In the fiscal sphere the sets of legislation referred to as the Six Pack and the Two Pack as well as the intergovernmental Treaty on Stability, Coordination and Governance (TSCG) made surveillance continuous throughout the year, enabled a larger involvement of national stakeholders and introduced stricter rules at EU level while at the same time some brought some flexibility to accommodate unusual events and severe economic downturns. ([15])

The recently adopted Communication from the Commission on the Economic governance review ([16]) analyses the effectiveness of the new rules in achieving their objectives and contributing to closer coordination of economic policies. While it is generally difficult to infer direct causal links between legislative instruments and macroeconomic outcomes – a difficulty which is aggravated in the current case by the relatively short experience of their application – the profound reform in the area of fiscal surveillance has proven valuable. In particular, the reformed fiscal framework is found to have been effective in guiding Member States in their efforts to consolidate public finances in difficult economic conditions.

The strengthened budgetary surveillance helped in bringing deficits considerably below their 2010 level, as shown in Part I. This allows a renewed focus on a policy strategy that relies on structural reforms, an initiative at EU level to boost investment and continuing growth-friendly fiscal responsibility. ([17])

The effective implementation of this enhanced framework requires that compliance with the rules be assessed properly. This implies regularly improving the quality of statistical data, clearly defining the methodologies for the assessment of compliance and strengthening national budgetary frameworks. Part II discusses four recent improvements in the EU budgetary surveillance framework, concerning (i) the review of the methodology for assessing effective action in the corrective arm of the Stability and Growth Pact; (ii) the latest methodological changes to the computation of the cyclically-adjusted balance; (iii) the introduction of ESA2010 and its implications for fiscal surveillance, and, finally (iv) the rise of independent fiscal institutions in the EU.

Since the 2005 reform of the Stability and Growth Pact (SGP), the cyclically-adjusted balance net of one-off measures (i.e. the structural balance) plays a central role in the European fiscal framework. First, it approximates the extent of the consolidation actions implemented by Member States and therefore contributes to distinguish between fiscal consolidation actions and fiscal consolidation outcomes. Moreover, fiscal targets are also expressed in structural terms both under the preventive and corrective arms of the Pact. Despite the known advantages of the structural balance as a measure of the fiscal effort, its endogenous relation with GDP may interfere with the estimations of governments' fiscal actions. The distortion of the structural balance by non-policy effects was aggravated during the crisis and the ensuing unwinding of macroeconomic imbalances accumulated in the EU, also related to the difficulties in estimating potential output.

Acknowledging the latter, the methodology for the assessment of effective action under the corrective

([15]) See the 2013 and 2012 Reports on Public Finances in EMU

([16]) Communication from the Commission to the European Parliament and the Council on the Economic Governance Review. Report on the application of Regulations 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011, 472/2013 and 473/2013

([17]) See the Communication from the Commission to the European Parliament, the Council, the European central bank, the European Economic and social Committee, the Committee of the Regions and the European Investment Bank on the 2015 Annual Growth Survey: http://ec.europa.eu/europe2020/pdf/2015/ags2015_en.pdf

Box II.1.1: Communication from the Commission on the Economic governance review

The legislative packages known as the Six Pack and Two Pack were at the centre of the latest reform to the European economic governance. In the fiscal domain, the reform aimed at (1) strengthening and deepening budgetary surveillance by making it more continuous and integrated, also via an intensified sanctions mechanism; and (2) introducing an additional surveillance for euro area Member States to ensure the correction of excessive deficits and the integration of EU policy recommendations in national budgetary processes.

The Communication from the Commission on the Economic governance review assesses the extent to which these two main objectives have been achieved. While the Communication acknowledges that drawing conclusions on the effectiveness of the regulations is limited by the short experience of their application, it also finds that overall they have proven effective in guiding Member States in their efforts to consolidate public finances in difficult economic conditions. Since 2011 most Member States have attained or made appropriate progress towards their medium-term budgetary objectives while the intermediate headline and structural deficit targets under the EDP have enabled more precise and transparent policy advice and monitoring. Furthermore the possibility for the Commission to issue autonomous recommendations, as envisaged by the Two Pack, is assessed as a significant addition to the monitoring of euro area Member States with excessive deficits, as it allows for earlier guidance.

Tangible improvements are found linked to the Two Pack's provisions to improve fiscal frameworks of euro area Member States. The scope and quality of annual budgeting and medium-term fiscal planning have been upgraded and, remarkably, these processes are now generally based on independently produced or endorsed macroeconomic forecasts.

Crucially, the rules are found to strike the right balance between sustainability and cyclical stabilisation requirements. At least three elements in the reformed fiscal framework underpin this delicate balance: first, under the preventive arm of the Pact, the fiscal effort is modulated according to economic conditions and sustainability risks; second, the deadline for correcting an excessive deficit under the excessive deficit procedure can be extended if the concerned Member State is assessed to have taken effective action but unexpected economic events hampered its ability to deliver on the headline targets. Finally, a general escape clause allows dealing with exceptional situations that could threaten the economies of the euro area of the EU as a whole, both under the preventive and the corrective arm of the Pact.

While the latest reforms have significantly bolstered the existing governance setup, the relationships between the various instruments of economic surveillance have also become more complex. This poses challenges not only for its implementation, but also for communication with stakeholders and the general public and consequently for ownership, democratic legitimacy and accountability. As established in the Communication from the Commission, a proper involvement of national Parliaments and the European Parliament remains crucial in ensuring the legitimacy of Member States' action.

arm of the SGP has undergone several changes. In particular, to disentangle policy errors from forecast errors, a correction of the estimated change in the structural balance for effects outside the control of government is undertaken and is then considered within the context of a careful analysis. This correction incorporates the impact of revisions to potential output growth estimates compared to those underpinning the growth scenario of the EDP recommendation – referred to as the *alpha* parameter – as well as the impact of revisions to the apparent revenue elasticities compared to those underlying the EDP recommendation – the *beta* parameter. A number of further improvements to the methodology were introduced earlier this year. In particular, the 'decision tree' for assessing effective action under the corrective arm of the SGP was revisited and the computation of the *beta* parameter refined. In parallel, the 'top-down' approach centred on the (corrected) change in the structural balance was complemented by a 'bottom-up' measure of the fiscal effort, with the piecing together of individual

measures. Chapter II.2 discusses these recent changes to the effective action methodology in detail.

The importance of the cyclically-adjusted balance in the EU fiscal surveillance framework has led to several methodological improvements and updates over the last few years. A first improvement consisted in using a so-called semi-elasticity parameter instead of the usual budgetary sensitivity parameter, to better measure the reaction of the headline balance-to-GDP ratio to cyclical conditions. Some data underlying the computation of the cyclically-adjusted balance were also updated, namely the weighting of individual revenue and expenditure elasticities. These changes, endorsed by the Economic Policy Committee in June 2012, had only second-order effects on the computation of the cyclically-adjusted balance itself but led to significant revisions to the estimated cyclical components of revenue and expenditure. As a consequence, the assessment of fiscal policy based on the composition of fiscal adjustment was substantially altered. More recently, the Commission has revised the methodology used for calculating output gaps, concerning the way the non-cyclical component of unemployment is estimated, ([18]) with a knock-on effect on cyclically-adjusted balance estimates. The latter is fairly limited on average but can be larger for specific countries in specific years. However, the fiscal surveillance implications are limited, notably thanks to the methodology for assessing effective action. ([19]) Finally, the OECD has just updated the estimates for tax elasticities underpinning the calculation of cyclically-adjusted balances and extended the scope to cover all EU Member States. The impact of this revision on the annual change in the cyclically-adjusted balance is fairly limited on average but can be, here as well, larger for specific countries in specific years. Chapter II.3 presents in details this latest methodological change.

Good quality and comparable data are indispensable to conduct efficient economic surveillance. Data are routinely improved by statistical offices worldwide. The European System of National and Regional Accounts (ESA 2010) is the newest internationally compatible EU accounting framework for a systematic and detailed description of an economy. ESA 2010 is being implemented as from September 2014; from that date onwards data transmission from Member States to Eurostat follows ESA 2010 rules. ESA 2010 differs in scope as well as in concepts from its predecessor ESA 95, reflecting developments in measuring modern economies, advances in methodological research and the needs of users. The structure of ESA 2010 is consistent with the worldwide guidelines on national accounting set out in the System of National Accounts 2008 (2008 SNA). The main methodological changes are R&D expenditure as well as expenditure on weapon systems being counted as investment, instead of intermediate costs, with this implying an upward revision to the level of GDP.

While these changes are standard practice in the statistical field, they have a specific relevance in the context of EU budgetary surveillance. In particular, any level increase in GDP leads to a corresponding level decrease in all indicators calculated as a percentage of GDP, including general government deficit and debt ratios. However, ESA 2010 also has an impact on the absolute values of government deficit and debt, being revised upwards for most Member States due to the reclassification of units inside the general government sector. Depending on the relative size of this change and the change in GDP, the ratios might go up, down or remain the same. However, the EU budgetary surveillance framework embeds enough flexibility to adequately handle these statistical revisions. Chapter II.4 outlines the main changes introduced by ESA 2010 and explains the implications for budgetary surveillance in detail.

The gradual rise of independent fiscal institutions is one of the most salient features of the recent evolution of the budgetary institutional setup in the EU. While in some countries such institutions have existed for a long time, recent legislative developments at EU level provided a decisive impetus for the rise of IFIs, both in terms of their

([18]) Commonly referred to as the 'non-accelerating wage rate of unemployment' (NAWRU).

([19]) For a detailed explanation of the methodological revisions and the impact on cyclically-adjusted balance estimates, see Chapter 1 in European Economic Forecast – Spring 2014, European Economy, 3|2014

number and their competences. The Two Pack builds on the Directive on national budgetary frameworks ([20]), which stressed the need for strengthening national ownership of common fiscal rules and highlighted the importance of unbiased macroeconomic forecasts for adequate budgetary planning. The Two Pack further attributed to IFIs the role of monitoring compliance with national numerical fiscal rules, building on the provisions of the TSCG. The progress made by Member States in establishing and operationalizing IFIs is examined in Chapter II.5.

Conducting effective fiscal surveillance requires regular updates of the EU budgetary framework cornerstones. These include strengthening budgetary frameworks, refining the indicators used to assess fiscal policy actions and improving fiscal statistics. Some of these refinements pose challenges in terms of ensuring a consistent and continuous application of the SGP. However, compliance with EU fiscal rules is assessed in a comprehensive and coherent way to ensure that decisions are taken based on the evaluation of policies rather than on changes triggered by methodological revisions.

([20]) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

2. THE ASSESSMENT OF EFFECTIVE ACTION IN THE CORRECTIVE ARM OF THE SGP

The corrective arm of the Stability and Growth Pact (SGP) aims at deterring excessive government deficits and, if they occur, at prompting their correction. ([21])To that end, Member States subject to an Excessive Deficit Procedure (EDP) are issued a recommendation under Article 126(7) or notice under Article 126(9) ([22]) by the Council. The EDP recommendation urges Member States to bring the general government deficit below 3% of GDP or, in case of high debt, to reduce it at an adequate pace until it falls under 60% of GDP.

The Commission regularly assesses whether Member States under EDP are acting in compliance with the Council EDP recommendation by taking sufficient policy measures to correct their excessive deficit by the recommended deadline. This exercise is known as the assessment of effective action, which plays a central role in the different phases of the EDP. ([23]) It crucially determines whether the procedure is held in abeyance or stepped-up with the corresponding sanctions imposed on the non-compliant Member State. ([24])

The foundations of the assessment of effective action are described in the Code of Conduct on the SGP ([25])and formalised in a methodology agreed with the Member States. It is a comprehensive analysis which compares the headline deficit and the fiscal effort delivered against the annual (intermediary) targets specified in the EDP recommendation. ([26]) Thus, taking into account both the fiscal outcome achieved and the fiscal effort undertaken. The fiscal effort has been traditionally measured through the change in the structural budget balance in the context of the assessment of effective action. However, the economic crisis unveiled the limitations of this metric to measure Member States' fiscal effort under certain circumstances. As a result, the methodology for assessing effective action was improved early in 2013 to correct the change in the structural balance for growth and revenue forecast errors.

A further review was conducted earlier this year and endorsed by the Economic and Financial Affairs Council in June 2014, together with the systematic sequencing for the implementation of the methodology for assessing effective action. ([27]) The review confirmed that the change in the structural balance more accurately approximates the fiscal effort when it is corrected for forecast errors. Furthermore, as a result of the review, a complementary indicator of the fiscal effort which revolves around the actual implemented measures was added to the fiscal surveillance toolbox. The experience gained since the entry into force of the Six-Pack has shown that focusing on the evolution of fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with EDP recommendations. Therefore, effective action is now assessed in cumulative terms.

This Chapter aims at providing an overall view of the methodology for assessing effective action with a special focus on the recent methodological updates along with a description of the subsequent steps for conducting the assessment of effective action. These latest methodological updates, by fine-tuning the distinction between fiscal consolidation actions and fiscal consolidation

([21]) It is based on Article 126 of the TFEU which specifies that Member States shall avoid excessive government deficits and implemented through Council Regulation EC/1467/97.

([22]) For simplicity the remainder of the Chapter refers only to "EDP recommendation".

([23]) See Part II, Chapter 2 of PFR 2012 for a detailed description of the procedural aspects linked to the assessment of effective action.

([24]) The Six-Pack reform of the SGP in 2011 reinforced the system of sanctions in case of non-compliance by making them gradual and increasing their automaticity.

([25]) "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", 3 September 2012: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

([26]) Since the Six-Pack reform of the SGP in 2011, the path towards the correction of the excessive deficit includes annual nominal targets and the corresponding annual fiscal effort of at least 0.5% of GDP as a benchmark. The estimated amount of measures needed to attain such targets is also specified in the recitals of the EDP recommendation since 2013.

([27]) Economic and Financial Affairs Council conclusions of the meeting of 20 June 2014: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/143478.pdf

outcomes, admittedly increase the complexity of the assessment. This poses challenges for its implementation and also for communication with the public. Increased transparency and involvement of stakeholders remains crucial to overcome these challenges.

2.1. HOW TO MEASURE EFFECTIVE ACTION

Since the overarching goal of the EDP framework is to bring the deficit below 3% of GDP in a durable manner, which is consistent with a reduction of the debt which ensures compliance with the debt criterion at the end of the correction period, the natural starting point of the assessment of compliance with the EDP recommendation is the comparison of the headline deficit against the annual targets specified in the recommendation. However, looking solely at fiscal outcomes may provide a partial view that ignores the economic reality in which Member States undertake their fiscal adjustments. In fact, Member States may fail to meet the recommended headline targets if economic circumstances turn out worse than anticipated.

Therefore, it is crucial to assess whether Member States have taken sufficient policy actions to meet their obligations, thereby distinguishing between fiscal consolidation actions and fiscal consolidation outcomes. For this reason, the structural balance is at the centre of the fiscal surveillance framework since the 2005 reform of the SGP. ([28]) The structural balance is computed by subtracting one-off and other temporary measures from the cyclically adjusted budget balance (CAB), which in turn corresponds to the budget balance that would prevail if the economy was running at potential. ([29]) The CAB is computed as the difference between the actual balance and its cyclical component, which is calculated on the basis of an estimated semi-elasticity of the budget balance with respect to the output gap. ([30]) The structural balance is therefore an unobservable variable which correct estimation depends on an accurate understanding of the cyclical position of the economy and on an accurate assumption about the sensitivity of the budget balance to the economic cycle. Hence, despite the advantages of the structural balance as a measure of the fiscal effort, it also has shortcomings. ([31])

Besides the budgetary effect of discretionary fiscal policy, which is the relevant variable for surveillance purposes, the change in the structural balance may also be influenced by forecasts errors linked to revisions in economic growth or changes in growth composition. The latter may lead to a departure of revenues' cyclical sensitivity from its standard values, resulting in revenue windfalls or shortfalls. This was the situation before the crisis, when growth in some Member States was fuelled by asset bubbles which boosted cyclical budgetary revenues far above standard levels. As a result, the structural balance gave an overly optimistic picture of the underlying budgetary position of these Member States, attributing to policy actions what turned out to be revenue windfalls. The false sense of fiscal soundness triggered excessive government spending which, after the outbreak of the crisis and the collapse of government revenues, resulted in large budgetary deficits. The large volatility of potential growth estimates over the crisis years posed an additional challenge to the measurement of the fiscal effort through the change in the structural balance. Furthermore, given the severe deterioration of fiscal accounts in the aftermath of the crisis, a large number of Member States were issued multi-annual EDP recommendations. In this context, the mere comparison between the observed change in the structural balance and the required one did not provide an unequivocal conclusion about effective action or the lack thereof.

The limitations of the structural balance were thus exacerbated by the economic crisis, which coupled with the SGP improved sanctions system, prompted the refinement of the methodology for

([28]) Presidency Conclusions - European Council, 22-23 March 2005: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf
([29]) See Mourre et al., 2013.
([30]) See Box II.3.1 in PFR 2013 for an analytical decomposition.
([31]) See PFR 2006 part II and PFR 2013 part III.

assessing effective action. These methodological changes concerned the correction of the structural balance for growth and revenue windfalls/shortfalls forecast errors with respect to the time of the recommendation (the top-down approach). An additional indicator of the fiscal measures actually implemented (the bottom-up approach) was also formally defined, thereby specifying the reference to this indicator contained in the Code of Conduct of the SGP. ([32]) See Box II.2.1 for the analytical details.

2.1.1. Top-down assessment of effective action: the change in the adjusted structural balance

Considering the abovementioned limitations to the structural balance as a measure of fiscal effort, the purpose of the top down approach is to correct the change in the structural balance (ΔS) for the impact of revisions on potential output and revenue windfalls/shortfalls with respect to the forecast at the time of the recommendation. Other unexpected events with an impact on the general government balance are also corrected for. ([33]) The adjustment is done in the following manner:

- First, the α-component adjusts for the impact of revisions in potential output growth compared to the forecast at the time of the recommendation. When comparing the recommended and the observed changes in the structural balance at different moments in time, differences can result from variations in the denominator, i.e. potential output growth. Hence, by construction, a higher (or a lower) potential output growth than the one forecast at the time of the recommendation would lead to a higher (or a lower) estimate of the change in the structural balance. Thus, providing a distorted measure of the government's policy actions.

- Second, the β-component corrects for the impact of revisions in revenue windfalls/shortfalls compared to the forecast at the time of the recommendation. It captures the fact that apparent revenue elasticities can differ from those underlying the EDP recommendation due to events outside the control of the government. Changes in the composition of GDP growth can have a clear impact on apparent revenue elasticities if, for instance, the relative contributions of external and internal demand to economic growth change, the former being typically tax-poorer than the latter.

- Third, the ϒ-component captures the impact of other unexpected events under very unusual and specific circumstances.

The comparison between the adjusted change in the structural balance ($\Delta S^* = \Delta S - (\alpha+\beta+\gamma)$) and the uncorrected change in the structural balance (ΔS) yields and approximation of unexpected events outside the control of fiscal authorities with an impact on government finances. In the past years, when potential growth surprised on the negative side and the rebalancing in several Member States led to a tax-poorer composition of economic growth, the adjusted change in the structural balance provided a more accurate measure of the fiscal effort undertaken by Member States and prevented many of them to be unduly penalised for factors beyond their control. Therefore, the adjusted change in the structural balance was already an integral part of the assessment of effective action. Going forward, if potential growth or revenue windfalls surprise on the upside, the adjustments to the change in the structural balance will have the opposite effect as the α and β corrections are symmetric by construction. Box II.2.1 provides the analytical derivation of the latter. The 2014 review of the methodology for assessing effective action confirmed the appropriateness of these adjustments to better grasp the extent of government fiscal actions introducing only a technical improvement to the calculation of the β-component.

2.1.2. Bottom-up assessment of effective action

In order to get a more comprehensive understanding of the extent of government policy actions, the top-down measurement of fiscal effort is complemented by a bottom-up estimate (FE), which aims at identifying the budgetary impact of the additional fiscal measures implemented since the EDP recommendation or notice was issued. In

([32]) The bottom-up indicator of fiscal effort is a variant of the Discretionary Fiscal Effort (DFE) indicator presented in Part III of the 2013 PFR.

([33]) See Part II, Chapter 2 of PFR 2012 for the original description of the adjusted change in the structural balance.

Box II.2.1: **Methodology for assessing effective action**

1. The top-down assessment of effective action: the adjusted change in the structural balance (ΔS*)

The impact of revisions in potential output growth (α)
The effect of revisions of potential output growth compared to the forecasts underlying the Council recommendations (α) is expressed as:

$$\alpha_t = \frac{G^S_{t-1}}{GDP^{potential}_{t-1}}\left(y_t^{potential} - y_t^{potential\,rec}\right)$$

where $\frac{G^S_{t-1}}{GDP^{potential}_{t-1}}$ is the expenditure to GDP ratio net of cyclical factors in year *t* -1, that is the year in which the EDP recommendation was issued, and $y_t^{potential}$ is potential GDP growth in year *t*. All variables refer to outturn or current forecast figures, except where the superscript *rec* denotes the value given at the time of the recommendation.

The impact of the composition of economic growth or other windfalls/shortfalls on revenue (β)
The windfall/shortfall is computed by comparing the actual variation in government revenues which is neither attributable to discretionary actions by the fiscal authorities nor to the cycle (i.e. the revenue windfall or shortfall estimated at the time of the assessment), with the comparable windfall or shortfall estimated at the time of the EDP recommendation, i.e. the revenue gap (β):

$$\beta_t = \frac{(\Delta R_t - DM_t - g^r_t . R_{t-1}) - (\Delta R^{rec}_t - DM^{rec}_t - g^{r\,rec}_t . R^{rec}_{t-1})}{GDP^{nom}_t}$$

Where ΔR_t , DM_t and g^r_t respectively stand for the change in government revenues, discretionary revenue measures and revenue increases linked to the cycle. Building on the experience gained over the past year with the implementation of the methodology, the computation of g^r_t was refined in June 2014 to better capture the automatic response of government revenues to a change in nominal GDP. The refinement acknowledges that the change in the output gap explains, in practice, between one quarter and three quarters of the economic growth depending on the country, but that there are other factors at stake and considers only the cyclical effect of revenues.

$$g^r_t = y^{nom}_t + (\eta^R - 1).\Delta OG_t$$

where y^{nom}_t and ΔOG_t respectively stand for nominal GDP growth and the variation of the output gap expressed in real terms. In turn, η^R is a technical coefficient measuring the reaction of revenues to the change in cyclical conditions.

2. Bottom-up assessment of effective action (FE)
From a bottom-up perspective, the annual fiscal effort can be estimated as follows:

$$FE_t = \underbrace{\frac{DRM_t^{assessment}}{GDP_t^{assessment}}}_{\text{(revenue)}} - \underbrace{\frac{\left(\Delta E_t^{\,assessment} - \Delta E_t^{\,baseline}\right)}{GDP_t^{assessment}}}_{\text{(expenditure)}}$$

(Continued on the next page)

Box (continued)

where:

- $DRM_t^{assessment}$ is the budgetary impact in year *t*, estimated at the time of the assessment, of the discretionary revenue measures additional to the ones already included in the baseline scenario underlying the EDP recommendation, ([1]) net of one-offs. ([2])
- $\Delta E_t^{assessment}$ is the change in total nominal expenditure in year *t*, net of one-offs, non-discretionary changes in interest payments, non-discretionary changes in unemployment benefits and public investment matched by EU funds as estimated at the time of the assessment as well as other country-specific effects in limited cases.
- $\Delta E_t^{baseline}$ is the change in the baseline underlying the EDP recommendation of total nominal expenditure in year *t*, corrected for statistical revisions, net of one-off measures, non-discretionary changes in interest payments, non-discretionary changes in unemployment benefits and public investment matched by EU funds as estimated at the time the recommendation was issued as well as other country-specific effects in limited cases.
- $GDP_t^{assesment}$ is nominal GDP in year *t* as estimated at the time of the assessment of effective action.

([1]) The baseline scenario is defined in the Staff Working Document accompanying the EDP recommendation.
([2]) One-off measures are by definition excluded from the calculation of the structural balance and should also be excluded in the bottom-up analysis for the sake of consistency.

fact, since 2013, the estimated amount of measures needed to attain the recommended headline and structural budgetary targets is specified in the recitals of the EDP recommendation. Similarly, the Council's decisions to give notice explicitly indicate the additional fiscal measures and the deadlines for their adoption as required by EU law. The methodology underlying the bottom-up assessment gives a differentiated treatment to revenue and expenditure measures.

This is because the total amount of revenues largely depends on endogenous factors beyond the direct control of the government (e.g. changes in disposable income, overall consumption, production or, more generally, changes in the tax bases) whereas expenditures are mostly considered under the direct control of the government, except for a limited number of endogenously driven expenditure items. ([34]) Consequently, on the revenue side, the bottom-up fiscal effort is calculated as the sum of the estimated annual budgetary impact of the additional discretionary revenue measures implemented since the EDP recommendation was issued. For a discretionary revenue measure to be considered in the bottom-up calculation it must have a direct fiscal impact, originate from an autonomous intervention by the government and be enacted or credibly announced in sufficient detail. ([35]) The budgetary impact of the discretionary measures also factors in any behavioural response or second round effects.

On the expenditure side, governments can influence expenditure trends by implementing new

([34]) These are changes in unemployment benefits due to a change in the number of unemployed, changes in interest expenditure related to fluctuations in interest and exchange rates and the share of public investment matched by EU funds. See Part III of the 2013 PFR.

([35]) The following are not considered as a rule discretionary revenue measures: i) commitments or targets (e.g. deficit targets, deficit rules) which are not underpinned by specific measures to achieve them and ii) specific measures whose entry into force is conditional on reaching certain budgetary thresholds.

measures but also by refraining to do so, as in the absence of new measures government spending evolves according to its underlying trends. In this sense, estimating the fiscal effort on the expenditure side by adding up measures which are officially implemented or announced, as done on the revenue side, will only capture part of the governments' decisions that determine expenditure: the explicit expenditure-related ones. The remaining share of the governments' choices, including not acting, which also affects expenditure outcomes, would be unduly left aside. Therefore, the bottom-up fiscal effort is computed by comparing the outturn expenditure ratio with the baseline scenario underlying the EDP recommendation net of one-off measures and non-discretionary expenditure items. The latter include the cyclical component of unemployment expenditure, the changes in interest expenditure, public investment matched by EU funds and possible country-specific elements in limited cases. The baseline scenario from the recommendation is also corrected for possible statistical revisions in the historical data.

2.1.3. Putting the pieces together: the careful analysis

The careful analysis brings together the top-down and bottom-up measures of fiscal effort in order to determine whether a Member State has delivered on the policy commitments laid down in the EDP recommendation. Such detailed analysis is always warranted if the Member State concerned has failed or is at risk of failing to meet the headline deficit target or/and the required improvement in the structural balance in order to determine the reasons of the shortfall.

When both the top-down and the bottom-up measures of fiscal effort point in the same direction, the careful analysis would be complemented by other considerations mainly to address possible measurement errors, especially in case the estimated effort only marginally exceeds or falls short of the recommended one.

When the top-down and bottom-up indicators send conflicting messages, the careful analysis aims at disentangling the possible sources of the differences. In particular, differences could arise for the following reasons:

- The top-down and the bottom-up measurements are based on different benchmark growth rates for structural expenditure. Namely, the baseline scenario at the time of the recommendation in the bottom-up approach, and the nominal potential GDP growth rate corrected for the α parameter in the top-down assessment. Inflation surprises, among other factors, would affect the expenditure benchmarks differently and lead to divergent measures of fiscal effort.

- The items excluded in the bottom-up measure – in particular interest payments and investment matched by EU funds – , which remain in the top-down measure of fiscal effort could also explain the difference between both indicators.

- The effect of the cycle on public expenditure, and more specifically on unemployment expenditure, is not measured in the same manner and may lead to divergent indicators.

Any other considerations, including of qualitative nature, are also taken into account in the careful analysis so as to have a complete view of the extent of the fiscal consolidation actions implemented by the Member State concerned. The report on action taken as well as the additional reporting requirements introduced by the Two-Pack for euro area EDP countries are important pieces of information feeding into the careful analysis. ([36])

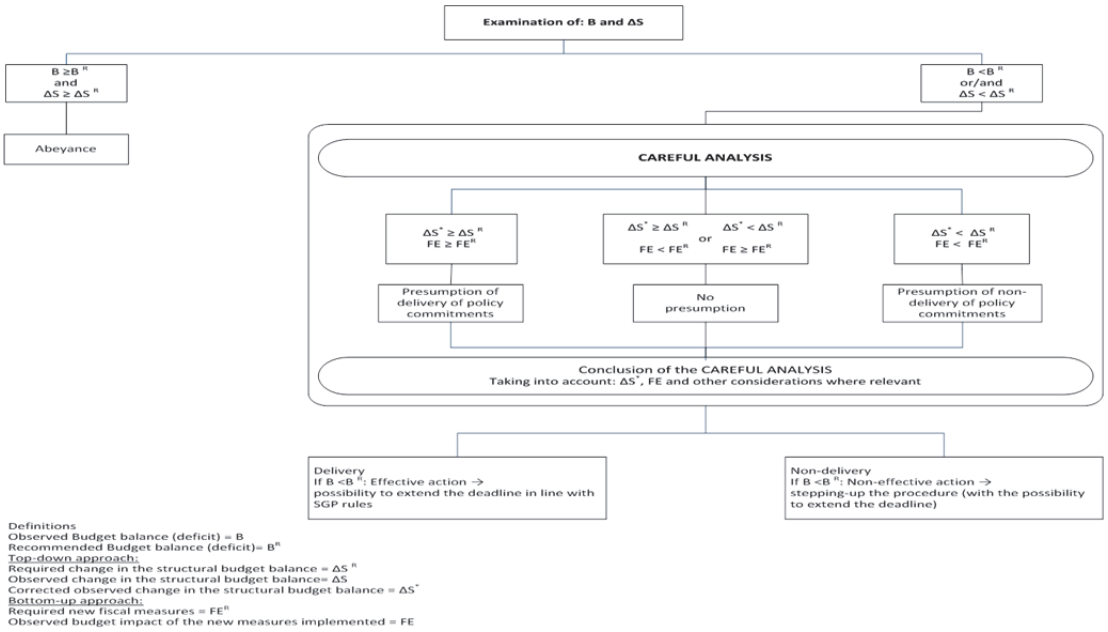
2.2. THE STEPS OF THE ASSESSMENT OF EFFECTIVE ACTION

The logical and procedural steps of the assessment of effective action laid down in the Code of Conduct of the SGP ([37]) can be summarised in a decision tree, described in Graph II.2.1.

([36]) See Part II Chapter 2 PFR 2013 for a description of the provisions under the Two-Pack.

([37]) The Code of Conduct on the SGP stipulates that "a Member State should be considered to have taken effective action if it has acted in compliance with the recommendation or notice, regarding both the implementation of the measures required therein and

Graph II.2.1: **The EDP decision tree for assessing effective action**



Source: Commission services

At first, the Commission examines whether the Member State has met or is forecast to meet the recommended headline deficit target and the underlying improvement in the structural balance.

Compliance with both requirements leads to a positive assessment of effective action.

If, on the contrary, the Member State fails or is at risk of failing to meet the recommended headline deficit or/and the required improvement in the structural balance the Commission engages in a more detailed examination to identify the reasons of the shortfall, known as the careful analysis. The aim of the careful analysis is to provide an adequate estimation of the extent of policy actions and to evaluate whether the Member State concerned has delivered on the policy commitments set out in the EDP recommendation. To that end, the careful analysis first builds on the two metrics of fiscal effort discussed above: (i) the change in the structural balance corrected for factors outside the control of the government (ΔS*) – the top-down approach – and (ii) a direct estimation of the budgetary impact of concrete fiscal measures (FE) – the bottom-up approach.

If ΔS* and FE show an effort equal or above the recommended one, there is a presumption that the Member State concerned has delivered on its policy commitments. Conversely, if both measures fall below the recommended effort, there is a presumption of non-delivery. When the top-down and the bottom-up approaches come to different conclusions, there is no prior presumption. In order to enhance the quality of the estimated budgetary impact of revenue measures, the Commission uses

budgetary execution. The assessment should in particular take into account whether the Member State concerned has achieved the annual budgetary targets initially recommended by the Council and the underlying improvement in the cyclically adjusted balance net of one-off and other temporary measures. In case the observed budget balance proves to be lower than recommended or if the improvement of the cyclically adjusted balance net of one-offs and other temporary measures falls significantly short of the adjustment underling the target, a careful analysis of the reasons for the shortfall would be made. In particular, the analysis should take into account whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented."

Box II.2.2: **An example of the new decision tree for assessing effective action**

The example below replicates the assessment of effective action for Slovenia done in spring 2014, concerning compliance with its EDP recommendation in 2013. Trying to replicate the real-time assessment the data reported below correspond to the Commission's 2014 spring forecast. Since this new methodology requires for its implementation a quantification of the top-down and bottom-up fiscal efforts in the EDP recommendations – that will serve as benchmarks against which the observed metrics will be compared – it can only be applied to a subset of Member States under excessive deficit procedures, namely those which received an EDP recommendation in 2013.

The EDP recommendation for Slovenia established that the country should reach a headline deficit of 4.9% in 2013 (3.7% of GDP excluding bank recapitalisations), consistent with an improvement of the structural balance of 0.7%. Furthermore, the recommendation established that in order to reach this structural target in 2013, the Slovenian authorities would need to implement additional consolidation measures amounting to 1% of GDP, which therefore constitutes the benchmark against which the bottom-up measure of the fiscal effort should be assessed.

Against these requirements, the Commission's 2014 spring forecast provided the following figures for Slovenia in 2013: the headline deficit stood at 14.7% in 2013 (4.3% excluding bank recapitalisations), considerably above the EDP target. Furthermore, the unadjusted and adjusted change in the structural balance came in respectively at 0.2% and 0.5%, both below the 0.7% target. However, the implemented additional bottom-up effort was estimated at 1%, complying with the amount of additional measures put forward in the EDP recommendation.

The careful analysis showed that the bottom-up measure of the fiscal effort provided a more accurate picture of the consolidation actions implemented by the Slovenian authorities, due to two main factors. First, inflation in 2013 turned out lower than expected at the time of the EDP recommendation. While this, by putting downward pressure on tax revenues, translates into a deterioration of the structural balance, the bottom-up metric is broadly unaffected by a negative inflation surprise. Second, the conventional semi-elasticity of expenditure to the output gap – used for the calculation of the structural balance – was underestimating the evolution of cyclical spending compared to the instantaneous semi-elasticity upon which the bottom-up metric relies.

Consequently, in spring 2014 Slovenia was assessed to have taken effective action with respect to its EDP recommendation for 2013.

all available information including in particular estimates by national IFIs.

In all cases, the careful analysis needs to be complemented by a qualified economic judgement to conclude whether the Member State concerned has delivered on its policy commitments. A positive conclusion implies that effective action has been taken, with a possibility to extend the deadline for correction of the excessive deficit, even if the headline deficit target has not been met.

If the careful analysis concludes that the Member State has not delivered on its policy commitments, the procedure will be stepped up. However a deficit-based EDP cannot be stepped up if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved. At the same time, though, a careful analysis should be conducted to better understand the nature of the underlying budgetary developments.

The experience gained since the entry into force of the Six-Pack has shown that focusing on the evolution of fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with the recommendations. Therefore, the Commission will examine the fiscal effort over the entire correction period for multi-annual EDPs. In this way, a Member State cannot be unduly punished for a frontloaded effort. At the same time, this ensures that a Member State meeting its nominal target the first year without delivering the

recommended annual fiscal effort would only be found compliant with the recommendation in the later years if it delivers the cumulative fiscal effort over the correction period under scrutiny, in case the nominal deficit falls short of the recommended one thereafter. Thus, for the purposes of the assessment of effective action, the cumulative adjusted structural balance and the annual amount of fiscal consolidation measures is compared with the cumulative change in the structural balance and the additional fiscal consolidation measures required in the recommendation. A concrete example on the implementation of this new decision tree is provided in Box II.2.2.

3. COMPUTING THE CYCLICALLY-ADJUSTED BALANCE: UPDATED EU METHODOLOGY FOR BUDGETARY ELASTICITIES

The importance of the concept of cyclically-adjusted budget balance (CAB) and that of structural balance (CAB minus one-offs and temporary measures) was restated forcefully with the reform of the European economic governance since 2011. This reform alongside the dramatic changes in economic data brought about by the economic and financial crisis underscored the need of making necessary technical improvements in the computation methodology of the CAB. In this context, the Output Gap Working Group (OGWG) of the Economic Policy Committee received at the end of 2011 the mandate to revise the CAB calculation methodology. Following this mandate, the Commission launched in early 2012 a two-tiered process to improve the CAB methodology.

The first tier of revision resulted in a conceptual improvement and in the update of all weighting parameters used in the CAB: (i) employing a semi-elasticity parameter instead of the usual budgetary sensitivity parameter and (ii) updating the data underlying the computation of the weighting parameters used in the CAB (shares of individual revenue and expenditure, ratios of total revenue/expenditure to GDP). The technical details are explained thoroughly in Mourre *et al.*, 2013.([38]) This first tier of revision has been fully up and running since the Commission's 2013 Winter Forecast in February 2013.

The second tier of revision was completed and approved by all EU Member States in September 2014 and applied for the first time in the Commission's 2014 Autumn Forecast, released in early November 2014. It consisted in updating the individual fiscal elasticities underlying the CAB. The Commission asked the OECD to revise their estimates of country-specific elasticities, as reported in Girouard and André (2005)([39]), which had been underlying the calculation of the CAB for both the OECD and the EU. The OECD's work aimed at (i) extending the exercise to cover all Member States, since the elasticities for non-OECD EU countries were computed by the Commission (European Commission, 2006)([40]), (ii) updating the calculation of revenue and expenditure elasticities with respect to the output gap based on most recent datasets and tax codes and (iii) making useful improvements or refinements of the methodology. The technical details of the revised CAB methodology are explained thoroughly in Mourre *et al.*, 2014([41]) and, for the revision of the OECD elasticities of individual revenue and expenditure, in OECD, 2014.([42])

While the main technical work for the revision of elasticities was entrusted to the OECD, representatives of Member States - in the framework of the OGWG - suggested some technical adjustments to better reflect the economic reality of their country. The Commission (and the ECB) also put forward some adjustments with the aim of ensuring a robust cross-country consistent methodology. The proposed adjustments mainly concerned (i) the correction of factual errors, (ii) the consistent application of model selection criteria for each country([43]) and (iii) the

([38]) Mourre, G., G.-M. Isbasoiu, D. Paternoster and M. Salto (2013), The cyclically-adjusted budget balance used in the EU fiscal framework: an update, European Commission Economic Paper n°478.

([39]) Girouard, N. and C. André (2005), Measuring Cyclically-Adjusted Budget Balances for OECD Countries, OECD Economics Department Working Papers, No. 434, Paris.

([40]) European Commission (2006), Public Finances in EMU, Part II 'Evolving budgetary surveillance', Chapter 4 'Measurement and statistical issues', pp. 110-127, and in particular Box II.3 "Budgetary sensitivities: definition and construction". See also European Commission "New and updated budgetary sensitivities for the EU Budgetary Surveillance", September 2005. Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/budg_sensitivities_092005_v02_en.pdf.

([41]) Mourre, G., Astarita, C. and Princen, S. (2014), Adjusting the budget balance for the business cycle: the EU methodology, European Commission Economic Paper.

([42]) OECD (2014a), New tax and expenditure elasticity estimates for EU budget surveillance, OECD Economics Departrment Working Papers 1174, forthcoming.

([43]) Given the complexity of the model section, multiple statistical criteria were used (goodness-of-fit of the equation, statistical significance of the variable of interest, absence of time-series correlation). The use of all these criteria may create some trade-off. Moreover, in case of equally acceptable models from a statistical standpoint, the model retained was the one making most sense from an economic standpoint and avoiding the occurrence of outliers which are difficult to explain.

coherent treatment of statistically non-significant results and data outliers. Only suggestions fully in line with the common methodology were retained. In rare cases, some limited exemptions were granted based on solid arguments validated by the Commission and the OECD and presented to all Member State delegates.

As for the previous methodological changes of the CAB (i.e. the first tier revision in the Commission's 2013 Winter Forecast and the NAWRU revision in the Commission's 2014 Spring Forecast), the CAB was back-casted up to the year 1995 and as such reported in the AMECO database. This is done in order to avoid a break in the series and to favour a correct interpretation of the developments in discretionary fiscal policy. A note of cautious is that the work was carried out with ESA1995 data, since ESA2010 data were not available at the time of the revision.([44])

The remainder of the chapter presents the revision and the new values of the fiscal semi-elasticities, which is the key cyclical-adjustment parameter (applied to the output gap). Section 3.1 sets out the main methodological improvements brought by the OECD in the calculation of the revised revenue and expenditure elasticities. Section 3.2 presents the new values of these elasticities. Section 3.3 shows the effect of the revisions on the value of fiscal semi-elasticities and on the CAB value.

3.1 MAIN METHODOLOGICAL INNOVATIONS

As the previous computations of the individual elasticities used data ending in 2003, the underlying data were updated using the most recent datasets (covering the period 1990-2013) and the more recent tax codes (the 2010-11 tax codes). The study was also extended to cover all EU countries, including those which are not member of the OECD, on the basis on data provided by the Commission.

The OGWG agreed to broadly keep the methodology used in Girouard and André (2005) to compute individual revenue and expenditure elasticities. As in the 2005 methodology, a two-step approach was used. The elasticity of individual revenue (expenditure) categories with respect to their base and the elasticity of the revenue (expenditure) base to the output gap are computed separately. They are then multiplied with each other to obtain the elasticity of individual revenue (expenditure) categories with respect to the output gap. Formally:

Table II.3.1: **Main revisions per revenue and expenditure category (OECD, 2014a)**

Revenue/expenditure category	Elasticity of revenue/expenditure to base	Elasticity of base to output gap
Personal income taxes	Update to 2010-11 tax/benefit codes Richer income distribution data Closer alignment of revenue to bases	Estimated for three income categories (wages and salaries, self-employment income, capital income)
Social security contributions	Update to 2010-11 tax/benefit codes Richer income distribution data Disaggregation employer-employee	Estimated for wages and salaries
Corporate income taxes	Estimated empirically rather than unitary elasticity assumption	Estimated empirically rather than taking reciprocal of wage to output gap elasticity
Indirect taxes	Estimated empirically but uniform assumption preferred	Unitary elasticity assumption
Unemployment-related expenditure	Unitary elasticity assumption	Estimated empirically

Source: OECD

However, the OECD improved the 2005 methodology by introducing the following innovations, summarised in Table II.3.1:

– using more disaggregated data for personal income taxes (wages and salaries, self-employment income, capital income) and estimating the elasticity for each disaggregated income item separately;

– using more disaggregated data for social security contributions (broken down into employees' and employers' contributions) and estimating the elasticity for each item separately;

– using the revised EU output gaps based on production function, using the new NAWRU methodology, as agreed by the Economic Policy Committee on 19 March 2014;

– estimating the revenue-to-base elasticities for corporate income taxes empirically (instead of being assumed to unity) and estimating directly the base-to-output gap elasticities for corporate income taxes (instead of using the reciprocal of the elasticity of wage bill to output gap);

([44]) For policy purposes, it was important to change the CAB methodology at the same time as the change-over to ES2010 and to implement the changes together. Otherwise, this would have led to staggered changes in the structural budget balance.

– supporting the zero elasticity assumption for non-tax revenue by empirical estimations. The latter indeed provided support to the assumed absence of cyclicality.

Empirical estimates were made for each revenue category, even for those whose elasticity was assumed to be unitary in the 2005 methodology. Also the elasticities of unemployment-related and earnings-related expenditure were empirically estimated. Other expenditure items were assumed not to be cyclically sensitive. However, for some revenue and expenditure categories, the estimates were not fully consistent with theoretical expectations and/or very disperse across countries, with no clear explanation of that. Therefore it was decided:

i. to keep the unitary elasticity assumption for indirect taxes, given robustness and data issues. There is large uncertainty regarding the exact value of the elasticity for each country, due to various causes.([45]) Moreover, the elasticities empirically estimated by the OECD show a great deal of cross-country dispersion and take a value lower than unity for many countries, which cannot be easily justified. The only solid evidence, as confirmed by panel estimates by the IMF and the Commission, is that the elasticity of indirect tax revenue to base is not far from one for most countries over the medium run.([46]) An elasticity slightly higher than one was assumed for Italy (1.1), given the large size of IRAP – a particular form of taxation not found in other EU Member States, ii) its specific base and its idiosyncratic cyclical pattern - confirmed by empirical estimates.

ii. not to retain earnings-related transfers as an additional cyclical expenditure item, given the high dispersion in the empirical estimates across countries, which was not easily explicable. Moreover, there is no binding theoretical rationale justifying a marked cyclical pattern for this type of – fairly heterogeneous – expenditure (family benefits, housing benefits, in-work-benefits).

iii. to retain the unitary elasticity assumption for unemployment expenditures compared with the level of unemployment, given statistical issues affecting the indicators of unemployment benefits. Moreover, no strong theoretical rationale supports the idea that the development in unemployment benefits should deviate significantly from that of the number of unemployed people.

3.2. REVENUE AND EXPENDITURE ELASTICITIES WITH RESPECT TO THE OUTPUT GAP

The individual elasticities of revenue and expenditure categories with respect to the output gap, as estimated by the OECD, follow the economic expectation. Corporate income taxes are the most cyclical, because of the high correlation of profits to the fluctuation of economic activity Moreover, in cyclical through, the proportion of firms with no or negative profits increases and they do not pay any tax. Personal income tax is also very cyclical because of the progressive tax scale in most countries. By contrast, social security contributions are less cyclical than the business cycle, since the tax base (the wage bill) does not respond fully to economic fluctuations. The uniform elasticity of indirect taxation assumes that indirect taxation follows closely the economic fluctuation. Table II.3.2 shows the elasticity of individual revenue and expenditure categories with respect to the output gap for each country. It also displays its two components, namely: (i) the elasticity of individual revenue (expenditure) with respect to its base and (ii) the elasticity of the revenue (expenditure) base to the output gap. However, the relative size of individual revenue and expenditure elasticities exhibits some dispersion across Member States.

([45]) These reasons are, among others, the irregular development of asset markets, different cyclical developments in VAT and excise duties, the inability to measure compositional effects and dynamics in the CAB methodology and the only partial correction for discretionary measures (only those affecting the standard tax rates, not the tax base).

([46]) The first component has no reason to be altered by the change to ESA2010, since the tax revenue and the tax base are not significantly affected by the change in the statistical base. The second component may be marginally altered by the change in the output gap.

Table II.3.2: **Components of individual elasticities of revenue and expenditure categories with respect to the output gap ([47])**

	Revenue												Expenditure		
	Personal income tax			Corporate income tax			Social security contributions			Indirect taxes			Unemployment-related expenditure		
	Revenue-to-base elasticity	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Revenue-to-base elasticity*	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Revenue-to-base elasticity*	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Revenue-to-base elasticity*	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Expenditure-to-base elasticity*	*Base-to-output gap elasticity*	*Expenditure-to-output gap elasticity*
	a	*b*	*= a * b*	*c*	*d*	*= c * d*	*e*	*f*	*= e * f*	*g*	*h*	*= g * h*	*i*	*j*	*= i * j*
BE	1.62	0.81	1.31	1.62	1.53	2.48	1.15	0.61	0.71	1.00	1.00	1.00	1.00	-3.70	-3.70
BG	1.11	1.04	1.15	1.81	1.18	2.13	0.93	0.66	0.61	1.00	1.00	1.00	1.00	-3.91	-3.91
CZ	2.23	0.74	1.65	1.23	1.45	1.78	0.99	0.87	0.86	1.00	1.00	1.00	1.00	-2.45	-2.45
DK	1.43	0.70	1.00	2.07	1.52	3.15	0.70	0.59	0.41	1.00	1.00	1.00	1.00	-4.97	-4.97
DE	1.88	1.00	1.87	1.59	1.20	1.91	0.86	0.70	0.60	1.00	1.00	1.00	1.00	-3.30	-3.30
EE	1.46	1.08	1.58	1.81	0.99	1.78	1.36	1.03	1.40	1.00	1.00	1.00	1.00	-5.18	-5.18
IE	2.04	0.77	1.58	1.00	1.26	1.25	1.51	0.69	1.04	1.00	1.00	1.00	1.00	-5.45	-5.45
EL	2.21	1.00	2.22	1.81	1.05	1.90	0.84	0.69	0.58	1.00	1.00	1.00	1.00	-3.15	-3.15
ES	1.88	0.98	1.84	1.32	1.18	1.56	0.82	0.88	0.72	1.00	1.00	1.00	1.00	-5.83	-5.83
FR	1.68	1.11	1.86	2.03	1.36	2.76	0.95	0.66	0.63	1.00	1.00	1.00	1.00	-3.23	-3.23
HR	1.75	0.98	1.71	1.81	1.27	2.29	1.00	0.71	0.70	1.00	1.00	1.00	1.00	-2.39	-2.39
IT	1.85	0.79	1.46	2.09	1.47	3.07	0.97	0.60	0.58	1.10	1.00	1.10	1.00	-2.29	-2.29
CY	2.25	1.01	2.28	1.93	1.17	2.26	1.00	0.91	0.91	1.00	1.00	1.00	1.00	-3.08	-3.08
LV	1.31	1.14	1.50	1.89	1.05	1.99	1.00	0.81	0.81	1.00	1.00	1.00	1.00	-3.94	-3.94
LT	1.46	1.23	1.79	1.68	0.99	1.67	1.00	1.04	1.04	1.00	1.00	1.00	1.00	-5.60	-5.60
LU	2.24	0.60	1.34	1.81	1.30	2.36	0.89	0.44	0.39	1.00	1.00	1.00	1.00	-3.06	-3.06
HU	1.80	0.96	1.73	1.81	1.22	2.21	0.99	0.77	0.76	1.00	1.00	1.00	1.00	-1.25	-1.25
MT	2.11	0.98	2.07	1.81	1.17	2.11	0.92	0.76	0.71	1.00	1.00	1.00	1.00	-1.96	-1.96
NL	2.00	1.19	2.37	2.81	1.11	3.13	0.86	0.73	0.62	1.00	1.00	1.00	1.00	-5.76	-5.76
AT	1.97	0.84	1.66	1.90	1.44	2.74	0.92	0.70	0.65	1.00	1.00	1.00	1.00	-4.71	-4.71
PL	1.93	0.98	1.88	2.30	1.27	2.92	0.97	0.99	0.97	1.00	1.00	1.00	1.00	-6.18	-6.18
PT	2.15	0.91	1.97	1.07	1.24	1.33	1.00	0.79	0.79	1.00	1.00	1.00	1.00	-6.04	-6.04
RO	1.36	0.95	1.29	1.81	1.11	2.02	0.99	0.62	0.62	1.00	1.00	1.00	1.00	-3.91	-3.91
SI	2.14	0.76	1.63	2.72	1.38	3.76	1.00	0.66	0.66	1.00	1.00	1.00	1.00	-2.81	-2.81
SK	2.43	0.79	1.93	1.24	1.28	1.58	1.19	0.75	0.89	1.00	1.00	1.00	1.00	-2.98	-2.98
FI	1.48	0.95	1.41	1.63	1.25	2.03	1.00	0.77	0.77	1.00	1.00	1.00	1.00	-3.66	-3.66
SE	1.42	0.93	1.32	1.19	1.30	1.56	0.95	0.75	0.71	1.00	1.00	1.00	1.00	-4.42	-4.42
UK	1.49	1.12	1.68	2.89	1.35	3.92	1.20	0.50	0.60	1.00	1.00	1.00	1.00	-4.21	-4.21
EU-28	1.81	0.94	1.68	1.81	1.25	2.27	1.00	0.74	0.74	1.00	1.00	1.00	1.00	-3.91	-3.91

Source: Commission services

3.3. FISCAL SEMI-ELASTICITIES AND CYCLICALLY ADJUSTED BUDGET BALANCES

3.3.1. The fiscal semi-elasticities used in the cyclical adjustment

The fiscal semi-elasticity is the key cyclical-adjustment parameter to compute the CAB. Multiplying it with the time-varying value of the output gap provides the cyclical component of the budget balance (as percentage of potential GDP). It is derived from the value of individual revenue and expenditure elasticities and a set of weighting parameters. The elasticities of unemployment-related expenditure and of corporate income taxes are the largest in size. However, this does not necessarily imply that those revenue and expenditure categories are the main drivers of the fiscal semi-elasticities, since individual elasticities are weighted by the corresponding share of the individual revenue (expenditure) category in total revenue (expenditure) and by the corresponding revenue (expenditure) weights (in percentage of GDP) (see Box II.3.1). In this respect, the combined effect of the weighting parameters of unemployment-related expenditure and corporate income taxes are fairly modest, compared with the other items, especially indirect taxes and social security contributions.

Table II.3.3 shows the components of the semi-elasticity of the budget balance to the output gap, based on the methodology explained in Mourre *et al.* (2014). Fiscal semi-elasticities average out to 0.50 for the EU and range from 0.31 to 0.65 across Member States, suggesting significant differences in the cyclicality of the budget balance. For instance, the cyclical component of the budget balance corresponding to a 1% output gap would be around 0.6% of GDP in Belgium, Denmark and France, compared to half in Bulgaria and Romania (around 0.3% of GDP).

Looking at the sub-components, the average of the semi-elasticities for revenue is close to zero, ranging from -0.08 to 0.07, since revenue is almost as cyclical as GDP, except for non-tax revenue. Therefore, the revenue-to-GDP ratio can be expected to remain broadly constant in a normal business cycle, especially in Member States where non-tax revenue is relatively low. In contrast, the semi-elasticities for expenditure average out to -0.50, ranging from -0.38 to -0.62, which accounts for the larger part of the disparity in the fiscal

([47]) The revenue-to-base and the base-to-output gap elasticities related to non-tax revenues are omitted because they are assumed zero.

Table II.3.3: **Decomposition of the semi-elasticity of budget balance to output gap ([48])**

	Elasticity of:				Weights (% of GDP) of:		Semi-elasticity for:		
	Revenue level	Expenditure level	Revenue-to-GDP ratio	Expenditure-to-GDP ratio	Total revenue	Total expenditure	Revenue	Expenditure	Budget balance
	(a)	*(b)*	*c = a-1*	*d = b-1*	*(e)*	*(f)*	*g = c*e*	*h = d*f*	*i = g-h*
BE	1.03	-0.17	0.03	-1.17	49.05	50.70	0.01	-0.59	0.61
BG	0.78	-0.03	-0.22	-1.03	37.75	38.10	-0.08	-0.39	0.31
CZ	0.97	-0.02	-0.03	-1.02	39.91	43.77	-0.01	-0.45	0.43
DK	1.00	-0.14	0.00	-1.14	55.75	54.34	0.00	-0.62	0.62
DE	0.98	-0.21	-0.02	-1.21	44.00	46.45	-0.01	-0.56	0.55
EE	1.10	-0.10	0.10	-1.10	37.63	36.99	0.04	-0.41	0.44
IE	1.05	-0.24	0.05	-1.24	35.20	41.14	0.02	-0.51	0.53
EL	0.94	-0.05	-0.06	-1.05	39.93	48.06	-0.02	-0.51	0.48
ES	1.03	-0.28	0.03	-1.28	38.14	41.13	0.01	-0.53	0.54
FR	1.00	-0.11	0.00	-1.11	49.90	54.11	0.00	-0.60	0.60
HR	0.97	-0.02	-0.03	-1.02	40.48	46.96	-0.01	-0.48	0.47
IT	1.08	-0.03	0.08	-1.03	45.14	48.77	0.04	-0.50	0.54
CY	1.18	-0.04	0.18	-1.04	40.27	43.47	0.07	-0.45	0.52
LV	0.92	-0.07	-0.08	-1.07	35.08	38.26	-0.03	-0.41	0.38
LT	1.07	-0.08	0.07	-1.08	32.92	36.13	0.02	-0.39	0.41
LU	1.01	-0.08	0.01	-1.08	41.87	41.09	0.00	-0.44	0.44
HU	0.96	-0.01	-0.04	-1.01	44.97	50.33	-0.02	-0.51	0.49
MT	1.02	-0.03	0.02	-1.03	39.48	43.74	0.01	-0.45	0.46
NL	1.15	-0.22	0.15	-1.22	45.25	47.37	0.07	-0.58	0.65
AT	1.02	-0.12	0.02	-1.12	48.49	50.77	0.01	-0.57	0.58
PL	1.07	-0.13	0.07	-1.13	38.78	43.79	0.03	-0.49	0.52
PT	0.95	-0.13	-0.05	-1.13	41.08	46.42	-0.02	-0.53	0.51
RO	0.86	-0.04	-0.14	-1.04	32.97	36.78	-0.05	-0.38	0.34
SI	0.99	-0.04	-0.01	-1.04	43.46	46.49	-0.01	-0.48	0.48
SK	0.99	-0.03	-0.01	-1.03	34.23	38.62	0.00	-0.40	0.39
FI	0.94	-0.18	-0.06	-1.18	53.13	51.08	-0.03	-0.60	0.57
SE	0.96	-0.15	-0.04	-1.15	53.99	53.13	-0.02	-0.61	0.59
UK	1.30	-0.03	0.30	-1.03	40.36	45.60	0.12	-0.47	0.59

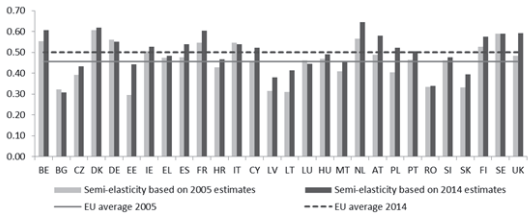
Source: Commission services

semi-elasticity across Member States. Its value broadly corresponds to the share of total expenditure in GDP. This mirrors the fact that the elasticity of expenditure to the output gap is close to zero (given that the only expenditure item expected to move with the business cycle is unemployment-related expenditure and its share in total expenditure is small). In turn, this means that the expenditure-to-GDP ratio can be expected to change in almost exact proportion as the output gap.

As regards the revision of the budgetary semi-elasticities compared to those based on the 2005 elasticities, two groups of Member States can be identified. For one group of Member States, the revision of the budgetary semi-elasticity was close to marginal, i.e. of 0.02 or less in absolute terms. As seen on Graph II.3.1, this group comprises 11 countries (Bulgaria, Denmark, Germany, Ireland, Greece, Italy, Luxembourg, Hungary, Romania,

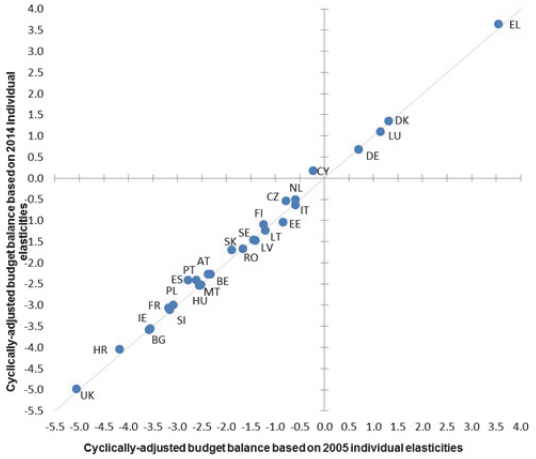
([48]) Parameter (a) is a weighted average of the revenue elasticities. Parameter (b) is a weighted average of the expenditure elasticity. The total revenue and expenditure as a percentage of GDP (columns e and f) correspond to the "Excessive Imbalance Procedure" definition. Further details on the methodology are found in Mourre et al. (2013).

Graph II.3.1: **Semi-elasticities based on 2005 and 2014 individual elasticities**



Source: Commission services

Graph II.3.2: **Cyclically-adjusted budget balance in 2014 before and after revision**



Source: Commission services

Slovenia and Sweden). For most of these countries (except Bulgaria, Germany, Italy and Luxembourg), the budgetary semi-elasticities are slightly higher than those based on the 2005 individual elasticities.

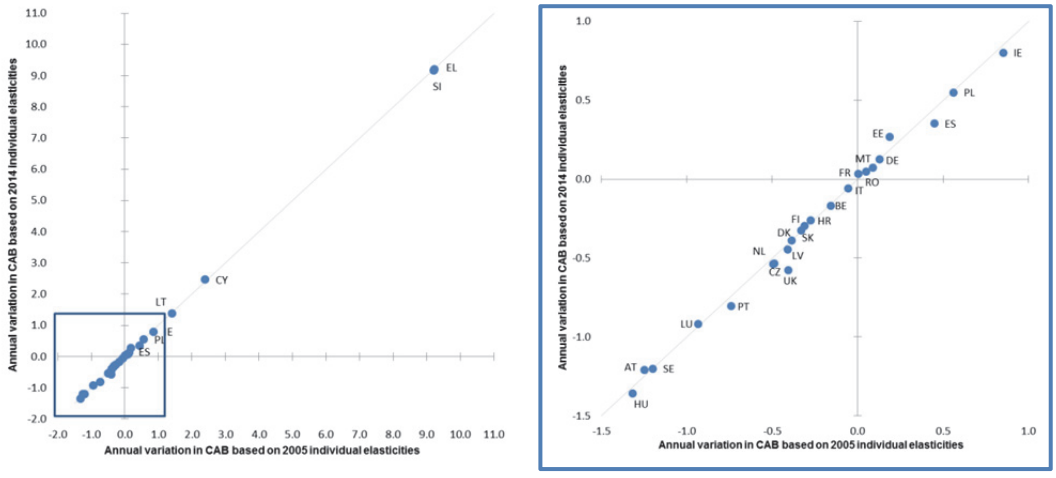
For the other - larger - group of Member States, the budgetary semi-elasticity has been revised upward, indicating a stronger cyclicality of the budget balance. This group comprises 17 countries (Belgium, the Czech Republic, Estonia, Spain, France, Croatia, Cyprus, Latvia, Lithuania, Malta, the Netherlands, Austria, Poland, Portugal, Slovakia, Finland and the United Kingdom), as shown in Graph II.3.1.

For all of them, the revised budgetary semi-elasticities are - by at least 0.03 - higher than those based on the 2005 individual elasticities. For most of these countries (except Estonia, Lithuania, Poland and the United Kingdom) the revision of the semi-elasticity does not exceed 0.1. In none of these countries the revision exceeds 0.15.

3.3.2. Cyclically-adjusted budget balances

As the CAB (minus one-offs and temporary measures) is the concept used to measure the adjustment of the structural balance towards the medium term objective, it plays a crucial role in

Graph II.3.3: **Annual variation of the cyclically-adjusted budget balance in 2014 before and after revision**



Source: Commission services

Box II.3.1: **Computing semi-elasticities based on individual revenue and expenditure elasticities**

The cyclically adjusted budget balance corresponds to the deficit/surplus ratio that would prevail if the economy was running at potential (see Mourre et al., 2013). It is computed as the difference between the actual balance (as a percentage of GDP) and an estimated cyclical component.

$$CAB_t = \frac{(R_t - G_t)}{Y_t} - \varepsilon \cdot OG_t$$

where R and G stand for the government revenue and expenditure (nominal) respectively and Y for nominal GDP. The cyclical component of the budget is the product of the output gap (OG) and the semi-elasticity (ε) of the balance-to-GDP ratio with respect to the output gap.

The semi-elasticity ε corresponds to the cyclical adjustment parameter of the budget balance and is assumed to be constant. It is computed as the difference between the semi-elasticity of revenue and the semi-elasticity of expenditure, which can themselves be easily derived from the (constant) revenue and expenditure elasticity with respect to the output gap. The semi-elasticity could be expressed mathematically as:

$$\varepsilon = \frac{d(\frac{B}{Y})}{\frac{dY}{Y}} = \frac{d(\frac{R}{Y})}{\frac{dY}{Y}} - \frac{d(\frac{G}{Y})}{\frac{dY}{Y}} = \left(\frac{\frac{dR}{R}}{\frac{dY}{Y}} - 1\right)\frac{R}{Y} - \left(\frac{\frac{dG}{G}}{\frac{dY}{Y}} - 1\right)\frac{G}{Y} = (\eta_R - 1)\frac{R}{Y} - (\eta_G - 1)\frac{G}{Y}$$

where η_R and η_G denote respectively the revenue and expenditure elasticity with respect to the output gap. The CAB methodology assumes that revenues are fully cyclical, while on the expenditure side only unemployment related benefits are cyclically driven.

On the revenue side, the elasticities of individual revenue items to the output gap are estimated by the OECD (personal income taxes, corporate income taxes, indirect taxes, social security contributions, non-tax revenue). They correspond to the percentage change in a particular type of revenue associated with a percentage change in output. They are then aggregated using the share of each in total revenue as weights, so as to derive the elasticity of total revenue level (in monetary amount) with respect to output. Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the revenue-to-GDP ratio with respect to output. Multiplying the latter with the size of total revenue as a share of GDP yields the value of the semi-elasticity of revenue.

On the expenditure side, the OECD elasticity of unemployment-related expenditure is used and weighted with the share of unemployment-related expenditure in total expenditure (based on Eurostat data). Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the expenditure-to-GDP ratio with respect to output. Multiplying the latter with the size of total public spending as a share of GDP yields the value of the semi-elasticity of expenditure.

The overall budgetary semi-elasticity ε, can be rewritten as:

$$\varepsilon = \varepsilon_R - \varepsilon_G = (\eta_R - 1)\frac{R}{Y} - (\eta_G - 1)\frac{G}{Y} = (\sum_{i=1}^{5}\eta_{Ri}\frac{Ri}{R} - 1)\frac{R}{Y} - (\eta_{G_U}\frac{G_U}{G} - 1)\frac{G}{Y}$$

Therefore, the necessary components to perform the calculation are the individual elasticities of five revenue categories and of unemployment expenditure with respect to the output gap (η_{Ri} and η_{G_U}) and the fixed weighting parameters (the shares of the individual revenue categories in total revenue R_i/R, the share of the unemployment-related expenditure to total expenditureG_U/G, as well as the weights of total revenue (expenditure) of general government as a percentage of GDP, R/Y and G/Y respectively).The weighting parameters (shares of individual revenue and spending categories, revenue/expenditure-to-GDP ratio) are

(Continued on the next page)

Box (continued)

those set in 2013 during the first tier of revision and are to be updated every six years to reflect changes in the government receipts and spending. ([1])

([1]) However, the Commission corrected an inaccuracy in the computation of the shares of revenue categories (% of total revenues). It concerns a limited number of countries (Cyprus, Latvia, Lithuania, Luxembourg, Malta and Romania), for which the AMECO database was used as OECD data were not available. The revenue shares for these countries were only slightly affected by the correction. The individual elasticities are those updated by the OECD in 2014.

the EU framework of fiscal surveillance. Multiplying the fiscal semi-elasticity with the output gap gives the cyclical component, which is removed from the nominal budget balance to obtain the value of the cyclically adjust the budget balance (CAB) (see Box II.3.1).

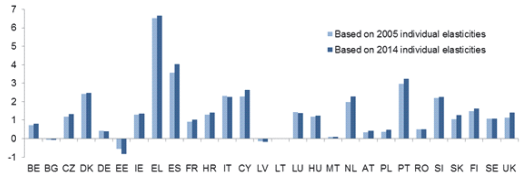
The revision of the individual elasticities had a fairly limited impact on the level of the CAB on average and in most countries for most years. Graph II.3.2 illustrates for the current year 2014 and in an optically intuitive way that the level of the CAB is only marginally affected by the revision of individual elasticities. This is shown graphically by the fact that most countries are very close to the 45 degree line. For specific countries in specific years, however, the revision of the cyclical components can be non-negligible.

The impact of the revision on the annual variation in the CAB is even smaller than the impact on the level of the CAB, as shown in Graph II.3.3 compared with Graph II.3.2.

However, as for the level, there is some non-negligible revision in some countries in 2014.Graph II.3.4a and 4b illustrate the underlying reason: the revision in the cyclical components of the budget balance, induced by the revision in the semi-elasticity, has been fairly limited in 2013 and 2014. The two graphs also suggest that, for most countries except Bulgaria, Germany, Italy and Luxembourg, the budget balance is slightly more responsive to the business cycle.

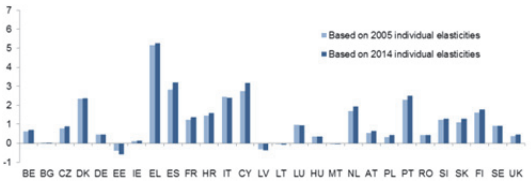
For specific countries in specific years, however, the revision of the cyclical components can be non-negligible. For 2013 (mostly non-forecast data), the largest revisions are observed for Spain, Cyprus, Estonia, the Netherlands and the United Kingdom. For 2014 (partly forecast), the largest revisions are observed for Cyprus and Spain. This corresponds, by definition, to the mirror image of the CAB in these countries for these years.

Graph II.3.4a: **Cyclical components of the budget balance in 2013**



Source: Commission services

Graph II.3.4b: **Cyclical components of the budget balance in 2014 (based on Commission 2014 Spring Forecast)**



Source: Commission services

4. THE CHANGE TO ESA2010

The Stability and Growth Pact is based on fiscal aggregates and economic data that are standardised across Member States. Given the importance of ensuring that the definitions of the general government deficit and gross debt enable the comparability and aggregation of economic data in the EU, these definitions are rooted in a series of legislative acts. This legal basis contains two tiers. The first tier is the European System of National and Regional accounts (ESA), ([49]) which is an internationally compatible accounting framework for a systematic and detailed description of a total economy, including the general government sector. Using the common framework ensures the comparability across Member States of key components of aggregates used in fiscal surveillance, i.e. government deficit and debt, and GDP.

The second tier of legislation sets out some specific provisions for the EDP statistics. In particular Regulation 479/2009, as amended, ([50]) stipulates the way how the ESA-based actual government deficit and debt data are reported by Member States and assessed by Eurostat for the EDP purposes. The Regulation notably defines government debt for EDP purposes as the total gross debt at nominal value outstanding at the end of the year of the sector of 'general government'.

The recording of national statistics is not static but is – and will always be – subject to changes and improvements. At the time of the entry into force of the Stability and Growth Pact in 1997, the 1995 version of the European System of Accounts was in force, known as ESA 95. In May 2013, a new version of national accounts (ESA 2010) was adopted by the European Parliament and the Council. This new version of the first tier of legislation applies to all data transmissions from September 2014, covering also historical time series. The second tier of legislation has also correspondingly been amended to base EDP statistics on the new system of accounts, so that the EDP deficit and debt data from September 2014 are also based on ESA 2010 instead of ESA 95. ([51])

The changes from ESA 95 to ESA 2010 have an impact on EDP statistics and these in turn may in theory affect the assessments made under the Stability and Growth Pact. This chapter explains the changes to the EDP statistics (section 4.1) and discusses the implications on the SGP (section 4.2).

4.1. CHANGES TO GOVERNMENT BUDGET BALANCE AND DEBT STEMMING FROM ESA 2010.

The introduction of ESA 2010 has resulted in revisions to governments' budget balance and debt levels, as well as to the level of GDP. The current chapter mostly concentrates on changes that affected general government's balance and debt (numerator). However, changes to the denominator (GDP) also play an important role in evolution of the ratios used for budgetary surveillance.

As outlined in the Eurostat's News Release of 17 October 2014, ([52]) the level of GDP in 2010 was revised up by 3.7% for the EU as a whole. Of this total impact, methodological changes due to the introduction of ESA 2010 resulted in an upward revision by 2.3 percentage points (pp) and other statistical improvements in an upward revision by 1.4 pp. The single most important factor among methodological changes is capitalisation of research and development, which caused an upward revision of 1.9 pp for the EU as a whole. The overall impact and its breakdown, however, vary quite noticeably among Member States.

The most common reason for revising absolute levels of governments' budget balance and debt is the reclassification of units from the non-financial

([49]) Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union, OJ L 174, 26.6.2013.

([50]) Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, OJ L 145, 10.6.2009.

([51]) Commission Regulation (EU) No 220/2014 of 7 March 2014 amending Council Regulation (EC) No 479/2009 as regards references to the European system of national and regional accounts in the European Union, OJ L 69, 8.3.2014

([52]) http://ec.europa.eu/eurostat/documents/2995521/5181746/2-17102014-BP-EN.PDF/1137702e-9583-46d7-8937-4c5441cd7c85

and financial corporations sector to the general government sector. The fundamental rules for the delimitation of the general government have not changed between ESA 95 and ESA 2010: under both systems, a unit is classified inside general government if (1) it is an institutional unit, (2) it is controlled by government and (3) it is a non-market unit. However, ESA 2010 introduces more detailed criteria for determining the notion of control, as well as qualitative criteria for distinguishing between market and non-market units. The latter step continues being supported by the quantitative "50% test", which determines whether prices are economically significant ([53]). In addition, according to ESA 2010, the government sector may include some specific government controlled entities for which the market/non-market test is not relevant (for example public holdings, public financial defeasance structures and units with the features of captive financial institutions controlled by government). Units reclassified inside (or in a few cases outside) general government as a result of these more precise criteria include public hospitals and schools, oil stockholding agencies, public transport companies, financial defeasance structures (i.e. 'bad banks'), deposit guarantee schemes, public banks, public holdings, etc.

The impact from sector reclassifications to net lending / borrowing of the general government can be positive or negative in any given year. Approximately two-thirds of Member States were affected only marginally by this change, while most notable revisions were observed in Lithuania (mainly due to reclassification of the deposit guarantee entity), in Ireland and Latvia (mainly due to reclassification of defeasance structures), in United Kingdom and Slovakia (mainly due to reclassification of public transportation companies and highways) and in Portugal and Austria (due to reclassification of a number of units in different areas). Except in the cases of Lithuania in 2011, Ireland in 2013 and Slovakia in 2011, the impact of sector classification did not exceed 0.5 pp of GDP. ([54])

On the contrary, the inclusion of units into the general government had quite pronounced effects on the level of government gross debt in some Member States. This was the only methodological change influencing government debt in absolute terms and the impact was most noticeable in 2013 in Croatia (+9.0 pp), Austria (+8.7 pp), Ireland (+7.2 pp), Belgium (+4.9 pp) and Portugal (+3.5 pp), while for earlier years the impact of revisions was particularly pronounced in case of Austria and Ireland.

The new sector classification rules also resulted in larger government sector; however, reclassification was not the only reason influencing the levels of total revenue and expenditure.([55]) The most noticeable increases in the absolute levels of total revenue and expenditure of the general government (both due to ESA 2010 and other reasons) were recorded in 2013 in Slovakia and Portugal (around 3 pp of GDP).

In the majority of Member States the denominator effect had, however, more profound impact on the ratios of government's gross debt, total revenue and total expenditure to GDP. This reflects the fact that the main reason for GDP's upward revisions is capitalisation of private sector's research and development, which thereby adds to private sector's output and increases its relative share in the economy (expenditure on research and development by government was already included in GDP under ESA 95 due to the way government's output is measured). As a result of this combined impact from revisions to the denominator and numerator, the debt-to-GDP ratio for 2013 declined at the EU level from 87.1% in the April 2014 EDP notification to 85.4% in

([53]) Prices are deemed economically significant if revenue from sales covers a majority (at least 50%) of production costs; the latter include under ESA 2010 also the net interest charge.

([54]) For more details on data revisions in individual Member States in 2010-2013 see: http://ec.europa.eu/eurostat/documents/1015035/2022675/Revisions-gov-deficit-debt-2010-2013.pdf/e1fb4083-c18a-4f69-9dbc-138fb73ad9a5

([55]) Other reasons include recording of payable tax credits on gross rather than net basis and treatment of VAT that forms part of EU own resources; the latter was previously shown as being paid directly to the EU, whereas under ESA 2010 both revenue and expenditure components are recorded in government's accounts.

October, with similar developments in the share of total revenue (which went down from 45.7% to 45.3%) and total expenditure (which decreased from 49.1% to 48.5%).

Other methodological changes listed below only affected general government's balance.

Some Member States' governments have in recent years taken over pension obligations of non-government units; usually this is also accompanied by a transfer of 'lump sum' payments relating to the assets of the pension schemes from these units to general government. Some recent examples include transfers of assets and obligations of public or private companies, as well as assets and obligations of economy-wide funded pension schemes. Under ESA 95 this transfer of assets had a positive impact on government's balance, while transfer of pension liabilities did not affect government's finances immediately due to their contingent nature. According to ESA 2010, this prepayment of assets is treated as a financial transaction and therefore does not affect government's balance. This prepayment is gradually 'used up' as revenue, offsetting payment of pensions; the management of the transferred scheme thus remains neutral for government's balance until the extinction of assets and liabilities. When the value of transferred assets is not fully covering the value of liabilities, the difference is recorded at inception with a negative impact on government's balance. The changes in recording of 'lump sum' payments had very pronounced deficit-increasing impact for the years when assets were transferred (notably in Hungary in 2011, with balance worsening by 9.6 pp of GDP) and gradual positive impacts in subsequent years. Other Member States where this methodological change had significant effects are Portugal, Ireland and the United Kingdom.

The treatment of interest payments resulting from swap arrangements and forward rate agreements (FRAs) changed with the introduction of ESA 2010. More precisely, payments resulting from swaps and FRAs were used for the calculation of interest payments under EDP reporting, whereas according to ESA methodology they are treated as financial transactions and thus do not affect net lending / borrowing. With the introduction of ESA 2010 this special treatment applied in the EDP reporting is discontinued and the concepts of net lending / borrowing under ESA and EDP are aligned. For the majority of Member States this resulted in only marginal revisions, with the impact being more noticeable for recent years in Finland, Sweden, Denmark, Italy, Ireland and Hungary.

In addition to these main categories, some Member States' government balances are affected by the following methodological changes in ESA 2010:

- tax credits that constitute a non-contingent liability of government are now treated as expenditure instead of reduction of tax revenue and recorded at the moment when government recognises the obligation to pay;

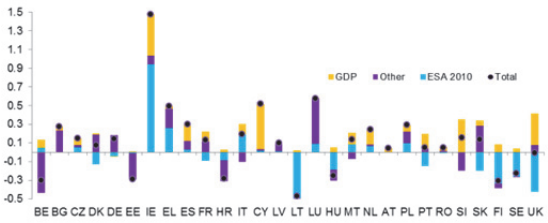
- licences (including mobile phone licences) and permits that cannot be transferred to a third party without government's permission and/or have to be kept until extinction are now recorded as rents spread over time until the extinction of the licence, instead of having an impact in the year of their allocation;

- standardised guarantees granted by government (typically on student loans and export credit) give now rise to the recording of a financial liability that reflects the probability of the guarantee being called. The counterpart of this liability is a non-financial transaction impacting government deficit in case government charges no fees (or if the fees charged by government are far from covering the total cost of the scheme). If the fees charged by government cover the total cost of the scheme, the counterpart of the liability is a financial transaction with no impact on government deficit.

Overall, these other changes due to the introduction of ESA 2010 have resulted in only modest revisions for recent years, affecting in particular Malta, United Kingdom, France, Greece, Sweden and Italy; impacts do not exceed 0.5 pp of GDP.

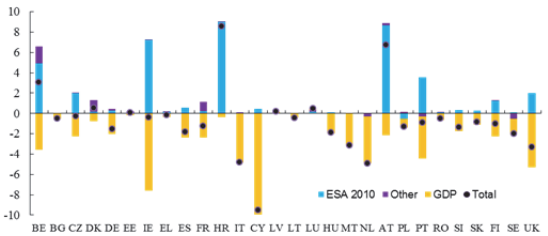
In addition to changes induced by ESA 2010, several Member States have taken the opportunity to implement other statistical improvements by switching to new data sources and methods and sometimes changing the treatment of some transactions. These changes unrelated to ESA 2010 are most common for 2013, as more comprehensive information became available since the finalisation of the spring 2014 notification. Graphs II.4.1 and II.4.2 disentangle the changes in the budget balance and debt ratios attributable to ESA 2010 and changes attributable to other statistical improvements.

Graph II.4.1: **Revisions to the budget balance-to-GDP ratio in 2013 (% GDP)**



Source: Eurostat

Graph II.4.2: **Revisions to the government debt-to-GDP ratio in 2013 (% GDP)**



Source: Eurostat

4.2. THE IMPACT ON THE SGP

With the switch to ESA 2010 in September 2014 data under the ESA 95 definitions ceased to be compiled and updated. Therefore all future SGP related assessments will, by definition, be based on the ESA 2010 data in line with legal requirements.

The changes in the fiscal aggregates due to the switch to ESA 2010 can in principle have implications for the assessments made under the SGP through the impact that they have on the deficit and debt levels, either directly or due to the impact of the changes in GDP which affect the variables as a share of GDP. These aggregates have a direct impact on the operation of the corrective arm of the SGP, while the debt may also have an indirect effect on the preventive arm, as different adjustment paces are required from Member States depending on their debt levels in order to respect the debt rule.

In addition, any change in the deficit can also affect the structural balance, which is a key variable in both the preventive arm of the SGP and in the assessment of the response to the EDP recommendations. It should however be noted that possible impacts of ESA 2010 on the assessment of compliance with EDP recommendations will be restricted to the years remaining until currently opened EDPs are abrogated. In fact, any impact on the assessment of compliance would stem from the fact that current EDP recommendations were issued on the basis of ESA 95 but the assessment will be conducted according to ESA 2010 data. It should also be born in mind that the change to ESA 2010 coincides with technical adjustments in the computation of the cyclically-adjusted balance as detailed in Chapter 3 above, a revision of the methodology for the computation of output gaps and other statistical adjustments operate at national level.

In any case, the SGP contains enough flexibility to take account of the impact of methodological changes, including the switch to ESA 2010, and avoid that countries face negative assessments as a result of the switch. The impact of the changeover to ESA 2010 and other statistical revisions on both deficit and debt figures have already been taken into account in the assessment of the 2015 Draft Budgetary Plans (the impact of the switch to ESA2010 was most significant in the case of France, Ireland, Italy, Portugal and Finland). In particular, statistical revisions have been dealt with in qualitative terms and, where feasible, also in quantitative terms in the staff working documents accompanying the Commission's Opinions, whenever their impact affected the main variables used for the assessment of compliance with the SGP. Other statistical changes have been explicitly

mentioned for Estonia, Latvia and Slovenia. In other cases, the impact was not significant and/or would not have changed the assessment. The way this flexibility operates in both arms of the SGP is summarised below.

4.2.1. The corrective arm of the SGP

The levels of the government deficit and debt primarily affect the opening of EDPs. However, an EDP is not automatically launched as a result of the government deficit breaching the 3% threshold or the debt breaching the 60% threshold. Instead, according to the SGP, the Commission should write a report considering first, whether the excess over the relevant threshold is 'close and temporary' and, second, any other relevant factors. Only if the Commission's report concludes that the threshold breach is excessive, will an EDP be launched. Any impact of the switch to ESA 2010 on the government deficit and debt is therefore identifiable before the opening of an EDP.

For Member States already in EDP the change in the structural balance provides the key reference for the assessment of effective action, as it is the starting point for measuring the fiscal effort undertaken by the concerned Member State. Any level change in the structural balance would have no impact in terms of the assessment of effective action under the EDP, as it is the change in the structural balance that is the variable of interest. Furthermore, the assessment of effective action under the EDP is considered by looking at both the (corrected) change in the structural balance and the bottom-up fiscal effort within the context of a careful analysis. Therefore, there is scope to consider the impact of the change to ESA 2010 before any assessment is finalised.

4.2.2. The preventive arm of the SGP

Under the preventive arm the assessment of compliance with the MTO and the adjustment path towards it is based on the structural balance and complemented by the expenditure benchmark. Any conclusion of the preventive arm is based on an overall assessment that looks at both these pillars in detail to determine on whether government policy was in line with the requirements. Therefore, the overall assessment will allow an evaluation of the contribution of the change to ESA 2010 to possible breaches in any of the two pillars, where data are available.

The actual level of the structural balance also plays a role on the preventive arm, in determining whether a country is at its MTO and, if not, how far it has to adjust towards it. A change in the level of the structural balance therefore changes the position of a Member State with respect to its MTO. While this has an effect in terms of the distance to the MTO, it does not have a retrospective or in-year impact. As the requirements for the adjustment path to the MTO for any given year are specified in the spring of the previous year, changes due to ESA 2010 will first be applicable to the adjustment required in 2016. Member States will therefore not be faced with unforeseen surprises.

5. INDEPENDENT FISCAL INSTITUTIONS ACROSS THE EU

Having separate bodies (or 'agencies') from the government that engage in tasks previously carried out by government services is not new. The concept applies to entities that are highly disparate in terms of their missions (e.g., regulating a sector of economic activity, delivering public services, counselling the government, promoting citizen participation, etc.), rationales, and institutional designs. At the national level a growing number of independent administrative entities have been established in many countries (US agencies, Non-Departmental Public Bodies in the United Kingdom, *Autorités Administratives Indépendantes* in France, *Autorità Amministrativa Indipendente* in Italy) with provisions of varying legal force aimed at ensuring their autonomy. These entities are usually accorded a discretionary power regarding the use of the resources granted to them. Nevertheless, the exercise of this power is framed by various standards or conventions established by the delegating power or specific to the administrative culture of the respective countries.

The recent years have witnessed the gradual rise of Independent Fiscal Institutions (IFIs) in fiscal policy-making and budgetary processes. Such institutions have existed for a long time in some countries. They include the Central Planning Bureau in the Netherlands, the Economic Council in Denmark, the Congressional Budget Office in the US and the High Council of Finance in Belgium. Recently, similar institutions have been created in Sweden, Hungary, Canada, Slovenia and the UK, to name a few. They are often labelled 'fiscal councils'. Within the emerging concept of budgetary framework, IFIs, at the crossroads of structural and fiscal policies, have been identified as one promising area for research and reform. A decisive impetus for the rise of independent fiscal institutions derives from recent legislative developments at the EU level, where requirements in relation to their status, tasks and structure were enshrined in legislation. Concise initial references to them have been gradually followed by more detailed and prescriptive provisions.

In this section, we will examine in turn the rationale for the introduction of such institutions in Section 5.1; the evolving legal underpinnings for the development of such institutions in the EU and euro area in Section 5.2, and finally some descriptive elements of the IFI universe and first lessons from their establishment in Section 5.3.

5.1. RATIONALE FOR INTRODUCTION

The emergence of such actors as Independent Fiscal Institutions in the budgetary area necessarily raises questions on the relevance, scope and instruments at their disposal.

5.1.1. Non-partisan input in fiscal policy-making

As regards economic policies independent institutions ventured first in the field of monetary policy. The need for time-consistency, in reaction to monetary stimulus -labelled fine-tuning in the sixties and seventies but linked to the political cycle- justified the recourse to independent institutions for the management of monetary policies throughout the world. In contrast with a government's tendency to abandon previously announced policy commitments (Kydland and Prescott, 1977), independent central banks were deemed to have escaped the time-inconsistency problem. Their expert leadership would then use the instruments of monetary policy at their discretion to reach their mandate-based objectives, with ex post accountability to Parliament and the public at large.

Fiscal policy was also identified in the literature as suffering from shortcomings including, but not only, time inconsistency. Calmfors (2010) reviews the various explanations leading to excessive debt accumulation. They range from an insufficient understanding of the long-run constraints on fiscal policy, rent-seeking behaviour from various constituencies, short-sightedness as too little weight is attached to the future (i.e. decision-makers have higher discount rates than citizens) or common pool issues.

While the first response to time-inconsistency took the form of fiscal rules, fiscal institutions were suggested as an alternative. Wyplosz (2005) grounded its support for fiscal institutions on the perceived weaknesses of fiscal rules designed to provide a numerical yardstick to fiscal policies on the path to sustainability. For fiscal rules to be effective and enforced, they should be stringent

and of a rigid nature. Yet there were too many uncertainties surrounding the setting of the numerical parameters which defined the essence of what a fiscal rule was. Foregoing discretion and constraining fiscal policy using rules on annual budget balance may cause welfare losses. Against that background, independent fiscal institutions were to be invested with a more intrusive mandate in fiscal policies, granting them powers equivalent to fiscal authorities. Therefore Wyplosz advocated having recourse to the '*radical*' idea of creating national Fiscal Policy Committees (FPC) composed of unelected experts with the authority to decide on the budget balance on the basis of an explicit growth forecast. As second best he advocated a softer approach having recourse to independent advisory bodies but only as an intermediate step towards full empowerment.

Yet the alleged ineffectiveness of fiscal rules was challenged by a substantial body of evidence (for instance Debrun et al. (2008)) that documented a robust link between numerical fiscal rules and fiscal performance. Stronger and more encompassing fiscal rules tended to encourage higher cyclically-adjusted primary balances, after taking into account other factors potentially affecting fiscal behaviour. What seemed to matter more for the effectiveness of fiscal policy is the type and design of rules. Against this background, the involvement of an independent institution did not stand in confrontation or substitution to fiscal rules, but rather in tandem with them.

5.1.2. Limits to fiscal policy delegation

Using economic concepts, Alesina and Tabellini (2004) look for the various parameters that may cause government to manage in-house economic policies or delegate them to non-elected individuals. They define a number of features that provide for a more efficient division of tasks between government policies and management by non-elected experts.

Table II.5.1: **Profiles and functions in fiscal policy-making**

Political leadership	*Non-political leadership*
Unclear/Switching objectives	Clear/Stable objectives
Soft skills	Technical skills
Time consistency is not important	Time consistency is important
Comprehensive approach needed (trade-off among separate policies)	Sector-specific issues
Redistributive aspects at stake	Neutral in terms of redistribution

Source: Alesina and Tabellini (2004)

Due to its overarching position, political leadership often makes trade-offs across policy streams that are sometimes loosely related. Objectives for one policy might be traded for progress in other areas considered more important. These trade-offs are usually not available to the leadership of single-purpose agencies. Another difference is that political leadership can provide compensation for losers from public policies or reforms (in particular in economic good times). This would not normally be envisaged by leadership tied to the fulfilment of a single objective or mandate. Conversely, the provision of time-consistent, well-targeted policy output against stable uncontroversial objectives may be left to non-political leadership.

Delegating decision-making powers in the fiscal field in the same conditions as monetary policy would represent a considerable break in existing practices as fiscal policies encompass a significant distributive component. To quote Alesina and Tabellini (2004): *'Politicians instead are better if the policy has far reaching redistributive implications, if criteria of aggregate efficiency do not easily pin down the optimal policy, and if there are interactions across different policy domains (so that a single measure of performance is affected by several policy instruments and policy packaging is important*)'.

5.1.3. Terms for a pragmatic involvement of IFIs as 'accountability-multiplier'

While investing IFIs with decision-making powers has been considered incompatible with the basic tenets of fiscal policy-making, room nevertheless exists for their involvement as advisory bodies, i.e bodies which could issue non-binding opinions over a broad range of fiscal issues. Such tasks do not necessarily collide with tasks of National Parliaments, which routinely ensure budgetary oversight. According to the principal-agent theory, in order to enforce the contract linking two parties with appropriate incentives and sanctions, information about the way the agent accomplishes his task is critical. Acquiring decision-relevant fiscal information is costly and time-consuming. Another constraint is that feedback about the quality of economic policy decisions may be slow, so only durable institutions would be able to collect and make sense of information that becomes available gradually. Even if information is available, specialised skills are necessary to

make the most of it and these skills may not be present in sufficient numbers in the staff of national Parliaments. Parliaments may then benefit from the IFI deliverables when making governments accountable.

IFIs can use three channels to exert influence. A first one is linked to the impact of its policy deliverables on fiscal authorities (direct impact). Second, if IFIs benefit from sufficient credibility, the possibility of their intervention may induce the government to adjust preventively its policies for fear of receiving public criticism (implicit impact). Third, IFIs are likely to enhance scrutiny from existing checks and balances embedded into the budgetary process (Parliament, Constitutional Courts, Court of auditors, EU authorities, and eventually the public at large). This indirect impact should not be underestimated, at least potentially.

Table II.5.2: **IFI Channels of influence**

Deliverables under policy mandate	→ Direct impact on fiscal authorities
Potential for deliverables under policy mandate	→ Implicit impact on fiscal authorities
Recycling of deliverables through other stakeholders	→ Indirect impact on fiscal authorities (*'accountability-multiplier'*)

Source: Commission services

In that sense, IFIs could be considered an 'accountability-multiplier'. The IFI deliverables may convey messages that may be taken on board by a wide range of stakeholders, as depicted in Graph II.5.1. As a result:

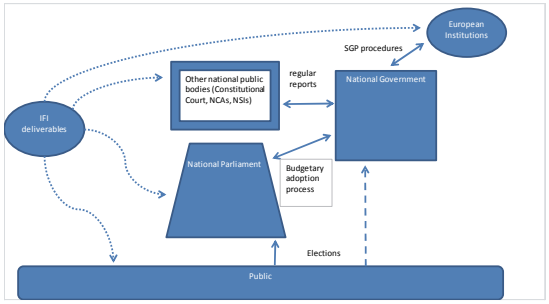
• The public would benefit from additional information;

• National Parliaments may find IFI deliverables useful to discharge their budgetary oversight;

• Public bodies mainly focused on legal compliance matters, such as Constitutional courts or courts of auditors may draw on economic information to better ground their own assessments;

• EU bodies may draw on policy deliverables to feed into fiscal surveillance.

Graph II.5.1: **The indirect impact of IFI as accountability-multiplier in a national context**



Source: Commission services

Existing accountability processes can capitalise on IFI deliverables to improve their general effectiveness. Governments themselves may use policy messages from IFIs. When budgets are prepared, timely IFI opinions may reinforce the authority of the Ministry of Finance over line Ministries, mitigating common-pool issues. In more fragmented political systems such as federal states, IFI recommendations could provide terms for a compromise between different layers of government.

Also, the public nature of assessments from an advisory body raises the stakes; it increases the costs of policy errors on both sides and the credibility losses that derive from them. Faced with uncertainty both fiscal authorities and IFIs may consider it safer to engage in cooperation rather than confrontation.

Under uncertainty, fiscal authorities may simply consider that the mere threat of a negative assessment may justify: (i) pre-emptive fiscal steps likely to win over the IFI's endorsement; or (ii) informal, non-public, talks ahead of the issuance of the policy deliverable to better ascertain IFI preferences and sense what would be the measures that would be more likely to be endorsed.

Conversely, also faced with uncertainty, IFIs, with limited access to media and low at-start credibility capital, may find it safer to think twice before issuing excessively confrontational public statements that may be misunderstood over their first years of activity. Initial prudence may subside

over time as the IFI accumulates a higher level of visibility and authority in the internal public debate.

Overall, the presence of an IFI: (i) increases the odds that the right policy choices are made; (ii) provides an incentive for both parties to behave prudently. This is however conditional on the IFI's ability to provide a positive contribution to sound public finances in the form of robust deliverables, solidly underpinned by clear economic reasoning and proven empirical evidence.

5.1.4. Overview of the tasks usually discharged by Independent Fiscal Institutions

The first IFIs have started operating on account of pragmatic reasons and conditional on the benevolent attitude of the government. Therefore their remits were necessarily modular; they aggregated a number of specific tasks with a country-specific purpose and possible synergies between them. The following tasks were typically present in forerunner IFIs:

i. *Monitoring of fiscal policy and rules;*

ii. *Policy costing;*

iii. *Macroeconomic forecasting;*

iv. *Analysis of long-run sustainability of public finances;*

v. *Promotion of fiscal transparency;*

vi. *Normative recommendations on fiscal policy.*

The following sections describe these tasks as they emerged and discuss resource requirements deriving from them. The capability to foster accountability is also mentioned.

5.1.4.1 Monitoring and assessing fiscal policy and rules

Table II.5.3: **Monitoring and assessing fiscal policy and rules**

Task	Contribution	Complexity	Resource requirements	Generate Gvt. Accountability?
Monitoring and assessing fiscal rules	To monitor how the commitments arising from fiscal rules are implemented	Medium to high	Low to medium	Yes

Source: Commission services

In their seminal paper over fiscal rules Kopits and Symansky (1998) stressed that for fiscal rules to be successful they should enjoy the support of an institutional infrastructure, '*especially as regards the budgetary process and surveillance mechanism*'. They mention that the traditional institutions in charge of vetting the legality of budget laws (namely National Court of Auditors and Constitutional Courts) might not have all the expertise required to carry assessment of a more economic nature. Against this background, the involvement of an independent institution does not represent a breakthrough in itself, but rather serve to equip existing processes with an additional module which is supposed to provide additional efficiency, without essentially affecting the objectives pursued.

Fiscal rules set inter-temporal constraints on annual budgets with a view to weighing on the annual and medium-term budget plans of the government sector. Their effectiveness rely on the fact that non-observance would cause costs for the government, by way of either sanctions or reputational costs hitting the government's credibility in the eyes of the public. Therefore an independent referee is an essential ingredient in the overall layout surrounding the functioning of a fiscal rule.

The degree of IFI involvement may vary. At its weakest materialisation providing a monitoring of fiscal policy in general terms does not make much of a difference with respect to reports produced by academic bodies or research institutes as such reports are rather of a descriptive nature (although the descriptive analysis therein may be very detailed).

Providing assessments on national fiscal rules goes a step further; while they include descriptive analyses similar to regular monitoring, on top of it assessments include judgement on whether the rules have been followed, and if not, why. The length and complexity of the assessment is obviously tied to the complexity of the rules themselves. Second-generation fiscal rules involving the computation and evaluation of structural balances and concurrent indicators of the fiscal stance might require sophisticated analysis. Yet the need to provide exploitable deliverables

for stakeholders calls for clarity of the deliverables (which does not exclude nuance). Such clarity is critical for ensuring that IFI actions foster accountability.

A somewhat stronger involvement of IFIs into rule assessment is provided for in the Fiscal Compact. There, 'monitoring institutions' do not only conduct ex post assessments; they also involved in 'on-the-spot' monitoring whereby opinions have to be issued on the management of the national correction mechanism attached to the fiscal rule itself. It differs conceptually from ex post assessment, which takes place with the benefit of hindsight. As such, it may foster a sense of 'co-responsibility' between IFI and fiscal authorities if the latter follows the opinions of the former.

In terms of resource requirements, delivering an *ex post* assessment over fiscal rules may only demand a relatively light structure meeting at distant intervals. This is for instance the format of the Swedish Fiscal Policy Committee. Monitoring fiscal rules require a more permanent structure, especially for the Fiscal Compact balanced-budget rule as a number of events subject to IFI opinion may occur at any time (such as the triggering of the correction mechanism). An appropriate skill set combining analytical excellence with the ability to communicate in non-technical terms is essential.

Table II.5.4: **Independent fiscal institutions and fiscal policy/rules assessment**

Monitoring fiscal policy	Delivering factual assessments based on past outcomes
Monitoring fiscal rules	Delivering opinions implying judgement on the fulfilment of fiscal rules based on past outcomes
Enhanced monitoring of fiscal rules à la Fiscal Compact	Delivering opinions implying judgement on the on-going functioning of fiscal rules

Source: Commission services

5.1.4.2 Policy costing

Table II.5.5: **Policy costing**

Task	Contribution	Complexity	Resource requirements	Generate Gvt. Accountability?
Policy costing	To ensure that the fiscal impact of new policy measures is accurately estimated	Medium	High	Some

Source: Commission services

Policy costing consists in providing, either at budget preparation stage or throughout the budget cycle, estimates of fiscal measures envisaged by fiscal authorities. Such estimates have a critical impact on the quality of the budgetary forecasts contained in budget bills and medium-term fiscal plans.

Non-public estimates are also critical when providing decision-makers with cost-benefit analysis when assessing different measures for a given policy action. Requests from fiscal authorities may come at short notice and require quick delivery. On the revenue side, costing requires first-hand knowledge of the often-complex tax legislation and access to non-public tax databases. On the spending side, it requires internal data from the relevant line ministries in relation to spending programmes. Entities in charge of such estimates often have recourse to modelling, either internally or from external sources. As a result, policy costing is often conducted by technical services of the Ministry of Finance or specialised public research institutions on behalf of the Ministry of Finance. Parliament may also request estimates in order to quantify the fiscal impact of amendments, either to its own administration or to the Ministry of Finance. As a result, the process is likely to involve significant resources.

The involvement in policy costing would usually be linked with a strong participation of IFIs in budgetary forecasting, given obvious linkages and scale economies to conduct both tasks jointly. This is the case in the UK with the Office of Budget Responsibility. Due to its limited resources, it liaises intensively with various government services so that it can get access to critical information and modelling resources. When IFIs are lodged in Parliament, it is more likely that the mandate includes such tasks, following the example of the US Congressional Budget Office, which prepares 500 to 700 of such estimates per year (CBO, 2012).

5.1.4.3 Preparing or assessing macroeconomic forecasts

Table II.5.6: **Preparing or assessing macroeconomic forecasts**

Task	Contribution	Complexity	Resource requirements	Generate Gvt. Accountability?
Preparing macroeconomic forecasts	To ensure that macroeconomic forecasts used for fiscal planning are realistic or prudent	High	High	No
Assessing macroeconomic forecasts	To ensure that macroeconomic forecasts used for fiscal planning are not unrealistic or biased	High	Medium	Conditionally

Source: Commission services

Identifying biased forecast errors erring on the side of optimism that affected fiscal policy outcomes of four major EU Member States, Larch and Jonung (2006) advocated delegating the production of macroeconomic and budgetary forecasts to independent institutions. By contrast, the forecasts prepared by detached agencies tasked in this respect (in Austria, Belgium and the Netherlands) exhibited no statistically significant bias. They contended that producing forecasts did not form part of the function of a government and therefore could be contracted at no democratic cost to a body of non-political experts. Furthermore, there were no direct redistributive aspects linked to preparing forecasts. Benefits from the independent production of forecasts included: (i) reduced bias; (ii) improve transparency and accountability; and (iii) smoother exchange of information with European and international bodies.

Producing macroeconomic forecasts is a time-consuming process, involving skilled personnel and recourse to modelling. Specialised skill requirements are therefore high. In addition, the production of forecasts requires exchanges of information between government and delegated producers. In addition, forecasts have to be updated several times throughout the annual budget cycle, implying strong coordination needs through heavily-codified processes. These requirements are heightened when preparing budgetary forecasts where the acquisition of inside knowledge about budgetary programs and tax elasticities are essential. Unless the option is chosen to devote very large resources to the producing body, some have questioned whether this close cooperation can compromise IFI independence (Calmfors, 2010). However in the case of the UK OBR, Wren-Lewis (2010) mentions two mitigating factors: (i) fragmented discussions with a wide array of different public bodies when collecting information practically prevent the capability for manipulation, and (ii) experienced staff should be able to spot such attempts.

In order to alleviate these heavy resource requirements, IFIs may be entrusted to assess (instead of prepare) macroeconomic forecasts before they are formally incorporated into the budget. Such a procedural step may induce governments to prepare realistic or prudent forecasts, while limiting the need for extra IFI resources. Yet assessing forecasts still requires specialised skills and strong coordination patterns that still somehow 'embed' the IFI into the budgetary process.

5.1.4.4 Long term sustainability of public finances

Table II.5.7: **Long term sustainability of public finances**

Task	Contribution	Complexity	Resource requirements	Generate Gvt. Accountability?
Long-term sustainability	To compute long-term trends in public finances aimed at ensuring fiscal sustainability	High	Low	Some

Source: Commission services

If existing stakeholders are not sufficiently informed about long-term sustainability of public finances, then fiscal policy choices might be skewed at the expense of future generations. An IFI can therefore exert influence by making its own calculations. While that analytical task could be carried out by research or academic institutions as well, the added-value of giving it to an IFI would lay in its capacity to properly compute and publish and integrate them in a narrative that would support the general objective of promoting sound public finances. Therefore strong synergies exist with other IFI tasks.

5.1.4.5 Promoting budget transparency

Table II.5.8: **Promoting budget transparency**

Task	Contribution	Complexity	Resource requirements	Generate Gvt. Accountability?
Fostering transparency	To bolster clarity of budgetary documentation and engage in outreach to explain the fiscal performance and prospects and the benefits of sound public finances	Medium	Medium	Yes

Source: Commission services

As the lack of information may be a cause of deficit bias, promoting transparency through clear explanations from fiscal authorities and unbiased information would foster better accountability. '*Fiscal transparency is defined…as openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities…so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications'* (Kopits and Craig (1998)). Alt and Lassen (2006) show that budget outcomes are more favourable in countries where fiscal policies were more transparent. This could translate into various initiatives such the screening of legislation and fiscal documentation to make it more accessible and clear, communication initiatives to explain the benefits of sound public finances, suggestions to improve statistical coverage of general government entities, etc.

For instance, in its founding ordinance, the Swedish FPC has received the mandate to '*examine the clarity of the budget bills*'. Also the Council is tasked '*to review and assess the extent to which the fiscal and economic policy objectives proposed by the Government and decided by the Riksdag are being achieved and thus contribute to more transparency and clarity about the aims and effectiveness of economic policy*'. It shall also '*work to stimulate more public debate on economic policy*'.

Yet, only a few countries explicitly mention transparency as a self-standing objective for IFIs. This may be explained by the fact that the objectives of transparency may be also fulfilled indirectly by discharging other tasks usually associated to IFIs. Also the relative vagueness of the objective might also justify broad policy activism, in areas like accounting and statistical legislation, whereas governments may prefer to narrow down IFI mandates to clearly-delineated tasks.

5.1.4.6 Issuing normative assessments

Table II.5.9: **Issuing normative assessments**

Task	Contribution	Complexity	Resource requirements	Generate Gvt. Accountability?
Issue fiscal policy recommendations	To provide recommendations as to the conduct of fiscal policies	High	Variable	Yes

Source: Commission services

It is tempting to draw logical consequences of a given assessment and top up positive analyses with explicit recommendations on the fiscal stance or analyse the consequences of alternative policies. Yet, outright recommendations are creating 'two-way' accountability by making IFIs also accountable if fiscal authorities were to follow its recommendations. Issuing normative assessments involve difficult trade-offs and require sizeable resources and a well-established reputation. It certainly raises the profile of the institution beyond a technical body, with the consequence of becoming an important domestic actor which is accountable itself for the relevance of its policy advice.

5.2. THE EVOLVING LEGAL UNDERPINNINGS FOR THE DEVELOPMENT OF IFIS IN THE EU AND EURO AREA

A decisive impetus for the rise of independent fiscal institutions has been given by recent legislative developments at the EU level, where requirements in relation to their status, tasks and structure were enshrined in legislation. Concise initial references to them have been followed by more detailed and prescriptive provisions.

5.2.1. The Council Directive on requirements for national budgetary frameworks

The Directive on requirements for national budgetary frameworks (Directive 2011/85/EU), adopted in November 2011 as part of the so-called 'Six-pack' legislation on economic governance, already contained a reference to the need for independent bodies. First, national fiscal rules should be conducive to the respect of EU fiscal rules, acting as a first defence line against infringements of EU rules in the fiscal domain. Second, according to Article 6(1)(b) national numerical fiscal rules in the sense of the Directive should be equipped with procedures ensuring the *'effective and timely monitoring of compliance with*

the rules'. The monitoring should be 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'*. While discussions on the specific status and structure of such bodies did not materialise at the time, the Directive laid down for the first time a task to be allocated to independent bodies as a necessary specification attached to national numerical fiscal rules.

5.2.2. The intergovernmental Fiscal Compact and the Commission common principles

The fairly concise provisions of the Directive were broad enough to fit with the wide variance of national layouts across EU Member States. Yet they were considered insufficient for the balanced-budget rule in structural terms envisaged in the Fiscal Compact, itself part of the Treaty for Stability, Coordination and Governance (TSCG). This budget balance rule was meant to be a critical commitment of the euro-area to fiscal sustainability and therefore care was given to add monitoring institutions to national correction mechanisms in an effort to bolster credibility. The Commission was tasked to provide common principles regarding, among others, '*the role and independence of the institutions responsible at national level for monitoring compliance with the rules (...)*' (Article 3(2) TSCG). In its June 2012 Communication on national fiscal correction mechanisms (COM(2012)342), the Commission laid down detailed rules for Member States on the tasks and status of the '*monitoring institutions*'.

As to tasks, the common principles implied a significant deepening. Monitoring institutions were expected to provide public assessments over: '*(i) the occurrence of circumstances warranting the activation of the correction mechanism; (ii) of whether the correction is proceeding in accordance with national rules and plans; and (iii) over the occurrence of circumstances for triggering, extending and exiting escape clauses'*. The requirements went beyond the mere monitoring of compliance and involved the monitoring institution into the functioning of the fiscal rule. The term of 'enhanced monitoring' can be used to describe such a continuous relationship as opposed to the usually discrete ex-post assessment of fiscal rules.

The TSCG-related enhanced monitoring was reinforced by the '*comply or explain*' principle – whereby the advice of these monitoring institutions would either be followed, or the concerned Member States would explain why it departed from it. The explanatory statement of the common principles recalled that the principle would '*ensure that assessments and opinions are not just ignored, without infringing on the policymaking responsibilities of fiscal authorities*.' It unequivocally fostered accountability.

As to independence, while signatory parties were left to exert discretion as they '*shall take into account the already existing institutional setting and the country-specific administrative structure*', a number of structural characteristics were suggested as instruments to indirectly foster independence. They include: *(i) a statutory regime grounded in law; (ii) freedom from interference, whereby the above bodies shall not take instructions, and shall be in a capacity to communicate publicly in a timely manner; (iii) nomination procedures based on experience and competence; (iv) adequacy of resources and appropriate access to information to carry out the given mandate*. While the margin of manoeuvre of legislators when grounding these institutions was not overly constrained, the principles nevertheless specify critical structural features of IFIs that enable them to function at arm's length from their respective governments.

5.2.3. The Two-pack Regulation (EU) No 473/2013 on enhanced budgetary monitoring

Regulation (EU) No 473/2013 adopted in May 2013 as part of the so-called 'Two-pack' legislation introducing enhanced fiscal governance arrangements for euro area Member States replicated the TSCG common requirements regarding essential structural features inherent to independent bodies. It laid a bridge with the previous initiatives by requesting that independent bodies assess compliance with the national numerical fiscal rules identified in Directive 2011/85/EU and the Two-pack balanced-budget rule closely inspired from the one described in the Fiscal Compact. The format of the assessments to be prepared replicated the list of the requirements contained in the common principles issued by the Commission (assessment of the activation of the

Box II.5.1: The involvement of Independent Fiscal Institutions in the 2015 DBP process

The autumn examination of the 2015 Draft Budgetary Plans (DBPs) complemented, for euro-area Member States, the assessment of stability programmes and convergence programmes that takes place each spring. ([1]) The examination is focused on providing concrete *ex ante* guidance for the budget of the year ahead rather than on medium-term fiscal plans. For IFIs it provided a genuine test of their involvement in forecasting across the euro area ([2]). According to the DBPs, macroeconomic forecasts have been produced by separate entities from the Ministry of Finance in five Member States (AT, BE, LU, NL and SI). Endorsement of forecasts has been the preferred option in EE, ES, FR, IE, IT, MT, PT and SK. The following developments provide country-specific information. Unless specified otherwise, the macroeconomic forecasts referred to below are underpinning the submitted DBPs to the Commission.

In Austria, the macroeconomic forecast has been produced by the Austrian Institute of Economic Research (WIFO). WIFO is a non-profit association and benefits from a reputation as one of Austria's prominent policy oriented economic research institutes.

In Belgium, the macroeconomic forecast has been prepared by the Federal Planning Bureau (FPB). The FPB is a well-established institution formally attached to the Government that positions itself as an independent institution.

In Estonia, the macroeconomic forecast prepared by the Ministry of Finance was endorsed by the Estonian Fiscal Council. The Estonian Fiscal Council is an advisory body attached to the Bank of Estonia. According to its mandate, it assesses the macroeconomic and budgetary forecasts.

In Finland, the macroeconomic forecast underpinning the budget has been prepared by the Economics department of the Ministry of Finance. The management of the Economics department is separated from the Budget department, but no special legal provisions have been enacted to secure its independence. The forecast is not endorsed by any other third party.

In France, the High Council for Public Finances (HCPF) has published two opinions as part of the national endorsement procedure, on the DBP as well as on the overall budgetary strategy underlying the draft budget. The HCPF was established by the Organic Law n° 2012-1403 of 17 December 2012 as a monitoring body attached to the French Court of Auditors and whose independence is formally guaranteed by law.

In Germany, the federal budget is based on the federal government's own macroeconomic forecast and involves the Joint Economic Forecast (*Gemeinschaftsdiagnose*) which is issued twice a year by leading research institutes shortly before the government's spring and autumn projections. The forecast is not endorsed by a third party.

In Ireland, the macroeconomic forecast prepared by the Department of Finance has been assessed and endorsed by the Irish Fiscal Advisory Council (IFAC), in accordance with the Fiscal Responsibility Acts of 2012 and 2013. According to a Memorandum of Understanding specifying the process, IFAC is required to issue its view (in a letter of endorsement) according to which the forecast either falls within an appropriate endorseable range or not.

In Italy, the Draft Budgetary Plan is based on Italy's Economic and Financial Document (DEF) which presents a trend scenario, based on the hypothesis of unchanged legislation, and a programme scenario including the impact of the measures contained in the DBP. Both macroeconomic scenarios have been prepared by the government and endorsed by the recently-established Parliamentary Budget Office (PBO). The functional autonomy of the PBO is referred to in Constitutional Law 1/2012s and further detailed in Law 243/2012.

([1]) CY and EL do not need to submit 2015 draft budgetary plans because they are subject to macroeconomic adjustment programmes.

([2]) While DBPs were already released in autumn 2013, IFI involvement was partial as many institutions had not been grounded or were at a very early stage of functioning

(Continued on the next page)

Box (continued)

In Latvia, the macroeconomic forecast prepared by the Ministry of Finance has not been formally endorsed by an independent body. The Fiscal Discipline Council, Latvia's fiscal monitoring institution, is expected to prepare a fiscal discipline monitoring report on the 2015 budget law that will be presented to the parliament, including an independent evaluation of the macroeconomic projections and the cyclical position of the economy.
In Luxembourg, the macroeconomic forecast has been prepared by the Direction "*Etudes, prévisions et recherche*" of the National Statistical Office (STATEC). The mandate and organisation of STATEC were revised by the law of 10 July 2012, which highlights its scientific and administrative independence.
In Malta, awaiting the creation of the Maltese Fiscal Council that is expected to endorse macroeconomic forecasts, the National Audit Office, whose independence is established in Article 108(12) of the Constitution of Malta, has published an assessment of the macroeconomic forecasts prepared by the Ministry of Finance.
In the Netherlands, the macroeconomic forecast underpinning the draft budget was produced by the Bureau for Economic Policy Analysis (CPB). This established practice has been formalised in 2013 by virtue of the Law on the Sustainability of Public Finances. The CPB is functionally attached to the Ministry of Economic Affairs but has built up since its foundation a strong reputation as regards the independence and quality of its deliverables.
In Portugal, the macroeconomic forecast prepared by a Department of the Ministry of Finance has been assessed and endorsed by the Public Finance Council (CFP). The CFP was established through the May 2011 reform of the Budgetary Framework Law (Article 12-I). It is a legal entity which has the nature of an independent body according to Article 5 of its Statutes.
In Slovakia, the macroeconomic forecast prepared by the Ministry of Finance is endorsed by the Macroeconomic Forecasting Committee (MFC). The constitutional act on budgetary responsibility, adopted in December 2011, formally endowed the MFC with the responsibility for assessing macroeconomic forecasts. The MFC assesses if the draft forecast by the Ministry of Finance is "conservative", "realistic" or "optimistic".
In Slovenia, the macroeconomic forecast is prepared by the Institute of Macroeconomic Analysis and Development (IMAD). In accordance with the Act amending the Government of the Republic of Slovenia Act of 2000, IMAD was reorganised as an independent government office managed by a Director who answers directly to the Prime Minister.
In Spain, the macroeconomic forecast underpinning the Draft Budgetary Plan has been endorsed by the newly-created *Autoridad Independiente de Responsabilidad Fiscal* -AIReF. The authority was created in law in November 2013 (Organic Law 6/2013), with a view to securing its independence.

correction mechanism, of exceptional circumstances, and of the way correction is proceeding) for consistency purposes. The Two-pack also introduced the requirement for national medium-term fiscal plans and draft budgets of the euro area countries to be based on independent and public macroeconomic forecasts, going beyond the broad principles contained in Directive 2011/85/EU about the need for 'up-to-date' and 'realistic' forecasts used for fiscal planning.

The box above provides a snapshot of IFI involvement in the 2015 Draft Budgetary Plans (DBPs) examination process that took place in the autumn 2014, where the provisions of Regulation (EU) No 473/2013 applied to macroeconomic forecasts used in the preparation of DBPs.

5.2.4. Legal requirements for IFI mandates

In the Member States where IFIs must perform multiple tasks, the differing terms of the legal bases open the possibility to task different bodies or institutions, provided each institution abide by the structural requirements fostering functional autonomy laid down in either the 2012 Commission Communication on national fiscal correction mechanisms or the 2013 Two-pack

Regulation. As a result, legal requirements follow an escalating pattern where monitoring institutions are subjected to increasing requirements in relation to the degree of involvement of Member States in the economic governance of the European Union.

Therefore in almost all Member States, EU legislation has provided considerable support for the creation of such bodies, while ensuring the capability for Member States to establish them in harmony with the idiosyncratic characteristics of their national frameworks. As many of them have therefore been created in recent years, further attention to their features is warranted.

Table II.5.10: **Legal requirements for independent fiscal institutions originating from EU legislation and intergovernmental Treaties**

AT, BE, CY, DE, EE, EL, ES, FI, FR, IE, IT, LT(*), LU, LV, MT, NL, PT, SK, SI	• Monitoring of national fiscal rules to be conducted by independent bodies • Enhanced monitoring for the Fiscal Compact balanced-budget rule • Production or endorsement of macroeconomic forecasts used in annual budget and medium-term fiscal plans
DK, RO, BG	• Monitoring of national fiscal rules to be based on independent analysis • Enhanced monitoring for the Fiscal Compact balanced-budget rule
HR, CZ, SE, PL, HU	• Monitoring of national fiscal rules to be based on independent analysis
UK	• No requirements

Source: Commission services
Note: (*) When LT joins the euro area

5.3. A DESCRIPTIVE ANALYSIS OF THE IFI UNIVERSE AND FIRST LESSONS

5.3.1. Fiscal Institutions in the Commission database on fiscal governance

Commission services compile a broad set of information on fiscal governance arrangements in the EU countries through a comprehensive survey launched in 2006 across Member States, known as the Fiscal Governance database. ([56]) This survey collects inter alia information related to the main characteristics of national fiscal institutions covering their mandates and functions. From 2009 onwards it is being updated annually. The latest available information is from the 2013 update. It should be stressed that the eligibility criteria of the database may be wider than a strict definition of IFI according to the new EU requirements. Yet it is a valuable source of information in relation to the structural characteristics of IFIs. As reported by Member States in the database the number of fiscal institutions has grown steadily over the years. The past two years have witnessed an accelerating built-up in relation with EU requirements, with 36 institutions in 2011 and 43 institutions in 2013.

Table II.5.11: **Fiscal institutions in the Commission services database on Fiscal Governance**

	2006	2008	2009	2010	2011	2012	2013
Fiscal Institutions	27	29	30	34	36	40	43

Source: Commission database on fiscal governance

A majority of such institutions rely on a legal base grounded in equal or higher than legislative provisions. This provides a stable base for starting operations, especially for newly-created institutions. Implementing provisions (relative to nomination procedures, operating rules, relations with other bodies, etc.) are grounded in legislation for a good half of the fiscal institutions.

Table II.5.12: **Legal base for fiscal institutions in the Commission services database on Fiscal Governance (vintage 2013)**

	Constitution	Law	Other
Establishing document	13	18	12
Implementing provisions	2	22	19

Source: Commission database on fiscal governance

As to tasks, monitoring fiscal policy and rules accounts for the lion's share according to the database. Other areas where fiscal institutions are active include long-term sustainability estimates and fiscal rule assessment for non-central government, in particular for local authorities. Given the technical skills required, few institutions produce macroeconomic and budgetary forecasts. A higher number of fiscal institutions have been tasked to provide assessments with a view to endorsing forecasts instead. Resource considerations and the potential for interference between tasks seem to have prevailed when choosing the endorsement way.

([56]) The Fiscal Governance database collects information self-reported by Member States on national fiscal rules, medium-term budgetary frameworks, budget procedures and fiscal institutions. More details and the results of surveys are available at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

The database also collects information on the structure and the functioning of fiscal institutions. While a majority of fiscal institutions are fully detached, others have been attached to hosting institutions that provide logistics and sometimes seconded staff. Smaller Member States are reported to opt for the attachment model against the background of scarce specialised skills in public finance analysis.

Table II.5.13: **Tasks of fiscal institutions as reported in the Commission services database on fiscal governance (vintage 2013)**

Monitoring of fiscal policy	24
Assessment of fiscal rules for central government	30
Assessment of fiscal rules for non-central government	17
Long-term sustainability assessment	16
Production of macroeconomic forecasts	5
Production of budgetary forecasts	3
Endorsement of macroeconomic forecasts	12
Policy costing	8

Source: Commission database on fiscal governance

Attachment is consubstantial to Parliamentary Budget Offices, which are included in the database. Parliamentary Budget Offices benefit from national Parliaments' resources, while being well-placed to deliver advice to members of Parliament in the fiscal area. As to staff resources for fiscal institutions, they are expected to be commensurate with the institution's task portfolio and a majority of them have relatively small staffing. Institutions with very large staffing (more than fifty) usually represent entities engaged in wider activities than fiscal surveillance (general economic analysis for economic research institutes, auditing of public accounts for national courts of auditors).

Table II.5.14: **Structural information on fiscal institutions (vintage 2013)**

Structure		Staff employed		
Detached	Attached	Less than 10	10 to 50	More than 50
27	16	27	16	27

Source: Source: Commission database on fiscal governance
(*) Number of fiscal institutions with such characteristics
(**) data not available for three institutions

To enhance the autonomy of fiscal institutions and in compliance with requirements for TSCG signatory parties bound by the Fiscal Compact and euro-area Member States, fiscal institutions have been equipped with a number of safeguards ensuring the prevention of interference from external bodies. Terms of leadership are usually sufficiently long so as at least match equivalent characteristics of national decision-makers in the budgetary field. Additional national requirements include criteria for qualification (expressed sometimes in terms of experience), provisions aimed to avoid situations of conflicts-of-interest and incompatibility clauses between membership of fiscal institutions and other public or private capacities. These requirements are often found in the recently-grounded fiscal institutions as reported in the database.

Table II.5.15: **Safeguards for the leadership of fiscal institutions (*)**

Terms of office (**)			Requirements for appointment		
Less than four years	Four to eight years	More than eight years	Qualification criteria	Conflict-of-interest provisions	Incompatibilities
5	27	8	30	17	33

Source: Commission database on fiscal governance
(*) Number of fiscal institutions with such characteristics
(**) data not available for three institutions

Other structural features in relation to the practical capability of fiscal institutions may matter for effectiveness. While fiscal institutions are perceived to have no major impediment to their ability to communicate, the situation in relation to access to budgetary information seems more contrasted. While the quality of ex post assessments may not be compromised by relying on public information only (provided strong transparency requirements are in effect), access to non-public information from fiscal authorities may be warranted when discharging certain types of tasks, in particular forecasting or the issuance of opinion regarding current management of fiscal rules (for instance an opinion on the decision on the triggering the national correction mechanism). As to funding, most institutions rely on the state budget, whereas some are funded by hosting institutions (such as national Parliaments, central banks or court of auditors).

Table II.5.16: **Other structural features of fiscal institutions**

Freedom to communicate			Access to non-public fiscal information			Main funding source	
Yes (any time)	Yes (fixed dates)	No	Fully	Partially	None	State budget	Other
36	5	2	19	19	5	26	17

Source: Commission database on fiscal governance

5.3.2. A typology of IFIs

With the impetus from EU legislation, the many new IFIs that have been created still allow Member States to tailor their mandate and structure to

country-specific considerations. As a result, the IFI landscape remains very diverse. IFIs are unified by the common tasks enshrined in EU legislation, but the breadth of such tasks depends often on EU legal requirements. Furthermore, Member States have used available room for manoeuvre to the full when designing the format of these new institutions. This has sometimes meant including tasks going beyond EU requirements.

Member States also sometimes decided to attach bodies tasked with EU requirements to existing entities. The attachment to existing entities facilitates access to resources (offices, IT equipment, staff secondment) and therefore a smooth start-up. A number of provisions have however to be in place to ensure that IFI activities are properly ring-fenced from the general missions of the hosting entity. While longstanding institutions may initially be better placed due to their established authority, it remains to be seen whether the credibility capital of these host institutions could 'spill over' to the attached entities.

While the description of the optimal features of an IFI is likely to remain elusive, a number of common characteristics are shared by several entities with similar functions and profiles. Three sub-groups could be isolated tentatively.

The first group gathers a number of already-existing entities tasked with the production of macro-economic and budgetary forecasts. From a legal perspective, these entities have joined only recently the IFI universe. The passing of Two-pack regulation (EU) No 473/2013 has been instrumental in making more visible their contribution to the annual budget cycle. These institutions are already well-established and with ample staffing; they usually enjoy autonomy in practical terms within the public sector on account of their technical expertise. They often discharge other tasks than just macroeconomic and budgetary forecasting. Examples of such institutions include the Dutch Bureau for Economic Policy Analysis (CPB) and the Austrian Institute for Economic Research (WIFO). The challenge for these entities would be to maintain their existing autonomy while the extra visibility conferred to their output might also lead to external pressures.

The second group also concerns existing entities, with the difference that such entities are mostly tasked with the assessment of fiscal rules, in relation with the TSCG and the Two-pack regulation (EC) No473/2013. These already-established institutions (like the Finnish Court of Auditors or the Dutch Council of State) have been earmarked to be 'monitoring institutions' in the TSCG sense. While such entities have already established strong credibility in their field of excellence, fiscal rule assessment has become a new field for these institutions. It may warrant some internal reorganisation to ensure adequate staffing. At the same time, ring-fencing of the staff from the rest of the institution should be ensured.

The third group seems more conform to the traditional idea one may have of a fiscal council, based on the first prototypes fielded in forerunner countries like the Swedish Fiscal Policy Committee. They are often of recent establishment and their mandate significantly influenced by EU reforms (Six-pack and Two-pack). They are stand-alone bodies and often lightly staffed. As a result, they have been equipped with stronger defences against undue interferences from external bodies. Their mandate is often solely focused on fiscal issues, including periodic fiscal policy and rule assessments. Examples of such fiscal councils include the Slovak Council for Budget Responsibility. An extension of this model has been devised in countries facing strong fiscal consolidation needs, where, conditional on capacity constraints, such bodies have been entrusted with a wider range of tasks, for instance those related to the fiscal oversight of local public finances or state-owned enterprises. Only the resource-heavy production of forecasts has been left outside the mandate of these entities, which are poised to become important counterpart to fiscal authorities in the concerned Member States.

5.3.3. First lessons from their establishment

The rise of Independent Fiscal Institutions has been one of the most visible features of the recent strengthening of national fiscal frameworks across the EU. Entrusted with an advisory role these institutions have been tasked with a variety of functions in the fiscal area. Recent legislative developments at the EU level provided a decisive impetus for the rise of Independent Fiscal Institutions, where requirements in relation to their

status, tasks and structure were enshrined in legislation. As many such institutions have been created only very recently, their capability to make a difference in national fiscal policy outcomes has yet to be tested against the background of a challenging fiscal policy environment. Yet their potential contribution to transparency and accountability should not be under-estimated. Eventually it will be their capability to adapt to the specificities of their national framework while pursuing effectively the general goal of ensuring fiscal sustainability that will ensure their standing on the national scene and their reputation in the European and global fiscal landscape.

6. CONCLUSIONS

To conduct efficient fiscal surveillance and offer good policy advice, accurate and reliable data and information is indispensable. This Part presented the recent advancements in measurement of policy actions –the effective action methodology –, policy-relevant variables –the cyclically-adjusted balance– and fiscal statistics –ESA 2010. These advancements are made by EU institutions in the context of EU fiscal surveillance, where the focus on comparability and across-country consistency takes central role in order to ensure equality of treatment between Member States. However, as national specificities might at times play a role, Independent Fiscal Institutions are best placed to provide a national angle to fiscal surveillance. Due to recent legislative developments at the EU level providing strong support, their rise has been one of the most visible features of the recent strengthening of national fiscal frameworks across the EU.

The statistical and methodological revisions often incite a question about their impact on surveillance decisions taken within the Stability and Growth Pact. Indeed, the recent reforms of the SGP have strengthened enforcement mechanisms in the event of non-compliance, among others, by making it more automatic. At the same time, however, the SGP has been equipped with flexibility, allowing it to accommodate exogenous factors, not related to policies. It is therefore possible to ensure within the rules of the SGP that surveillance decisions are taken based on the assessment of policies rather than based on the data revisions triggered by methodological changes.

Part III

Medium-term budgetary planning in the context of the EU fiscal surveillance

1. INTRODUCTION

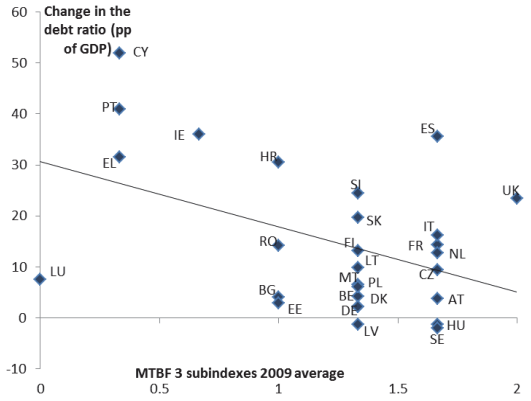
Government debt levels have increased significantly both in the euro area and the EU, currently standing at historically high levels which are, on average, around 18 percentage points (pp.) of GDP higher than before the onset of the crisis. In a context of already high government revenue-to-GDP ratios returning to more moderate debt levels will crucially depend on EU Member States' ability to deliver on budgetary adjustments. In particular, it will be crucial for Member States to effectively manage their expenditure trends as, in the absence of discretionary measures, government revenues typically follow GDP over the medium term.

It is generally acknowledged that effective expenditure management requires medium-term budgetary plans, as a single-year perspective gives fiscal policymakers a poor basis for strategic budgetary planning. In fact, most discretionary fiscal policy decisions – and particularly those that concern expenditure – have economic and budgetary implications which go well beyond the year in which they are taken. Therefore, fiscal policy decisions should be adopted in the context of medium-term budgetary frameworks, which take into account future implications of policy measures.

Since 1998 Member States annually submit and discuss medium-term budgetary plans contained in their Stability or Convergence Programmes (SCPs). Even though the SCPs do not contain policy commitments as such but rather normative extrapolations, they outline Member States' medium-term budgetary plans in a comparable way. Since 1998, EU law on medium-term budgetary frameworks has been considerably strengthened. In particular, the adoption of the Six Pack – specifically the Directive on National Budgetary Frameworks – and the Two Pack respectively anchored the production of medium-term fiscal plans in the national context and introduced a common budgetary timeline for all euro area Member States. The addition of the expenditure benchmark to the fiscal surveillance toolbox after the Six Pack also reflects the need to tightly control expenditure trends.

The literature suggests that budgetary institutions are crucial to ensuring sound government finances. ([57]) Different institutional aspects, such as fiscal rules, budgetary procedures, independent institutions (see Part II) or medium-term budgetary frameworks all play a role in this respect. This Part focuses specifically on medium-term budgetary frameworks (MTBF).

Graph III.1.1: **Debt increase and MTBF indexes (2009-2013)**



Source: Commission services
Note: debt figures are corrected for expenditure one-off measures. Higher values of the MTBF sub-indexes correspond to more binding MTBFs. The index captures the quality of the medium-term budgetary framework through five criteria: (i) existence of a domestic medium-term framework, (ii) connectedness between the multi-annual budgetary targets and the preparation of the annual budget, (iii) involvement of national parliaments in the preparation of the medium-term budgetary plans, (iv) existence of coordination mechanisms between general government layers prior to setting the medium-term budgetary targets for all government tiers, and (v) monitoring and enforcement mechanisms of multi annual budgetary targets.

Graph III.1.1 uses the fiscal rules database built by the European Commission ([58]) to show the importance of MTBF for sound public finances during the crisis. There seems to be a negative correlation between the average increase in government debt over the period 2009-2013 and

([57]) See Part III of the 2011 PFR for a review of the empirical evidence.
([58]) The dataset can be found here: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm

the strength of MTBF, which broadly persists after controlling for growth developments. ([59])

While it is generally argued that medium-term fiscal frameworks contribute to sounder fiscal policies, the literature has pointed out a number of key conditions that need to be met for them to be effective. In the EU context, data from the last seventeen years of Stability and Convergence Programmes provide a good basis for a thorough analysis of the effectiveness of medium-term budgetary planning.

In this context, Chapter 1 of Part III discusses the current status of medium-term budgetary frameworks in the EU. Following the outbreak of the crisis, EU legislation was introduced requiring Member States to anchor medium-term budgetary planning in their practice and/or legal order. In particular, Chapter 1 argues that the strain put on Member States public finances by the recent crisis contributed to strengthening the multiannual dimension to fiscal planning. As a result of that many Member States either recently introduced new medium-term budgetary frameworks or significantly upgraded the existing ones.. Recent developments in the MTBFs of EU countries are presented in this Chapter, including a detailed overview of those of three Member States: Austria, Greece and Spain.

Using the information contained in the Stability and Convergence Programmes, Chapter 2 presents a comparison between budgetary targets in the planning and the implementation phase and checks for possible sources of deviations between the two. Results seem to indicate that expenditure slippages are the main reason why actual budgetary outcomes deviate from planned targets. In particular, deviations with respect to plans are found to be the largest in social benefits other than social transfers in kind and gross fixed capital formation.

([59]) The strength of MTBF is proxied by the average of three MTBF subindexes related to the framework's binding force.

2. THE EVOLUTION OF MEDIUM-TERM BUDGETARY FRAMEWORKS IN THE EU

2.1. DEFINITION OF MTBFS AND THEIR RATIONALE

Medium-term budgetary frameworks (MTBFs) are generally understood as institutional policy instruments that allow the extension of the horizon for fiscal policy-making beyond the annual budgetary calendar. ([60]) However, this definition is not as unambiguous as it might sound. There are at least two approaches to MTBFs. The first approach, a "procedural" one, considers the MTBFs as the structural sets of arrangements and procedures that preside over the production of multi-annual budgetary figures. The second approach, a more "quantitative" one, interprets the MTBFs as the set of figures itself, i.e. the "multi-year budget" or budget plan.

One lesson learned from the latest crisis is that short-sighted approach to budgetary planning, usually limited to the next year's horizon, is a poor policy instrument for fiscal policy management and can result in enormous strain on public finances. What has ensued is a renewed focus on giving the budgetary planning a medium-term orientation. This does not prevent the annual budget preparation from still being the centrepiece of the budgetary planning. However, most discretionary policy measures have an impact that goes beyond the annual cycle. In particular, decisions on the expenditure side should always be taken with the medium-term perspective in mind. According to IMF ([61]), an MTBF can contribute to enhancing fiscal discipline by (1) showing a multi-year impact of planned measures, (2) issuing early warning about the lack of sustainability of existing policies and (3) setting binding multiannual expenditure ceilings. Provisions on MTBFs in the EU legislation

2.1.1. Stability and Convergence Programmes

Since 1998, in accordance with Regulation (EC) No 1466/97 also known as the preventive arm of the Stability and Growth Pact, EU Member States are obliged to present to the Commission on an annual basis (initially in the autumn and subsequently from 2010 by end of April) their medium-term budgetary plans contained in their Stability Programmes (for euro area Member States) or Convergence Programmes (for non-euro area Member States). More specifically, Member States are obliged to present, among other things, information on their medium-term budgetary objective and the adjustment path towards it, the expected path of the general government debt ratio, the planned growth path of government expenditure, including the corresponding allocation for gross fixed capital formation, the planned growth path of government revenue at unchanged policy and a quantification of the planned discretionary revenue measures. There is copious evidence that the plans presented in these programmes were in many instances not executed as foreseen. This suggests that the link between the annual budgets and these programmes was weak. Arguably the programmes were perceived more as an imposition from the EU level than as an instrument of national fiscal policy making. In other words the national ownership of the fiscal projections presented in these programmes was missing to some extent.

2.1.2. Budgetary frameworks directive

The lack of ownership of Stability Programmes pointed to the need to anchor the production of medium-term budgetary plans in the national context. This need was addressed by the Six-Pack and in particular by the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States (henceforth "budgetary frameworks directive") which calls for the Member States to have in place, among other things, medium-term budgetary frameworks at national level by 31 December 2013. The directive follows mainly the "procedural" approach and defines an MTBF as a specific set of national budgetary procedures that extend the horizon for fiscal policy-making beyond the annual budgetary calendar, including the setting of policy priorities

([60]) See European Commission, Directorate-General for Economic and Financial Affairs (2007), "Public Finances in EMU – 2007" for the definition and details.

([61]) IMF (2013), Public Financial Management and Its Emerging Architecture, editors M. Cangiano, T. Curristine and M. Lazare

and of medium-term budgetary objectives. According to Article 9.1 "Member States shall establish a credible, effective medium-term budgetary framework providing for the adoption of a fiscal planning horizon of at least three years, to ensure that national fiscal planning follows a multiannual fiscal planning perspective". Furthermore, the directive introduces a list of items for the production of which there should be dedicated procedures in place. This list includes:

a) comprehensive and transparent multiannual budgetary objectives in terms of the general government deficit, debt and any other summary fiscal indicator such as expenditure, ensuring that these are consistent with any numerical fiscal rules;

b) projections of each major expenditure and revenue item of the general government with more specifications on the central government and social security level, for the budget year and beyond, based on unchanged policies;

c) a description of medium-term policies envisaged with an impact on general government finances, broken down by major revenue and expenditure item, showing how the adjustment towards the medium-term budgetary objectives is achieved compared to projections under unchanged policies;

d) an assessment as to how in the light of their direct long-term impact on general government finances, the policies envisaged are likely to affect the long-term sustainability of the public finances.

Article 9.3 requires Member States to base their budgetary projections on realistic macroeconomic and budgetary forecasts. According to Article 10 Member States should make sure that their annual budgets are consistent with multiannual fiscal planning stemming from the national medium-term budgetary frameworks. Article 11 refers to the possibility for a new government taking office to "update its medium-term budgetary framework to reflect its new policy priorities", from which one can infer that in this particular case the MTBF also concerns the set of numbers and not only the underlying procedures.

2.1.3. The Two-Pack

In order to enhance the coordination of the formulation of fiscal policy strategies by the euro area Member States, Article 4 of the Two-Pack Regulation 473/2013 ([62]) introduced the notion of a common budgetary timeline, covering the preparation of both the national medium-term fiscal plans and the annual budgets. Euro area Member States are thus required to make public their national medium-term fiscal plans (NMTFPs) at the same time as their Stability Programmes and National Reform Programmes, preferably by 15 April and no later than 30 April. Although the Regulation does not explicitly state it, the publication of the NMTFPs at the same time as the Stability Programmes should promote a wider domestic debate on the medium-term direction of fiscal policy and possibly a higher involvement of national parliaments. The NMTFPs are documents laying down the national fiscal strategy in line with the medium-term budgetary framework defined by the fiscal frameworks directive. The Regulation requires that NMTFPs contain at least the information required for the Stability Programmes (and in fact they can be the same document) and include information on how the reforms and measures set out are expected to contribute to the targets and national commitments established within the framework of the Union's strategy for growth and jobs. Their content should be consistent with the framework for economic policy coordination in the context of the annual cycle surveillance, as established in Regulation 473/2013. Additionally, indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact should be included either in these NMTFPs or in the National Reform Programmes.

On top of the provisions regarding the timing of submission of the key documents in the national budgetary processes, Article 4 (paragraph 4) requires the euro area Member States to base their NMTFPs and annual budgets on independent

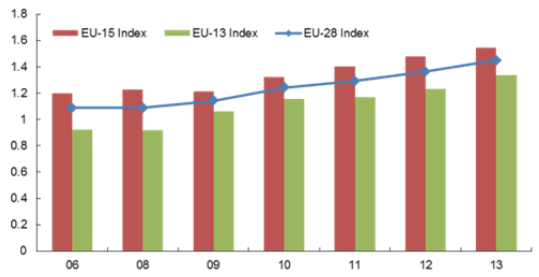
([62]) Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

macroeconomic forecasts. The Member States should also indicate whether the budgetary forecasts have been produced or endorsed by an independent body. All such forecasts should be made public.

2.2. RECENT DEVELOPMENTS IN THE MTBFS OF EU MEMBER STATES

The growing consensus on the desirability of adding the multiannual dimension to budgetary planning inspired many EU Member States to introduce brand new MTBFs into their practice/legal order or substantially upgrade the existing arrangements. The process was accelerated by the adoption of the budgetary frameworks directive, which obliged the Member States to have such frameworks in place by the end of 2013 and by coming into force of the Two-Pack. Intense activity ensued in the run up to the expiration of the deadline for the transposition of the directive. These developments are captured in the MTBF index presented in Graph 1 constructed on the basis of Member States' replies to the questionnaire underlying the Commission-managed database of Fiscal Governance in EU (see Box 1 for more details). The following description gives a snapshot of the recent changes as reported by Member States (by end 2013) in the above-mentioned database and the Stability and Convergence Programmes of spring 2014 but does not aspire to provide a definitive picture given further developments in 2014.

Graph III.2.1: **The MTBF index from 2006 to 2013**



Source: Fiscal Governance Dataset

To give a few concrete examples, a completely new MTBF was introduced in Greece in 2011, encompassing fiscal projections for all sectors of the general government for the next four years. The same year, Ireland introduced a reform which set out the medium-term parameters for budgetary policy accompanied by broad indications as to the composition of budgetary adjustments in the medium-term. In addition, expenditure control was enhanced by the introduction of multi-annual expenditure framework and performance-based budgeting.

In 2012, Portugal introduced an MTBF that obliges the government to annually submit (simultaneously with the draft budget) to the parliament a draft law on a budgetary multi-year planning setting expenditure ceilings for the central government expenditure for the subsequent four years in accordance with the targets contained in the latest Stability Programme. The government, the parliament and the independent fiscal institution (*Conselho das Finanças Publicas* - Public Finance Council) are involved in setting the objectives. In Austria, the 2013 budget law was prepared under the amended MTBF in the sense that each line ministry was obliged to define the outcomes to be achieved with the budgetary resources provided. In France, a new MTBF (*La loi de programmation des finances publiques)* was introduced and its first edition was adopted setting out among others the budgetary targets in nominal and structural terms for the whole legislative term (up to 2017). Estonia introduced a new MTBF adjusted annually on a rolling basis covering a period of four years. The new Danish Budget Law introduced a new MTBF which includes binding multi-annual expenditure ceilings consisting of nominal upper limits on spending by central government, regions and municipalities. The Spanish MTBF was extended to all entities of public administrations and the monitoring of compliance with the rules underpinning the framework was improved by establishing an automatic correction mechanism. Greece enhanced the connectedness between the preparation of the annual budget and the MTBF.

In 2013, Lithuania passed a law aimed at making its MTBF more binding by the introduction of the obligation for the government to submit to the parliament a written clarification of how any departure from the medium-term fiscal plans can be justified by new economic policy priorities. Latvia passed the Fiscal Discipline Law which,

Box III.2.1: **MTBF index in the DG ECFIN database on Fiscal Governance in EU Member States[1]**

Since 2006 the European Commission's Directorate-General for Economic and Financial Affairs has been running a database on the Fiscal Governance in the EU. This is a result of deliberations at the Ecofin Council, which on numerous occasions stressed the importance of robust national budgetary frameworks for sound public finances. In January 2006 the Ecofin Council urged the Commission to conduct a comprehensive analysis of the existing national fiscal rules and institutions in the EU Member States and their impact on budgetary developments. Three years later the Ecofin Council invited Member States to update on an annual basis the Commission's questionnaire on recent changes to their fiscal frameworks, while the Commission was asked to report back regularly on the results and to publish the data.

The survey information on medium-term budgetary frameworks is summarised into a composite index illustrating the quality of MTBFs in force. The index captures the quality of MTBFs based on five dimensions: (1) the existence of a domestic MTBF, (2) the connectedness between the multi-annual budgetary targets and the preparation of the annual budget, (3) the involvement of national parliaments in the preparation of the medium-term budgetary plans, (4) the existence of coordination mechanisms between subsectors of general government prior to setting the medium-term budgetary targets, and (5) the monitoring and enforcement mechanisms of multi-annual budgetary targets. The evaluation of the survey information also takes into account the relationship between MTBFs (if any) and the SCPs of the Member States in terms of multi-annual budgeting. While SCPs can be considered a specific type of MTBF, they are not on an equal footing with the latter. This has been taken into consideration in the construction of the MTBF index as well. In absence of strong theoretical base or preference regarding the weights for each dimension, 10,000 sets of randomly-generated weights are drawn from a uniform distribution.

Dimension 1: Existence of a national MTBF

2 MTBF covers the whole of general government or a large part of it (e.g. central government and social security)
1 MTBF covers central government
0 there is no national MTBF

Dimension 2: Connectedness between the multi-annual budgetary targets and the preparation of the annual budget (domestic MTBF or Stability/Convergence Programme)

2 fixed framework (articulated around a pre-defined path for government expenditure, generally not revised over time)
1 the medium-term budgetary targets form the basis upon which the budget is prepared, but there can be deviations
0 flexible framework in which medium-term targets are only indicative (no clear link with the annual budget)

Dimension 3: Involvement of the national parliament in the preparation of the medium term budgetary plans (domestic MTBF or SCP)

2 vote of the parliament on the main medium-term objectives (in the context of a national MTBF or of the SCP)
1 no vote but formal presentation of the objectives to the national parliament
0 no formal presentation of the objectives to the national parliament

([1]) http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

(Continued on the next page)

Box (continued)

Dimension 4: Existence of coordination mechanisms prior to setting the medium-term budgetary targets (domestic MTBF or SCP)
2 there is a proper ex ante coordination mechanism between all levels of general government
1 coordination mechanisms only for some general government sub-sectors
0 no coordination mechanism

Dimension 5: Monitoring and enforcement of multiannual budgetary targets
2 there are well-defined actions in case of deviations from plans and a regular monitoring of targets (reports, etc.)
1 some monitoring and enforcement procedures
0 no clearly defined monitoring and enforcement procedures

among other things, introduced binding multiannual expenditure targets albeit with some degree of flexibility in respect to social insurance expenditure ([63]). Poland passed an amendment to its Public Finance Act according to which the Convergence Programme would from that moment on constitute a part of the Multiannual State Financial Plan.

It should be noted that not all Member States respected the end-2013 deadline for the transposition of the budgetary frameworks directive and developments on the MTBF front continued in 2014. In April, Belgium amended the laws on budget planning and accounting for all levels of government, which now envisage a budget planning over a minimum of 3 years, the publication of explanations in case of deviation in the annual budgets from the multiannual budgets and detail the content of the latter. In July, Luxemburg introduced the law on multiannual financial planning including projections of main fiscal indicators for all sectors of general government and setting spending limits for the central government. In August, Malta passed the Fiscal Responsibility Law, which among other things introduced the National Medium-Term Fiscal Plan encompassing the entire general government sector.

At first glance, without pre-empting the formal assessment of the directive transposition which is currently being carried out by the Commission, one can conclude that medium-term budgetary planning is now in place to some extent in all EU Member States. However, since the directive only sets the general requirements for such frameworks and is not prescriptive on details of their arrangements, a variety of solutions has been applied. Therefore, MTBFs differ quite significantly from one country to another in terms of their various features.

The MTBFs differ in that some Member States – BE, ES, HU, IE, LU ([64]) and MT ([65]) – have medium-term budgetary procedures in place that result in the production of solely Stability or Convergence Programmes, whereas in other Member States a country-specific document is produced alongside the Stability or Convergence Programme that all EU Member States are obliged to submit annually.

A vast majority of the country-specific MTBFs cover a period of three years, but in a quite a number of Member States they encompass four years (AT, DK, EE, FI, FR, IT, LU, PT, SE and SI). Most of the MTBFs are produced on a rolling basis whereby a new outlying year is added every year, similar to the approach adopted in the Stability and Convergence Programmes. However, there are countries (such as NL and UK) where the

([63]) European Commission (2013b), Directorate-General for Economic and Financial Affairs, "Fiscal frameworks in the European Union: Commission services country factsheets for the Autumn 2013 Peer Review"

([64]) *Loi relative à la coordination et à la gouvernance des finances publiques* of July 2014 foresees that a multiannual fiscal plan would be published from now on.

([65]) The Fiscal Responsibility Act of August 2014, introduced a Medium-Term Fiscal Plan to be published from spring 2015.

MTBFs cover a set period of time beyond the budget year. This timespan usually coincides with the term of an elected government.

The coverage of the general government sub-sectors also varies across countries. A majority of the Member States has MTBFs encompassing them all, but some of the federal states' MTBFs (AT, DE) tend to only apply to the central government. However, the latter should be looked at in conjunction with other instruments (e.g. debt brakes) imposing discipline on all sectors. There are various arrangements in the Member States regarding the coordination mechanisms between the levels of government in the preparation of the medium-term budgetary targets. In some countries there is a proper ex ante coordination (e.g. AT, BE, DE, DK, EE and EL), but in others the targets are perceived as imposed by the central government (CZ, HU, SK and UK).

The level of political commitment involved in an MTBF differs across countries. In a majority of the EU Member States it is the government that adopts a medium-term fiscal plan and sends it to the parliament either for information or debate, which is typically not followed by a parliamentary vote on these projections. However, there is a group of countries (AT, CZ, EL, FR, IT, LV, PT, RO, SK and UK) where such parliamentary adoption does take place.

The MTBFs across countries imply various degrees of connectedness between the multiannual budgetary targets and the preparation of the annual budgets. Here the options range from the obligation of preparing an annual budget strictly respecting the medium-term projections to the situation where the annual budget deviates from the MTBF and where the latter is treated only indicatively. Some Member States set rigid expenditure envelopes for major items in their frameworks whereas other countries allow some flexibility in terms of expenditure depending heavily on the economic cycle (e.g. AT, IE and LV).

Some Member States have fixed frameworks where targets/ceilings can only be changed under strictly defined conditions (e.g. AT, DK, FI, IE, LU, LV, and PT). Other Member States do envisage (regular) adjustments to the projections contained in their MTBFs, typically with the obligation to explicitly justify the changes. The MTBFs differ also in that some are binding for their whole duration, whereas others are binding only for the first one or two years (e.g. EL, FR, RO and SK). There are various arrangements in terms of defining the ceilings in the sense that some MTBFs set ceilings for more detailed categories of expenditure for the first years of the framework and at a more aggregate level for the outlying years (e.g. PT). There are also differences regarding the monitoring and enforcement of the multiannual budgetary targets. Some Member States have clearly defined procedures in this regard (e.g. DE, IE, FR, RO, and UK) and others do not, relying only on reputational cost for the government of non-compliance with its own fiscal commitments (e.g. HR).

The MTBFs also differ in terms of the producer of the macroeconomic forecast underlying the medium-term projections. The Two-Pack urges the Member States to base their NMTFPs and their draft budgets on independent macroeconomic forecasts that should be made public. In preparing their NMTFPs in 2014 (be they the Stability Programmes or other country-specific documents), five Member States (AT, BE, LU, NL, and SI) relied on macroeconomic forecasts prepared by (what they considered) independent institutions. In five instances, the underlying macroeconomic forecast was produced by the ministry of finance and then endorsed by an independent institution (in EE by Bank of Estonia, in IE by the Fiscal Advisory Council, in MT by the National Audit Office, in PT by the Public Finance Council and in SK by the Macroeconomic Forecasting Committee). The macroeconomic forecast underpinning France's NMTFP presented in December 2012 was not endorsed by an independent institution as at that time the HCFP (*Haut Conseil des Finances Publiques*) was not operational yet. The HCFP did issue an opinion on the macroeconomic scenario on which the Stability Programme 2014 had been based, where the HCFP assessed the scenario realistic for 2014, "not out of bounds" for 2015 and optimistic for 2016-17. The macroeconomic forecasts underlying the NMTFPs of Finland, Germany, Italy, Latvia and Spain have neither been produced nor endorsed by an independent institution. In the case of Italy, Latvia and Spain this problem was due to the delay in the operationalisation of the fiscal councils responsible for issuing opinions on the forecasts prepared by

the ministry of finance and has been resolved in the meantime

2.3. COUNTRY-SPECIFIC EXAMPLES OF MTBFS AND THEIR RECENT DEVELOPMENTS

A more detailed overview of the recent developments in the MTBFs of Austria, Greece and Spain is presented below. While a far-reaching reform of the Austrian budgetary framework was already designed before the outbreak of the crisis, Spain strengthened its budgetary framework after the crisis together with some other Member States. In turn, the Greek case provides an illustrative example of a budgetary framework that was established from scratch after the onset of the crisis.

2.3.1. Austria

The introduction of the Federal Budgetary Framework Law (*Bundesfinanzrahmengesetz*) for the central government in 2009 constituted the first part of a far-reaching reform of the budgetary framework law. The second part of the reform, implemented in 2013, saw the introduction of a new budget structure which included global budgeting instead of line item budgeting, results-oriented management of administrative units, output-based budgeting – i.e. performance budgeting – and the modernisation of the public administration's accounting system.

Under the rules of the Federal Budgetary Framework Law (FBFL), the parliament is obliged to adopt a four-year plan, spanning from current year *t* to *t+4*, setting binding expenditure limits in nominal terms for the five main budgetary headings (rubrics) and then roll them forward by 30 April on an annual basis. Ceilings are also set at sub-heading level (chapters), but these are binding only for the following year *t+1* and have only indicative character for the remaining three years. Expenditure ceilings are divided into fixed – encompassing about 80% of total expenditure – and flexible – for the remaining 20% –. A special regulation adopted by the Minister of Finance defines areas for which flexible ceilings are to be set. They concern, inter alia, areas which depend on cyclically-sensitive expenditure in broad terms, such as unemployment benefits but also several kinds of social transfers, giving the government scope for manoeuvre during economic downturns. The flexible ceilings are determined on the basis of certain pre-defined indicators contained in regulations adopted by the Minister of Finance. The FBFL also sets binding limits in terms of number of staff employed by the central government in the corresponding period. Each new edition of the FBFL is accompanied by a budget strategy report which, among other things, lays down the goals of the government's economic policy and their quantification in terms of summary fiscal indicators for the general government such as government debt, budget balance, etc. It also provides the macroeconomic assumptions underpinning the expenditure ceilings in the FBFL and the corresponding revenue projections.

The FBFL gives line ministries the freedom to build unlimited reserves from any unspent appropriations at the end of the year, thereby encouraging a more efficient use of resources. As a result of the introduction of this rule line ministries refrained from spending all the unused appropriations at the end of the year as they were given the possibility to carry them over to the next year. However, the accumulation of these reserves also constitutes a risk due to their relative size. A mitigating factor here is that the bulk of the reserves fall under the remit of the Ministry of Finance. Nevertheless, since they are being used to 'finance' the gap in a given category between the expenditure planned in the FBFL and the expenditure planned in the subsequent budget law for the given year, the size of these reserves may be perceived as an element diminishing somewhat the stringency and predictive power of the framework.

The jury is still out as to what extent the FBFL has contributed to enhancing fiscal discipline in Austria. A cursory look suggests that the framework was more stable closer to its inception. In the subsequent years, on several occasions the expenditure ceilings were revised upwards. In some instances, the revisions were due to developments outside the control of the authorities (e.g. advanced payments to the ESM) but in others they were done at government's discretion. Changes occurred both in the fixed and flexible parts of the ceilings. Looking at the actual execution of the annual budgets, it appears that the ceilings – not only the ultimate but the original

ones as well – were respected globally up to 2012. In the following year recourse to a reserve, taking the budget as a total had to be made.

It should be noted that the FBFL only encompasses the federal government expenditure, which amounts to about 50% of total general government expenditure. In an attempt to extend this framework to subnational authorities, the latest edition of the Austrian Stability Pact, in force since January 2012, introduced a provision whereby the provinces and municipalities shall adopt multiannual financial plans with fixed liability limits in a legally binding form. These multiannual financial plans shall be notified then to the Austrian Coordination Committee, a body monitoring the respect of the Pact. However, it remains to be seen in practice how strictly this new requirement is being enforced, how binding these financial plans are in reality and how much they will contribute to the predictability of the public finances of the general government as a whole.

2.3.2. Greece

The Medium-Term Fiscal Strategy (MTFS) was introduced in Greece by law ([66]) in 2010 in order to reflect the fiscal policy of the general government as a whole. The law obliges the government to approve by 30 April each year the MTFS prepared by the Ministry of Finance and to submit it for adoption to the Parliament, which in turn should take place by the end of May of the same year. The strategy covers the budget year and the subsequent three years. The MTFS works on a rolling basis, i.e. it is extended by one year on an annual basis.

According to the law, the MTFS shall comprise indicative targets for the general government fiscal balance in nominal and structural terms as well as for the consolidated social budget for the four year period. It may also contain binding targets for the nominal balance path. Moreover, it shall also set upper limits on the expenditure of ministries and other central government bodies as well as on specific expenditure in the healthcare sector for the next four years, of which the first two years are binding. ([67]) Furthermore, the MTFS shall comprise targets for balances of the consolidated budgets of local authorities and other general government bodies, with the targets binding for the first two years. Finally, the MTFS shall present the expected impact on the general government balance of the envisaged policy measures.

The MTFS is accompanied by an explanatory report which must be consistent with the objectives and limits laid down in the MTFS. The law defines a long list of elements to be included in the report which is supposed to give a comprehensive picture of macroeconomic and fiscal developments in the recent past as well as to present the projections among other things for revenue, expenditure, budget balance, funding and debt of the general government and each sub-sector thereof and the macroeconomic forecast underlying these budgetary projections. The report should also quantify the impact of envisaged policy measures on public finances both in the short/medium term as well as in the long term accompanied by a discussion of debt sustainability.

The law stipulates that the annual or supplementary budgets should be prepared and executed "in absolute consistency with the ceilings" approved within the MTFS. There are well-defined procedures in place to be applied in case this provision is not respected. However, the law also foresees the possibility to update the MTFS by the first Monday of October each year in case the underlying macroeconomic or budgetary forecasts changed significantly. The accompanying explanatory report should at least include a comparison of the updated numbers with the original ones. The MTFS can also be revised when a new Prime Minister is sworn in or in case the corrective mechanism is activated whenever there is a significant deviation from the MTO or the path thereto. In all three cases, the parliament shall decide on the updated or revised MTFS within ten days from the submission of the draft by the government.

([66]) Law 3871/2010.

([67]) Currently, the expenditure ceilings for the central government and the binding targets for the balance of other general government subsectors are discussed within the framework of the Economic Adjustment Programme for the entire period

2.3.3. Spain

In Spain, the principle of multiannual budgeting for each sub-sector ([68]) is enshrined in Organic Law 2/2012 on Fiscal Stability and Financial Sustainability (LOEPySF). It enriches pre-existing procedures setting budgetary objectives over a multiannual time horizon. In practice, the Stability Programme now plays the role of the consolidated medium-term budgetary plan foreseen by this law. It is adopted by the Government, covers a minimum of 3 years and is annually updated as well as extended by one year. It is not submitted to Parliament. Deviations from the Stability Programme have to be explained by the Government.

The Stability Programme is meant to guide the preparation of annual budgets. It contains targets for year t and the following 3 years in terms of budget balance, debt, revenue and expenditure broken down by sub-sector. A no-change policy scenario and a change policy scenario are used. Macroeconomic forecasts and budgetary projections underpinning the programme have to be consistent with those developed in the annual budgetary process.

The key components of the Stability Programme are the targets for budget balance and debt set as percentage of GDP for the following three years, for the consolidated general government and for each subsector. The coordination mechanism to set these multiannual budgetary targets is developed in the LOEPySF. The Government establishes multi-annual targets for all subsectors during the first half of the year, based on a proposal from the Ministry of Finance and Public Administration. The institutions representing sub-federal governments ([69]) have a consultative role in the process. The targets are submitted to the Parliament, which can request an update from the Government within one month. Regional targets are then broken down for each Autonomous Community, based on a recommendation from the newly-established Independent Authority for Fiscal Responsibility (AIReF). The Government is expected either to comply with this recommendation, or to explain the rationale for deviating from it. The Autonomous Communities Fiscal and Financial Policy Council have a consultative role in the establishment of these targets.

One innovation from the above-mentioned law is the distribution of the General Government's debt ceiling of 60% of GDP across subsectors as of 2020 (with the obligation to converge towards these ceilings in the preceding years): the debt ceiling will be 44% for the Central Administration, 13% of each Autonomous Communities and for all of them together, 3% for all the local governments together.

A strong mandate of monitoring the multiannual budgeting was granted to the newly-established AIReF, which was founded by the Organic Law 6/2013 and has been operational since April 2014. This mandate includes the ex-ante assessment of the Stability Programme in general and its compliance with the above-mentioned budgetary targets in particular, as well as the assessment of credibility of the underlying macroeconomic forecasts. This assessment has to be published by April 15th on an annual basis, so just before the submission of the targets to the Parliament. The first assessments of this kind are thus expected in 2015.

While it may be too early to judge the quality of post-crisis multiannual budgetary planning in Spain, the contribution of the AIReF will prove instrumental in putting the budgetary objectives presented in the Stability Programme in perspective in terms of planning update and execution.

([68]) Central Government, the 17 Autonomous Communities, the local governments, the social security
([69]) The Autonomous Communities Fiscal and Financial Policy Council and the National Local Administration Commission

3. PLANNING VERSUS IMPLEMENTATION: WHY ARE MEDIUM-TERM BUDGETARY TARGETS NOT ALWAYS RESPECTED?

3.1. INTRODUCTION

Medium-term budgetary frameworks (MTBFs) can remarkably contribute to enhancing fiscal discipline. However, as discussed in the previous Chapter, existing MTBFs will only contribute as intended to bringing and maintaining government finances on a sustainable path if the institutional arrangements are fully implemented and respected in practice.

This is crucial in the present EU context. In fact, reducing current debt levels in the EU will depend on Member States' ability and willingness to effectively deliver on their planned budgetary outcomes. Past performance of EU Member States in this respect can shed some light on (i) whether implementation slippages are to be expected, and (ii) where will these slippages mainly stem from.

The comparison between implemented and planned budgetary targets has already been discussed by the literature. Its main findings are summarised below. Further to these results and using a larger sample both on the spatial and the time dimensions – EU-27 over fourteen years, this Chapter presents a detailed analysis of the contribution of different expenditure categories to expenditure slippages between the planning and the implementation phase.

3.2. LITERATURE REVIEW

The information contained in Member States' SCPs provides with annual updates of a considerable amount of macroeconomic and fiscal data. Soon after the submission of the first vintages of SCPs, non-negligible differences between the projections contained therein and observed budgetary outcomes started to emerge. In particular, a general trend of over-optimism in predicting the underlying macroeconomic scenario and budget balance position has been observed in the EU (Jonung and Larch, 2006; Milesi-Ferretti and Moriyama, 2006; Beestma et al, 2009). A large literature assessing the differences between plans and outcomes has flourished in the last two decades. It covers many different aspects including the sign and size of biases in budgetary projections, institutional and political factors influencing those biases, the quality of the macroeconomic forecasts based on the selected forecasting institution and the efficient or rational use of the information at forecast time.

Two main strands can be distinguished in the literature. The first one investigates the quality of budgetary and real GDP growth projections as contained in the SCPs, interpreting them as fiscal and economic forecasts and testing for efficiency and unbiasedness (Strauch et al., 2004; Annett, 2006; Brück and Stephan, 2006; Jonung and Larch, 2006; Pina and Venes, 2007). The second one, instead, emphasizes the political nature of the forecasts contained in the SCPs, which can be interpreted as the "expressions of a government's fiscal intentions given its medium-term economic forecasts" (von Hagen, 2010; Moulin and Wierts, 2006). According to this strand of the literature, deviations with respect to plans may come from unforeseen economic developments but also from changes in political intentions. Therefore, at least part of the deviations with respect to the declared budgetary targets should not be considered as errors but as intentional results.

Several factors have been identified by the literature as main determinants of biases in the government budgetary projections. Political and institutional factors such as the proximity of general elections, the number of political parties concurring in them, the presence of veto-players or the form of fiscal governance, have been found to determine budgetary slippages. Indeed, biases in deficit forecast tend to be larger and more frequent before elections (Brück and Stephan, 2006; Pina and Venes, 2011 and Beetsma et. al., 2011).

Annett (2006) finds that the cyclical position has a decisive effect on the sign of the deviation of the budget balance with respect to plans. In particular, EU Member States tend to be overly optimistic in good times, while forecasting is more cautious during bad times. Member States' characteristics, such as the country's size also have some influence according to Annett (2006). Given that the loss of

reputation from violating fiscal rules is greater for small countries (De Haan, Berger and Jansen, 2003) and that the cost of fiscal consolidation tends to be higher in large countries (Buti and Pench, 2004), large Member States tend to submit overly-ambitious medium-term fiscal plans which they later fail to carry out. Similarly, Member States with large government deficits tend to be overly optimistic in their deficit reduction plans (Frankel and Schreger, 2013).

The literature has found a predominant role of expenditure slippages in explaining overall budgetary shortfalls. Moulin and Wierts (2006) point to the difficulties in adhering to primary expenditure plans in nominal terms as one of the main factors explaining budgetary slippages. This is confirmed by Beetsma et al. (2009) or Holm-Hadulla et al. (2010) who, on the basis of outturn data, find that actual discretionary spending tends to systematically exceed planned levels.

In connection to the findings of Part II, most of the literature agrees on the relevance of independent fiscal institutions in ensuring more realistic medium-term budgetary plans and minimizing budgetary slippages (Jonung and Larch, 2006). The bias sign, either positive or negative, appears strictly dependent on the country's fiscal governance form (Von Hagen, 2010). In particular, growth and fiscal projections of governments operating under delegation ([70]) tend to be too optimistic, while growth projections of governments operating under strong fiscal rules are systematically downwardly biased. Strong fiscal rules at national level (Abbas et al. 2011, Frankel and Schreger, 2013, Von Hagen, 2010) and better institutional quality – captured through fiscal transparency indexes and MTBFs indexes (Beetsma et al., 2011) – are also found to increase caution on policymakers fiscal plans. Finally, Beetsma et al., (2011) assess that supranational fiscal rules have no significant impact on the size and sign of forecast biases. ([71])

Following the literature, this Chapter evaluates the role of four specific expenditure items in explaining overall expenditure slippages: gross fixed capital formation, interest expenditure, subsidies and social benefits other than social transfers in kind.

3.3. DATA AND METHODOLOGY

The database ([72]) presented here is based on the annual SCPs of the EU-27 Member States, covering the period from December 1998 ([73])to April 2014 ([74]). As known, these programmes contain fiscal and macroeconomic projections in a medium-term perspective at least for three years ahead. So, if *t* is the year of submission of the SCP, *t+1*, *t+2* and *t+3* represent the years of the medium-term projections. Further data are also contained in the document, mainly first release data for year *t* – i.e. the first information for the current year –, and outturn data for the previous year *t-1*.

This dataset makes available Member States' projections at the time of SCPs' submission in a user-friendly way. It covers main expenditure components – i.e. interest expenditure, subsidies, gross fixed capital formation, social benefits other than social transfers in kind –, the main macroeconomic assumptions underlying budgetary projections (namely, real GDP growth) and projections for fiscal variables (general

([70]) Under a delegation approach, budgetary decision making rests on the delegation of power to the Minister of Finance. Conversely, under a contract approach, budgetary decision making hinges on pre-established budgetary rules and targets.

([71]) Positive bias is also observed by Strauch et al. (2004) when analysing the effects of the Maastricht convergence process. According to them, making realistic projections was not a dominant strategy at the time as projecting an excessive deficit would have put the accession to EMU on risk, while strong fiscal consolidation, although followed by milder or insufficient results could assure a successful willingness and ability of joining EMU at an early stage.

([72]) The database is available here: http://ec.europa.eu/economy_finance/db_indicators/scp/index_en.htm

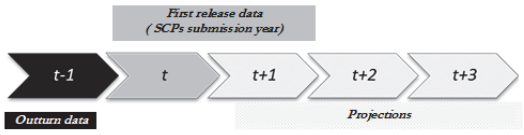
([73]) Only towards the end of the 1990s were SCPs submitted on a regular basis. Croatia is excluded from the analysis as it was first required to submit an SCP in 2014.

([74]) It has to be taken into account that Member States joined the EU at different points in time, so for certain countries the series may be shorter.

government balance, general government revenues, general government spending and general government debt), all expressed as percentage of GDP.

The database consists of annual observations on real GDP growth, GDP deflator, general government balance, general government debt and general government revenues and expenditure, by Member State. Some SCPs however do not include all the assessed variables. ([75])

Graph III.3.1: **SCPs horizon**



Source: Commission services

The analysis below focuses on the SCPs' implementation slippages since 1999. Following the previous literature ([76]) and considering the three different phases of the budget process – planning, adoption by the Parliament and implementation, ([77]) the implementation slippage ([78]) for any variable X is defined as the difference between the change in variable X shown by first-release data (*actual change*) and the change in variable X shown in the fiscal plans (*planned change*). ([79]) Real-time, first-release data are used instead of *ex-post* data to approximate the information known by policymakers when implementing their fiscal plans. ([80])

Therefore, if superscript t represents the year of the SCP submission and subscript t the forecast period, the implementation slippage for any variable X can be formalized as follows:

$$\underbrace{X_{t+i}^{t+i} - X_{t+i-1}^{t+i}}_{actual\ \ change} = \underbrace{X_{t+i}^{t} - X_{t+i-1}^{t}}_{planned\ \ change} + \underbrace{(X_{t+i}^{t+i} - X_{t+i-1}^{t+i}) - (X_{t+i}^{t} - X_{t+i-1}^{t})}_{implementation\ \ \ slippage}$$

, where i= [1, 3]

where *actual change* represents the adjustment implemented in year t, as reported in the SCP submitted in t, and the *planned change* represents the adjustment envisaged for that same year t in the SCP submitted in year *t-1*. Assessing the variables in first differences instead of levels neutralizes possible base effects and influences of statistical revisions over the different time-horizons. For variables already expressed in percentage change, such as real GDP growth, the implementation slippage can be formalized as follows:

$$\underbrace{X_{t+i}^{t+i}}_{actual\ \ change} = \underbrace{X_{t+i}^{t}}_{planned\ \ change} + \underbrace{(X_{t+i}^{t+i} - X_{t+i}^{t})}_{implementation\ \ \ slippage}$$

Positive values of the implementation slippage correspond to higher-than-projected outcomes or larger-than-planned consolidation efforts, while negative values can be associated to overly

([75]) Although the SCPs were first introduced in the EU's economic governance in 1998, it was only with the adoption of a Code of Conduct on the content and format of SCPs by the Council, in July 2001, that the SCPs acquired a more standardized structure which has been followed effectively only through time. This implies that not all SCPs contain full and detailed information with the consequent gaps in the series. Thus, the dataset contains 12574 observations. Besides, some Member States used to forecast the relevant variables under several scenarios (baseline, "optimistic" and/or "pessimistic" scenarios). In these cases, the baseline or the more cautious scenario is considered. The SCPs submission deadline changed in 2009, from the end of the year to April. The transition between these two submission dates implied that no SCP was submitted in the year 2010, and therefore outturn data for 2009 were not reported in any SCP. In order to solve this, and as the series are in terms of change and not level, the SCPs series are integrated with 2009 outturn figures stemming from the 2010 Commission Spring forecast. Finally, as the so-called new Member States submitted their first SCPs in July 2004 or later, the database is not balanced. This does not levy homogeneity issues, as repeating the analysis on the EU15 shorter sample shows similar results.

([76]) See PFR (2007), Beestma et al., (2009), von Hagen, (2010).

([77]) Von Hagen and Harden (1995) decompose a full budget cycle in three different steps: the planning phase, the adoption of the Annual Budget Law by the Parliament, and the implementation phase.

([78]) Contrary to Beetsma et al. (2009) the differences between planned and realized budgetary targets is not considered as a forecast error because of their potential nature.

([79]) In terms of the three steps in the budget process identified by Von Hagen and Harden (1995) this approach takes the planning and the adoption phases together.

([80]) Differences between first release and outturn data are small in principle, except for possible technical revisions.

optimistic forecast or smaller-than-planned consolidation efforts.

3.4. DESCRIPTIVE ANALYSIS

The analysis of the SCPs data over these seventeen past years shows that medium-term fiscal plans are optimistic when it comes to macroeconomic variables, fiscal outturns and the composition of fiscal adjustment. This holds both for the whole sample and when it is split between the pre-crisis and post-crisis period.

The main descriptive statistics of the implementation slippage for real GDP growth, the budget balance and the revenue- and expenditure-to-GDP ratios are summarized in Table III.3.1, for the whole sample and excluding 2009. ([81]) The analysis focuses on the EU mean of the implementation slippage of each variable in year *t*. ([82])

Implementation slippages on real GDP growth are on average negative, implying that Member States have tended to overestimate it. On average real growth is estimated to be around 0.8 pp. lower in year *t* when compared with the projection for the same year in the SCP submitted in year *t-1*. This is reported in Table III.3.1, in the row corresponding to the EU mean and the column corresponding to the implementation slippage found in year *t*.

This growth forecast wedge increases with the forecast horizon until it reaches 2 pp. difference in *t+2*. The figures with 2009 excluded from the sample confirm that Member States tend to be overoptimistic in terms of growth, although the size of the implementation slippage throughout the forecast horizon roughly halves.

Furthermore, Member States appear also to suffer from an optimistic bias when it comes to project budget balance developments. In fact, while one-year ahead Member States plan to improve their headline deficit by around 0.2 pp. of GDP on average, a deterioration of 0.2 pp. of GDP is instead estimated in the implementation phase. This 0.4 pp. difference between the two phases increases with the forecast horizon up to around 0.8 pp. both in *t+1* and *t+2*. The EU average slippage excluding 2009 corroborates that Member States tend to be overambitious in terms of fiscal adjustment during the planning phase, while the size of the implementation slippage significantly declines.

Turning to the composition of the fiscal adjustment, the data suggest that while Member States typically plan to consolidate through expenditure restraint, the implementation phase involves higher-than-planned expenditures and also slightly higher-than-planned revenues. In particular, in year *t* the expenditure-to-GDP ratio is envisaged to be between 0.6 and 1.2 pp. of GDP larger than planned the year before, depending on the forecast period. Conversely, Member States are usually prudent when they plan their revenue developments as in year *t* the revenue-to-GDP ratio is on average between 0.2 and 0.4 pp. of GDP

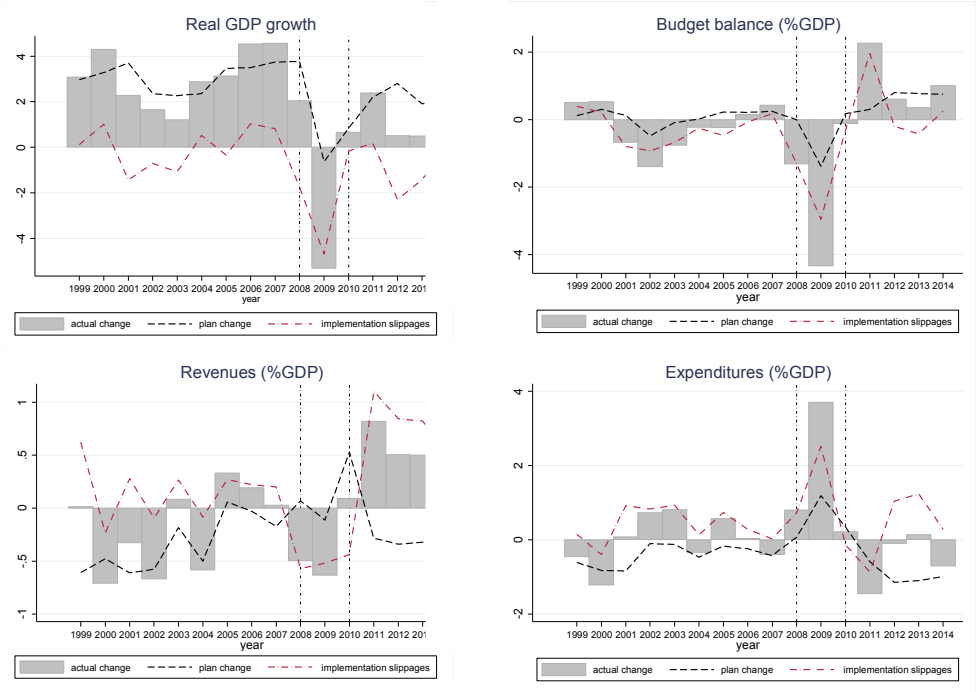
Table III.3.1: **Descriptive statistics for implementation slippages in the EU: 1998-2014**

EU AVERAGE									
	Change envisaged in year t (Actual change)			*Change envisaged in year t-1 (Planned change)*			*Implementation slippage (Actual – Planned)*		
	Year t	*Year t+1*	*Year t+2*	*Year t*	*Year t+1*	*Year t+2*	*Year t*	*Year t+1*	*Year t+2*
Real GDP growth									
Mean (all period)	1.67	1.54	1.24	2.43	2.97	3.28	-0.76	-1.43	-2.04
Mean (excl. 2009)	2.27	2.31	1.94	2.69	2.88	3.24	-0.42	-0.57	-1.29
St.dev. (all period)	2.44	2.67	2.49	1.24	0.67	0.38	1.51	2.8	2.59
N (all period)	342	265	230	342	265	230	342	265	230
Budget balance									
Mean (all period)	-0.21	-0.29	-0.2	0.15	0.47	0.62	-0.36	-0.76	-0.82
Mean (excl. 2009)	0.17	0.16	0.2	0.29	0.49	0.63	-0.13	-0.33	-0.43
St.dev. (all period)	1.54	1.66	1.64	0.56	0.37	1.06	1.09	1.47	1.9
N (all period)	325	269	235	325	269	235	325	269	235
Revenue-to-GDP ratio									
Mean (all period)	0.05	-0.0	0.06	-0.16	-0.42	-0.32	0.22	0.41	0.38
Mean (excl. 2009)	0.11	0.07	0.12	-0.17	-0.44	-0.34	0.28	0.51	0.45
St.dev. (all period)	0.47	0.47	0.48	0.29	0.97	1.44	0.54	0.91	1.5
N (all period)	313	254	221	313	254	221	313	254	221
Expenditure-to-GDP ratio									
Mean (all period)	0.25	0.28	0.28	-0.32	-0.87	-0.95	0.57	1.16	1.23
Mean (excl. 2009)	-0.08	-0.12	-0.12	-0.47	-0.92	-0.98	0.39	0.8	0.86
St.dev. (all period)	1.24	1.36	1.39	0.65	0.91	0.75	0.83	1.58	1.45
N (all period)	312	253	220	312	253	220	312	253	220

Source: SCPs and Commission services' computations.
Note: the table reports unweighted averages

([81]) As shown in Graph III.3.2. the largest implementation slippages in all analyzed variables happened in 2009, which is an outlier year.
([82]) Standard deviation figures and the number of observations are reported for information on significance.

Graph III.3.2: **First-year implementation slippage**



Source: SCPs' and Commission services' computations
Note: the graphs report unweighted averages.

higher than planned the year before. The picture remains broadly similar after excluding 2009 data.

Graph III.3.2 complements the information in Table III.3.1, showing the implementation slippage of the four analyzed variables for year *t*, i.e. the first year of the planning. The effect of the crisis on the implementation slippage is self-evident. In particular, the largest implementation slippages in all analyzed variables happened in 2009, which is an outlier.

A similar analysis, focusing on a sample comprised only of euro area Member States confirms the results above. A first conclusion that can be drawn from the descriptive analysis is that failure to implement the targeted reductions in the expenditure-to-GDP ratio is the main driver behind the lower-than-planned improvements in the government budget balance. This confirms the results found by Moulin and Wierts (2006) over a shorter period of time.

Looking further into the differences between planned and implemented changes in the expenditure-to-GDP ratio across Member States, a more heterogeneous picture emerges. Focusing still on the implementation slippage in the first year of the SCPs horizon (year *t*) Graph III.3.3 scatters the average actual change in the expenditure ratio against the corresponding average change planned one year before, by Member State. Again, as forecasting becomes obviously more difficult amidst a downturn, results both including and excluding the most recent crisis years are shown. Graph III.3.3.a) shows that, on average and excluding the crisis years, all Member States but the UK are located either on the first or the fourth quadrant, meaning that on average they all planned cuts in the expenditure ratios for the following year. However, only Denmark, Poland, Portugal, Romania, Ireland, Cyprus and Belgium – which stand around the forty five degree line represented by the equation $y = x$ – actually implemented such average changes. While Spain – which stands below the forty five degrees line – implemented on average slightly larger cuts than

planned one year in advance, ([83]) the actual cuts implemented by the majority of Member States deviated by around 0.5 pp. of GDP from their previous year's targets. It is the case of Sweden, Austria, France, the Netherlands, Germany, Finland, the Czech Republic or Slovenia, which stand around the first parallel to the forty-five degrees line represented by the equation $y = x + 0.5$.

In turn, the average first year implementation slippage in Italy, Malta and Luxembourg has been around 1 pp. of GDP while in Hungary, Bulgaria and Estonia has been considerably above that level.

Including the crisis years changes the picture in two senses as shown by Graph III.3.3.b). First, a considerably larger amount of Member States is moved up from the forth quadrant into the first one, implying that even though countries planned to cut expenditure ratios, for many of them the implementation phase actually brought increases in these ratios on average.

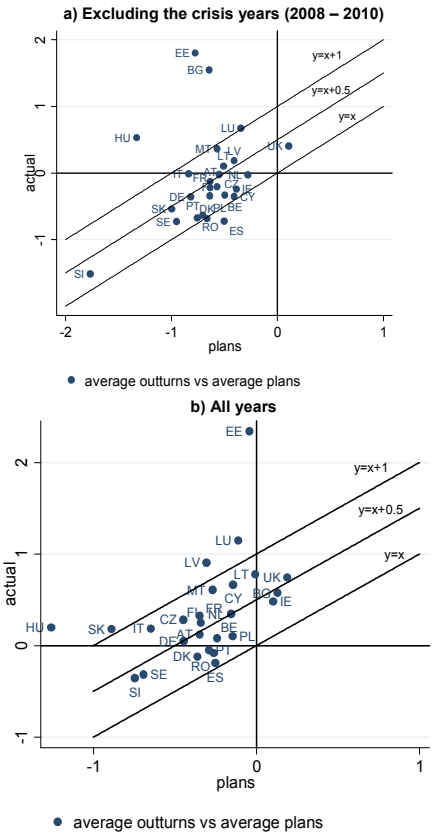
Second, the implementation slippage by the majority of Member States increases and is in the range of 0.5 and 1 pp. of GDP – as shown by the fact that most countries are placed between the first and second parallel to the forty five degrees line –, instead of around 0.5 pp. of GDP as in Graph III.3.3.a).

However, the conclusions on individual Member States should be interpreted carefully as the length of the SCPs series is not the same across Member States.

Expenditure slippages can be the result of two different factors. The first one, non-discretionary, is the error stemming from growth surprises, i.e. the endogenous change in projected expenditure due to unforeseen GDP growth developments. The second one is attributable to discretionary policy measures. Following von Hagen, (2010), the non-discretionary component of expenditures slippages is proxied by multiplying the GDP implementation slippage – e_t^{GDP} – times the budgetary semi-elasticity of expenditure -ε- used in the EU fiscal surveillance process.

The overall expenditure slippage in a year *t* –*et*– can thus be decomposed into its discretionary component $-\delta_t-$ and its non-discretionary one in the following way: $e_t = \delta_t + \varepsilon * e_t^{GDP}$ with t= [1999, 2014]

Graph III.3.3: **Average planned versus implemented change in the expenditure-to-GDP ratio in year t (% GDP) 1998 – 2014.**



Source: SCPs and Commission services' calculations.
The graphs compare, by Member State, the average change in the expenditure-to-GDP ratio planned in year t-1 for year t, with the change in the expenditure ratio actually implemented in year t. Graph a) shows averages calculated excluding the crisis years 2008-2010, while Graph b) shows the averages computed including all years in the sample. The three parallel lines respectively represent the points where the changes in the expenditure ratio came in exactly as planned (y=x); the points where the changes in the expenditure ratio came in 0.5 pp. of GDP higher than planned (y = x + 0.5), and the points where the changes in the expenditure ratio came in 1 pp. of GDP higher than planned (y = x+1).

([83]) The results for Spain are driven by the expenditure cuts implemented between 2011 and 2014 – which were larger than planned – as shown in Graph III.3.4.

Table III.3.2: **Decomposition of expenditure slippages: the role of the discretionary component**

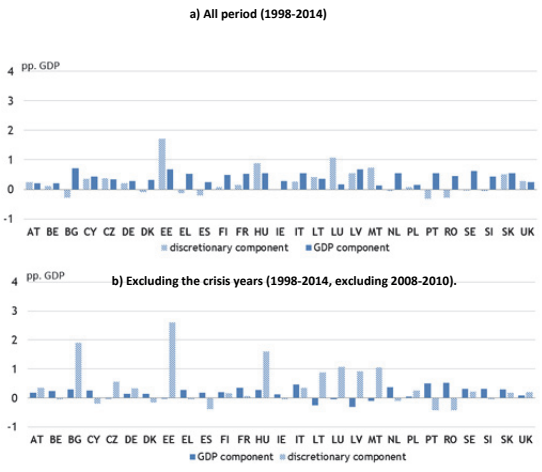
	Year *t*								
	1999-2007			*2008-2010*			*2011-2014*		
	GDP component	Discretionary	implementation slippage	GDP component	Discretionary	implementation slippage	GDP component	Discretionary	implementation slippage
Mean	-0.17	0.6	0.41	1.19	-0.15	1.04	0.47	-0.05	0.42
St.dev	0.54	0.29	0.41	1.2	0.24	1.11	0.53	0.43	0.8
N	129	129	129	81	81	81	102	102	102
	Year *t+1*								
Mean	-0.24	1.5	1.03	2.25	-0.22	2.03	0.58	-0.16	0.45
St.dev	0.75	1.99	1.65	2.08	0.87	1.70	0.57	0.39	0.75
N	102	102	102	76	76	76	75	75	75
	Year *t+2*								
Mean	-0.15	1.39	1.16	2.48	-0.29	2.19	0.83	-0.44	0.39
St.dev	0.69	1.35	1.17	1.91	1.24	1.66	0.41	0.39	0.79
N	76	76	76	70	70	70	74	74	74

Source: SCPs and Commission services' computations

As shown in Table III.3.2, there is a clear difference across sub-periods: negative GDP growth surprises explain on average the bulk of the slippage in the expenditure ratio in the EU after 2008. Growth disappointments led to higher-than-planned expenditure ratios, in spite of the efforts to contain expenditure trends signaled by the sign of the discretionary component after 2008.

On the contrary, the discretionary component was the main factor driving expenditure slippages before the crisis. In fact, until 2007 growth typically turned out better than envisaged during the planning phase while the implemented discretionary expenditure effort was lower than planned.

Graph III.3.4: **Decomposition of expenditure slippages in year t across Member States**



Source: SCPs and Commission services' computations.
Positive values correspond to the implemented cuts in the expenditure-to-GDP ratio turning out smaller than the cuts planned one year in advance and vice versa.

A more nuanced picture of the contribution of both factors to expenditure slippages in year t across Member States can be found in Graph III.3.4.

3.5. EXPENDITURE SLIPPAGES: WHICH IS THE LEADING ITEM?

The analysis of past SCPs confirms, in line with the findings in the literature, that slippages in the implementation of expenditure-to-GDP targets are the main driver behind budget balance slippages, on average across Member States and across time. A closer look at the contributions of four different spending items – gross fixed capital formation, interest expenditure, subsidies and social benefits other than social transfers in kind – may provide further insights ([84]) Table III.3.3 provides such information.

It should first be noted that the SCPs typically plan expenditure cuts across all the analysed expenditure categories and spanning over the whole forecast horizon, except for the period 2008-2010.

As it is to be expected, social payments – which typically account for a large share of total government expenditure in EU Member States – is one of the spending items that most significantly contributes to overall expenditure slippages, especially during the crisis period 2008-2010 (columns c in Table III.3.3)

Interest expenditure has typically come in broadly as planned, since Member States' Treasuries can largely anticipate it – except maybe for those countries with a large share of short-term debt. It is interesting to note however that in the period 1999-2007 the change in the interest expenditure-to-GDP ratio was overestimated in the plans, which could suggest that on average a budgetary buffer was incorporated in the interest expenditure projections by the Treasuries. It is actually the only component for which a negative sign is observable in column (c).

([84]) The rational of this choice relies exclusively on the completeness of the data at our disposal. The series of the other expenditure items are largely affected by missing data problems.

Table III.3.4: **Decomposition of expenditure slippages**

	Actual (a)	Plan (b)	Slippage GDP (c)	Slippage % plan (d)= |c/b|	Actual (a)	Plan (b)	Slippage GDP (c)	Slippage % plan (d)= |c/b|	Actual (a)	Plan (b)	Slippage GDP (c)	Slippage % plan (d)= |c/b|
	1999-2007				2008-2010				2011-2014			
	1-year ahead											
	Total Expenditure											
Mean	0.0	-0.4	0.4	1.1	1.6	0.5	1.0	1.9	-0.5	-1.0	0.4	0.4
	Social payments											
Mean	0.1	-0.1	0.1	1.6	0.9	0.4	0.5	1.2	-0.1	-0.3	0.2	0.7
	Interest expenditure											
Mean	-0.2	-0.2	-0.1	0.4	0.1	0.1	0.0	0.0	0.1	0.1	0.0	0.4
	Subsidies											
Mean	0.0	0.0	0.1	1.7	0.1	0.0	0.1	6.0	0.0	-0.1	0.0	0.6
	GFKF											
Mean	0.1	0.0	0.1	3.0	0.2	0.2	0.0	0.2	0.1	-0.2	0.3	1.8
	2-years ahead											
	Total Expenditure											
Mean	0.0	-1.0	1.0	1.0	1.7	-0.4	2.0	5.5	-0.7	-1.2	0.5	0.4
	Social payments											
Mean	0.0	-0.3	0.3	1.1	0.9	0.0	1.0	24.3	-0.2	-0.3	0.1	0.5
	Interest expenditure											
Mean	-0.2	-0.1	-0.1	0.6	0.1	0.0	0.1	4.7	0.1	0.1	0.0	0.1
	Subsidies											
Mean	0.0	0.0	0.1	2.0	0.0	-0.1	0.1	1.6	0.0	-0.1	0.0	0.4
	GFKF											
Mean	0.1	0.0	0.1	8.0	0.2	0.0	0.1	4.3	0.1	-0.2	0.3	1.5
	3-years ahead											
	Total Expenditure											
Mean	0.0	-1.1	1.2	1.0	1.6	-0.6	2.2	3.7	-0.7	-1.1	0.4	0.4
	Social payments											
Mean	0.1	-0.3	0.4	1.4	0.9	-0.2	1.1	5.0	-0.1	-0.3	0.2	0.6
	Interest expenditure											
Mean	-0.2	-0.1	-0.1	0.5	0.1	-0.1	0.2	2.6	0.2	0.1	0.1	1.8
	Subsidies											
Mean	0.0	0.0	0.0	2.0	0.0	0.0	0.1	2.0	0.0	-0.1	0.0	0.5
	GFKF											
Mean	0.1	0.0	0.1	2.8	0.1	0.0	0.1	6.0	0.2	-0.1	0.3	2.2

Source: SCPs and Commission services' computations.
Shaded cells represent slippages in the different expenditure components. These slippages are firstly expressed in pp. of GDP (columns c), showing the amount by which the respective expenditure component contributed to the overall expenditure slippage. A positive (negative) sign implies that the corresponding expenditure component turned out higher (lower) than was planned. However, this measure is influenced by the share of each expenditure component in GDP so that in principle larger expenditure components are expected to contribute more to the overall expenditure slippages than smaller components. To complement this picture, the table also shows how much the slippage represents in terms of the initial plan, in absolute value (columns d).

The implementation slippage in subsidies is very small when computed in pp of GDP, as corresponds to the typically reduced size of this expenditure component in Member States' GDP. However, the implementation slippage in this expenditure item has been sizeable when compared to the planned changes. Similarly, GFKF slippages have moderately contributed to overall expenditure slippages, except in most recent years. Still the size of the slippage with respect to the initial plans is amongst the highest –columns (d).

4. CONCLUSIONS

Evidence of the last seventeen years shows that budgetary outcomes have recurrently deviated from planned targets. Moreover, it shows that implementation slippages have been mainly driven by expenditure ratios turning out higher than planned.

Robust and effective medium-term budgetary frameworks are crucial to minimize implementation slippages and, more generally, to ensure that government finances are on a sustainable path, especially in the current context. Recent developments in the EU fiscal framework in this respect are encouraging for, at least, two reasons. First, all twenty-eight EU Member States have now in place institutional arrangements that allow fiscal authorities to extend the horizon for fiscal policymaking beyond the annual budgetary calendar. Second, medium-term budgetary frameworks have been considerably strengthened in the recent years, both as a result of EU and national initiatives. The challenge ahead lies in the strict enforcement of these frameworks, in order to ensure their benefits are effectively unfolded.

Part IV

Expenditure trends in the EU and expenditure-based consolidations

1. INTRODUCTION

The accumulation of fiscal imbalances, the return to sound fiscal fundamentals, or the ability to maintain a sustainable budgetary position over time are all typically determined by government expenditure dynamics in the EU. This is linked to the fact that government revenue-to-GDP ratios are overall already high across EU Member States. Furthermore, in the absence of discretionary measures, government revenues typically follow GDP.

Government expenditure in EU-15 Member States has been on an increasing trend since 1970. ([85]) In fact, the overall share of total government expenditure in GDP increased by more than 15 percentage points in the last four decades. The persistent upward trend was however curbed in two specific periods along the past forty years, which coincided with two waves of fiscal consolidation primarily designed as expenditure-based. More recently, EU Member States have been particularly encouraged to control expenditure dynamics in the latest consolidation episodes.

Against this background, the purpose of Part IV is to investigate the extent at which expenditure-based consolidations have managed to achieve different results in terms of fiscal fundamentals. More specifically, linked to the crucial role of expenditure trends in ensuring fiscal sustainability, the differential impact of expenditure-based consolidations on medium-term spending trends in the EU is examined.

The vast literature on the determinants of successful fiscal consolidations typically favours spending-based over revenue-based adjustments. In particular, the empirical literature generally finds that successful fiscal adjustments favour cuts in primary current spending rather than on capital goods. Building on Giavazzi and Pagano (1990), this is justified on the grounds that decisive spending cuts can change future expectations about taxes and government spending, expanding private demand and resulting in an overall economic expansion. Therefore, expenditure-based consolidations are less damaging to growth and more effective in reducing deficit and debt ratios. Two caveats can however be mentioned with regards to these findings in the literature.

First, little has been explored about whether expenditure trends are actually affected by expenditure-based consolidations, thus allowing permanent lower taxes. At the same time, studies such as Cahuc and Carcillo (2012) empirically show that some spending cuts are typically temporary and procyclical. Therefore, it is only natural to wonder whether expenditure-based consolidations actually manage to curb medium-term expenditure trends or, to put it differently, whether there is an actual basis for the credibility effects that the literature argues are associated to expenditure-based consolidations.

Second, from a technical point of view, the findings of the traditional literature on the composition of fiscal consolidation risk being affected by an allocation bias as shown by Jordá and Taylor (2013). Indeed, one of the main difficulties when estimating the effects of fiscal policy is that consolidation shocks are seldom randomly allocated. On the contrary, much of the variation in fiscal policy is the result of endogenous factors. If fiscal shocks are not accurately identified, their effects will not be correctly disentangled.

In this context, Part IV analyses the main features of expenditure-based consolidation episodes in the EU over the last four decades and investigates the link between the composition of fiscal adjustments and medium-term expenditure trends. A brief summary of the existing literature on the determinants of successful consolidations – Chapter 2 – is followed by an overview of past total expenditure trends and its sub-components in the EU – Chapter 3 –. Chapter 4 presents the results of an empirical analysis of medium-term expenditure trends after expenditure-based consolidations in a sub-sample of EU Member States. Finally Chapter 5 analyses in further detail the specific measures implemented in five successful expenditure-based consolidations in the EU.

The empirical analysis shows that medium-term expenditure trends are substantially reduced over

([85]) Complete General Government data under ESA system of accounts are not available pre-1995 for accession Member States.

the four years following an expenditure-based consolidation, while no such effect is noticeable after the implementation of other type of fiscal consolidations. Looking into the detailed measures comprised in the five successful expenditure-based adjustment episodes, it is interesting to note that all consolidation programmes embedded an explicit budgetary objective to be achieved in the medium term and were accompanied by institutional budgetary reforms that increased spending efficiency and budgetary discipline.

Moreover, spending cuts were wide ranging but were in all cases particularly concentrated towards categories traditionally acknowledged to be the most rigid, most persistent, and least discretionary components of government spending, such as compensation of public sector employees and transfers to households. Contrary to that, cuts to capital spending varied considerably across the different episodes.

The above findings allow drawing valuable lessons in the current context as returning to more moderate government debt ratios will crucially depend on EU Member States' ability to, on the one hand, deliver on budgetary adjustments and, on the other hand, preserve and enhance potential growth. ([86])

([86]) See Part I for details on the recently adopted Communication from the Commission on an Investment Plan for Europe.

2. LITERATURE REVIEW

The determinants of successful fiscal consolidations have been extensively explored by the literature. A consensus has emerged that composition matters: the mix of expenditure and revenue measures has important implications with respect to output growth and fiscal fundamentals, as well as other key macroeconomic variables. This has obvious implications on the debate around the optimal design of fiscal consolidation strategies.

Linked to the fact that only expenditure trends can be exogenously controlled over the medium term – as government revenues typically follow GDP – a common finding in the literature is that spending cuts are more effective in ensuring lasting consolidations and thus, in reducing government deficit and debt ratios. Moreover, they are also usually found to be less damaging to growth, at least in the medium term. These results hold regardless of the methodology used to identify the fiscal shock, that is, the part of the change in the deficit that is due to the discretionary action by the policymaker – i.e. either the traditional approach based on the change in the cyclically-adjusted balance or the narrative approach. ([87])

The importance of the composition of fiscal adjustments has been particularly stressed by Alesina and Perotti. Within the traditional approach to the identification of fiscal shocks, the seminal article by Alesina and Perotti (1995) finds that fiscal adjustments that rely on cuts in current expenditure have a higher probability of generating strong economic growth and, therefore succeed in reducing fiscal imbalances. Building on Giavazzi and Pagano (1990) they claim that spending cuts can change future expectations about taxes and government spending, expanding private demand and resulting in an overall economic expansion. While they find that the success of expenditure-based consolidations is delivered in the long run, its effects over the short term are more debatable. In fact, a number of conditions need to be met to ensure its success over the short run, which includes the implementation of product- and labour market reforms (Alesina and Perotti, 1996; Alesina and Ardagna, 1998). More recently, Alesina and Ardagna (2012) have empirically found that spending-based fiscal adjustments have caused smaller recessions than tax-based ones.

On the other hand, following the narrative approach ([88]), Guajardo, Leigh and Pescatori (2011) find that spending-based adjustments are less contractionary than tax-based ones, particularly after the first year. Fiscal adjustments are found to have especially low output costs when, on top of being based upon spending cuts, they consist of permanent measures rather than stop-and-go ones (Alesina, Favero and Giavazzi, 2012). Moreover, under specific circumstances, cutting expenditure can have a positive effect on growth as there is some evidence that large government expenditure levels can have a negative impact on growth (Fölster and Henrekson, 1999).

Apart from a more benign effect on growth, spending-based consolidations are found less likely to be reversed and more effective in reducing deficit and debt-to-GDP ratios (Alesina and Ardagna, 2012). Heylen, Hoebeeck and Buyse (2011) show that consolidation programs imply a stronger reduction in the government debt-to-GDP ratio when they mainly rely on spending cuts, except for public investment. However, some spending cuts – typically cuts in the wage bill – contribute to debt reduction only if public sector efficiency is low. Conversely, downsizing the public sector when its efficiency is high may have negative effects on overall productivity and growth. Large spending based consolidations are also more likely to reduce deficits and debt-to-GDP ratios than large tax increases (Alesina and Ardagna, 2010).

Drilling down into specific expenditure items, the empirical literature generally finds that successful fiscal adjustments favour cuts in primary current spending rather than on capital goods (Alesina and Ardagna, 2012). Hauptmeier et. al (2006) find that

([87]) See Perotti (2012) for a detailed description of the two approaches to identify fiscal policy shocks.

([88]) In contrast to the traditional approach, that identifies fiscal shocks through changes in the structural or cyclically-adjusted balance, the narrative approach seeks to identify exogenous fiscal shocks directly, examining policymakers' intentions and actions as described in contemporaneous policy documents.

spending-based consolidations are more likely to be successful when they aim to tackle the largest and most dynamic expenditure items on government expenditure. Summing up their findings over eight successful expenditure-based consolidation episodes they claim that "*it becomes apparent that all countries focused efforts strongly on government consumption (wages and employment) and transfers and subsidies (...) All reform episodes are marked by public wage restraint and tightened eligibility criteria as well as reduced benefits for social transfers. By contrast, only few episodes contained major declines in public education*".

Past episodes of successful adjustments suggest that reforms to the government wage bill have been the most lasting and growth-friendly spending cut (Alesina and Perotti, 1996; Hauptmeier et. al, 2007; Kumar, Leigh, and Plekhanov, 2007). Moreover, Hernández de Cos and Moral Benito (2014) find that reducing the government sector wage bill has positive spill-over effects on the private sector and increases competitiveness. However, a closer look suggests that while wage and public employment restrictions can be effective in the short-run, they cannot substitute for lasting reforms that specifically address genuine staffing needs and efficiency in the civil service.

Afonso and Jalles (2013) claim that cuts in social transfers and subsidies help the consolidation to succeed. Better targeting of social welfare spending, including social benefits, can provide substantial fiscal savings as social benefits are large in many countries with high adjustment needs.

The above findings by the empirical literature are underpinned by work that shows the impact on growth of different expenditure items. Barro (1997), as well as Afonso and Furcieri (2010), find a significant negative effect on growth of high government consumption to GDP ratios. Conversely, theoretical work, such as Romer (1986), shows that government expenditure providing public goods and addressing market failures and externalities can be growth-enhancing. In turn, Barro (1990) shows that when a government increases 'utility-enhancing' public consumption while reducing 'production-enhancing' public spending, growth rates fall regardless of the level of total spending.

Still, the breakdown between capital and current spending does not necessarily provide the appropriate benchmark to differentiate between 'productive' or growth-enhancing, and 'non-productive' expenditure. This distinction is backed by several studies that emphasise the functional breakdown of expenditure rather than on the economic decomposition. In this vein, government expenditure in research, development and innovation or public education is usually associated to higher potential growth (Conte et al., 2009).

One important technical caveat to all results above has lately been noted by a new strand of the literature. This relates to the well-known endogeneity problem in the identification of fiscal shocks. The work by Jordá and Taylor (2013) presents an articulated discussion in this regard and applies a new estimation technique – already used in cross-sectional data in applied microeconomics – to fiscal aggregates. This work shows that both the traditional and the narrative approach to the identification of fiscal shocks can be affected by an allocation bias, as fiscal shocks are not randomized. This implies that some of the variables that determine the propensity to undergo fiscal consolidation may also affect the outcome under analysis, thus leading to substantial bias in the estimated effect of consolidation shocks. To our knowledge, the specific effects of expenditure-based consolidations have not been tested under this alternative estimation technique.

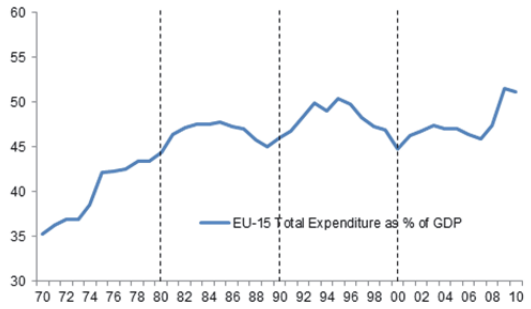
3. EXPENDITURE TRENDS IN EU-15:1970-2010

3.1. EU_15 AGGREGATE EXPENDITURE TRENDS

Government expenditure in EU-15 Member States ([89]) has been on an increasing trend since 1970. In fact, the overall share of total government expenditure in GDP increased by more than 15 percentage points in the last four decades. However, different sub-periods can be distinguished when looking at the evolution of expenditure in the EU-15 since 1970, roughly delimited by the turns of the decades.

From 1970 to 1980 expenditure climbed steadily, rising from approximately 35% for the EU-15 in 1970 to around 45% in the early 1980s.

Graph IV.3.1: **Evolution of Total Expenditure as Percentage of GDP in EU-15**



Source: Commission services

([89]) Complete General Government data under the ESA system of accounts are not available pre-1995 for accession Member States. Pre-1980 data are only available for Belgium, Denmark, France, the Netherlands, Austria, Portugal, Finland and the UK (and only three of these extend back to 1970). Consequently, Government expenditure data using ESA78 is compiled (from AMECO) for the period 1970 to 1995. A further break in the data exists in the pre-1995 series relating to the re-unification of Germany, with only West German data available up to 1991 and re-unified German data post-1991. Separate series of growth rates for each variable are generated for the period 1970-1991, 1991-1995 and 1995-2010 using West German data in substitute for full German data prior to 1991. The three series are then appended to create a full data series of growth rates in each expenditure variable running 1971 to 2010. In looking at expenditure as a percentage of GDP, two full sets of variables are available for the year 1995 (one based on ESA'95 and the other on the former definition). As it is difficult to make a clear argument for selecting one or the other, the observations for each variable for both years are summed, with the resulting variables as a percentage of GDP representing an average.

It continued to rise in the early 1980s, reaching around 48% by mid-1980s.

Coinciding with a first wave of expenditure-based consolidation episodes in countries such as Ireland, Belgium, United Kingdom, Netherlands and Luxembourg, expenditure levelled off by mid-1980s and, then dipped slightly before the end of the 1990s. It is worth pointing out that part of this initial increase in expenditure was related to the catching-up process that a notable part of the EU-15 Member States was experiencing at the time. In fact, in 1970 the share of total government expenditure with respect to GDP was quite diverse across EU-15 Member States, with Sweden having the largest ratio at 41% of GDP while Portugal's expenditure-to-GDP ratio was only 17%.

During the following two decades around half of EU-15 Member States steadily brought their government expenditure-to-GDP ratios in line with the average in advanced economies. Picking for the sake of comparison the 35% - 40% interval as an arbitrary benchmark for total expenditure-to-GDP ratios, it can be observed that in 1970 six out of the EU-15 Member States had ratios below that benchmark and actually four of them (PT, ES, EL and LU) had expenditure-to-GDP ratios at or below 25%.

The blue line in Graph IV.3.2 represents the cumulated change in expenditure – expressed in percentage points of GDP – that each of the EU-15 Member States should have experienced over the period 1970-1990 to reach an expenditure-to-GDP ratio of 40%. As can be observed, the four Member States with the lowest expenditure ratios at the beginning of the series increased their government spending so as to converge with levels within the 35%-40% interval. This implied very large cumulated increases of between 15-23 percentage points of GDP in the course of these two decades.

At the same time however, it can be observed that several EU-15 Member States whose expenditure-to-GDP ratios were already at or above the interval arbitrarily picked for the sake of this comparison – and, in any case, already at or above the average in advanced economies - still experienced very substantial increases in their expenditure-to-GDP

ratios of between 10 and 15 pp cumulatively over the two decades.

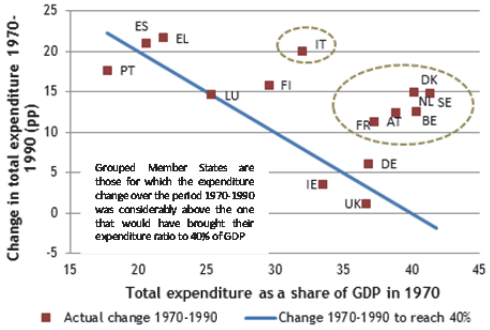
Therefore, it is interesting to note that by 1990 the magnitude of the divergence between the highest and the lowest expenditure-to-GDP ratio in the EU-15 was similar to that of two decades before. In fact, this difference only marginally decreased from 23 percentage points in 1970 – corresponding to the difference between Sweden' and Portugal's expenditure-to-GDP ratios – to 20 percentage points in 1990 – again, corresponding to the difference between Sweden' and Portugal's expenditure-to-GDP ratios. However, the share of government expenditure in GDP had shifted upwards by more than 15 percentage points of GDP in both countries and, on average, by 10 percentage points of GDP in the EU-15.

In turn, two sub-episodes can be distinguished in the period 1990-2000 as shown in graph IV.3.1:

- 1990-1995: Even though dipping slightly before the end of the 1980s, expenditure growth resumed sharply in the early 1990s, rising to a new peak of over 50% of GDP in the EU in 1995. Real expenditure growth for the EU-15 as a whole stood at 8% per year on average during those five years. Meanwhile the majority of EU-15 Member States experienced real expenditure growth rates of around 6 -7% per year on average during the first half of the 1990s, Portugal, Austria and Greece stood out with average real growth rates of around or above 10% per year. Finland and Sweden's equivalent rates were of a more moderate 2½% approximately. Partly as a result, by 1995 twelve out of the EU-15 Member States had headline deficits around or above 5% of GDP.

- 1995-2000: A second wave of consolidation episodes kicked-in in the mid-1990s, partly encouraged by the Maastricht convergence criteria, as was the case in Spain, Finland, Sweden, the Netherlands and Ireland. This, together with the strong growth in output during the second half of the decade, contributed to expenditure falling back to 45% of GDP in 2000. In fact, most Member States halted the dynamics of real expenditure growth of the first half of the decade, with six of them more than halving their previous growth rates. Thus, average annual real expenditure growth in the EU-15 stood at a more moderate 2¼% per year for the last half of the 1990s. By the end of the decade, only two Member States (Greece and Portugal) registered headline deficit above the 3% threshold with the excess being of less than ¼ pp.

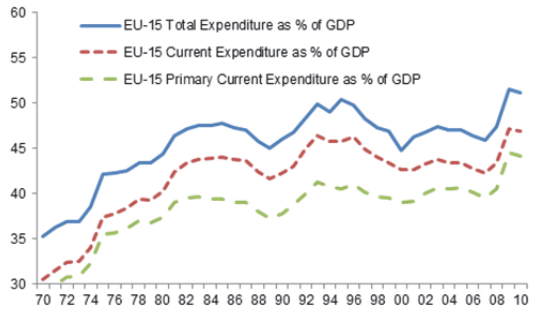
Graph IV.3.2: **Evolution of Total Expenditure-to-GDP against Benchmark Ratio**



Source: Commission services

Finally, real expenditure growth rates picked up again in the 2000s to an average 4% per year in the EU-15. While its share in GDP for the EU-15 remained broadly steady during the 2000s, reflecting the strong growth in output during this time, a sharp spike is evident at the end of the decade as the financial crisis led to GDP falls and social expenditure increases, thereby pushing total expenditure back up above 51% of GDP. Ireland stands out with an average real expenditure growth rate of 10% per year over the decade –partly driven up by bank recapitalization costs by the end of the decade –, followed by Spain and Greece where spending expanded at an average rate of 8% per year during that same period. Most of the EU-15 Member States experienced average annual expenditure growth rates around 3% and 4% over the decade, apart from Sweden that showed a more moderate annual increase of around 1.5%.

Graph IV.3.3: **Total, current and primary current expenditure in the EU-15 (% GDP)**



Source: Commission services

3.2. EU-15 DISAGGREGATED EXPENDITURE TRENDS

In order to understand the underlying dynamics driving government expenditure within EU Member States, it is helpful to briefly examine the evolution of disaggregated expenditure categories since 1970. This is particularly important in the context of assessing the efficacy and durability of expenditure-based consolidation, as a number of studies point to the varying impact of cuts to different expenditure areas in this regard (Alesina and Ardagna, 2012; Hauptmeier et. al, 2006; Alesina and Perotti, 1996).

As detailed above, the literature suggests that successful adjustment relies more heavily on cuts to primary current expenditure, rather than public investment. Graph IV.3.3 indicates that the steady rise evident in total expenditure in the EU from 1970 until the mid-1990s was mainly driven by current expenditure trends. During the latter half of the 1990s, current expenditure as a percentage of GDP did not contract to the same extent as total expenditure, and remained flattish for most of the 2000s, before a spike at the end of the decade was brought about by the onset of the financial crisis. The slight decoupling between the evolution of total expenditure on the one hand and the evolution of current and primary current spending on the other hand in years 1996, 1997 and 2000 is explained by a sharper decline of capital spending during those years.

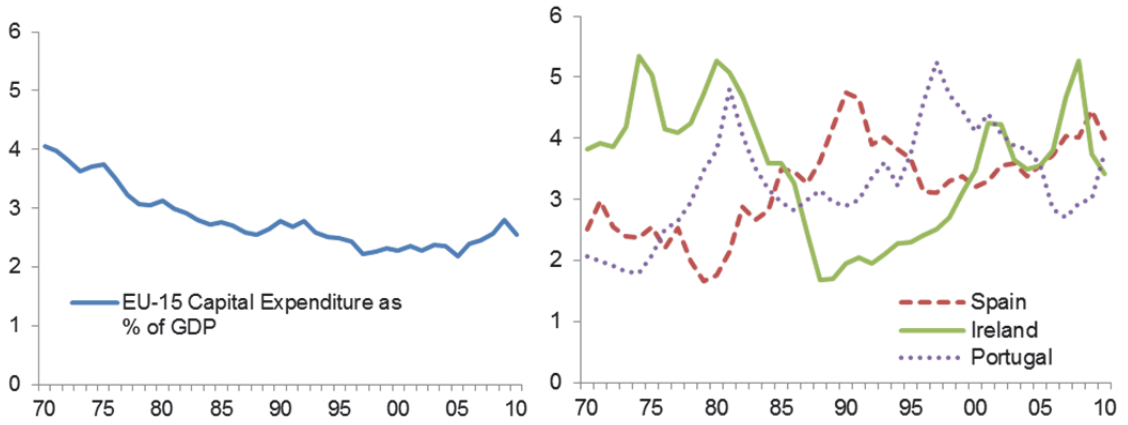
Contrary to the steady rise in current expenditure, at an EU-level, capital expenditure declined steadily over the sample period, almost halving from over 4% of GDP in 1970 to bottom out at around 2.2% of GDP in the late 1990s and early 2000s. Some signs of a pick-up in the late 2000s are evident – partly linked to bank recapitalization costs –, though it remained under 3% of GDP throughout.

However, there is a considerable degree of variance at a country level. Austria, Belgium, Germany, Denmark, Sweden and the UK all saw a steady decline in capital expenditure from the early 1970s into the 1990s, with the level remaining broadly flat thereafter. Finland, the Netherlands, France and Italy display a similar pattern though not as pronounced, with a flatter trend in the latter two and a subsequent reflation in the late 1990s in the Netherlands. Interestingly, the use of public investment as a key component of fiscal consolidation efforts appears to be evident in a number of countries, where steep falls in the capital expenditure-to-GDP ratio were followed by gradual recoveries, most notably in Spain in the 1990s, Ireland in the late 1980s and early 1990s and Portugal in the 1980s.

Turning to the interest expenditure-to-GDP ratio, for the EU as a whole it rose steadily through the 1980s and 1990s from a relatively low base, to peak at around 5% of GDP in the early to mid-1990s before declining almost as steadily through the second half of the 1990s, into the noughties, reflecting preparation for and introduction of euro. However, the aggregate figures for the EU are held down by the flat and relatively low profile of interest expenditure in Germany, France and the UK.

In contrast, a number of countries display a noticeable bell-shape to the trend of debt interest costs, with interest expenditure as a percentage of GDP peaking at levels of 9% of GDP or higher in the middle of the sample period in Belgium, Denmark, Greece, Ireland, and Italy. A similar but less pronounced pattern is evident in Spain, Portugal, the Netherlands and Sweden, with almost all countries experiencing a decline in spending in this area in the late 1990s and 2000s. The convergence of nominal rates reflects the lead-in to monetary union, as Member States strove to meet the Maastricht entry criteria and markets

Graph IV.3.4: Capital expenditure in EU-15 and selected Member States (% GDP)



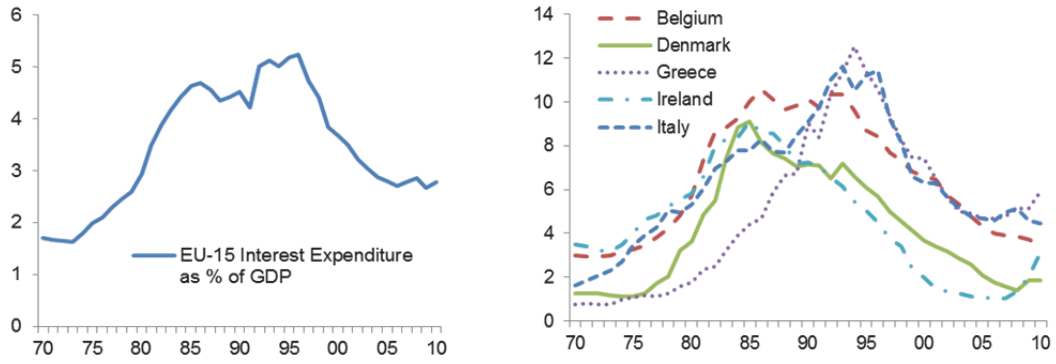
Source: Commission services

anticipated the elimination of exchange rate risks. As detailed in chapter II, controlling the public wage bill is often identified as beneficial to both growth and long-term expenditure control. At an EU aggregate level, pay expenditure appears to have been well controlled during the sample period, showing a moderate rise during the 1970s from under 10% of GDP to over 12%, before declining slowly since the early 1980s back to around 10.5% in 2000 and remaining broadly level since. However, considerable variation in both trends and levels exists at country-level.

Austria, Belgium, France, Ireland, Italy, the Netherlands and the UK are broadly reflective of the overall trend, while Denmark and Sweden also stabilised public sector pay as a percentage of GDP in the 1980s, though at higher levels above 15% of GDP. A clear rising trend is evident, though from a low base, in Greece, Portugal and Spain. This trend was stabilised and slightly reversed in the latter case in the 1990s. Finland achieved a significant reduction in the pay expenditure-to-GDP ratio in the 1990s, bringing it down from over 17% to less than 13% in 2000, while Germany achieved a steady and gradual decline to below 8%.

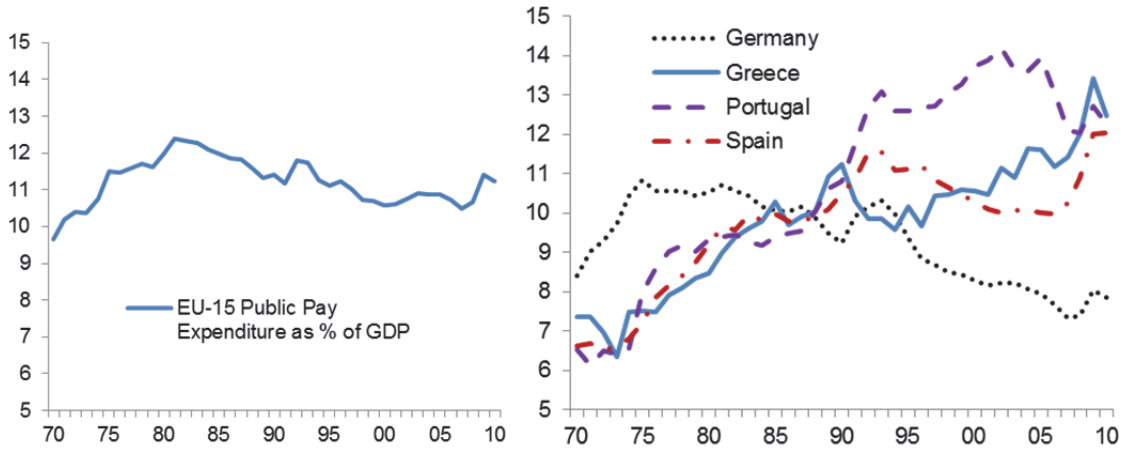
The evolution of spending on social benefits over the 1970-2010 period is more difficult to examine due to a statistical reclassification in the mid-nineties, which saw a significant reduction in the spending which was categorised under this

Graph IV.3.5: **Interest expenditure in the EU-15 and selected Member States (% GDP)**



Source: Commission services

Graph IV.3.6: **Compensation of employees in the EU-15 (% GDP)**



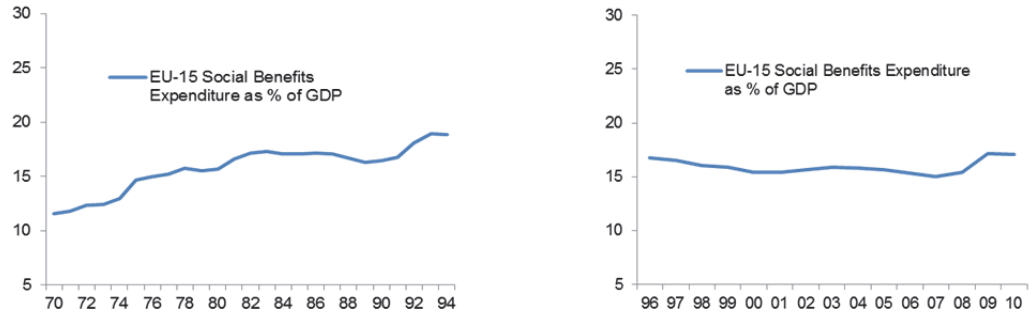
Source: Commission services

heading. ([90])

Consequently, it is necessary to examine the two periods separately. As it happens, the statistical break in the data is coincides with the end of a period of change in the trend of expenditure on social benefits. In the pre-95 period, a broadly increasing trend is discernible across the EU-15 in the 1970s, with spending on social benefits rising from 12% of GDP in 1970 to stand at 17% by 1981.

However, a number of countries, including Belgium, Sweden, the Netherlands and Ireland had begun to exert control over spending in this area during the mid to late 1980s, so that expenditure on social benefits in the EU-15 stood at 19% of GDP in 1994. Reflecting the generally strong overall economic and employment environment, this trend was consolidated post-1995, with expenditure on social benefits in the EU-15 holding in a range between 15% and 18% of GDP for the remainder of the sample period. Indeed, as illustrated in Graph III.3.8, although spending on

Graph IV.3.7: **Social benefits other than transfers in kind in the EU-15 (% GDP)**

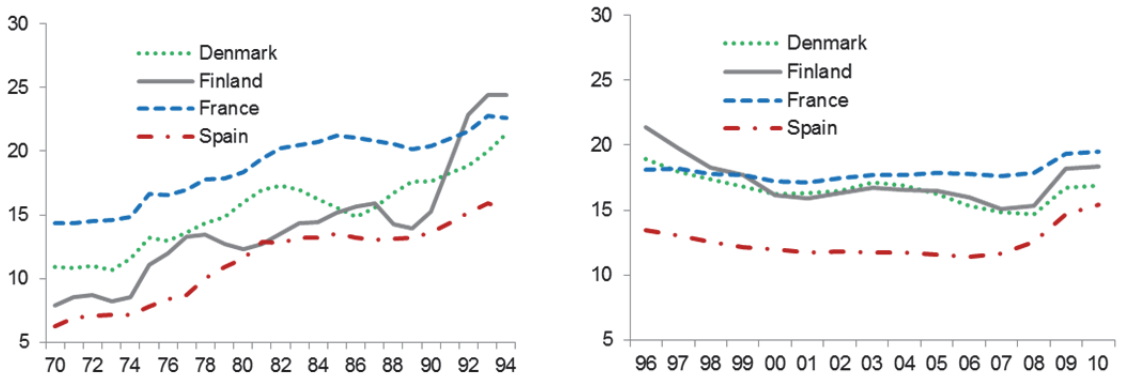


Source: Commission services

social benefits had continued to rise in Denmark, Finland, France and Spain into the early to mid-1990s, the share of GDP spent on this category was held flat or declining for most of the next fifteen years. The exceptions to this trend are

([90]) Expenditure on social benefits excluding social transfers-in-kind refers mainly to all social benefits in cash - both social insurance and social assistance benefits - provided by government units, including social security funds, and NPISHs.

Graph IV.3.8: Social benefits other than transfers in kind in the EU-15 (% GDP)



Source: Commission services

Portugal and Greece, where benefits expenditure as a percentage of GDP exhibits a relatively steady increase throughout the 1970 to 2010 sample period.

The evolution of disaggregated expenditure trends within the EU has varied both across the sample period and between Member States. While some countries have achieved extended periods of control over both total expenditure and individual areas of spending, others have experienced large rises and falls. A more detailed examination of individual budgetary measures and their efficacy is provided for five episodes of successful expenditure-based consolidation in chapter V. However, an attempt to estimate the potential benefits associated with such strategies will precede.

4. ARE EXPENDITURE-BASED CONSOLIDATIONS REALLY DIFFERENT? AN EMPIRICAL ANALYSIS

4.1. INTRODUCTION

As set out above, high and increasing spending levels are frequently associated with persistent deficit and debt increases, which erode budgetary positions and put at risk the sustainability of government finances. As shown in the previous chapter, expenditure has been on a persistently increasing trend in the EU for over four decades. This trend was only interrupted around the mid-1980s and mid-1990s. Moreover, the expenditure ratio seemed to have stabilized subsequently until it surged again driven by the Great Recession. This chapter analyses the features of the different consolidation episodes that occurred from 1978 to 2007 in EU Member States and, in particular, it examines the link between the composition of consolidation and expenditure dynamics.

The aim is to investigate whether fiscal consolidations based on spending cuts are more successful in restoring sound budgetary positions by curbing expenditure trends. While the literature on the composition of fiscal adjustments suggests that expenditure-based consolidations tend to be more successful, little has been investigated on their medium-term impact on precisely expenditure trends.

There are two main channels through which expenditure-based consolidations can achieve more lasting results. First, through a differentiated effect on growth if – as it is suggested by the literature – spending based adjustments are less damaging to growth than revenue based ones. But beyond that, expenditure-based consolidations could also have a differentiated impact on expenditure itself if they manage to curb spending trends in the years thereafter, thus allowing lower taxes. While it is obvious that spending cuts will have an impact on contemporaneous government expenditure, this analysis rather focuses on its differentiated impact on medium-term expenditure trends, as it checks the evolution of expenditure in the four years after a consolidation episode.

For that purpose an 'expenditure-based fiscal treatment' is identified using the Devries et al (2011) ([91]) action-based dataset, and is defined as a binary variable which indicates whether a consolidation has been expenditure-based or rather revenue-based. The differentiated effect of the former subset of consolidation episodes on future expenditure dynamics is investigated with the aim of establishing whether it is more effective in curbing expenditure dynamics than the alternative revenue-based fiscal consolidations and thus, a better strategy to restore and maintain sound budgetary positions.

Results suggest that expenditure trends are only significantly curbed if fiscal consolidation is expenditure-based. In fact, expenditure is found to decline between 15 and 25% cumulatively over the four years after the implementation of spending cuts, while no significant decrease in expenditure is found after other type of fiscal consolidations. ([92])

4.2. DATA

The sample covers thirteen EU Member States, namely Belgium, Germany, Denmark, Spain, France, Ireland, Italy, the Netherlands, Austria, Portugal, Finland, Sweden and the United Kingdom ([93]). For all countries the dataset spans from 1978 to 2007, with the most recent crisis years being excluded from the analysis.

Data sources are twofold. In fact, except for the variables characterizing the fiscal shocks, which are taken from Devries et al (2011), all data are extracted from the annual macro-economic database (AMECO) of the European Commission's Directorate General for Economic and Financial Affairs. Fiscal data cover the general government.

([91]) Devries, P., Guajardo, J., Leigh D. and Pescatori, A. *A New Action-based Dataset of Fiscal Consolidation*, IMF Working Paper, WP/11/128.
([92]) See footnote 96 for details.
([93]) Luxembourg and Greece are not included in the analysis as no fiscal shocks are registered for these two Member States in the Devries et al. database.

Fiscal consolidation episodes are identified following the action-based dataset by Devries et al (2011). This dataset records the estimated budgetary impact of fiscal consolidation actions primarily motivated by the desire to reduce the budget deficit. In contrast to the traditional approach that identifies fiscal shocks through changes in the structural or the cyclically-adjusted balance, this narrative approach seeks to identify exogenous fiscal shocks directly by examining the policymakers' intentions and actions as described in contemporaneous policy documents.

Despite its advantages, it is generally acknowledged that the cyclically-adjusted balance may fail to appropriately capture exogenous policy changes. In fact, cyclical adjustment methods suffer from measurement errors that are likely to be correlated with economic developments, therefore biasing the analysis of the effects of fiscal policy. The narrative approach tries to avoid these problems by directly identifying fiscal consolidation actions.

In Devries et al. (2011) fiscal consolidation dataset – restricted to the EU-13 Member States – fiscal consolidations are identified in one hundred and eleven occasions between 1978 and 2007 representing around 30% of all observations. In only thirteen out of the total cases did the consolidation episode last for just one year, while the other ninety-eight fiscal shocks were part of multiannual consolidation episodes. As can be expected, the number of consolidation episodes is negatively correlated with the average duration of the consolidation period in each Member State.

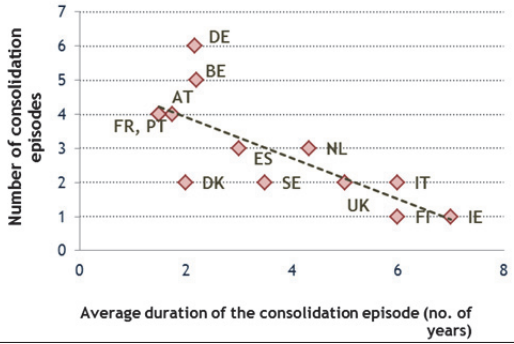
Table IV.4.1: **Main features of the consolidation strategies in the EU-13 (1978-2007)**

	All consolidations	Both revenue and expenditure measures	Both revenue and expenditure measures, each amounting to more than 0.3% of GDP	Expenditure measures larger than revenue measures
Number of cases	111	68	44	77
Percentage over total	100%	60%	40%	70%

Source: Commission services

Across the panel, the average consolidation episode in the EU-13 lasted three and a half years and included annual consolidation measures amounting to 1.3% of GDP. In every three out of five cases, the annual consolidation strategy was mixed, relying both on expenditure and revenue measures, even though the bulk of the estimated adjustment – around 60% – stemmed from spending cuts. Thus, annual consolidation measures averaged 0.8% and 0.5% of GDP respectively on the expenditure and the revenue side. In 70% of the cases, the effort on the expenditure side was larger in absolute terms than the one achieved through the revenue side. ([94])

Graph IV.4.1: **Average duration of the consolidations episodes in the EU-13 (1978-2007)**



Source: Commission services

The expenditure-based fiscal shock is characterized as a binary variable with a value of 1 when the effort stemming from spending cuts is larger than the one stemming from revenue measures and 0 otherwise.

4.3. METHODOLOGY

The endogeneity bias is a typical problem faced when trying to disentangle the effects of fiscal policy shocks on outcome variables. The fact that fiscal consolidation episodes may be correlated with outcome variables (typically GDP growth or,

([94]) Devries et. al (2011) report as the budgetary impact of the consolidation measures the *ex-ante* estimates provided in contemporaneous historical sources, instead of retrospective estimates which are rarely available. Yet, estimating the budgetary impact of discretionary measures on the expenditure side is complicated by the difficulty of defining a benchmark for expenditure. Furthermore, evidence presented in Part III suggests that the average expenditure effort actually implemented by EU Member States falls often short of the *ex-ante* planned adjustment. Therefore, the estimates reported in the dataset should be interpreted cautiously. In any case, possible overestimation of the budgetary impact of expenditure measures has limited influence on this analysis due to the fact that expenditure-based consolidation shocks are defined as binary dummy variables.

in this case, expenditure dynamics) is not enough to make valid causal claims about the effects of fiscal policy. Alternatively, the causal relationship could go the other way around – with the analysed outcome variable determining the occurrence of consolidation episodes – or an unobserved variable could jointly determine both the fiscal consolidation episode and the outcome variable. As noted by Jordá and Taylor (2013) ([95]) the fundamental reason why correlation does not allow concluding on causal relationships in this context is that fiscal policy shocks are not randomly allocated.

If fiscal policy shocks were randomly assigned, establishing causality would be equivalent to determining whether the outcome variable is correlated with fiscal consolidation, as random assignment would ensure that on average economies under shock are similar to those not exposed to it. In particular, the expected value of the dependent variable would be statistically identical in both groups before exposure to the fiscal shock.

Contrary to that, fiscal policy decisions are insufficiently randomized, i.e. they typically respond to the characteristics of the economy concerned, some of which may be unobservable. Using a medical analogy, the allocation of the treatment – i.e. fiscal consolidation – is determined by the characteristics of the treated – i.e. the situation of the concerned economy –. In this case, estimation techniques that do not correctly tackle this endogeneity bias will not be able to properly disentangle *ex-post* the part of the evolution of the relevant outcome variables attributable to the 'treatment' itself (fiscal consolidation or, more narrowly, expenditure-based consolidations in the present case) from that attributable to the underlying characteristics of the 'treated' economy. This is a problem found in many of the studies quoted above, as those by Guajardo, Leigh and Pescatori as well as Alesina and Ardagna.

For the purpose of our analysis, it is then important to check whether our expenditure-based consolidation 'treatment' – as defined in the previous section – is randomly allocated in the EU, or, as can be expected, can be predicted by a set of control variables, such as GDP growth, expenditure growth or government debt. If the insufficient randomisation of the treatment is confirmed, this will bias any estimates of the impact of spending cuts on government expenditure dynamics that omits these controls.

Table IV.4.2 reports the coefficients and p-values associated with the null hypothesis that the respective variable is not significant in determining the likelihood of an expenditure-based consolidation. The message stemming from the table is clear: spending cuts as identified using Devries et al. (2011) can be predicted by the same economic variables that are correlated with expenditure developments (i.e. they are not randomly allocated).

Table IV.4.2: **Expenditure-based fiscal treatment regression (pooled probit estimators).**

	PROBIT (a)
Public debt to GDP ratio	0.0376***
Dependency ratio	0.0761*
Real GDP growth	-0.180***
Lagged treatment	1.042***
Real expenditure growth	0.0202
Real expenditure growth (lagged)	0.0980***

* p<0.05 ** p<0.01 *** p<0.001

Source: Commission services

In particular, the above results show that an expenditure-based consolidation is more likely when both government debt-to-GDP and dependency ratios are high. The probability to observe such consolidation increases with the lagged real expenditure growth rate. Finally, the pooled probit results confirm that expenditure-based fiscal consolidation episodes tend to be multiannual, as the probability of being under an expenditure-based consolidation increases if such a 'treatment' was already applied in the previous year.

([95]) The time for austerity: estimating the average treatment effect of fiscal policy, Jordá, O. and Taylor, A. (2013)

Box IV.4.1: **Estimating treatment effects of fiscal policy**

The methodology applied in this Chapter brings to the macroeconomic field estimation techniques typically used in epidemiology and medicine. When trying to estimate the effect caused by individuals getting one treatment instead of another, researchers frequently use observational or non-experimental data, which defining characteristic is that the treatment status is not randomized. This implies that some variables may affect the assignment of treatment and the treatment-specific outcomes at the same time.

The analogy with problems faced in macroeconomics when trying to elucidate the effect of a specific economic policy is intuitive. Ideally, to determine the effect of a specific policy shock or 'treatment' X on an outcome Z, Z should be observed when the economy is treated (Z_1) and again when the same economy is not treated (Z_0). Both observations of Z should be made under identical conditions so that the only difference between the two outcomes Z_1 and Z_0 is the presence or absence of the policy shock.

Unfortunately this ideal experiment is never available in macroeconomics (or generally when using observational data). In particular, we may know the outcome Z_1 for an economy that did receive the policy shock or 'treatment', but we will ignore what would the counterfactual or potential outcome (Z_0) be if that same economy would have not received the 'treatment', and vice versa. In this non–randomized context treatment status could be related to covariates that also affect the outcome, causing an endogeneity bias.

In a way, this is a missing-data problem: data on the other potential outcome or counterfactual are informative but are unavailable. In other words, the observed distribution is not the true distribution of all the potential outcomes associated to the policy shock. Treatment-effect methods account for that problem trying to recreate the full joint distribution that would result from a randomized 'treatment' in order to correctly estimate the effect of the policy shock. In brief, the unobserved part of the full distribution is inferred through some control variables that determine the likelihood of being exposed to the policy shock. The endogeneity bias is then corrected by giving more weight to the rare observations where the policy shock was unlikely but still happened and less weight to the more frequent observations where the policy shock was very likely and happened.

In more detail, treatment effect estimators use potential outcome models that specify the potential outcome that each economy (or subject in general) would obtain under each 'treatment' or policy shock, the 'treatment' assignment process and the dependence of the potential outcomes on the 'treatment' assignment process.

Such models generate data in which Z_i is the observed outcome variable for an economy i, t_i is the treatment variable (which we take as binary, t=0 and t=1 in the absence and presence of treatment respectively), x_i is a vector of covariates that affect the outcome and y_i is a vector of covariates that affect the treatment assignment. x_i and y_i typically have elements in common. The observed data contain Z_i, t_i, x_i and y_i but do not show both Z_{0i} and Z_{1i}, for any given economy i. The model for t determines how the data on Z_0 and Z_1 are missing.

The potential outcome model specifies that the observed outcome variable Z is a random variable which takes value Z_0 when t=0 and Z_1 when t=1:

$$z = (1 - t)z_0 + tz_1$$

Where the outcome model estimates both potential outcomes Z_0 and Z_1 for all economies and can be expressed as:

$$Z_0 = x'\beta_0 + \epsilon_0$$

$$Z_1 = x'\beta_1 + \epsilon_1$$

(Continued on the next page)

Box (continued)

β_0 and $\beta_1$are coefficients to be estimated and $\in_0$ and $\in_1$ are error terms, unrelated to x or y.

In turn, the treatment model is:

$$t = \begin{cases} 1, & \text{if } y^{'}\varphi + \delta > 0 \\ 0, & \text{otherwise} \end{cases}$$

where φ is a coefficient vector and δ an unobservable error term unrelated to either x or y.

Consequently the potential outcome mean for each treatment t is $E(Z_t)$.

The average outcome for the 'treated' economies $E(Z_1)$ is then compared with the average outcome for the 'untreated' economies $E(Z_0)$. The difference between the two averages is the so-called Average Treatment Effect (ATE), which is the unbiased estimation of the 'treatment' impact.

$$ATE_t = E(Z_1 - Z_0)$$

Different types of treatment effect estimators can be used, some of them based on models for the outcome variable – such as regression-adjusted estimators (RA) –, some based on treatment models – such as inverse-probability weighting estimators (IPW) –, and some based on models for both the outcome and the treatment. The latter – such as the IPWRA estimator – are 'doubly robust' estimators, which imply that only one of the two models needs to be specified appropriately for the estimates to be unbiased. IPWRA estimators use the inverse of the estimated likelihood of treatment as weights to estimate regression coefficients corrected for missing data. These coefficients are then subsequently used to compute the respective POMs.

More specifically, the IPWRA estimator uses weighted regression coefficients to compute the averages for the 'treated' and the 'untreated' economies. The weights used are the inverse of the likelihood of 'treatment' estimated on the basis of the control variables. In this sense, observations for treated outcomes for which a policy intervention had a low probability of occurring are given more weight. Similarly, untreated economies for which the policy model predicted an intervention are also given more weight. The goal of this reweighting is to rebalance the sample so that the 'treated' and the 'untreated' groups resemble each other as much as possible, i.e. so that the sample is as similar as possible as the one that would result from a randomized experiment.

The assumptions needed to use treatment-effects estimators include the conditional independence assumption and the overlap assumption. The former restricts the dependence between the treatment model and the potential outcomes. The latter ensures that each economy could receive any treatment. Finally, the independent and identically distributed sampling assumption ensures that the potential outcomes and the treatment status of each economy are unrelated to the potential outcomes and treatment statuses of all other economies in the sample.

At least some of the same controls that determine the propensity to apply an expenditure-based consolidation also affect the outcome under analysis – i.e. expenditure dynamics –. Therefore, there could be a substantial endogeneity bias in the results of the estimations that do not specifically tackle this problem. In order to purge this bias, the effects of expenditure-based consolidations on expenditure dynamics are estimated by using inverse-probability weighted regression-adjustment (IPWRA) estimators. A more detailed description of the methodology is provided in Box IV.4.1.

4.4. RESULTS

The analysis below compares the medium-term evolution of expenditure after two different shocks: first, when an expenditure-based consolidation is implemented; second, when any type of fiscal consolidation is implemented – i.e.

including strategies that rely mainly on the revenue side, mainly on the expenditure side and both. ([96])

Table IV.4.3: **Average treatment effect on expenditure of spending-based consolidations and all consolidations**

Log expenditure-to-GDP (relative to Year 0, x100)

	Year 1	Year 2	Year 3	Year 4	Sum
ATE, all fiscal consolidations	-0.314	-1.047	-1.830*	-2.871**	-6.205**
ATE, expenditure-based consolidation	-1.915***	-3.035***	-4.465***	-5.327***	-15.31***
Observations	336	323	310	297	297

* p<0.05 ** p<0.01 *** p<0.001

Log nominal expenditure (relative to Year 0, x100)

	Year 1	Year 2	Year 3	Year 4	Sum
ATE, all fiscal consolidations	0.194	-1.137	-1.852	-3.503*	-6.843
ATE, expenditure-based consolidation	-1.581*	-2.724*	-5.085***	-7.262***	-17.49***
Observations	349	336	323	310	310

* p<0.05 ** p<0.01 *** p<0.001

Log real expenditure (relative to Year 0, x100)

	Year 1	Year 2	Year 3	Year 4	Sum
ATE, all fiscal consolidations	0.219	-2.700	-4.375	-6.131*	-12.70
ATE, expenditure-based consolidation	-2.642**	-5.316**	-7.612***	-9.627***	-25.54***
Observations	349	336	323	310	310

* p<0.05 ** p<0.01 *** p<0.001

Source: Commission services

Results suggest that expenditure trends are only significantly curbed when fiscal consolidation is expenditure-based. In fact expenditure declines between 15 and 25% cumulatively over four years when expenditure-based fiscal consolidations are applied. Conversely, expenditure is found to decline half as much over the same horizon, but with weaker or no statistical significance, following other consolidation strategies.

All results are shown in Table IV.4.3 which presents average effects – average treatment effects (ATE) – of the two types of fiscal shocks on three expenditure aggregates. ATEs provide unbiased estimations of consolidation impacts. ([97])

First, results show that cumulatively over the four years following a consolidation episode, government expenditure-to-GDP ratios decline by 9% more if the adjustment is expenditure-based.

Furthermore, focusing exclusively on expenditure evolution, results also suggest that while spending cuts manage to considerably curb spending trends, other type of fiscal consolidations have no significant impact on these trends.

Nominal government expenditure is found to cumulatively decrease by 17% in the four years following an expenditure-based consolidation. Conversely, no significant containment of nominal expenditure trends is found when other consolidation strategies are implemented. In the same vein, while in general fiscal consolidations have no significant impact on real expenditure dynamics, consolidation episodes where the effort concentrates on the expenditure side are found to generate a cumulative decrease in real government expenditure of 25% over four years.

([96]) As shown in the summary table above, there are a limited number of observations where the effort from the revenue side is larger than the one stemming from the expenditure side. Therefore, the effects of expenditure-based consolidations cannot be directly compared to the ones generated by revenue-based consolidations (if these are to be symmetrically defined, i.e. as a binary variable with a value of 1 when the revenue effort is larger than the expenditure one and 0 otherwise), due to lack of sufficient data. Conversely, the effects of expenditure-based consolidations are compared to those of all types of consolidations, assuming that the difference – if any – stems mainly from the effects of revenue-based adjustments.

([97]) See Box IV.4.1 for more details on the methodology.

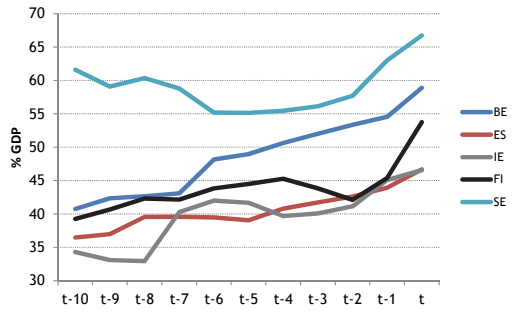
5. LESSONS FROM FIVE SUCCESSFUL EXPENDITURE-BASED CONSOLIDATION CASE STUDIES

According to the empirical findings of the previous chapter, spending-based adjustments in the EU have managed to considerably decrease expenditure in the medium term.

This chapter takes a more detailed look into the concrete measures and policy decisions implemented in five of these spending-based consolidation episodes: Belgium 1982-1827, Ireland 1982-1989, Spain 1994-1997, Finland 1992-1997 and Sweden 1994-1998. These episodes share a set of common aspects, that include the characteristics of expenditure dynamics before and after the fiscal consolidation episode took place. More importantly, there are also some interesting parallels in relation to the nature of the measures implemented during the consolidation period, from which lessons can be drawn.

One caveat should however be noted. Measures are detailed and reported reflecting their *ex-ante* estimated budgetary impact as per the respective budget laws, unless specified differently. Therefore the quantification of the spending measures does not reflect their actual yield which, as pointed out by Perotti (2012), may be rather different from their announced values. Still, an average reduction in expenditure-to-GDP ratios of between 0.5 and 1 percentage points a year over the decade after the consolidation started was achieved in all five episodes thoroughly described below. This suggests that policy actions were effective, and together with the econometric results, justifies a careful examination of the measures taken.

Graph IV.5.1: **Total expenditure-to-GDP in the decade before the consolidation episode started**



Source: Commission services

These episodes share common features concerning their starting situation, the final situation, and the characteristics of the consolidation:

1. *Before the consolidation episode*

All five countries had explosive expenditure dynamics before the fiscal consolidation years. Average annual real expenditure growth in the decade previous to the consolidation period had been around 8% in Ireland, 7% in Belgium, 5.5% in Spain and Finland and slightly below 3% in Sweden. All countries experienced economic downturns before the consolidation started that, together with these explosive expenditure trends, made expenditure-to-GDP ratios rocket: total expenditure to GDP increased by more than 15 percentage points - with respect to ten years before the consolidation period started - in Belgium, Ireland and Finland and around 10 percentage points in Spain. In the case of Sweden, total expenditure with respect to GDP increased by almost 12 percentage points just in the five years before the consolidation started.

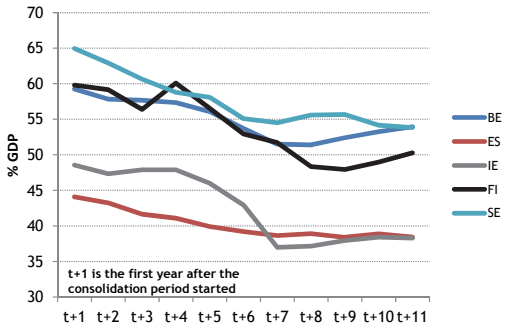
All listed countries were therefore facing the need to implement large consolidation packages and reduce their deficit levels. Most had little chances of consolidating on the revenue side due to either relatively recent revenue-based consolidation episodes (e.g. Spain and Ireland) or due to already very large revenue-to-GDP ratios (e.g. Sweden and Finland).

2. *After the consolidation episode*

After the consolidation period started - and for the following decade - these five countries managed to reduce their deficit levels and, most importantly, to curb their previous expenditure trends, maintaining their expenditure levels on a more stable and lower path thereafter. In particular, Belgium and Spain reduced their total expenditure-to-GDP ratio by an average 0.5% per year in the decade after the year when consolidation started, while Ireland, Finland and Sweden did it by an average 1% per year. This resulted in expenditure-to-GDP ratios between 5

and 11 percentage points lower than before the consolidation episode. Similarly, primary expenditure was also substantially reduced in the following decade.

Graph IV.5.2: **Total expenditure-to-GDP in the decade after the consolidation episode started**

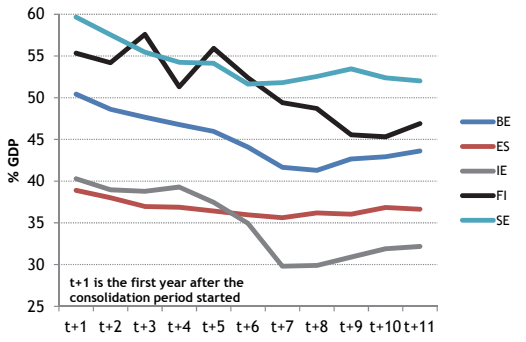


Source: Commission services

3. *Characteristics of the consolidation*

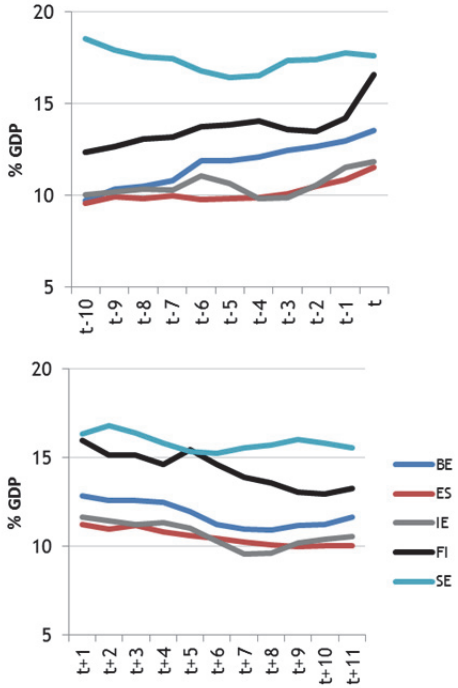
A. All five countries implemented wide-ranging spending cuts, spanning over a period of 4 or 5 years. In particular, drastic cuts were applied to compensation of employees and social benefits other than transfers in kind. On top of that, Belgium and Ireland slashed capital spending with the other three countries implementing more moderate or no cuts in government gross fixed capital formation.

Graph IV.5.3: **Primary expenditure-to-GDP in the decade after the consolidation episode started**



Source: Commission services

Graph IV.5.4: **Compensation of employees in the decade before and after the consolidation episode**

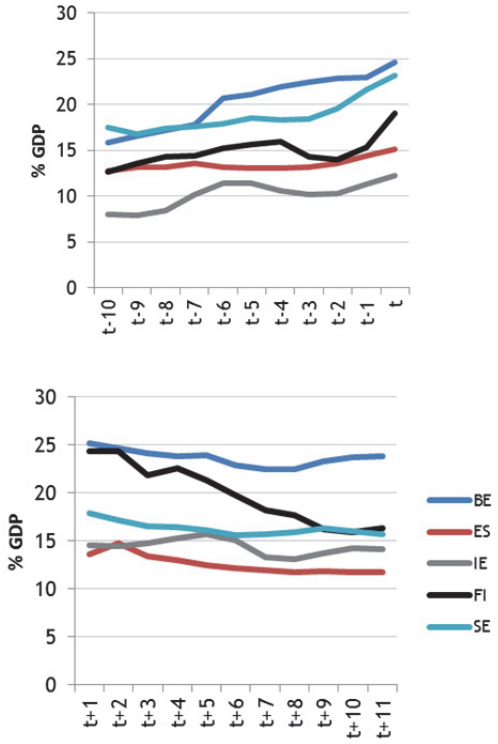


Source: Commission services

Compensation of employees was severely cut in Belgium, Finland and Spain where the reduction in this spending item accounted for between one-fifth and one-fourth of the total reduction in government expenditure as a share of GDP after the consolidation period. Sweden and Ireland compressed compensation of employees more moderately, though non-negligibly, accounting for around one-tenth of the total reduction in government expenditure as a share of GDP.

The wage bill was reduced both by freezing public sector wages and by reducing the number of civil servants. The latter measure ranged from replacement only one out of four government employees in the case of Spain to a full public sector recruitment embargo whereby no vacancy could be filled in in the case of Ireland without the express consent of the Minister for Finance.

Graph IV.5.5: **Social benefits other than social transfers in kind in the decade before and after the consolidation episode**



Source: Commission services

Social benefits other than social transfers in kind were drastically cut in most cases. ([98]) Finland stands out with cuts in social benefits explaining more than three-fourths of the decline in total expenditure as a share of GDP after the consolidation period, while the same figure explain one-third of the total decline in expenditure in the case of Spain, and one-fourth in the case of Belgium and Sweden.Ireland's more moderate cuts in social benefits contributed very modestly to the overall reduction in the country's total expenditure.

Moreover, cuts concerned several transfers to households, such as unemployment benefits. Substantial reforms to the unemployment benefits regime were passed in Belgium, Spain, Finland and Sweden. A reform of the pension system was implemented in Belgium, while pensions were frozen in Finland. Furthermore, different grants such as housing grants and child allowances were cut in Finland and Sweden respectively.

Capital spending was also cut in all consolidation episodes. However, the magnitude of such cuts varied considerably across countries, with Belgium standing out as government GFKF slash accounted for one-third of the overall decrease in total expenditure as a share of GDP. Ireland also drastically reduced its capital spending during the consolidation period, explaining around one-fifth of the decrease in total expenditure. In turn, Sweden and Spain implemented less severe capital spending cuts, while Finland fully preserved this expenditure item.

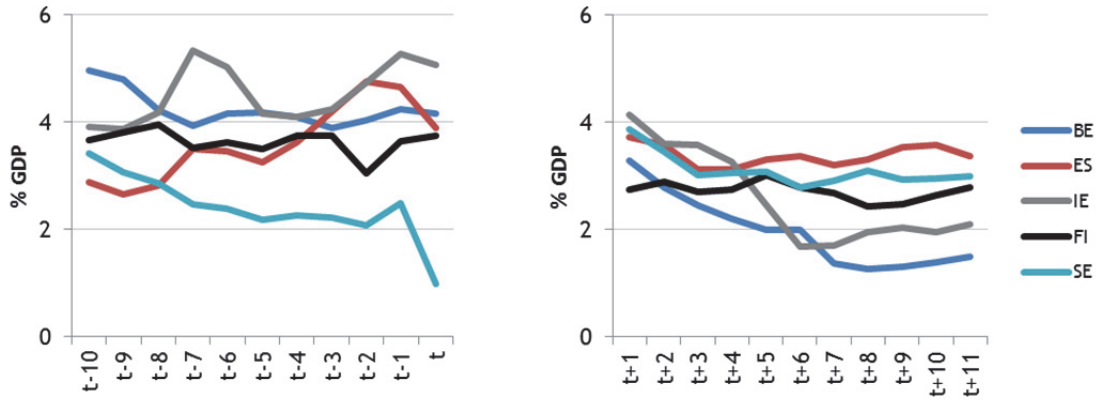
A first lesson can already be drawn from the above analysis. These expenditure-based consolidations were largely concentrated towards spending categories traditionally acknowledge to be the most rigid, most persistent, and least discretionary components of government spending (see Albanese and Modica, 2012). The idea is supported by the case of compensation for public sector employees and transfers to households, which constitute long-term commitments of government expenditure in the terminology used by the mentioned authors. It seems that the analysed countries were only able to reverse the previous expenditure trends by compromising the mentioned spending categories, which are also considered in the literature to be the most severely affected by cyclical ratcheting (Hercowitz, 2004).

In this respect, spending reviews which systematically scrutinize baseline expenditures can contribute to achieving fiscal consolidation targets and, more generally, to enhancing the performance of government spending. Box IV.5.1 contains more information on spending reviews, including the most recent ones undertaken by EU Member States.

B. In all five case studies expenditure cuts were accompanied by institutional budgetary reforms that increased spending efficiency

([98]) In most of the cases growth picked up in the course of the consolidation episode so, besides the impact of measures, this decrease also reflects to some extent a more favourable cyclical position

Graph IV.5.6: **Government GFKF in the decade before and after the consolidation episode**



Source: Commission services

and/or budgetary discipline. The unsustainable dynamic of expenditure prior to the consolidation episodes in these countries was also due to spending profligacy, lack of budgetary discipline or poor budgeting frameworks. The success in controlling expenditure after consolidation was also related to new Budgetary Discipline Laws (Spain), the rationalization of government spending put forward by Expenditure Review Committees (Ireland) or changes to the budgetary process moving away from incremental budgetary procedures (Belgium and Finland). Furthermore, the public enterprise sector was reformed and reshaped in several cases, notably in Spain and Finland, contributing to spending control.

C. All five consolidation programmes embedded an explicit medium-term budgetary objective (although not linked to a permanent budgetary framework). In some cases, at the beginning of the consolidation episode the authorities committed themselves to reach some budgetary targets over the medium-term; in other cases, the medium-term objective was to access the euro, as the Maastricht criteria had a clear convergence effect on public finances. The inclusion of objectives opened up for the possibility of fiscal policies to be measured and evaluated, providing the authorities and general public with a clear road-map and benchmark against which to evaluate the government's actions, and thus promote political accountability. This feature is likely to prove the more crucial the longer the consolidation episode.

D. From a political economy point of view it is also interesting to note that the (bulk of the) consolidation measures were implemented in all five countries by newly elected governments, and were not reversed by subsequent governments. Furthermore, fiscal consolidation was part of a wider package that included several reforms, including reforms to the taxation system aimed at reducing distortions and broadening tax bases or labour market reforms (as in Sweden and Finland).

E. Without entering into causality discussions, it is also worth noting that although fiscal adjustments started amidst recessions, growth picked up shortly after, which also contributed to their success. The expansion of GDP was often initially driven by exports with domestic demand recovering later. Currency devaluations took place in all five cases, either during or immediately before the fiscal adjustment, while wage moderation often translated this nominal depreciation into a real one. The recovery in private investment was also remarkable across all five case studies, linked to short- and long-term real interest rates falling, very sharply in some cases.

A detailed description of each episode follows.

Box IV.5.1: **Spending review**

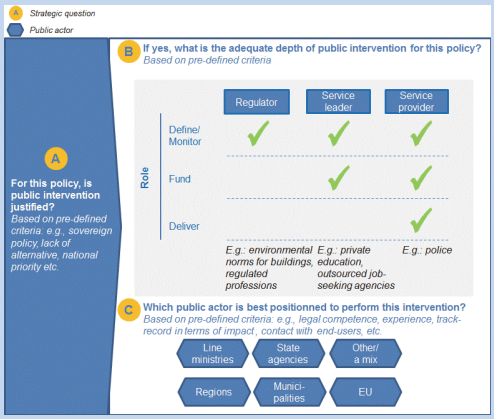
Spending reviews refer to the systematic and in-depth scrutiny of baseline expenditures with the objective to detect possible efficiency savings and opportunities for cutting low-priority or ineffective expenditures in a coordinated effort. They rely on the general assumption that government expenditure can be more targeted and efficient, irrespective of its aggregated share in GDP.

In this respect, **spending reviews are a suitable instrument to improve expenditure performance**. They seek a 'smarter' expenditure allocation across national policy priorities based on selective and sustainable savings. They offer a more sustainable approach compared to linear across-the-board expenditure cuts. Therefore, spending reviews can contribute tangibly to the achievement of fiscal consolidation targets and may also free up fiscal space for new policy priorities. Unsurprisingly, a renewed interest on spending reviews emerged with **the need to enhance the performance of government expenditure in the EU in the recent crisis**.

During spending reviews, expenditures are analysed in the light of the policies they are supposed to fund and the end-user these policies are meant to ultimately serve. Two approaches are usually observed. The strategic approach questions the relevance of public funding for a specific policy objective, the depth of the involvement of public authorities and consequently the most adequate public level/body in charge. The tactical approach aims at increasing - for policies passing the strategic test - the efficiency of each public euro spent by optimizing the relationship between expenditure level and impact, for example in terms of quality of service. One example of strategic reform is the mapping of publicly-funded committees and their subsequent merger/suppression where relevant. Illustrations of tactical reforms include the pooling of administrative back-office functions (like paymaster offices or IT services) across decentralised entities, the set-up of 'one-stop' front offices for administrative processes, and the better targeting of social grants.

The potential savings stemming from spending reviews can be significant for public finances and for end-users as well. For example, in the 1980s and 1990s, Canada, the Nordic EU Member States and the Netherlands engaged in large-scale spending reviews that contributed to restoring sound budgetary positions after severe budgetary shocks. At least eight EU Member States are currently or were recently engaged in one form or another of spending reviews ([1]) : the UK, the Netherlands, France, Italy, Ireland, Denmark, Spain, and Sweden.

Graph V.5.7: **Examples of strategic questions and roles for public intervention**



([1]) The Economic Policy Committee contributes to the Council's work of coordinating the economic policies of the Members States and of the Community and provides advice to the Commission and the Council. It comprises delegates from the Member States, the Commission, and the ECB.

(Continued on the next page)

Box (continued)

Source: Commission services

At the European level, the Economic Policy Committee ([2]) and the European Commission organised two peer reviews in 2014 with the objective to share best practices and lessons learnt. The UK, Ireland, the Netherlands and Spain presented their experiences with spending reviews and public administrative reforms. As part of its efforts to promote spending review practices, the Commission published in July 2014 a paper ([3]) providing elements of methodological guidance for the design, conduct and implementation of spending reviews.

Whereas there is no one-size-fits-all methodology for spending reviews, key success factors have emerged based on experiences so far. They include political commitment, ownership by the administration, clear objectives and governance, turning into facts reform options in terms of savings, cost and feasibility to inform political decision, integration of selected reform options in the budgetary process, building of transformation capability and performance culture at all levels of public service.

([2]) For all Member States except Spain: based on self-declared data published by the OECD in 2013.
([3]) Vandierendonck C. (2014), Public Spending Reviews: design, conduct, implementation, Economic Paper no 525, European Commission, Directorate-General for Economic and Financial Affairs: http://ec.europa.eu/economy_finance/publications/economic_paper/2014/pdf/ecp525_en.pdf

5.1. BELGIUM 1982-1987

5.1.1. INTRODUCTION

At the beginning of the eighties, the Belgian economy suffered from large macro-economic imbalances following the oil shocks of the seventies. The economy experienced high inflation with a negative impact on unit labour costs through the automatic indexation of wages. This resulted in low competitiveness, growing current account deficits and high unemployment. Moreover, differences between language communities and disagreement on an anti-crisis policy led to an unstable political climate, with seven different governments taking turns in office between 1977 and 1981.

The crises of the seventies also led to a strong deterioration of government finances. During the same period, government expenditure in Belgium grew significantly, at an average rate of 6.5% in real terms between 1970 and 1981. Up until the oil shock of 1974, rising expenditure had been supported by strong economic growth. However, the rising expenditure trend continued after the oil crisis, due to a recovery policy based on increased spending. Thus, primary expenditure increased from 37% of GDP in 1970 to over 53% of GDP in 1981, mostly due to increases in the government wage bill and social benefits. The government deficit peaked at 15.5% of GDP in 1981, leading in turn to a rapidly growing debt level.

As a consequence, Belgium implemented a sizeable consolidation between 1982 and 1987.

5.1.2. CONSOLIDATION EPISODE

5.1.2.1 Overview of the consolidation episode

Decisive consolidation action was taken in 1982. The initial policy focus was on increasing competitiveness in order to address the large macro-economic imbalances, which would also have a positive impact on government finances. The government shifted from a counter cyclical expansionary fiscal policy to structural measures aiming at increasing competitiveness and fighting unemployment. As part of the package, in February 1982, the Belgian franc was devalued and measures aiming at wage moderation were included. Companies could reduce working time and decrease wages in exchange for job creation, and social security contributions in some industries were reduced. A multi-year consolidation plan was initiated and government expenditure was cut by 1.7% of GDP that year, of which more than half was in social benefits. The subsequent year saw further cuts of 1.1% of GDP. Moreover, tax increases amounted to 0.7% of GDP in 1983, of which the bulk was due to an increase in the standard value-added tax rate.

A new multi-annual savings plan was agreed upon in 1984, as a way to improve government finances. Expenditure cuts amounted to 0.4% of GDP in 1984 and 0.9% of GDP in 1985. In addition, tax hikes had an impact of 0.3% and 0.7% of GDP respectively. Between 1984 and 1986, the automatic wage indexation was skipped three times. As an alternative to the wage indexation, companies had to pay an equivalent amount to the government in the form of increased social security contributions. Real wages remained frozen. Important expenditure cuts were also carried out at the level of local government.

In 1986, a plan to recover the economy (the so called new "Sint Anna" plan) contained 2.4% of GDP consolidation measures for 1987, entirely based on expenditure reduction. Additional measures taken in 1987 added another 0.4% of GDP of expenditure cuts. The plan included large cuts in social security: the abolishment of early retirement before the age of 60, the harmonization of the statutory retirement age to 65, changes in the unemployment benefit system and a reduction of certain sickness and disability benefits. In 1988, the fiscal consolidation stalled because of the government collapse, stemming from increasing tensions between linguistic communities.

5.1.2.2 The measures

A more detailed description of the expenditure reducing measures follows. The main expenditure cuts were related to investment, social benefits, compensation of employees and subsidies to companies over the consolidation period. Figures reported in the following section are based on ex-post data originating from the AMECO database.

Expenditure on compensation of employees grew rapidly between 1971 and 1981, at an average 6.1% per year. Over the consolidation period however it declined in real terms at an average of -1.2% per year. The measures to increase external competitiveness also entailed wage moderation in the public sector, through real wage freezes. After a very strong increase in the previous decade, the number of employees declined in the central administration, but was offset by increases at other levels of government.

In the first phase of the consolidation, a strong decline occurred in intermediate consumption, but was followed by an increase as of 1985.

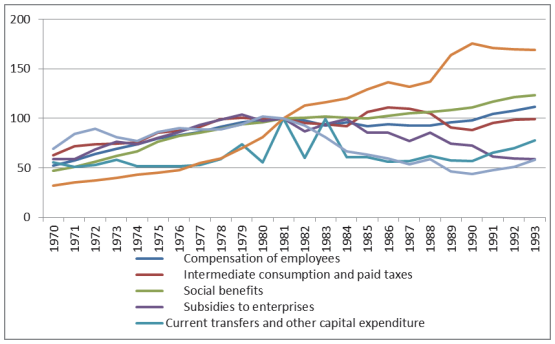
Expenditure on social benefits grew with an average of 0.8% in real terms over the consolidation period. The growth was largely due to an increase in the number of beneficiaries, but is in its magnitude not comparable with the explosive annual growth of 7.2% on average in of the seventies. Social benefits were no longer adjusted to the evolution of real wages between 1982 and 1990, and the curtailment of the automatic indexation mechanism was also applied to social benefits. The qualification requirements for social benefits became more stringent, with regards to financial conditions or family composition, as a way to target prioritized groups. Different social schemes were harmonized and measures were taken to avoid accumulation of multiple allowances.

Due to measures aiming at increasing selectivity for entitlement, expenditure on unemployment benefits decreased as of 1983, despite a strong increase in unemployment in the first years of the consolidation period. The decrease is also partially explained by the shift of senior unemployed citizens who changed status to the early pension system. In 1986, a profound reform induced more differentiation according to the needs in the unemployment benefit system, e.g. lump sum replaced proportional benefits to some extent.

Despite an increase in the number of beneficiaries, expenditure on sickness and disability benefits was reduced. Expenditure on early retirement and career termination increased strongly due to measures aiming at promoting job opportunities for young unemployed. As a result, over the consolidation period, the activity rate of the age group between 50 and 64 years declined. In 1986, however, the access conditions to early retirement and career termination were tightened.

The average real increase in pension expenditure was limited to 0.8% a year, compared to 7.2% a year between 1971 and 1981, which was lower than the increase in the number of retirees. The non-indexation and absence of welfare adaptations had an especially strong moderating effect on the evolution of this spending item. On the other hand, accumulated pension rights were often higher than

Graph IV.5.8: **Evolution of expenditure by national accounts aggregate (ESA95, 1981=100, in constant prices)**



Source: Commission services

in the past due to the increase in participation rate in the previous decades, partially attributable to higher female labour market participation and rising wages during the boom years.

The most substantial decrease in expenditure took place in family allowances, with an average yearly decrease of 2.1% between 1981 and 1987. The decrease was also facilitated by a fall in birth rate. Child allowances were reformed and strictly reduced. In health care, measures were taken to limit both volume increases as well as price increases through price regulation of medicines amongst other policies. Technologic evolution, a higher awareness of health issues, and increases in life expectancy led to an average yearly real increase of 3.3% of health care expenditure over the consolidation period, compared to 7.1% a year between 1970 and 1981.

The initial response to the economic crisis had consisted of large subsidies to companies in difficulties. These subsidies decreased strongly over the consolidation period, with a sharp decline from 1985.

Lastly, the consolidation had a particularly heavy impact on government investment. In 1981, government investment accounted for 4.6% of GDP as a result of large programmes of public works launched in the seventies. In 1987, however, government investment had been reduced to 2.3% of GDP.

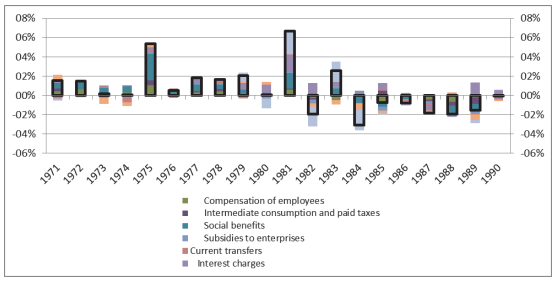
5.1.2.3. The impact on expenditure of the described measures.

Overall, cyclically-adjusted primary expenditure decreased gradually from over 53% of GDP in 1981 to 45% of GDP in 1987. At the same time, the revenue ratio remained relatively stable. The primary balance improved from a deficit of 7.4% of GDP in 1981 to a surplus of 2.1% of GDP in 1987. From 1984 onwards, the consolidation was supported by a better economic environment and lower unemployment.

However, the headline deficit remained high at 8% of GDP in 1987 due to rising interest expenditure, which peaked in 1986 at 10.6% of GDP, linked to the rising government debt and the higher cost of debt. Afterwards, interest expenditure contributed positively thanks to lower interest rates and more active debt management. Over the consolidation period, the debt increased from 89% of GDP to 128% of GDP, and peaked in 1993, notably due to a negative snowball effect.

Towards the end of the decade, stronger economic growth and reduced interest rates created some fiscal space which was used to soften some of the consolidation measures. At the beginning of the nineties, government expenditure began to rise again, which might partly be attributable to the regionalisation of an increasing number of competences.

Graph IV.5.9: **Contributions to the change in expenditure-to-GDP ratio (ESA95).**



Source: Commission services

5.1.2.4. Other major reforms in the budgetary area.

While in 1982-1983 the focus was initially on competitiveness and job creation, these efforts

alone proved to be insufficient in putting government finances back on track, and additional packages where needed in 1984 and 1986. Initially, due to the size of the imbalances, part of the consolidation took place on the revenue side, including by increasing in the standard VAT rate, freezing the personal income tax brackets, and increasing social security contributions. Tax reforms took place in parallel, with reductions in capital taxation being motivated by a desire to stimulate investment. In a second phase, tax reforms focused on base broadening and rate lowering, leading to a small decrease in the revenue-to-GDP ratio.

In parallel to the consolidation effort, changes in budgetary procedures occurred, focussing on a more selective approach for budgeting. Nevertheless, thorough reforms of public accounting and new fiscal rules were only to be implemented towards the end of the decade.

5.1.3. CONCLUSION

Belgium undertook a decisive and wide-ranging expenditure-based consolidation, putting an end to clearly unsustainable expenditure trends. Government deficit and debt was over time brought under control, coinciding with a significant increase in trend growth and employment initially linked to the exports recovery. In fact, as part of the 1982 package, the Belgian franc was devalued by 8.5% in February that year and measures aiming at wage moderation were also included. Wages were actually frozen in real terms throughout most of the consolidation period. Linked to the resulting real depreciation, exports picked up in 1984 and contributed to more dynamic GDP growth.

This episode also offers some relevant political economy considerations. The economic situation and government finances at the beginning of the 1980's had deteriorated so much that there was virtually no alternative than to adopt radical measures. In this context, Belgium proved to be flexible in its policy-making process. The Parliament gave extra-ordinary powers to the government, and drastic measures were taken in close informal consultation with socio-economic stakeholders. In both 1982 and 1986, the government chose to frontload the consolidation. The central idea was that the short-term negative impact for the population would be offset in the medium-term by restoring economic growth and job creation. However, this strategy suffered from contradictions. Indeed, the need for decisive consolidation also led to drastic cuts in government investment, which was to be unfavourable for Belgium's growth potential.

5.2. SPAIN 1994-1997

5.2.1. INTRODUCTION

There were two fiscal consolidation episodes in Spain between 1975 and 2000. The first episode took place between 1986 and 1988 and was mainly revenue-driven. The second episode saw a reduction in the general government deficit between 1994 and 1997, achieved by a compression in expenditure.

The build-up of government deficit in Spain started during the period 1975-1986, partly linked to an expansionary fiscal policy which tried to compensate the effects of the two oil shocks. Social demands of building up the welfare state, little developed in Spain before 1975, brought about expansionary fiscal policies of a more structural nature. Government expenditure soared increasing by 2 percentage points of GDP per year until 1982, and then at more moderate pace of 0.9 percentage points a year. Consequently, expenditure as a share of GDP increased from around 24% in 1975 to 40% in 1985, reaching the average spending of industrialized countries. Government revenues also increased during this period but at a much slower pace, with total revenues representing 34% of GDP in 1985. This led to a chronic general government deficit that went from 0.0% in 1975 to around 6% of GDP in 1985 and a notable increase in government debt.

A first consolidation attempt occurred between 1986 and 1988, primarily based on revenue increasing policies such as the adoption of the VAT. However, the higher tax burden was unable to keep pace with increasing expenditure needs, leading to persistent deficit and debt accumulation. Spain's budgetary outlook further deteriorated as a result of the economic crisis in 1992. Fiscal imbalances contributed to higher inflation expectations and macroeconomic stabilization had to rely only on tight monetary policies, entailing

high interest rates and an over-appreciation of the real exchange rate. In 1993 government deficit was higher than 6% of GDP and the debt-to-GDP ratio exceeded 60%. Spain was about to face Maastricht convergence criteria for EMU accession with a structural budgetary imbalance that required decisive action. An irregular consolidation programme was thus implemented between 1994 and 1997. During those years the government deficit was reduced by around 3 percentage points of GDP. More crucially, the explosive dynamic of increasing expenditure was curbed: from its maximum of almost 48% of GDP in 1993, the expenditure ratio was brought down to around 40% of GDP, where it remained for the next decade.

5.2.2. CONSOLIDATION EPISODE

5.2.2.1 Overview of the consolidation episode

The government deficit decreased by around 3 percentage points of GDP between the years 1994 and 1998. Reduction was mainly achieved by a compression of expenditure that resulted both from discretionary measures and non-discretionary developments, namely the historically low interest rate levels and the favourable economic situation by the end of the consolidation episode.

By the end of the consolidation period in 1997 total and primary expenditure were respectively 5 and 4 percentage points of GDP lower than in 1993. Depending on the years, cuts concentrated on compensation of employees, purchases of goods and services, unemployment and disability benefits, capital transfers and government investment as shown in Table IV.5.1.

Table IV.5.1: **Estimated budgetary impact of expenditure consolidation measures on the year they were implemented. Spain 1994-1997**

p.p. GDP	1994	1995	1996	1997
Compensation of employees	0.2	0.1.	-	0.5
Purchases of goods and services	0.1	0.1	0.2	0.2
Unemployment and disability benefits	0.4	-	-	-
Capital transfers	-	-0.6	0.6	0.3
Government investment	0.3	0.4	0.4	0.1

Source: Commission services

However, it was not a smooth process and an evaluation of the outcomes in 1995 and 1996 is complicated due to several factors. First, in spite of the planned expenditure cuts for 1995, unrecorded and unpaid expenditure from that year's and prior years' budget exercises were detected in 1996. This unexpected discovery raised the 1995 deficit on a national accounts basis by 0.8% of GDP. Second, the 1996 draft budget was rejected by Parliament and fiscal policy was based on the prorogation of the 1995 budget and the use of Royal Decrees to obtain additional fiscal adjustment.

5.2.2.2 Measures

The main consolidation measures carried out between 1994 and 1997 concentrated on unemployment and disability benefits, compensation of employees, intermediate consumption, capital transfers and gross capital formation.

Government consumption experienced consolidation measures in both wage and non-wage components. The government wage bill was reduced by the implementation of a public sector wage freeze and a reduction in civil servants. In practise, the latter meant that only one out of every two retiring civil servants was replaced in 1994, 1995 and 1996. This replacement norm was tightened in 1997 when only 25% of government employees at all levels of government were authorized to be replaced. These measures were also made compulsory for regional and local governments by the budget law, which stated that regional and local corporations should also envisage such restrictions. This did not apply however to the armed forces, justice and educational personnel. The budgetary impact of these measures is estimated to have been around 0.2% of GDP per year between 1994 and 1996. The budgetary impact in 1997 is estimated at a larger 0.5% of GDP.

The non-wage component of intermediate consumption fell as a result of a decline in the purchase of goods and services, with a deficit decreasing impact of around 0.2 % of GDP per year. Purchases of supplies decreased by 8% in absolute terms, government travel expenses were down by 13%, maintenance expenses were reduced by 12%, and office rental payments were cut by 13%.

A large unemployment compensation reform was passed in 1994, reducing coverage by stricter accessibility conditions, and the amount of the unemployment benefits was even reduced in some

cases. As a result of this reform, coverage was reduced from 83% of registered unemployed in 1993 to 69% in 1994. The estimated impact of this reform was around 0.3% of GDP in 1994. Moreover, the reform permanently lowered spending in unemployment benefits and had therefore a long-lasting deficit-decreasing impact.

Temporary disability benefits were also reformed, shifting large part of the costs to the employers. In particular, the employers were to bear the benefits paid from the 4th to the 15th day of the temporary disability period. This measure had an estimated deficit decreasing impact of 0.1% of GDP.

Government investment was also compressed throughout the whole consolidation episode with an annual deficit-decreasing impact of between 0.1% of GDP and 1% of GDP, depending on the year. It should however be noticed that these cuts were at least partly compensated through the use of alternative financing procedures for investment, including the participation of the private sector through long term concessions, and the use of turnkey payment procedures, by which payments took only place at the moment when the investment project was completed.

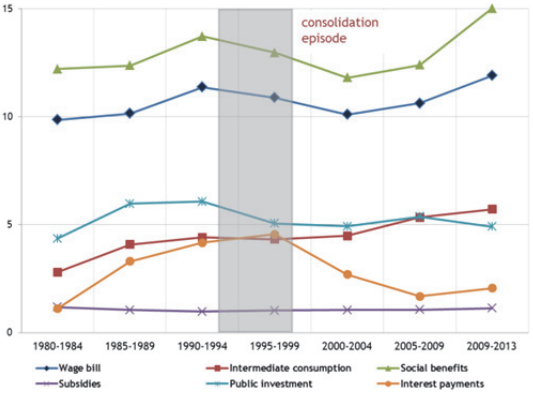
Finally, additional compression of expenditure came from the re-organization of the public enterprise sector in 1997 and from pushing certain items off the budget: cuts in capital transfers to state-owned enterprises and government agencies (which were not consolidated in the general government sector) respectively amounted to 29% and 6% in absolute terms when compared with 1996 equivalent items. Part of the financing needs of public enterprises and entities were met from resources outside the budget, essentially through profitable state-owned enterprises and privatisation receipts. An important process of restructuring and privatization of state-owned enterprises took place the very same year (see below).

5.2.2.3 The impact on expenditure of the described measures

Over the short run, the consolidation that took place succeeded in reducing expenditure. The share of total government expenditure in GDP declined by 5 percentage points of GDP between the years 1993 and 1997. In turn, the share of primary expenditure in GDP declined by 4 percentage points of GDP during the same period. Consolidation efforts were also helped by non-discretionary reductions in certain expenditure categories, mainly interest payments especially in the years closer to EMU accession. Interest expenditure decreased by 0.5 percentage points of GDP in 1997. Furthermore, the return to a more dynamic economic growth at the end of the consolidation period, with a growth rate of almost 4% in 1997, also contributed to the success of the consolidation episode at large.

Over the medium and long-run, the consolidation succeeded in containing expenditure trends. Total and primary government expenditure as a share of GDP remained stable at below 40% for the decade following the consolidation period. Notably, expenditure categories where cuts were concentrated during the consolidation episode – mainly compensation of employees and social benefits – also helped containing expenditure in the following years.

Graph IV.5.10: **Government expenditure by component – five year moving averages (% GDP)**



Source: Commission services

5.2.2.4 Other major reforms in the budgetary area

Fiscal consolidation was underpinned by two reforms passed in the second half of this episode.

The budgetary execution process was substantially reformed and improved after unrecorded and unpaid expenditure from the 1995, as well as prior

budget exercises was detected in 1996. This unexpected expenditure, related mostly to investment and capital transfers, raised the 1995 deficit on a national accounts basis by almost 1% of GDP. Budgetary execution was then assessed to be too lax and the Court of Auditors severely criticised the frequent practice of carrying forward expenditure to future budgets. In the following year, 1996, an extraordinary credit was approved by the government to cover for the previous years' budgetary commitments. By the end of the fiscal year 1996, a set of budgetary discipline measures were approved in order to control the execution of government expenditure. These measures were compiled in Law 11/1996, dated December 27, on Budgetary Discipline. In particular, credit transfers from capital to current operations were prohibited, and the possibility to carry forward expenditures to future budgets was severely curtailed.

The second reform occurred in 1996 and 1997 and tackled issues related to the state-owned enterprise sector. Before 1996, public control of enterprises had resulted in huge budgetary costs as public firms were receiving substantial support in the form of current and capital transfers. In June 1996 the government announced an ambitious programme to modernise the state-owned enterprise sector. Enterprises under the state's control were to be restructured or privatized. As a result the budgetary resources to public enterprises were sharply reduced from 1997 onwards, both in nominal terms and as a percentage of GDP. As an example, the 1997 State budget operating subsidies and capital transfers amounted to 0.6% GDP compared to around 1.2% GDP in 1996.

5.2.3. Conclusions

A drastic reduction of deficit and debt ratios, both over the short and the medium term, followed the fiscal consolidation implemented by Spain in the mid-1990s. Between 1995 and 2000 the budget balance improved from a deficit of 7.5% of GDP to 1.3% of GDP, while debt levels were reduced by around 10 percentage points of GDP to below 60%.

While the decisive expenditure cuts and reforms in the budgetary area were crucial in this respect, the improvement in the fiscal fundamentals was undoubtedly supported by the buoyant growth, high job creation rates and sharp fall in interest rates that concurred with the consolidation episode.

After the 1993 recession, the Spanish economy grew at an average 3.7% a year between 1994 and 2000. Employment also registered record performance since the mid-1990s, growing at an annual rate around 3.5% on average in the same period.

Moreover, monetary policy was especially growth supportive in Spain during and after the consolidation phase. Since the mid-nineties the Bank of Spain aimed at keeping inflation under control, also with a view to meeting the Maastricht criteria. Historically low inflation rates allowed for a steady reduction of real interest rates and resulted in loose monetary policies between 1996 and 1998. Since then, monetary policy was transferred to the ECB and a single nominal interest rate responding to the euro area average inflation induced further monetary loosening in Spain due to the positive inflation differential with the rest of the euro area.

In this respect, the expenditure consolidation efforts were part of a policy shift that took place in Spain since 1994, contributing to macroeconomic stability and hence improving long-run growth prospects.

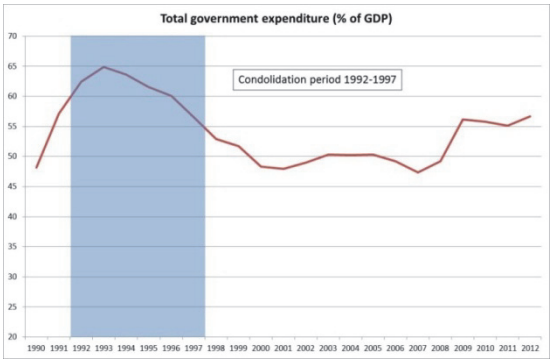
5.3. FINLAND 1992-1997

5.3.1. INTRODUCTION

Fiscal consolidation started amidst an unprecedented recession in Finland, where real GDP fell by 14 percentage points between 1990 and 1993. Large macroeconomic imbalances had built up in the second half of the 1980s, fueled by a large credit expansion. Financial deregulation and the abolition of exchange rate controls led to a rapid expansion of bank lending and an increase in capital inflows from foreign countries. Following

the large credit expansion in the late 1980s, a housing and stock market bubble developed. The economy was in a state of overheating which showed up in the increase of labor costs. This further eroded external competitiveness, which had already been weakening for some time.

Graph IV.5.11: **Total government expenditure (% GDP)**



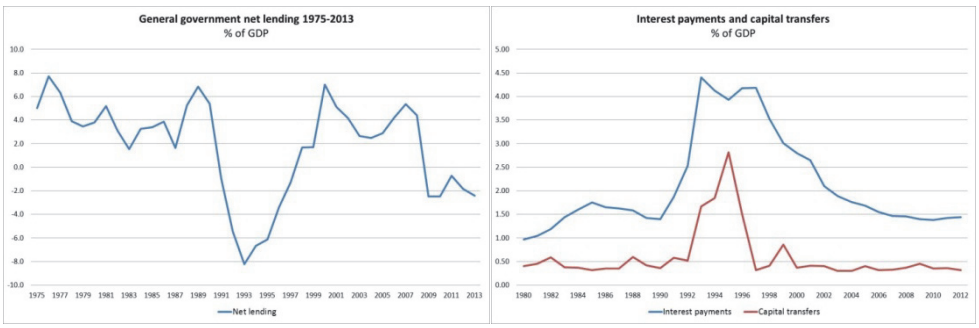
Source: AMECO

Towards the end of 1989 the housing and stock market bubble started to collapse. Tighter monetary conditions and high debt levels undermined domestic demand. At the same time, export performance deteriorated not only in response to weakened price competitiveness but also due to the collapse of trade with the Soviet Union in 1991: exports to the Soviet Union went from 20 % of total exports to virtually zero. The confidence in the Finnish economy and in the fixed exchange rate was weakened, and finally the markka was devalued by 12.3% in November 1991. The depreciation of the markka abruptly raised the debt-service burden for domestic firms, with large foreign currency denominated debt. The number of bankruptcies increased significantly and non-performing assets in bank's portfolios increased accordingly. A banking crisis followed, leading the state to recapitalise the banking system between 1991 and 1996. The cost of this crisis for government finance is estimated to have amounted to around 5% of GDP. ([99])

Finland had had a long history of general government surpluses, amounting to 4% of GDP in the period 1975-1990 on average. However, the general government surplus of 5.4% in 1990 quickly turned into a severe deficit, with the government debt increasing accordingly. The deficit-to-GDP ratio shot up mainly as a result of the collapse in nominal GDP and government revenues against unchanged or even increased expenditure trends. In fact, total government expenditure increased from less than 50% of GDP before 1991 to 65% of GDP in 1993, linked to rising unemployment benefits, interest payments and capital transfers to the banking system. The deficit peaked at 8.2% of GDP in 1993. By 1994 government debt as a share of GDP had quadrupled, from 14% in 1990 to 58%.

The first attempt to consolidate occurred in 1991 and continued until 1999, but the bulk of the consolidation efforts were to be materialised between 1992 and 1997. The government implemented a fiscal consolidation that was mainly expenditure cut driven. By 1999 government expenditure was back to below 50% of GDP and stayed at this level until the recent financial crisis.

Graph IV.5.12: **General Government net lending and selected expenditure components (% GDP)**



Source: AMECO

([99]) Tarkka and Tulla (2000)

5.3.2. CONSOLIDATION EPISODES

5.3.2.1 Overview of the consolidation episode

First consolidation efforts started already in 1991, but did not materialise in a deficit reduction immediately as the deficit continued to increase until 1993. The consolidation consisted mainly of wide-range expenditure cuts implemented between 1992 and 1997 and covering central government transfers to local governments, social benefits and government consumption.

The Finnish government decided to pursue an expenditure-based consolidation, firmly convinced that high taxes have adverse effects on economic growth and employment, particularly in a small open economy. ([100]) Cuts in transfers to local governments played a crucial role in this consolidation episode, after the 1993 reform of the transfers system to municipalities. Local governments are responsible for all major welfare services in Finland – such as education, health care, day care or long-term care – , which are funded by the central government. Before 1993 local government expenses were automatically compensated on the basis of actual costs and transfers from the central government were earmarked to specific services. After the 1993 reform transfers were instead general and non-earmarked, based on average costs and modulated according to statistical data on population or age distribution. This generated a strong incentive for efficiency gains across local municipalities.

Fiscal consolidation resulted in a remarkable improvement in Finland's budgetary outlook: by 1998 the budget balance moved back into surplus and government debt had decreased by 10 percentage points of GDP. While expenditure cuts played a crucial role in these developments, fiscal consolidation was also achieved through revenue increasing measures, as further explained in section 2.

5.3.2.2 Measures

A more detailed explanation of the measures implemented on the expenditure side follows. The amounts reported below are summing up the estimated budgetary impact of the measures put in place in the period 1992-1997.

It should first be mentioned that identifying the actual implemented measures is complicated in the Finnish case, mainly because supplementary pieces of legislation often undid the spending cuts decided in the annual budgets. The events around the 1992 budget illustrate this well. The 1992 draft budget law put forward permanent saving measures amounting to 1.7% of GDP. It included the abolishment of the obligation by the public sector to employ all long-term unemployed (with an estimated impact of 0.3% of GDP), savings in income transfers and other benefits (0.3% of GDP), laying off all public sector employees for 14 days (0.2% of GDP), cuts in the level of earnings-related unemployment benefits (0.1% of GDP), a reduction in the level of public sickness insurance compensation (0.1% of GDP) and cuts in subsidies to agriculture. Finally, however, only half of the proposed expenditure measures were actually implemented, amounting to 0.8% of GDP. Some of the rejected expenditure cuts were replaced instead with revenue-increasing measures.

As anticipated, cuts in transfers to local governments – and more specifically social benefits and social transfers – were crucial throughout the consolidation period, amounting to around 2.5% of GDP. These cuts concentrated on education expenditure, which decreased by around 1% of GDP. In particular, financial aid for students was reduced by tightening the eligibility criteria and the extension of adult education was limited. Healthcare spending also decreased by 0.3% of GDP, by reducing the compensation levels of public sickness insurance and cutting adult dental care. Child allowances were also affected by the consolidation episode, decreasing by around 0.1% of GDP. Moreover subsidies on local businesses and exports of agricultural products were reduced by around 0.4% of GDP.

Central government expenditure was also drastically reduced by 3.5% of GDP, including pension and unemployment benefits cuts. The pension system was reformed twice during the consolidation period. The eligibility age for early retirement and part-time retirement was raised in 1993. In 1996, the pension index was changed,

([100]) Tarkka and Tulla (2000)

moving away from a simple average of consumer prices and wages, to a weighted average where consumer prices were given more preponderance (80%) than wages (20%). ([101]) On top of that, the number of working years on the basis of which the amount of the pension was calculated was extended from 4 to 10 years.

Between 1991 and 1997, the government concluded yearly comprehensive income policy agreements with the social partners. Contractual pay increases were frozen from 1 April 1991 to 28 February 1995. In return, the unemployment benefit scheme was broadly preserved. It was only in 1997 that the system was reformed, with the eligibility criteria being tightened. In particular, the minimum working period to be entitled to earnings-related unemployment benefit was raised from 6 to 10 months and unemployment pension eligibility age was raised from 55 to 57 years. Total savings in unemployment benefits were estimated at around 0.3 % of GDP in 1998. Government employment also fell by almost 8% between 1991 and 1994.

Finally, it is interesting to note that government gross fixed capital formation was broadly preserved in Finland during the consolidation. Only road and railway maintenance were reduced by around 0.2% of GDP.

Revenue-increasing measures also helped improving the budgetary figures, amounting to more than 1% of GDP. Excise duties on petrol, coal, gas or tobacco were raised. A new electricity tax was also introduced starting 1993. Finally an additional income tax was levied on high income earners and the income tax brackets were adjusted.

5.3.2.3 The impact of the described measures

As shown by Table IV.5.2, the measures implemented by Finland during this consolidation episode had a substantial impact across the main subcomponents of government expenditure. On top of reducing spending levels in the short-term, the adopted reforms managed to contain expenditure trends also in the medium-term.

Table IV.5.2: **Government expenditure by component – moving averages (% GDP).**

% of GDP	1990	1991-1993	1994-1999	2000-2004	2005-2009	2010-2012
Compensation of employees	14.8	17.1	14.7	13.3	13.6	14.4
Purchases of goods and services	7.8	9.1	8.8	8.6	9.9	11.6
Subsidies	2.8	3.3	2.2	1.5	1.4	1.5
Pensions ja benefits (child, unemployment and disability)	17.4	24.8	24.0	20.5	21.2	24.1
Capital transfers	0.4	0.9	1.3	0.4	0.4	0.3
Public investments	3.7	3.3	2.8	2.6	2.5	2.5
Interest payments	1.4	2.9	3.8	2.2	1.5	1.4

Source: Statistics Finland

5.3.2.3 Other major reforms in the budgetary area

Fiscal consolidation was supported by several reforms. In particular, Finland's budgetary framework was considerably strengthened by the adoption of expenditure guidelines in 1991 for the first time. These guidelines aimed at steering the 1992 Budget Proposal and served as a basis for the medium-term economic and budgetary plans of 1992-1994. ([102]) Different ministries were to keep their budget proposals within the limits of the total given in the guidelines, even though the guidelines were not legally binding as such. ([103]) As mentioned already, the reform of municipalities funding was also crucial to contain expenditure trends.

In order to smoothen the policy making process, authorities decided to suppress the "special minority provision", by which a one third minority in Parliament could postpone any bill concerning expenditure cuts beyond the next parliamentary elections. The Parliament accepted this amendment proposed by the Government in 1992. ([104])

([101]) More on the pension reform: Laesvuori, A., Risku, I., Knuuti, J., Keski-Heikkilä, S. and Uusitalo, H. (2009): 'Työeläkkeiden indeksisuoja TEL:stä TyEL:iin', Eläketurvakeskuksen raportteja 2009:1.

([102]) The spending ministries were to keep their budget proposals within the limits of the total cash ceiling given in the guidelines, even though the guidelines were not legally binding as such. In the first years the deteriorating public finances soon made the expenditure guidelines obsolete, but later the spending limits became a key fundament in keeping sound public finances (Tarka and Tulla, 2000)

([103]) Tarkka and Tulla, 2000

([104]) Law on the reform of the constitution 818/1992 (Laki valtiopäiväjärjestyksen muuttamisesta)

The government also proceeded by selling of and privatising several state-owned companies. Between 1994 and 1999, revenue from privatisation proceeds totalled 6% of GDP. On top of the direct increase in revenue, this helped improve government finances also through expenditure compression. Notably, general government employment fell significantly. In 1995, 60,000 employees used to work in market oriented units, which accounted for more than one third of the total personnel in the public administration. Mainly as a result of the privatization of state-owned enterprises the number of public employees was cut by half, decreasing from 240,000 to 122,000. ([105])

5.3.3. CONCLUSIONS

This Finnish consolidation was part of a comprehensive institutional and macroeconomic reform programme. By the end of the consolidation programme in 1997, the general government deficit had disappeared, general government expenditure had decreased by more than 8 percentage points of GDP with respect to its 65% of GDP peak in 1993 and debt as a share of GDP had also come down by 4 percentage points of GDP with respect to its peak three years earlier. Remarkably, thereafter expenditure continued to decline by another 9 percentage points of GDP in the period 1997-2001 and debt continued to fall by additional 8 percentage points. Government finances registered budgetary surpluses that lasted until the outbreak of the most recent crisis in 2009.

This remarkable improvement in Finland's public finances was decisively supported by growth and employment picking up pace shortly after the consolidation started. Growth turned positive in the third quarter of 1993 and was 5% per year on average between 1994 and 1997. The recovery was initially driven by external demand. The considerable nominal depreciation that followed the markka depreciation was actually translated into a real one thanks to wage moderation. Exports began to pick up in 1992 and grew at an annual average rate above 10% for the rest of the decade.

Furthermore, early in 1993 Finland's central bank adopted an inflation targeting regime which contributed to signal a regime change. Thereafter nominal interest rate displayed a large decline, also fostering growth.

Finally, it is interesting to note that while the consolidation measures were partly based on the need to meet the Maastricht criteria, they were also grounded on the national will to regain the confidence of financial markets. In fact, fiscal consolidation aimed at a stricter balancing than what was strictly necessary under the Maastricht criteria. ([106])

5.4. IRELAND 1982-1989

5.4.1. INTRODUCTION

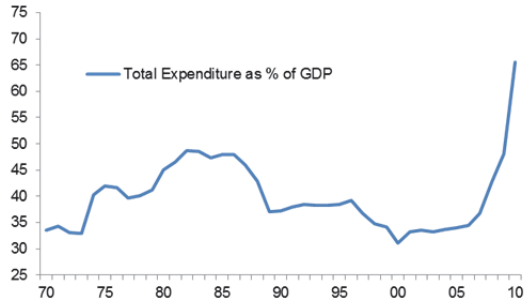
Ireland's fiscal crisis in the 1980s did not have a short build-up, but rather represented the eventual culmination of a sustained preceding period of loose fiscal policy. In an attempt to bolster a lack of demand in the 1970s, the Government engaged in an expansionary fiscal policy. This led to a sharp increase in debt levels, necessitating increases in tax rates, which, accompanied by the high interest rates of the early 1980s, fostered an environment that was not conducive to economic growth. This focus upon revenue-raising measures proved self-defeating and in 1985 the general government deficit stood at 10.5% of GDP.

The unsustainability of ever-increasing tax rises to meet growing current expenditure needs was becoming clear. Every year from 1979 on, taxes increased as a share of GDP, rising 8 percentage points to stand at 39% by 1984. Honohan and Walsh argue that high taxes placed upward pressure on wages, which together with rising levels of government debt, eroded business confidence. Thus, although inflation and the external deficit came down, the economy remained extremely weak in Ireland during this period. So, following this attempt to maintain domestic

([105]) Tiihonen, Seppo (2012), 'The Ministry of Finance, Two hundred years of state-building, nation-building & crisis management in Finland'

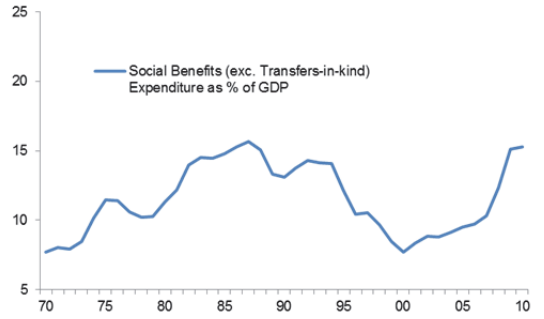
([106]) Tarkka, Helena and Tulla, Sirpa (2000): "Finland", in *Reallocation – Aligning Polical Priorities and Budgetary Funding, Case Studies,* Paris, 21st Annual Meeting of Senior Budget Officials, 29-30 May 2000, PUMA/SBO(2000)5/ANN1, OECD

Graph IV.5.13: **Expenditure Trend 1970-2010**



Source: Ameco
* Total expenditure as a % of GDP in 2010 was inflated by the provision of bank support measures of approximately 20% of GDP

Graph IV.5.14: **Expenditure on Social Benefits (exc. transfers-in-kind) 1970-2010**



Source: Ameco

demand through expansionary fiscal policy during the 1970s, a significant fiscal consolidation was inevitable in the 1980s. A greater focus on government spending is often considered to have caused the deficit to fall rapidly over subsequent years, reaching 2.6% of GDP in 1989. The rapidity and extent of the recovery in the Irish government finance has sparked a considerable degree of analysis and resulted in its use as a prime example of a so-called "expansionary fiscal consolidation" (see Giavazzi and Pagano, 1990 and Alesina and Perotti, 1995).

5.4.2. CONSOLIDATION EPISODE

5.4.2.1 Overview of the consolidation episode

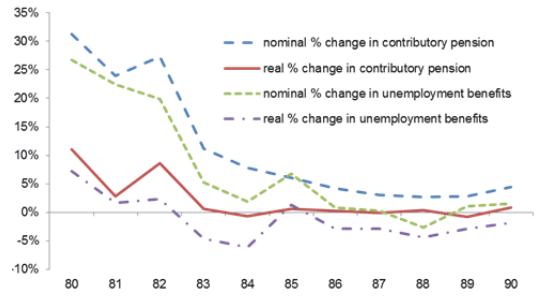
A cursory examination of the evolution of the general government expenditure to GDP ratio shows that it was not until the years after 1985 that the ratio started to decrease, falling from 48% in 1985 to 37% in 1989. During the same period, total General Government expenditure excluding interest declined form 39% of GDP to 30%, indicating that the fall in overall spending was not only driven by a reduction in borrowing costs, though these also fell. Government spending was maintained at around 38% of GDP until the mid-1990s, when it started decreasing again, falling from 38% of GDP in 1994 to a low of 31% in 2000.

In terms of successful expenditure-based consolidation, it would specifically appear that measures introduced in 1985 and subsequent years represent the critical steps undertaken which allowed a compression in government spending in the late 1980s and facilitated the expenditure control that was evident during the 1990s. However, a wider scope is needed to fully understand the underlying factors already driving expenditure dynamics by this period.

Budgetary policy in the years 1982 to 1989 evidences a certain stop-start nature of fiscal consolidation efforts during this period. The early years of the period show a heavy reliance on tax increases and despite successive governments during this period espousing an overarching commitment to reducing the current budget deficit and stabilising the debt ratio, the annual budgets repeatedly contain increases to social transfer and public sector pay rates, which represented the two most significant government expenditure areas during this period.

As regards social transfers, successive Ministers for Finance in their Budget statements set out their government's desire to maintain social welfare benefits and Graph IV.5.14 shows that social transfers excluding benefits-in-kind not only maintained its share of GDP during this period but actually rose from 12% in 1981 to 15.6% in I987, before starting to fall. However, this figure is partially driven by unemployment, which rose from 9.9% in 1981 to reach 17.5% in 1987.

Graph IV.5.15: **Change in Average Transfer Payments 1980-1990**



Source: OECD Economic Survey of Ireland 1991
Graph shows changes in average weekly payments as calculated by total disbursements divided by the number of recipients.

A closer examination of the real value of the increases in social welfare rates actually reveals that while providing nominal increases, the real value of pensions payments was held broadly flat from 1983 onwards while the real change in unemployment benefits was actually negative for much of the period.

By contrast, the somewhat camouflaged gradual consolidation being achieved through social transfers was very visibly supported by large cuts to capital expenditure. As shown in Graph IV.5.16 government capital spending as proportion of output was reduced from 5.1% in 1981 to as low as 1.7% in 1989. This process was most heavily concentrated during the period 1985 to 1988, with the four budgets during these years targeting average annual cuts to the government capital estimates of 6.2%. This included a massive cut of over 15% in 1988, before reverting to slight growth of 1.2% in 1989. Such swingeing cuts to government investment are not optimal from a government finance policy perspective and left Ireland with a substantial infrastructure deficit when growth picked up in the 1990s.

The third main contributor to the reversal of the rapid rise in government expenditure during the late 1970s and early 1980s was the public sector recruitment embargo announced in the second half of 1981 and this is the reason why an analysis of the reductions in government spending in the late 1980s must include the budget decisions made earlier in the decade.

The embargo was initially enforced through leaving two out of every three vacancies unfilled and was then tightened further in 1987 with the requirement that all hiring be approved by the Minister for Finance. The result of this policy was that public sector pay as a percentage of GDP fell from almost 12% in 1981 to 9.5% in 1989, despite repeated increases to nominal public sector pay rates during this period.

However, the real success of this policy is illustrated through a look at the evolution of the actual numbers of public servants. Table IV.5.3 shows that from a peak of 314,000 in 1982, numbers fell steadily across the period, with a significant acceleration in 1988 and 1989 as the embargo was tightened and the voluntary redundancy scheme introduced. However, the acceleration of the policy effort from 1987 would

Graph IV.5.16: **Government investment trend 1970-2010**

Source: Ameco

Graph IV.5.17: **Expenditure on Compensation of Employees 1970-2010**

Source: Ameco

Table IV.5.3: **Public Sector Employment 1982-1989**

	1982	1983	1984	1985	1986	1987	1988	1989	Total Change
Public Sector Employment (000s)	314.3	312.5	307.3	302.6	300.7	295.5	285.7	270.1	-42.4
Annual% Change	+3.4	-0.6	-1.7	-1.5	-0.6	-1.7	-3.3	-5.5	-14.1

Source: OECD surveys of Ireland 1985-1991

have been significantly more difficult if the groundwork had not been laid by the earlier policy decisions.

The impact of the policy measures in the three areas outlined above was supported by a general tightening in expenditure management across government departments, though this is difficult to detect in the budgetary measures due to the slightly drawn out nature of the expenditure allocation process in Ireland, whereby a provisional allocation was outlined in the Abridged Estimates Volume published before the budget and subsequently amended through announcements on budget day and potentially again in the Revised Estimates Volume published some weeks after the budget.

Table IV.5.4 shows that while consolidation efforts showed some success in the early 1980s, the period 1984-1986 showed a slackening in effort, particularly on the current side. Even during the years considered to be one of the most successful consolidation episodes of recent times, i.e. 1987-1989, current expenditure was barely reduced and in fact in 1990 again stood above its 1987 level. However, the holding flat of nominal expenditure, while allowing current revenues to rise in line with economic growth and significantly cutting capital expenditure, appears to have been sufficient to affect a turning point in the government finances. The efficacy of the measures is also demonstrated by the maintenance of the gains in subsequent years, while the rapidly improving economic performance, itself due to a number of factors, also contributed strongly.

Table IV.5.4: **Average Annual Changes in Selected Fiscal Variables**

	1987-89	1984-86	1982-83	1982-89
Average annual change in current expenditure	-0.3%	+8.5%	+18.3%	+7.7%
Average annual change in current revenue	+5.0%	+8.5%	+19.9%	+10.1%
Average annual change in public capital expenditure	-4.6%	-2.0%	-0.7%	-2.6%

Source: OECD surveys of Ireland 1985-1991

5.4.2.2 The measures

A chronological explanation of the measures implemented each year of this consolidation period follows.

- **1982-1986**

Fiscal policy in the period 1982-1986 was initially built around a medium-term objective of eliminating the current budget deficit by 1986, though this target-date was soon extended. A key foundation of the consolidation strategy was the public sector expenditure package of July 1981, and in particular the decision to contain public sector employees at 1981 levels ([107]). These restrictions on the filling of public service vacancies were tightened in the Budget Statement of 27 January 1982 with two out of every three vacancies to be left unfilled.

However, the robust commitment to reducing public sector numbers stood in contrast to the more stop-start approach to fiscal consolidation in general over this period. Large annual increases in current expenditure were implemented every year, including repeated rises in social transfer and public sector pay rates, though the magnitude of the increases to current expenditure did gradually fall from almost 25% in 1982 to 6% in 1986. Capital expenditure was more successfully targeted, with nominal cuts achieved in three out of the five years. However, despite the already elevated level of tax rates, the bulk of the consolidation effort initially fell on the revenue side, with rises in consumption, income and social security rates in the 1982 and 1983 budgets. Even

([107]) The Exchequer pay and pensions bill had grown substantially to a point where it amounted to 19% of GDP in 1982, which represented an increase of over 13.5% on the 1981 outturn. Furthermore, this occurred despite a supposed moratorium on special pay increases.

this limited fiscal effort proved too much for the Fine Gael-Labour coalition government, with noticeable consolidation fatigue evident in the 1984, 1985 and 1986 budgets which delivered little in the way of further corrective measures on expenditure or revenue.

- **1987**

Disagreements over budgetary policy eventually led to the fall of the coalition Government and a general election returned a minority Fianna Fáil Government in early 1987. However, crucially, the largest party in opposition, Fine Gael, supported the government in its continuation of the consolidation strategy which had been the policy under the previous administration. The medium-term budgetary objective, announced as part of the October 1987 Programme for National Recovery, was to reduce the Exchequer Borrowing Requirement to 5-7% of GNP by 1990. The March 1987 budget, introduced shortly after the new Government came into office, announced the government's intention to deliver on this rare consensus over fiscal policy, implementing a 1.5% reduction in capital spending, though current spending was still increased by 3.8%. On the expenditure side, measures aiming at curbing further expenditure developments included increases in social welfare payments limited to 3%, public service pay increase limited to 2% and a tightening of the public sector recruitment embargo. The main budgetary measures included on the revenue side: desindexation from inflation of tax-bands, 10% reduction in mortgage tax relief, abolition of three out of four housing grants and the introduction of a 35% professional fees withholding tax.

During the year, the Government established an Expenditure Review Committee (colloquially known as Bord Snip), an advisory committee established to recommend cuts in government spending ([108]), though the impact of the report has since been downplayed by one of the authors. ([109])The Government also announced in July 1987 the first ever voluntary redundancy scheme for permanent public sector employees, with the intention of reducing public sector numbers by 10,000, though with some upfront costs. In addition, the Programme for National Recovery deal negotiated with social partners and announced in October 1987, agreed on public sector pay increases not exceeding 2.5% annually for the next three years, to be partially compensated by reductions in personal income tax. The agreement also committed to maintaining the overall value of social welfare payments.

The year-end figures showed current expenditure actually grew by 2.8%, 1% below the budget estimate, while capital expenditure fell by 4.3%, a substantially greater contraction than was planned. Current revenues, meanwhile, grew by 6.6%, which was one per cent below forecast.

- **1988**

The 1988 Budget sought to consolidate the progress of the 1987 budget, in the context of delivering the Programme for National Recovery. To that end, the budget projected a historical 2.1% reduction in current spending and a whopping 16.9% cut in capital spending in 1988. The other main budgetary measures on the expenditure side were a limitation to 3%, of the general increase in social welfare payments (worth 0.2% of GDP in 1988 and 0.4% in a full year), and additional expenditure provisions for school-building, tourism promotion, homeless accommodation and provision for general public sector pay rises in line with the Programme for National Recovery but a continuation of the embargo on public sector recruitment.

Owing in part to rapid increase in output growth, the 1988 budget deficit outturn was substantially lower than expected. The outturn for the year saw current expenditure fall by 3.9%, a larger contraction than planned at budget time, while capital expenditure was down by 15.2%, not as

([108]) It was a three-man committee comprising two senior civil servants and a private sector economist which made a number of recommendations for expenditure reductions across the public service.

([109]) The private sector economist on the committee has since stated that "the role of expenditure cuts under the first Bord Snip has been exaggerated in journalistic renderings." See McCarthy, Colm, "Fiscal Consolidation II – Lessons from Last Time."

great a reduction as had been intended but still an enormous decrease. Current revenues, boosted by unexpectedly high returns from a tax amnesty, increased by 7.5% year-on-year, far above the budget day forecast of a 1.6% contraction.

- **1989**

The pre-Budget Abridged Book of Estimates published in October 1988 indicated provisional spending cuts for 1989 of approximately 0.8% of GDP, mostly concentrated on the field of education. It included notably cuts of 18% in school transport subsidies, cuts of 21% in school and college building programmes, a 5% rise in university fees and reductions in grants to local authorities and local authority housing expenditure.

The 1989 budget projected a 1.8% rise in current expenditure and a 1.2% increase in capital expenditure. The main measures included were in line with measures put in place since 1987. In particular, the welfare payments increase was limited to 3%, the embargo on recruitment to the public sector was maintained and general public sector pay increases were limited to 2.5% in line with the terms of the Programme for National Recovery.

The outturn for the 1989 saw current expenditure remain flat at the 1988 level, which was below target, but capital expenditure grew by 5.8%, significantly above the budget estimate. Current revenues were broadly flat, with a small increase of just 0.9%, though this was substantially above the budget day forecast of a 4.7% year-on-year contraction, as better than expected growth offset the negative base-effect of the previous year's tax amnesty.

5.4.2.3 Other major reforms

The fiscal position also benefitted from the receipt of substantially expanded EU structural funds after 1988. These funds helped to restore government capital spending after it had been severely reduced as a main plank of the fiscal consolidation programme. As well as raising potential output through infrastructure investment, there was a direct demand effect to these transfers, which are estimated by Honohan and Walsh to have lifted the level of Irish GDP by up to 4%. They also note that the contribution of greatly improved external conditions should not be over-looked, supported by two currency devaluations within the European Monetary System in 1983 and 1986. McCarthy cites the "well-executed" devaluation of August 1986 (a unilateral realignment of 8% according to Honohan) as a key contributory factor to the economic recovery.

With the Programme for National Recovery agreed in 1987, the first of five successive social partnership agreements, the Irish Congress of Trade Unions (ICTU) agreed to limit wage increases to 3% for the first £120 of weekly pay and 2% for the part exceeding £120 for each of the three years covered by the agreement. Also, the ICTU committed itself not to take industrial action that would result in additional cost increases for the employers. In exchange, government agreed to reform the tax system so that take-home pay would be increased. Government also agreed to keep the value of social welfare allowances unaltered.

5.4.5. CONCLUSIONS

The recovery in the Irish fiscal position in the late 1980s was outstanding. By 1990 deficit- and debt-to-GDP ratios had respectively fallen by 8 and 20 percentage points with respect to their peaks only a few years earlier. Likewise total and primary expenditure trends had been substantially reduced and their share in GDP decreased by around 10 percentage points with respect to its maximum levels.

There appears to be little doubt that the improvement in the Irish fiscal fundamentals was supported by an improving economic environment. The Irish economy went from recording flat real GDP growth of 0.3% in 1986 to an average growth rate of 5.0% over the next three years. A commonly cited driver of the pick-up in growth is the devaluation of the Irish pound by 8% against all other currencies in the European Monetary System (EMS) on 2nd August 1986, along with a recovery in external partners, particularly the UK. ([110]) Large FDI flows were also entering the country in the late 1980s in the lead-up to the

([110]) See McCarthy, "Fiscal Consolidation II – Lessons from Last Time."

Single European Market. However some authors have argued against assessing that the improvement in the fiscal position was driven by the economic recovery pointing instead to the important role that fiscal consolidation played in ensuring the credibility of a regime shift that contributed to the economic recovery. ([111])

5.5. SWEDEN 1994-1998

5.5.1. INTRODUCTION

Almost twenty years before the current crisis, Sweden experienced a deep and protracted recession when GDP contracted by a total of roughly 5% in three consecutive years between 1991 and1993. The recession and quickly mounting unemployment led to a rapid deterioration of government finances in 1991 and 1992, from a surplus of 3.3% of GDP in 1990 to a deficit of 11.2% of GDP in 1993. The government debt reached 74% of GDP in 1993, having climbed from roughly 40% of GDP in 1990. As a reaction, a focused consolidation programme was adopted in 1994.

The bulk of the measures contained in the consolidation programme were frontloaded so that in 1995 alone the consolidation amounted to 3.5% of GDP. Already by 1994 government finances started to improve and by 1998 the debt had started to decrease again and the budget balanced (graph IV.5.18).

Coming out of the 1980's the country built up important macroeconomic imbalances due to three main factors listed as: loss of competitiveness, German reunification, an unsustainable exchange rate regime, and tax reforms. The devaluations of the Swedish krona in 1981 and 1982 in combination with an internationally strong economic outlook resulted in an export boom and increased investment.

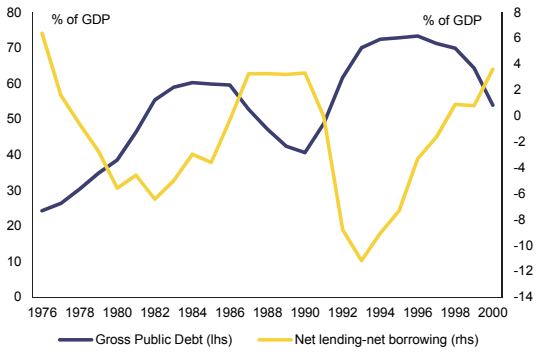
A rapid credit growth on the back of the Swedish deregulation of the credit market that took place in the mid-1980s further spurred domestic demand and real-estate investments.

Gradually however, Sweden suffered from a loss of competitiveness due to strongly increasing wages and prices coupled with a fixed exchange rate regime, and export market shares started to fall as the effect of the devaluations subsided.

Moreover, expansive government finances in Germany coupled with tightened monetary policy by the Bundesbank drove real interest rates upwards internationally, putting further pressure on the Swedish economy. The Swedish relative loss of international competitiveness created uncertainty about the exchange rate of the Swedish krona, which had been pegged to the ECU in May 1991, and pushed interest levels further upwards. On the other hand, linked to the increasing unemployment, inflation expectations were adjusted downwards. The combination led to very high real interest rate levels, compared to the previous period. The uncertainty culminated with turbulence on the financial markets and currency speculation in the autumn of 1992, which eventually led to a fierce defence of the Swedish krona, with marginal rate hikes reaching 500%. However, even such measures proved insufficient and the Swedish Riksbank allowed the krona to float in late 1992.

As an element of the thorough overhaul of the Swedish tax system that had been done in 1990-91, far-reaching reforms linked to housing taxation increased interest rate sensitivity of households and companies substantially, which in turn affected housing investments (with investments falling by 72% over 1990-1995) and house prices

Graph IV.5.18: **Government Finances Evolution in Sweden**



Source: Commission services, OECD

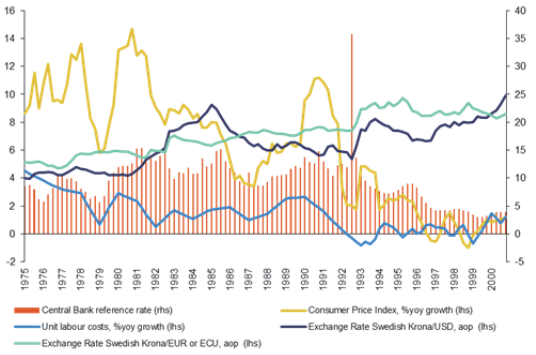
([111]) See Perotti (2013).

drastically.

The Swedish financial and currency crisis, in combination with the deterioration in relative competitiveness, led to a deep recession concerning virtually all sectors of the economy, which hit the economy 1991-1993. At the same time, it was aggravated by the fact that many trade partners also entered a recession in the early 1990s. The Swedish labour market was severely hit. Unemployment saw an increase from 2% to 8%, to a peak at roughly 12% in 1997. Over the course of a few years, employment levels fell from 83% to 71% of the total labour force. The recession was further accentuated by a rapid fall of domestic consumption and investments. Households and corporations deleveraged and increased their saving rate very quickly, from -5% of GDP in 1990 to 10% in 1993, partially as a reaction to the housing taxation reforms.

On the back of the economic downturn, tax revenues fell and expenditures rose sharply from 57% of GDP in 1990 to 69% in 1993. These developments led to a deterioration of government finances from a surplus of 3.3% of GDP in 1990 to a deficit of 11.2% of GDP in 1993. Furthermore, between February and August 1994 interest rates on government debt rose from 7% to over 12%, making the deficit increasingly expensive for the government budget to bear.

Graph IV.5.19: **Inflation, interest and exchange rates**



Source: Commission services, European Central Bank, Statistics Sweden, Riksbank

General elections in September 1994 led to a change of government, and one of the top priorities of the new Cabinet was to take action against the soaring deficit and to restore fiscal stability. This was achieved through a comprehensive consolidation programme, strengthening government finances by both increased revenues and expenditure cuts. The compression of expenditure resulted both from discretionary measures laid down in the consolidation programme as well as from non-discretionary, cyclical developments. The economic situation improved quickly, partly spurred by the depreciation of the Swedish krona that took place once it was allowed to float (graph IV.5.19).

5.5.2. CONSOLIDATION EPISODE

5.5.2.1 Overview of the consolidation episode

The consolidation programme adopted in two stages in 1994-95 and implemented over 1994-1998 implied a permanent strengthening of the government finances of 8% of GDP, roughly equally distributed between the revenue and expenditure sides. It was accompanied by clearer objectives for the budgetary process, including expenditure ceilings and government financial balance.

Table IV.5.5: **Estimated budgetary impact of expenditure consolidation measures (1994-1998)**

Type of expenditure consolidation measures	Effect by 1998 (Billions of SEK)
Transfers to households	34.6
Reduced subsidies	8.1
Reduced central government consumption	6.8
Other	21.7
Total effect of expenditure cuts	**71.2**

Source: Commission services

The expenditure side in particular, amounting to roughly SEK 71 billion, or 4.2% of GDP, in the consolidation programme, was designed to prioritise the maintenance of public services such as health care, education and social services. As a consequence, cuts concentrated mainly on transfers to households, accompanied by reduced subsidies and reduced central government spending as shown in Table IV.5.5. By design, the consolidation programme focused on maintaining health care and education, but some cuts concerned these areas as well. In general, the cuts were meant to be distributed more or less evenly across all

areas of government spending, so as to spread the burden of consolidation.

5.5.2.2 The measures

Based on the overview presented in table IV.5.5, a more detailed explanation of the measures implemented on the expenditure side follows. The amounts reported below are summing up the measures for the period 1994-1998.

The most important measures on the expenditure side concerned cuts in transfers to households, amounting to 2.1% of GDP which is roughly half of all expenditure cuts. Already as from June 1994, the income replacement rate of the parental insurance was cut from 90% to 80%. This was followed up in the spring Budget Bill of April 1995 with a general cut of replacement levels of the national social insurance system from 80% to 75%, affecting unemployment and sickness benefits. Pensions were also affected, as they were uncoupled from inflation adjustments, and through limitations in replacement ratios for some pensioners. Other types of transfers concerned by the consolidation exercise were for instance child-, student-, and housing allowances, where more restrictive rules were implemented.

Subsidies were reduced by 0.5% of GDP across sectors and affected for instance municipalities, public services, local airports, regional support or environmental protection measures. The construction sector was also affected by substantially reduced subsidies for municipal housing companies.

Government consumption was cut across the areas of responsibility of numerous ministries of the government, along the principle that all had to contribute. In total, the savings amounted to 0.4% of GDP. The Ministries of Finance and Social Affairs, and their respective authorities bore the heaviest burden of reduced consumption. The Ministry of Justice was also subject to substantial cuts. However, the reduced central government consumption was not coupled with any official policy in terms of wage components and while the public sector contracted over the consolidation period (by some 100 000 jobs), there were no general wage freezes or mandatory staff reductions put in place.

Other expenditure cuts were distributed across the areas of responsibility of different ministries affecting the budget of almost all policy areas, according to the principle that small streams make big rivers. In total, these diverse, individually limited expenditure cuts added up to additional savings of 1.3% of GDP. A number of areas can be highlighted:

- Education sector investments: education sector expenditure, although spared from more drastic cuts, still decreased by 0.25% of GDP. The system of financial aid for studies was reformed and the aid was uncoupled from automatic inflation adjustment. Contributions for lifelong learning and continued education, international research cooperation and adult educational associations were cut and allowances for education abroad were reviewed.

- Health care sector: similarly, health care sector expenditure especially linked to medicine and dental care, also decreased by 0.17% of GDP. In particular, the ceiling for the fee applied to patients' hospitalisation was increased as well as the ceiling for the high-cost protection.

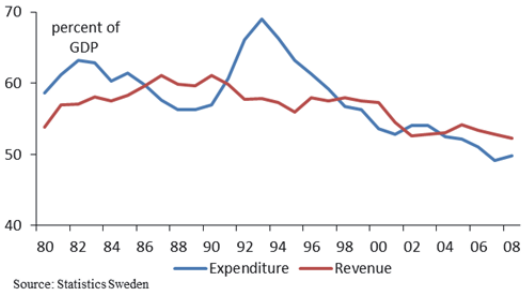
- Government investment: Both civil and military investments were cut during the consolidation exercise, with expenditure cuts of 0.16% of GDP only related to roads and railways etc. Savings of 0.12% of GDP also affected military investments.

The consolidation programme included a strengthening of the budget on the revenue side by roughly 4% of GDP, which almost matched the reduction on the expenditure side. The largest portion of these increases was due to adjusted individual national health insurance contributions with 1.4% of GDP. A uniformed capital taxation reform, increasing tax levels from 25% to 30%, also yielded revenues of roughly 0.45% of GDP.

In line with the distributional policy ambitions of the government, the progressivity of the tax system was emphasised as additional income tax was levied on high income earners, which moved from

20% to 25%, accounting for revenue increases of 0.25% of GDP. ([112]) While introduced as a temporary measure, the tax increase was rendered permanent after three years when the tax was transformed into an additional layer in the progressive state income tax brackets.

Graph IV.5.20: **Long-term developments of expenditure and revenue in Sweden**



Source: Statistics Sweden

Other taxes that were affected by the consolidation exercise include excise duties at 0.36% of GDP and a newly introduced general wage fee added to the payroll tax totalling 0.37% of GDP. The fee was not, however, linked to any benefits of the social insurance system and was in fact conceived to help finance the EU membership fee when Sweden acceded to the EU in 1995. ([113])

Some compensatory measures were also adopted during the consolidation episode. VAT rates on food were lowered from 21% to 12% to compensate for the substantial cuts in transfers to households. Tax relief schemes for companies or a softer scaling down of interest deductibility were also introduced. Overall, these compensatory measures had a deficit increasing impact of around 0.9% of GDP.

([112]) Payroll taxes are composed of state income tax and local income tax, with the former only kicking in as from a certain threshold. Above the threshold, the level of the state tax was increased from 20 to 25%.

([113]) Initially the fee represented 1.5%of the total taxable income, whereas its use has been gradually shifting to a more general tax to support public finances. In 2014 it represents 9.88%.

5.5.2.3 The impact on revenue and expenditure of the described measures.

Taken together, the effects of the consolidation measures including both the revenue and expenditure side, were distributed over the short term according to Table IV.5.6:

Table IV.5.6: **Implementation of the consolidation programme (% of GDP)**

Year	Percentage of GDP
1995	3.5
1996	2.0
1997	1.4
1998	1.1
Total:	**8.0**

Source: Nordic Council of Ministers, 1997

Even though the consolidation programme as budgeted put equal emphasis on expenditure cuts and revenue increases, it is clear from Table IV.5.7 that the total evolution of the government finances in 1994-1998 was substantially skewed towards lower expenditure ([114]). This partly reflected the comeback of the Swedish economy and the stronger-than-expected growth. Therefore, it remains complicated to disentangle various effects on government finances resulting from cyclical factors not related to the consolidation exercise *per se*.

Table IV.5.7: **Budget key parameters before, during and after the consolidation exercise ()**

	Before 1991:1-1994:3	On the verge 1994:3	During 1994:4-1997:4	Coming out 1998:1	After 1998:1-2000:4	Post-Crisis 2000:4
Total expenditure as share of GDP	67.5	68.2	63.3	58.7	58.5	58.1
Total revenue as share of GDP	60.3	59.4	58.9	59.3	60.6	61.8
Deficit	-7.2	-8.8	-4.4	0.6	2.0	3.7

Source: Bergman, U. Michael (2010), Report to the Fiscal Policy Council 2010/2

In any case, it is clear from Table IV.5.7 that the measures contained in the consolidation exercise had a substantial impact on the expenditure side, with total expenditures as a share of GDP falling from 68.2% in the quarter immediately preceding the consolidation, to 58.7% in the first quarter of 1998, when the consolidation was coming to its

([114]) The Exchequer pay and pensions bill had grown substantially to a point where it amounted to 19% of GDP in 1982, which represented an increase of over 13.5%on the 1981 outturn. Furthermore, this occurred despite a supposed moratorium on special pay increases.

end. On the revenue side, the situation appears more stable, with revenues falling only slightly as a share of GDP during the consolidation exercise. The budget deficit turned from red figures to a surplus over the period, and the reversal came quicker than anticipated due to strong economic performance and thriving exports. Over the medium-term, coming from a situation where total expenditure reached almost 70% of GDP, it declined rapidly during the episode and reached roughly 58% by 2000 (Table IV.5.7). Since then, it fell further and stood at 51% in 2012. As for the revenue side, the evolution is characterised by more stability. Over time, however, government revenues have fallen as a proportion to GDP and stood at roughly 50% in 2012.

5.5.2.4 Other major reforms in the budgetary area.

The success of the Swedish consolidation episode in containing the expenditure trends was also underpinned by a strengthened fiscal framework.

Institutional reforms aiming at improving the budgetary and fiscal framework to ensure fiscal discipline after the crisis were established and still contribute to the sound fiscal stance of Sweden. In fact, reform pressure had mounted as Sweden was found to have the second laxest budget procedure in the EU. ([115]) As a consequence, an expenditure ceiling and a surplus target were established to contain expenditure. A fiscal policy council was also created to vet government finances. Central government moreover prohibited local governments from borrowing for consumption.

Furthermore, the reform of the pension system from a defined benefit to a defined contribution system, undertaken in the 1990s and implemented gradually, was decisive for the long-term sustainability of government finances in Sweden. The in-depth reform of the tax system that took place in the early 1990s – with the aim of broadening the tax base, reducing marginal taxes and removing exceptions - also supported the consolidation.

The credibility of the central bank was also strengthened as the Riksbank was granted its independent status in Swedish law in 1999. An inflation target of 2% ± 1% was decided upon by the Riksbank in January 1993.

Other significant reforms included the deregulation of some infrastructure sectors (electricity, postal services, telecom, railway and airway), which helped tackling the issues of rigidities and improved competitiveness. The fixed-exchange rate regime was abandoned in late-1992 and the subsequent depreciation of the krona supported the Swedish economy while domestic demand was contracting.

5.5.3. CONCLUSIONS

Following the implementation of the consolidation programme in 1994-98, net lending balanced and the government debt stabilised. While acknowledging the sound design of the consolidation programme, the beneficial outcome is also strictly linked to the economy picking up already in 1994 and developing rather vigorously throughout the consolidation episode. This happened partly on the back of the depreciation of the Swedish krona following the decision to let the currency float in 1992. An export-led recovery, with Sweden's EU accession in 1995 boosting Swedish firms' interest in the single market, is hence also an important explanatory factor behind the quick improvement of the public finances. The Swedish preparations for joining the EU were also a supporting factor in in this context, enhancing the international credibility of the consolidation effort.

Following three years of negative growth in 1991, 1992 and 1993, GDP growth picked up vigorously at 4% in 1994 and remained rather strong throughout the consolidation episode, including 1998 and beyond.

Table IV.5.8: **Macroeconomic development before, during and after the consolidation exercise ()**

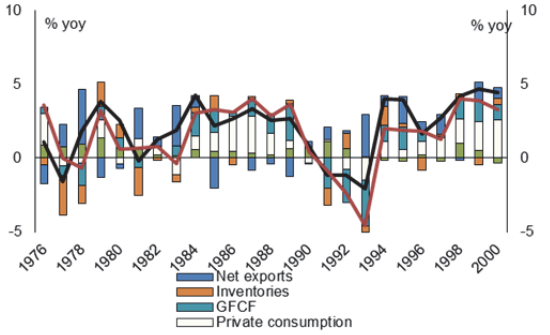
	Before 1991:1-1994:3	On the verge 1994:3	During 1994:4-1997:4	Coming out 1998:1	After 1998:1-2000:4
GDP growth	-0.5	4.2	2.9	3.5	4.2
Unemployment	8.0	11.1	11.3	10.3	8.5

Source: Bergman, U. Michael (2010), Report to the Fiscal Policy Council 2010/2

([115]) See Molander (1992).

By studying the macroeconomic developments (Table IV.5.8), it is clear that average GDP growth was negative during the period before the consolidation (Q1:1991-Q3:1994). As may have been expected, growth was affected negatively during the consolidation exercise itself, but then gained speed once it was completed. The main driving forces behind the GDP growth recovery were increased investments and, eventually, improved net exports and private consumption (Graph IV.5.21).

Graph IV.5.21: **GDP composition**

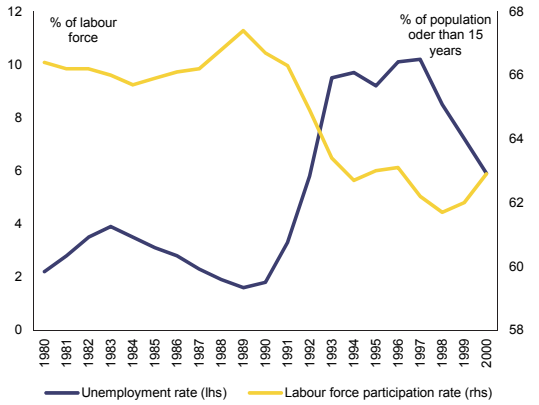


Source: Commission services

Unemployment figures also remained high during the consolidation period, but began to fall as from the beginning of 1998. After three years, figures for unemployment had come down substantially (graph IV.5.22). However, while also catching up, the employment rate did not develop just as vigorously and it seems that the recession had a lasting effect on the equilibrium between the state of the economy and the labour market through a NAIRU increase.

However, the implementation of the consolidation programme in 1994-98 not only led to an improvement of Sweden's fiscal variables over the short term. Crucially, Sweden managed to maintain strong government finances thereafter, even in the adverse context of the recent financial and economic crisis. This suggests that the consolidation was indeed successful in containing expenditure trends and ensuring the sustainability of public finances.

Graph IV.5.22: **Swedish Labour Market Evolution**



Source: World Bank

6. CONCLUSIONS

The results presented in Part IV confirm that expenditure-based consolidations are different from revenue based efforts, and are the most effective way of achieving medium-term consolidation in government finances when revenue ratios are already high.

The evidence of previous successful consolidation case studies shows that wide-ranging spending cuts, when accompanied by increased expenditure efficiency and budgetary discipline, result in lower medium-term expenditure levels and sounder budgetary positions. These episodes also show that cuts should concentrate on the more rigid and persistent components of government expenditure, namely compensation of employees and social benefits among others. Another lesson to be drawn from these episodes is that successful expenditure cuts take several years to implement. Therefore, strong political commitment is crucial to its success.

These results are confirmed when broader EU expenditure developments are examined. An empirical analysis of expenditure-based consolidations since 1978 shows that spending cuts in the EU significantly decrease expenditure levels in the medium term, while revenue-based fiscal consolidations do not impact expenditure trends.

The reform of the Stability and Growth Pact has given more weight to expenditure control and institutional arrangements that favour sound government finances. The analysis in Part IV confirms the importance of these rules and suggests that their implementation is crucial to reach sound budgetary positions in the medium term.

Part V

Resources

1. ABBREVIATIONS AND SYMBOLS USED

Member States

BE	Belgium
BG	Bulgaria
HR	Croatia
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EI	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
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, 27 Member States
EA-18	European Area, 17 Member States

Other

AIReF	Independent Authority for Fiscal Responsibility
AMECO	Macro-economic database of the European Commission
ATE	Average treatment effects
AWG	Ageing Working Group
CAB	Cyclically Adjusted Budget Balance
CAPB	Cyclically-adjusted primary balance
COFOG	Classification of the functions of government
COM	Commission
CSR	Country-Specific Recommendations
DBP	Draft Budgetary Plan
DFE	Discretionary Fiscal Effort
DG ECFIN	Directorate-General Economic and Financial Affairs
DRM	Discretionary Revenue Measures
ECB	European Central Bank
ECON	Council and to the Economic and Financial Committee
EDP	Excessive Deficit Procedure
EERP	European Economic Recovery Plan
EFC	Economic and Financial Committee
EFSF	European Financial Stability Facility

EMU	Economic and Monetary Union
EPC	Economic Policy Committee
ESA	European System of National and Regional Accounts
EA	European area
EU	European Union
FBFL	Federal Budgetary Framework Law
FE	Fiscal effort
FPC	Fiscal Policy Committees
GDP	Gross Domestic Product
GFKF	Gross fixed capital formation
IFI	Independent Fiscal Institutions
IMF	International Monetary Fund
IRAP	Imposta regionale sulle attivita' produttive
IPW	Inverse-probability weighted estimators
IPWRA	Inverse-probability weighted regression-adjustment estimators
ICTU	Irish Congress of Trade Unions
MTBF	Medium-Term Budgetary Framework
MTFS	Medium-Term Fiscal Strategy
MTO	Medium-Term budgetary Objective
NAWRU	Non-accelerating Wage Rate of Unemployment
NMTFP	National medium-term fiscal plans
NPISH	Non-profit institutions serving households
NRP	National Reform Programme
OECD	Organisation of Economic Co-operation and Development
OG	Output Gap
OGWG	Output Gap Working Group
PFR	Public Finance Report

pp	Percentage Points
RA	Regression-adjusted estimators
R&D	Research and development
ROG	Representative output gap
SB	Structural Balance
SCPs	Stability and convergence programmes
SGP	Stability and Growth Pact
SPB	Structural primary balances
TSCG	Treaty on Stability Coordination and Governance
TFEU	Treaty on the Functioning of European Union (TFEU)
VAT	Value added tax

2. GLOSSARY

Automatic stabilisers Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Broad Economic Policy Guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses general government aggregates. See also structural budget balance, primary budget balance, and primary structural balance.

Budgetary rules Rules and procedures through which policy-makers decide on the size and the allocation of public expenditure as well as on its financing through taxation and borrowing.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Candidate countries Countries that wish to accede to the EU. Besides the accession countries, they include Croatia and Turkey.

Close-to-balance requirement A requirement contained in the 'old' Stability and Growth Pact, according to which Member States should, over the medium term, achieve an overall budget balance close to balance or in surplus; was replaced by country-specific medium-term budgetary objectives in the reformed Stability and Growth Pact.

Code of Conduct Policy document endorsed by the ECOFIN Council of 11 October 2005 setting down the specifications on the implementation of the Stability and Growth Pact and the format and content of the stability and convergence programmes.

COFOG (Classification of the Functions of Government) A statistical nomenclature used to break down general government expenditure into its different functions including general public services, defence, public order and safety, economic affairs, environmental protection, housing and community amenities, health, recreation, culture and religion, education and social protection.

Composite indicator A compilation of several indicators into a single index reflecting the different dimensions of a measured concept.

Convergence programmes Medium-term budgetary and monetary strategies presented by Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the Stability and Growth Pact. Prior to the third phase of EMU, convergence programmes were issued on a voluntary basis and used by the Commission in its assessment of the progress made in preparing for the euro. See also stability programmes.

Cyclical component of budget balance That part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap. See automatic stabilisers, tax smoothing and structural budget balance.

Cyclically-adjusted budget balance See structural budget balance.

Demand and supply shocks Disturbances that affect the economy on the demand side (e.g. changes in private consumption or exports) or on the supply side (e.g. changes in commodity prices or technological innovations). They can impact on the economy either on a temporary or permanent basis.

Direct fiscal costs (gross, net) of a financial crisis The direct gross costs are the fiscal outlays in support of the financial sector that increase the level of public debt. They encompass, for example, recapitalisation, purchase of troubled bank assets, pay-out to depositors, liquidity support, payment when guarantees are called and subsidies. The direct net costs are the direct gross cost net of

recovery payments, such as through the sale of acquired assets or returns on assets. Thus, the net direct fiscal costs reflect the permanent increase in public debt.

Direct taxes Taxes that are levied directly on personal or corporate incomes and property.

Discretionary fiscal policy Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of automatic stabilisers. See also fiscal stance.

Early-warning mechanism Part of the preventive elements of the Stability and Growth Pact. It is activated when there is significant divergence from the budgetary targets set down in a stability or convergence programme.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, the EFC is a Committee of the Council of the European Union set up by Article 114 of the. Its main task is to prepare and discuss (ECOFIN) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior government officials whose main task is to prepare discussions of the (ECOFIN) Council on structural policies. It plays an important role in the preparation of the Broad Economic Policy Guidelines, and it is active on policies related to labour markets, methods to calculate cyclically-adjusted budget balances and ageing populations.

Effective tax rate The ratio of broad categories of tax revenue (labour income, capital income, consumption) to their respective tax bases.

Effectiveness The same concept as efficiency except that it links input to outcomes rather than outputs.

Efficiency Can be defined in several ways, either as the ratio of outputs to inputs or as the distance to a production possibility frontier (see also Free Disposable Hull analysis, Data Envelope analysis, stochastic frontier analysis). Cost efficiency measures the link between monetary inputs (funds) and outputs; technical efficiency measures the link between technical inputs and outputs. Output efficiency indicates by how much the output can be increased for a given input; input efficiency indicates by how much the input can be reduced for a given input.

ESA95 / ESA79 European accounting standards for the reporting of economic data by the Member States to the EU. As of 2000, ESA95 has replaced the earlier ESA79 standard with regard to the comparison and analysis of national public finance data.

European semester European semester New governance architecture approved by the Member States in September 2010. It means that the EU and the euro zone will coordinate ex ante their budgetary and economic policies, in line with both the Stability and Growth Pact and the Europe 2020 strategy. Based on previous discussions on Commission's Annual Growth Survey, each summer, the European Council and the Council of ministers will provide policy advice before Member States finalise their draft budgets.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State. Its application has been further clarified in the Stability and Growth Pact. See also stability programmes and Stability and Growth Pact.

Expenditure rules A subset of fiscal rules that target (a subset of) public expenditure.

Fiscal consolidation An improvement in the budget balance through measures of discretionary fiscal policy, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal decentralisation The transfer of authority and responsibility for public functions from the central government to intermediate and local governments or to the market.

Fiscal federalism A subfield of public finance that investigates the fiscal relations across levels of government.

Fiscal governance Comprises all rules, regulations and procedures that impact on how the budget and its components are being prepared. The terms fiscal governance and fiscal frameworks are used interchangeably in the report.

Fiscal impulse The estimated effect of fiscal policy on GDP. It is not a model-free measure and it is usually calculated by simulating an econometric model. The estimates presented in the present report are obtained by using the Commission services' QUEST model.

Fiscal institutions Independent public bodies, other than the central bank, which prepare macroeconomic and budgetary forecasts, monitor the fiscal performance and/or advice the government on fiscal policy issues.

Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also budgetary rule, expenditure rules.

Fiscal stance A measure of the effect of discretionary fiscal policy. In this report, it is defined as the change in the primary structural budget balance relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General government As used by the EU in its process of budgetary surveillance under the Stability and Growth Pact and the excessive deficit procedure, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, government borrowing, or changes in the monetary base. In the context of EMU, the ability of governments to finance spending through money issuance is prohibited. See also stock-flow adjustment, sustainability.

Government contingent liabilities Obligations for the government that are subject to the realization of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depend on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Growth accounting A technique based on a production function approach where total GDP (or national income) growth is decomposed into the various production factors and a non-explained part which is the total factor productivity change, also often termed the Solow residual.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are the value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Integrated guidelines A general policy instrument for coordinating EU-wide and Member States economic structural reforms embedded in the Lisbon strategy and which main aim is to boost economic growth and job creation in the EU.

Interest burden General government interest payments on public debt as a share of GDP.

Lisbon Strategy for Growth and Jobs Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the broad economic policy guidelines and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up three-year national reform programmes at the end of 2005. They reported on

the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Maastricht reference values for public debt and deficits Respectively, a 60 % general government debt-to-GDP ratio and a 3 % general government deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also Excessive Deficit Procedure.

Maturity structure of public debt The profile of total debt in terms of when it is due to be paid back. Interest rate changes affect the budget balance directly to the extent that the general government sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the budget balance to changes in the prevailing interest rate. See also public debt.

Medium-term budgetary framework An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annul basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO) According to the reformed Stability and Growth Pact, stability programmes and convergence programmes present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see structural balance).

Minimum benchmarks The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the 'medium-term budgetary objectives (MTO).

Monetary Conditions Index (MCI) An indicator combining the change in real short-term interest rate and in the real effective exchange rate to gauge the degree of easing or tightening of monetary policy.

NAIRU Non-Accelerating Inflation Rate of Unemployment.

Non-Keynesian effects Supply-side and expectations effects which reverse the sign of traditional Keynesian multipliers. Hence, if non-Keynesian effects dominate, fiscal consolidation would be expansionary.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also structural balance.

Outcome indicator Measures the ultimate results (outcomes) of policy choices (e.g. education attainment, healthy life years, economic growth).

Output costs from a financial crisis This is the gap between the hypothetical output development without a crisis and the actual output realised against the back of the crisis. Various methods are available to calculate output losses, in particular either using the trend GDP growth or the level of GDP as a benchmark.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also cyclical component of budget balance.

Output indicator Measures the technical results (outputs) of policy choices (e.g. number of university graduates, number of patents, life expectancy).

Performance-based budgeting A budgeting technique that links budget appropriations to performance (outcomes, results) rather than focusing on input controls. In practice, performance-informed budgeting is more common which basis decisions on budgetary allocation on performance information without establishing a formal link.

Policy-mix The overall stance of fiscal and monetary policy. The policy-mix may consist of

various combinations of expansionary and restrictive policies, with a given fiscal stance being either supported or offset by monetary policy.

Potential GDP 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, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also production function method and output gap.

Pre-accession Economic Programmes (PEPs) Annual programmes submitted by candidate countries which set the framework for economic policies The PEPs consist of a review of recent economic developments, a detailed macroeconomic framework, a discussion of public finance issues and an outline of the structural reform agenda.

Pre-accession Fiscal Surveillance Framework (PFSF) Framework for budgetary surveillance of candidate countries in the run up to accession. It closely approximates the policy co-ordination and surveillance mechanisms at EU level.

Primary budget balance The budget balance net of interest payments on general government debt.

Primary structural budget balance The structural budget balance net of interest payments.

Pro-cyclical fiscal policy A fiscal stance which amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the cyclically-adjusted budget balance unchanged over the economic cycle but lets the automatic stabilisers work. See also tax-smoothing.

Production function approach A method to estimate the level of potential output of an economy 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 the estimation of cyclical component of the budget.

Public debt Consolidated gross debt for the general government sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public goods Goods and services that are consumed jointly by several economic agents and for which there is no effective pricing mechanism that would allow private provision through the market.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Public-private partnerships (PPP) Agreements that transfer investment projects to the private sector that traditionally have been executed or financed by the public sector. To qualify as a PPP, the project should concern a public function, involve the general government as the principal purchaser, be financed from non-public sources and engage a corporation outside the general government as the principal operator that provides significant inputs in the design and conception of the project and bears a relevant amount of the risk.

Quality of public finances Comprises all arrangements and operations of fiscal policy that support the macroeconomic goals of fiscal policy, in particular economic growth.

Quasi-fiscal activities Activities promoting public policy goals carried out by non-government units.

QUEST The macroeconomic model of the EU Member States plus the US and Japan developed by the Directorate-General for Economic and Financial Affairs of the European Commission.

Recently acceded Member States Countries that became members of the EU in May 2004 and include Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Two additional countries, Romania and Bulgaria joined in January 2007.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection, given various changes in the underlying assumptions.

Significant divergence A sizeable excess of the budget balance over the targets laid out in the stability or convergence programmes, that triggers the Early warning procedure of the Stability and Growth Pact.

Size of the public sector Typically measured as the ratio of public expenditure to nominal GDP.

'Snow-ball' effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy. See also government budget constraint.

Social security contributions (SSC) Mandatory contributions paid by employers and employees to a social insurance scheme to cover for pension, health care and other welfare provisions.

Sovereign bond spread The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also Excessive Deficit Procedure.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the Stability and Growth Pact. See also Convergence programmes.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance. See also primary structural budget balance.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the budgetary sensitivity.

Tax gaps Measure used in the assessment of the sustainability of public finances. They measure the difference between the current tax ratio and the constant tax ratio over a given projection period to achieve a predetermined level of debt at the end of that projection period.

Tax smoothing The idea that tax rates should be kept stable in order to minimise the distortionary effects of taxation, while leaving it for the automatic stabilisers to smooth the economic cycle. It is also referred to as neutral discretionary fiscal policy. See also cyclical component of fiscal policy.

Tax wedge The deviation from equilibrium price/quantity as a result of a taxation, which results in consumers paying more, and suppliers receiving less. When referring to labour tax wedge more specifically, the tax wedge is usually regarded as the difference between the difference between the salary costs of an average worker to their employer and the amount of net income that the worker receives in return, the difference being represented by taxes including personal income taxes and compulsory social security contributions.

Total factor productivity Represents the share of total output not explained by the level of inputs

(labour, capital or primary product). It is generally considered as a measure of overall productive efficiency.

Welfare state Range of policies designed to provide insurance against unemployment, sickness and risks associated with old age.

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4. USEFUL INTERNET LINKS

European Union

European Commission	ec.europa.eu
Directorate-General for Economic and Financial Affairs	ec.europa.eu/economy_finance/index_en.htm
Eurostat	epp.eurostat.ec.europa.eu
European Council	consilium.europa.eu
European Parliament	www.europarl.europa.eu

Economics and Finance Ministries

Belgium	www.treasury.fgov.be/interthes	Ministère des Finances - Ministerie van Financen
Bulgaria	www.minfin.bg	Ministry of Finance
Croatia	http://www.mfin.hr/en	Ministry of Finance
Czech Republic	www.mfcr.cz	Ministry of Finance
Denmark	www.fm.dk	Ministry of Finance
Germany	www.bundesfinanzministerium.de	Bundesministerium der Finanzen
Estonia	www.fin.ee	Ministry of Finance
Ireland	www.irlgov.ie/finance	Department of Finance
Greece	www.mnec.gr/en/	Ministry of Economy and Finance
Spain	www.mineco.es/	Ministerio de Economía y Hacienda
France	www.finances.gouv.fr	Ministère Économie, Finances et l'Industrie
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Poland	www.mofnet.gov.pl	Ministry of Finance
Portugal	www.min-financas.pt	Ministério das Finanças
Romania	www.mfinante.ro	Ministry of Finance
Slovenia	www.gov.si/mf	Ministry of Finance
Slovak Republic	www.finance.gov.sk	Ministry of Finance
Finland	www.vn.fi/vm	Ministry of Finance
Sweden	finans.regeringen.se	Finansdepartementet
United Kingdom	www.hm-treasury.gov.uk	Her Majesty's Treasury

Independent Fiscal Institutions

Belgium	http://www.plan.be/	Federaal Planbureau/Bureau Fédéral du Plan (Belgian Federal Planning Bureau)
	http://www.docufin.fgov.be/intersalgfr/hrfcsf/onzedienst/onzedienst.htm	Hoge Raad van Financiën/Conseil Supérieur des Finances (Belgian High Council of Finance)
Bulgaria		
	http://www.mfin.hr/en/fiscal-policy-committee	Odbor za fiskalnu politiku (Croatian Fiscal Policy Committee)

Czech Republic		
Denmark	http://www.dors.dk/	De Økonomiske Råd (Danish Economic Councils)
Germany	http://www.stabilitaetsrat.de/DE/Beirat/Beirat_node.html	Unabhängiger Beirat des Stabilitätsrates (German Independent Fiscal Advisory Council to the Stability Council)
Estonia	http://www.eelarvenoukogu.ee/en	Eelarvenõukogu (Estonian Fiscal Council)
Ireland	http://www.fiscalcouncil.ie/	Irish Fiscal Advisory Council (IFAC)
Greece	http://www.pbo.gr/	Greek Parliamentary Budget Office
Spain	http://www.airef.es/	Autoridad Independiente de Responsabilidad Fiscal (AIReF)
France	http://www.hcfp.fr/	Haut Conseil des Finances Publiques (French High Council of Public Finance)
Italy	http://www.parlamento.it/1122	Ufficio Parlamentare di Bilancio (Italian Parliamentary Budget Office)
Cyprus		Fiscal Council of Cyprus
Latvia		Fiskālās disciplīnas padome (Latvian Fiscal Discipline Council)
Lithuania		Lietuvos Respublikos Valstybes Kontrole (National Audit Office of Lithuania)
Luxembourg		National Statistical Office (STATEC, Luxembourg)
		Conseil National des Finances Publiques (CNPF, Luxembourg)
Hungary	http://www.parlament.hu/kt/tagok.htm	Költségvetési Tanács (Hungarian Fiscal Council)

Malta		
Netherlands		Raad van State (Dutch Council of State)
	www.cpb.nl	Centraal Planbureau (Netherlands Bureau for Economic Policy Analysis)
Austria	http://www.fiskalrat.at/	Fiskalrat (Austrian Fiscal Advisory Council)
	http://www.wifo.ac.at/	Österreichisches Institut für Wirtschaftforschung (WIFO - Austrian Institute for Economic Research)
Poland		
Portugal	http://www.cfp.pt/	Conselho das Finanças Publicas (Portuguese Public Finance Council)
Romania	http://www.consiliulfiscal.ro/	Consiliul Fiscal (Romanian Fiscal Council)
Slovenia	http://www.umar.gov.si/	Urad RS Slovenije za makroekonomske analize in razvoj (Slovenian Institute of Macroeconomic Analysis and Development -IMAD)
Slovak Republic	http://www.rozpoctovarada.sk/	Rada pre rozpočtovú zodpovednosť (Slovak Council for Fiscal Responsibility)
Finland		Valtiontalouden Tarkastusvirasto (Finnish National Audit Office)
Sweden	http://www.finanspolitiskaradet.com/	Finanspolitiska Rådet (Swedish Fiscal Policy Council)
United Kingdom	http://budgetresponsibility.org.uk/	Office for Budget Responsibility

(OBR)

Central banks

European Union	www.ecb.int	European Central Bank
Belgium	www.nbb.be	Banque Nationale de Belgique / Nationale Bank van België
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Finland	www.bof.fi	Suomen Pankki
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United Kingdom	www.bankofengland.co.uk	Bank of England

EU fiscal surveillance framework

Stability and Growth Pact:

ec.europa.eu/economy_finance/sg_pact_fiscal_policy/index_en.htm?cs_mid=570

Excessive deficit procedure:

ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy554_en.htm

Early warning mechanism:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy1075_en.htm

Stability and convergence programmes:

ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy528_en.htm

Sustainability of public finances:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/fiscal_policy546_en.htm

Quality of public finances

http://ec.europa.eu/economy_finance/publications/publication_summary12186_en.htm

http://ec.europa.eu/economy_finance/epc/epc_publications_en.htm#Quality%20of%20public%20finances

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