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The opinions expressed in this document are the sole responsibility of the European Fiscal Board and do not necessarily reflect the views and positions of the European Commission or any other institution the Members of the Board are affiliated or work with.
ABBREVIATIONS

**Member States**
BE Belgium
DE Germany
EE Estonia
IE Ireland
EL Greece
ES Spain
FR France
IT Italy
CY Cyprus
LV Latvia
LT Lithuania
LU Luxembourg
MT Malta
NL The Netherlands
AT Austria
PT Portugal
SI Slovenia
SK Slovakia
FI Finland
EA Euro area
EU European Union
EU-28 European Union, 28 Member States
EA-19 Euro area, 19 Member States

**Other**
AWG Ageing Working Group
CAB Cyclically adjusted budget balance
CAPB Cyclically-adjusted primary balance
CSR Country-specific recommendation
DBP Draft budgetary plan
DG ECFIN Directorate-General for Economic and Financial Affairs
DSA Debt Sustainability Analysis
ECB European Central Bank
ECOFIN Economic and Financial Affairs Council
EDP Excessive Deficit Procedure
EFB European Fiscal Board
EFC Economic and Financial Committee
EMU Economic and Monetary Union
EPC Economic Policy Committee
GDP Gross domestic product
GFCF Gross fixed capital formation
HICP Harmonized Index of Consumer Prices
IMF International Monetary Fund
MLSA Minimum Linear Structural Adjustment
MTBF Medium-Term Budgetary Framework
MTO Medium-term budgetary objective
NAWRU Non-Accelerating Wage Rate of Unemployment
OECD Organisation of Economic Co-operation and Development
OGWG Output Gap Working Group
SB Structural balance
SDP Significant Deviation Procedure
SGP Stability and Growth Pact
SP Stability Programme
SPB Structural primary balance
TFEU Treaty on the Functioning of the European Union
TSCG Treaty on Stability, Coordination and Governance
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FOREWORD

Fiscal rules exemplify a classic policy dilemma: they enjoy widespread support as a means of improving fiscal policymaking, yet opinions on how to implement them or make them work in practice diverge widely. The EU’s fiscal framework is a case in point. Since its adoption in the early 1990s, there has been a common understanding among pundits and policymakers alike that fiscal rules are a necessary component of successful economic and monetary integration in Europe. At the same time, the implementation of the Stability and Growth Pact (SGP) has consistently met with both approval and opposition on many fronts.

The debate on the effectiveness of the EU’s fiscal framework intensified following the post-2007 crises, leading to a re-examination of the EU’s economic governance framework as a whole. The European Fiscal Board (EFB) is a product of that process. Inspired by the proposals set out in the Five Presidents’ Report of June 2015 on Completing Europe’s Economic and Monetary Union, the legal foundations of the EFB were laid at the end of that year, followed by the appointment of its members at the end of 2016.

In its first annual report the EFB offers an independent assessment of the EU’s fiscal framework. In line with its mandate, the Board focuses on the euro area and its Member States. The report has a backward-looking and a forward-looking part. The backward-looking part includes an evaluation of how the mutually agreed fiscal rules have been implemented in the recent past and how that implementation has affected the direction taken by fiscal policy in the euro area as a whole. Building on the insights from the backward-looking part, the report also looks at ways to improve the EU’s fiscal framework, both within the bounds of its existing architecture and beyond.

The publication of this report falls during a moderate but steady recovery of the euro area from the deepest and longest economic crisis in post-WWII European history. With regard to the SGP, the initiatives launched in the aftermath of the crises tightened the surveillance of the rules while at the same time broadening their flexibility, at the cost of a higher degree of complexity and reduced transparency. And indeed, greater flexibility comes with both advantages and disadvantages. The current rules and procedures can accommodate a wide range of contingencies, especially unfavourable ones. They also involve a much greater degree of judgment and discretion. This may at times be difficult to reconcile with the intended rules-based nature of the fiscal framework, and it raises questions of transparency.

On a number of points, the EFB’s first report is critical of the way the European Commission and the Council of the European Union implemented the fiscal framework in 2016. At the same time, these critical remarks complement the EFB’s view that the framework has made a net positive contribution to moving the economies of the euro area away from the crisis years, hence providing a better basis for the modest, but steady recovery observed since 2014.

There is, admittedly, no foolproof way to establish how the euro area would have performed under a different fiscal framework, including one of the earlier incarnations of the SGP rules. However, the Board believes that the 2016 implementation succeeded in avoiding on the one hand a major relaxation of the rules, potentially detrimental to the longer-run sustainability of public finances, and, on the other hand, a rigid application of the rules, which could have undermined the continuation of a still fragile recovery. Imperfectly implemented rules can, in our view, sometimes prove preferable to the ‘gross errors’ of either a very lax or a very narrow application.

This view will be regarded as controversial by those who would have preferred to go further in either direction. The SGP was agreed in 1997 to make the Excessive Deficit Procedure in the Maastricht Treaty clearer and more operational; the early focus was on helping ensure the longer-term sustainability of public finances. This rested on the assumption that a solid longer-term anchor would enable national fiscal policies and the operation of automatic stabilisers to be left largely in national hands. There would thus be no need for detailed monitoring by the Commission and other Member States. When the SGP was revised in 2005, this feature was retained, but the emphasis in policy evaluation shifted towards the cyclically adjusted public sector balance to minimise the risk of procyclical fiscal policies. When the rules were again reformed in the light of experience of the crisis, the emphasis was once again placed on sustainability, and the criteria for judging it were made more readily enforceable. Finally, in early 2015, the Commission
clarified the degree of flexibility with which it would apply the criteria, with the 2016 European Semester cycle as the first case.

Overall, flexibility cannot be seen as the failure of a framework perceived as being more one-dimensional than the way in which it can realistically be expected to operate. At the same time, there is abundant evidence that discretion on its own does not ensure sound fiscal policymaking. We see the EFB's annual report as an input to help decision-makers reconcile compliance with rules with providing the necessary flexibility.

In the forward-looking part of the report, the EFB proposes a number of amendments to the fiscal rules. These are designed to reduce asymmetries in the way they are applied in economically favourable and unfavourable times, to improve compliance and enforcement, and to simplify the framework. The EFB believes that the proposed changes are consistent with the aim of the framework, and that there should be opportunities to implement them at a time when the economic recovery has lowered the tension between pursuing the main objective of the rules — making public finances sustainable in the longer term — and a stabilising role for public budgets in national economies.

However, the EFB is under no illusions that the proposed amendments will suffice to meet the future challenges facing the EMU. Some future shocks to the European economies will — as over the past decade, though hopefully less violently — prove to be too large to be dealt with by joint monetary accommodation and national fiscal policies, even if these are better designed. To cope with such shocks, a euro area stabilisation function will be useful before the ESM crisis mechanism kicks in to help a euro area member regain access to financial markets to rebuild its financial institutions.

The debate on this subject was relaunched in the Five Presidents' Report. Its scope goes well beyond fiscal issues and thus transcends the EFB's remit. However, this report focuses on the possible contribution of a central fiscal capacity in the euro area towards improving the performance of the participating economies. More specifically, it takes a first look at two of the options for a central fiscal capacity outlined in the 2017 Commission's Reflection Paper on deepening the EMU — an investment protection scheme and an unemployment reinsurance fund. The report also looks briefly at a wider role for fiscal policy, going beyond stabilisation by enhancing the overall efficiency and allocation of resources in the euro area.
1. EXECUTIVE SUMMARY

This annual report — the first of its kind — documents the work carried out by the European Fiscal Board (EFB) since its appointment at the end of 2016. It offers an independent view of fiscal policy surveillance and coordination in the euro area and aims at informing relevant stakeholders — of which the European Commission is the main one — in their attempt to strengthen and improve the EU’s fiscal framework. The report’s content and structure are based on the main areas of responsibility set out in Commission Decision (EU) 2015/1937 establishing the EFB. Firstly, it provides an evaluation of the implementation of the EU’s fiscal framework. Secondly, it reviews and assesses the fiscal stance for the euro area as a whole. Thirdly, it takes a look at national fiscal councils with a view to identifying aspects of best practice. Finally, the report also puts forward a number of suggestions on the future evolution of the EU’s fiscal framework.

The main reference period of the report is the last full annual fiscal surveillance cycle, 2016. Assessing the implementation of the EU’s fiscal framework is a complex and resource-intensive exercise. EU fiscal surveillance is underpinned by a complex and expanding set of provisions. It is based on an annual cycle comprising successive stages of policy guidance, monitoring and deliberations. Hundreds of specialists at the Commission and in national finance ministries are involved in implementing the surveillance framework. To keep the EFB’s task manageable, this report focuses on 2016, the latest year for which the surveillance cycle, including guidance in 2015 and compliance assessment in 2017, has been completed. It is essential to cover a full cycle to grasp the logic of the EU’s fiscal framework and to assess, with economic judgement, how the relevant provisions have been applied, both across countries and across the successive stages of the surveillance exercise.

2016, a particularly testing year, was not representative of the full history of the EU’s fiscal framework. It was the third year in a steady, but modest and fragile recovery from the deepest and most severe financial and economic crisis in Europe’s post-WWII history. Although growth had resumed, important legacies of the crisis, both political and economic, were still very much present in most participating Member States and the euro area as a whole. Given this difficult economic and political context, 2016 may not have been the most representative year in the history of the EU’s fiscal framework. However, it is particularly indicative of the challenges fiscal frameworks face in implementing commonly agreed rules while ensuring that they are underpinned by an economic rationale and by ownership. This report is thus a snapshot of a changing framework.

Concerns about the stability of the euro area prompted a rethink of how to apply the EU’s fiscal rules. In January 2015, before euro area countries presented their broad budgetary plans for 2016 and beyond, the Commission published an interpretative communication on making best use of the flexibility allowed under the existing rules of the Stability and Growth Pact (SGP). The communication provided additional guidance on how to take account of government investment, structural reforms and the economic cycle when defining the fiscal requirements of the Member States under the SGP. In parallel, the euro area perspective of fiscal policymaking, beyond the mechanical aggregation of national policies, received increasing attention, first in the committees of the ECOFIN filière and then in the Commission’s and Council’s official surveillance documents. These developments took place against the background of an economic recovery in the euro area that was expected to continue at a modest pace, whose persistence was far from certain in spite of the unprecedented measures taken by the monetary authority. One of the main questions in the economic debate at the time was whether the euro area’s governance framework, including the fiscal framework, would effectively safeguard the overall stability of the single currency area.

Both conventional and additional degrees of flexibility were used in 2016. In the autumn of 2015, when euro area countries submitted their draft budgetary plans for the coming year for scrutiny at EU level, the Commission’s assessment still showed sizeable gaps between requirements under the SGP and the projected outcomes in 2016. For several countries in both the preventive and the corrective arm of the SGP, significant risks of not meeting the requirements were highlighted. However, more than a year later, when the Commission assessed budgetary outturns in spring 2017 for the previous year, compliance gaps had largely disappeared. No euro area country under the preventive arm of the SGP was found to deviate significantly from the required adjustment path, although nominal GDP growth had largely come in as expected or even lower. Member States had either benefited from greater
flexibility provisions under existing rules and/or used the conventional margins. Similarly, while most countries subject to an Excessive Deficit Procedure (EDP) had not carried out the structural adjustment laid down in the original Council recommendations, no new steps were initiated in the spring of 2017. Some Member States had used the economic recovery to replace structural effort with cyclical windfalls, as headline targets ultimately trump structural adjustment under current practice. In other cases, when neither nominal nor structural targets were met, the timeline for correcting the excessive deficit had already been extended in 2016 and, within the discretionary margins allowed under EU law, sanctions had been cancelled. Finally, non-compliance with the debt benchmark in low-growth and high-debt countries did not trigger any new EDP, thanks to extensive recourse to the so-called other relevant factors. In particular, the adjustment towards the medium-term budgetary objective (MTO) — taking into account new and conventional margins of flexibility — effectively became the crucial criterion for deciding whether to launch an EDP. This practice is predicated on the assumption that economic growth is exceptionally low. Under normal conditions, being at the MTO would bring debt dynamics on a sustainable path.

**While the fiscal stance for the euro area was broadly appropriate, its distribution across countries was not.** Despite three consecutive years of economic recovery, there was still considerable slack in the euro area economy in 2016. In the autumn of 2015, when euro area countries presented their draft budgetary plans for 2016, the aggregate level of economic activity in 2016 was estimated to be more than one percentage point below its potential level. At the same time, the rate of unemployment, though falling, remained well above pre-crisis levels, and inflation was expected to remain stubbornly low. Looking at the euro area as a whole, an expansionary fiscal stance was appropriate, both in real time and with hindsight, also in view of the fact that the European Central Bank had already cut nominal policy rates to zero. The actual implementation of the SGP in 2016 delivered a marginally expansionary fiscal stance, while a very strict implementation of the SGP, without recourse to flexibility, would have produced a slightly restrictive fiscal stance. The SGP would have allowed for a sizeable amount of additional fiscal support in 2016 if Member States with fiscal space had made full use of it. However, the SGP makes no provision for countries over-achieving their MTO. As a consequence, the slightly expansionary fiscal stance for the euro area in 2016 resulted from a cross-country distribution, which, from an economic perspective, was not entirely appropriate. The general orientation of fiscal policy was loose or looser than warranted in countries where the sustainability analysis was less favourable; and it was restrictive or more restrictive than warranted in countries where the sustainability analysis indicated no particular constraints. As the EFB’s assessment of June 2017 noted, such tensions between the euro area and the national perspective are bound to arise in the current governance framework, which features decentralised fiscal policymaking without centralised fiscal capacity.

**Greater flexibility and economic rationale came at the price of complexity and more discretion.** The stated objective of the Commission communication of January 2015, coupled with a greater attention on the euro area aggregate, was to strengthen the economic rationale of the SGP, given an unprecedented economic context that could hardly have been predicted when the SGP was first designed. The adapted implementation of the SGP added to the complexity of a system that had already become fairly elaborate following the 2011 and 2013 reforms of the SGP. In particular, enhanced flexibility, coupled with the use of more than one indicator when assessing compliance, has multiplied the instances where judgment and discretion play a crucial role. Questions of transparency and even-handedness were raised throughout the 2016 surveillance cycle by Member States, the ECB and the IMF. This is not to say that the main institutions responsible for implementing the EU’s fiscal framework have been deliberately secretive or non-transparent. The reverse is true. The Commission, in cooperation with the Council, has invested considerable time and effort in explaining and codifying the higher degree of flexibility and the way in which the assessment of compliance is structured. However, while rules may be equally strict or lax for everyone, discretion, by its very nature, cannot guarantee the same degree of acumen across all cases. A complete computer code for the applications of the SGP does not exist, and in all likelihood never will. Discretion ultimately involves judgement the conclusions of which cannot be mapped into the available set of information in a fully consistent manner. To be clear, discretion as such is not the issue. What matters is how discretion is exercised: on the basis of economic reflections or other considerations.

**Increased flexibility and discretion have fuelled competition between institutions.** The Commission and the Council are, by Treaty design, the two main institutions responsible for implementing the SGP. More recently, national fiscal councils have been added to the cast list with very specific roles. In the pre-crisis years, when the degree of flexibility and discretion of the existing rules had not been fully explored yet, the division of labour was fairly clear and there was limited scope for negotiating and clarifying how the rules should be applied in practice. Practice changed as, against the backdrop of a more difficult macroeconomic environment, successive SGP reforms added new contingency provisions and the margins of flexibility and
discretion were successively explored. Discussions between the Commission and the Council on how to implement the more elaborate and intelligent provisions intensified and sometimes involved the drawing up of written and public agreements. This was specifically the case in relation to the flexibility clauses for structural reforms and investment. The Commission Communication of January 2015 led to a lengthy exchange with the Member States in the Council committees. The exchange ended with a commonly agreed position which was formally endorsed by the ECOFIN Council in February 2016. The growing importance of judgment and discretion in the application of the more elaborate and intelligent rules also brought the national fiscal councils into the arena. They increasingly argued that the necessary and independent expertise to draw the right conclusions within the wider margins of flexibility resided with the national fiscal councils. Overall, more flexibility and discretion predictably heightened the competition between institutional players over who should set the course. The so-called ‘margin of discretion’, introduced by the Commission in spring 2017 to assess compliance with the preventive arm of the SGP, is likely to fuel this competition further.

There is room for improvement in several areas of the EU’s fiscal framework. The EFB’s assessment of how the SGP was applied in the 2016 surveillance cycle supports a number of suggestions of an incremental nature, that could most likely be accommodated within the current legal framework; others are more far-reaching. Ideally, any update of the fiscal framework should be discussed in lockstep with the ongoing broader debate of how to deepen the EMU. However, as long as important parts of fiscal policy making remain in the hands of Member States, common fiscal rules of some sort will be needed. The experience with the current framework points to issues of a very general nature that apply to any system of fiscal rules.

(1) Creating fiscal buffers for economic bad times. The flexibility provisions of the SGP are mostly limited to events with an unfavourable impact on public finances: there are no effective incentives to take advantage of good economic times. Measuring cyclical conditions is also inherently difficult. As a result, most euro area countries entered the last crisis with no or very limited fiscal space which contributed to the pro-cyclical fiscal tightening after 2010. Successive reforms have not eliminated the problem as they were typically introduced in response to economic downturns. The current asymmetry could be addressed by:

- requiring Member States to compensate for past deviations from the adjustment path if they exceed a certain threshold. Examples of such correction mechanisms already exist at national level;
- updating Council recommendations under the EDP to prevent recurring practice of replacing structural adjustment with windfalls during upturns.

(2) Strengthening the enforcement of fiscal rules. The credibility and effectiveness of fiscal rules also hinges on their enforceability. Existing provisions on sanctions in the SGP turned out to be impracticable, confirming very early doubts about the prospect of penalising sovereign countries. A promising alternative to sanctions is to make wider and more effective use of conditionality in relation to the EU budget. The aim of conditionality is not to punish, but to safeguard the effectiveness of public funds. In principle, it can be positive or negative. With positive conditionality, a country may become eligible for funds if it abides by predefined policies or achieves certain results. Negative conditionality, on the other hand, would mean suspending access to funds until a given situation is remedied. A broader and more effective use of macroeconomic conditionality for fiscal surveillance purposes also seems to dovetail with the ideas promoted in the context of ongoing discussions about the future of EU finances.

(3) Strengthening the comply-or-explain principle in relation to advice of national fiscal councils. One of the most significant post-crisis innovations in the EU’s fiscal framework was the establishment of national advisory fiscal councils. These have become an integral part of the policy framework in all euro area countries and beyond. By providing an independent assessment of specific aspects of the budgetary process, they enhance transparency in fiscal policymaking and, in turn, policymakers’ accountability. One important way to bolster the advisory role of national fiscal councils would be to strengthen the ‘comply-and-explain principle’, which requires national governments to respond publically to the councils’ advice, in a structured manner and within a given timeframe.

(4) Simplifying the complex set of fiscal rules while safeguarding flexibility and a clear responsibility for surveillance. The rules and provisions governing the implementation of the SGP have reached a degree of complexity and opacity where the costs outweigh the expected benefits of a detailed codification of how to deal with a wide range of economic contingencies. But then, complexity and opacity are not an inevitable price to pay for more flexibility. Simplicity and flexibility can go hand in hand by combining clear and simple requirements for fiscal policymaking with a more methodical use of escape clauses. Escape clauses provide the leeway to avert pro-cyclical policies or to
address exceptional economic circumstances. Guaranteeing that escape clauses are used transparently and non-opportunistically requires independent advice. The responsibility for fiscal surveillance under a simplified system of EU fiscal rules should be with one institution. A fragmentation would weigh on its effectiveness.

(5) Strengthening economic resilience. The pre-crisis years have shown that sound budgets are a necessary but not sufficient condition for safeguarding the long-term sustainability of public finances. The resilience and adjustment capacity of an economy play an important role too, and the accumulation of macroeconomic imbalances may pose risks to debt sustainability. While economic resilience depends on many external factors, such as the incomplete design of the EMU, national economic reforms also play a crucial role. To encourage Member States to implement the reforms needed to make their economies more resilient, and to offset the risks that imbalances may pose to public finances, a link could be established between the preventive arm of the SGP and the Macroeconomic Imbalance Procedure.

Despite imperfections and scope for improvement, the EU’s fiscal framework has helped make the euro area more stable. The past few years have seen mounting criticism of the SGP and its implementation. This has come from different directions, often opposing ones. For some, the application of the rules was too lenient, while for others it was excessively strict. One of the notorious limitations of economics is that it cannot rely on counterfactual experiments. We will therefore never know for sure what would have happened if the SGP had been implemented in the strictest possible way in spite of an exceptional economic and financial crisis. Nor can we know what the outcome would have been had the SGP been dropped altogether. What we do know is that at the height of the crisis, serious questions were raised about the sustainability of public finances in several euro area countries, while in parallel there were risks of a deflationary spiral. On the back of such an exceptional situation the short-run response was to explore the margins of the SGP – alongside the establishment of intergovernmental crisis-management tools – while launching a process towards closing other gaps in the EMU governance framework, notably by breaking the ‘doom-loop’ between banks and their sovereigns. Such an approach made sense, albeit it justifiably raised concerns over the integrity of the fiscal framework. Looking ahead, the challenge will be to adapt the fiscal framework to the return of normal and good economic times so as to avoid the mistakes of the past and build the buffers to withstand future crises.

A centralised fiscal instrument would add stability to the euro area. The ongoing debate on the future of the EMU goes well beyond the realm of fiscal policy and rightly looks at interactions and complementarities between various new instruments. A centralised fiscal stabilisation capacity has been a fix-point in this debate. Various proposals have been advanced on the reasonable assumption that the long-term sustainability of the single currency area requires further fiscal integration. They involve making sure that, in the event of very large common or country-specific shocks, the limits of a decentralised system of fiscal policymaking can be overcome. The two most prominent proposals for a centralised stabilisation capacity are (i) an investment protection scheme, to remedy the observed pro-cyclicality in public investments; (ii) a common unemployment reinsurance scheme, to give national budgets more breathing space during downturns, when the provision of unemployment benefits becomes significant. While both proposals have pros and cons, the EFB is of the view that the investment protection scheme would be easier to implement both technically and politically.
2. EX-POST EVALUATION OF THE IMPLEMENTATION OF THE EU’S FISCAL FRAMEWORK

The most demanding and important duty with which the European Fiscal Board (EFB) is tasked is evaluating the implementation of the EU’s fiscal framework for euro area Member States. This section presents the results of the first such evaluation. To keep the exercise manageable, the Board’s assessment is centred on the last full annual surveillance cycle (2016), including guidance provided in 2015 and assessment of compliance in 2017. The objectives of the ex-post evaluation are twofold. Firstly, by offering an independent and reasoned view of how the rules and procedures of the Stability and Growth Pact (SGP) have been applied it helps improve transparency and provide a better understanding of the EU’s fiscal framework. Secondly, the evaluation highlights challenges and issues in current practice. These are taken up again in Section 5 in a discussion of suggestions for the future evolution of the EU’s fiscal framework.

This section is structured as follows. The first part sets the scene for the Board’s evaluation by sketching out the key macroeconomic and fiscal background against which the EU’s fiscal framework was implemented in 2016. It also briefly compares the budgetary outturns with the budgetary plans presented by euro area countries in their 2015 Stability Programmes for 2016. The second part deals with the actual evaluation exercise. For practical reasons, given the complexity of the SGP, it is divided into two parts: (i) a discussion of selected issues in relation to how the provisions of the preventive and the corrective arm of the SGP were applied in 2016; (ii) a synthetic overview of the full 2016 assessment cycle for all euro area countries.

2016 was not a typical year in the history of EU fiscal surveillance. The euro area economy continued to recover but the legacy of the deepest economic and financial crisis in Europe’s post-WWII history remained omnipresent, including in the area of public finances. The economic outlook also remained uncertain, with the balance of risks still tilted to the downside. As a result, and since many euro area countries had entered the crisis with limited buffers — or no buffer at all — compliance with the EU fiscal rules was imposing clear limits to fiscal stabilisation in individual countries and, in turn, in the euro area as a whole.

Against this background, two concerns featured prominently in the economic policy debate in the euro area: (i) the monetary authority, which had already lowered policy rates to the lower zero bound, might not be in a position to generate enough support to aggregate demand in the short term to sustain the economic recovery; (ii) fiscal consolidation, though warranted in view of sustainability issues in several euro area countries, might further weaken the fragile recovery and jeopardise the stability of the single currency area as a whole.

The implementation of the EU’s fiscal framework reflected the macroeconomic environment and the policy debate. To start with, 2016 was the first year in which the flexibility provisions of the SGP — as clarified by the Commission in early 2015 and agreed with the Council in early 2016 — were implemented and used over a complete annual assessment cycle. The flexibility provisions encompass: (i) a codified modulation of the required fiscal adjustment as a function of cyclical conditions and sustainability concerns; (ii) specific allowances for countries carrying out structural reforms or significant public investment. Additional flexibility margins were clarified and agreed. These were used to cope with unusual events, specifically to accommodate the extraordinary budgetary costs arising from refugee flows and security issues. 2016 was also a year in which the application of the debt rule of the SGP was increasingly put to the test. Given low rates of economic growth and inflation, countries with high government debt found it increasingly hard to reduce their debt at an appropriate pace. Assessment of the ‘other relevant factors’ became increasingly important in concluding whether or not prima facie non-compliance with the debt rule constituted a gross policy error under the Treaty. Finally, 2016 was the year in which some of the reinforced provisions on sanctions brought in under the Six-Pack reform of the SGP were tested for the first time and full use was made of the respective room for discretion.

Application of the full range of flexibility clauses and other contingency provisions of the SGP revealed a degree of complexity that raised questions of transparency and equal treatment in the Council. Discretion and judgement came to play an increasingly important role, raising the issue of who was to exercise them, and how. The actual assessment of compliance with the SGP rules also drew increasing attention because it involves two indicators, or two different methods which, although conceptually equivalent, in practice often support diverging conclusions in terms of compliance or non-compliance. Again, the role of judgement in a system originally designed to be rules-based came increasingly to the fore.

In procedural terms, several developments stood out.

1. Under the preventive arm of the SGP, the Commission’s ex-post assessment of a flexibility clause granted to Italy did not provide a firm conclusion as to whether or not the required structural reforms had been implemented.

2. There were inconsistencies, across both time and several countries, in the way the two indicators for assessing compliance were used.
3. Cases of early and late submissions of draft budgetary plans gave rise to discussions among Member States in the autumn of 2015. The period during which plans were to be presented was made clear in September 2016, as were the specific rules for caretaker governments.

4. In May 2016, the Commission put forward country-specific recommendations for Spain and Portugal which extended the deadline for correcting their excessive deficits, in conflict with the existing recommendations issued by the Council under Article 126 of the Treaty.

5. The Commission delayed its assessment of effective action under the corrective arm of the SGP for Spain and Portugal until July 2016, despite having proposed already in May to extend the deadline for correction.

6. Member States with an insufficient rate of debt reduction – Belgium, Italy and Finland - were not placed under the corrective arm of the SGP, thanks to a broad interpretation of the other relevant factors.

These points are significant but they need to be seen in the specific context of the 2016 surveillance cycle. As indicated above, 2016 was not a typical year in the history of the SGP. In one way or another, virtually all the limits implied by the rules turned into actual constraints putting a lot of pressure on Member States, the Commission and the Council. The margins of the rules-based system have been explored and it is actually noteworthy that the number of significant cases was fairly limited.

2.1. MAIN MACROECONOMIC AND FISCAL DEVELOPMENTS IN 2016

For the euro area, 2016 was the third year of economic recovery from the double dip recession of 2009 and 2012. Real GDP increased by 1.8 %, mainly driven by private consumption and investment on the back of low commodity prices, a comparatively low effective exchange rate and a very accommodating monetary policy. Price and wage developments were exceptionally subdued. Headline inflation, as measured by the annual increase in the harmonised index of consumer prices, stood at 0.2 %. Core inflation, which excludes energy and unprocessed food prices, was 0.8 %. Employment continued to improve but without resulting in any significant wage growth.

Because of the extraordinary depth of the post-2007 crises, in 2016 the recovery eased but did not eliminate the impact of the previous downturn, despite three years of steady growth. The aggregate output of the euro area was estimated to be still more than 1 % below its potential level; investment-to-GDP ratios still fell substantially short of their pre-crisis levels; the unemployment rate, though falling, was still more than two percentage points above pre-crisis levels, and the share of long-term unemployment and involuntary part-time employment remained exceptionally high, together affecting more than a third of the labour force. Moreover, in several euro area countries financial sector repair was still far from complete, slowing economic recovery and giving rise to potential risks to macro-financial stability. On the whole, the euro area economy still looked weak and its recovery fragile.

Additionally, the aggregate picture masked significant differences between countries. 2016 was the first post-crisis year in which all euro area countries recorded non-negative real GDP growth. However, the differences among them were considerable. Growth was stronger and more broadly-based in countries such as Spain, Germany, the Netherlands and most of the smaller euro area countries. By contrast, it was more subdued in France, Italy and Portugal. Similar disparities were also observed in the labour market, where historically low unemployment rates in Germany coexisted with high rates in Spain, Italy, France and Portugal.

Turning to public finances, the moderate economic recovery of the euro area economy translated into improved budgetary conditions and declining debt ratios. For the euro area as a whole, the general government deficit fell to 1.5 % of GDP, from 2.1 % in 2015. As total government revenues inched lower as a percentage of GDP, the improvement in the headline balance came mainly from a reduction in primary expenditure with a major contribution from public investment, which reached its lowest level as a share of GDP since at least 1995. On the back of a very accommodating monetary policy, lower debt servicing costs also continued to contribute to the aggregate budgetary improvement with 0.2 percentage points.

General government debt relative to aggregate output fell for the second year running reaching 91.3 % of GDP in the euro area as a whole, as compared to a peak of 94.3 % of GDP in 2014. The bulk of the reduction came from the primary surplus. The remaining reduction came equally from debt reducing stock-flow adjustments and the excess of economic growth over the average interest rate. Despite debt reduction in 2016, debt levels remained very high, particularly in certain countries. Focusing on larger euro area countries, the debt-to-GDP ratio remained well above 100 % in

\[\text{This result was characteristic of the composition of budgetary adjustment during the crisis years. In clear contrast to the conventional wisdom according to which cuts in government investment spending weaken prospects for medium-term economic growth, making a successful budgetary adjustment less likely, authorities typically decided to adjust public accounts by significantly compressing investment.}\]
Belgium and Italy, and was approaching 100 % in Spain and France.

In 2016, the budgetary outturn for the euro area as a whole was essentially in line with the plans laid down in the 2015 Stability Programmes (SPs). Nominal growth was somewhat lower than projected, mainly owing to a negative inflation surprise in most Member States. In the cases of Ireland, Spain and Luxembourg, in particular, the impact of the inflation surprise more than offset that of a positive real growth surprise. Several countries, such as Germany, Estonia, Ireland, Latvia, Lithuania, Luxembourg and Finland, surpassed their budgetary targets although nominal GDP growth was in line with or lower than the projections included in the SPs. Others, such as the Netherlands and Malta, surpassed their budgetary targets while benefiting from a positive growth surprise. In France, Portugal and Austria, the plans largely materialised in terms of both nominal GDP growth and budget balance. Belgium, Italy and Spain had budgetary outturns that were worse than planned. In the case of Italy and Spain, the slippage was coupled with growth that was weaker than projected, adversely affected by inflation below expected rates. Belgium recorded a positive growth surprise, benefiting from inflation that exceeded expectations.

The ongoing economic recovery in 2016 was not used as an opportunity to adjust public finances in structural terms. For the euro area as a whole, the structural deficit, that is, the headline deficit net of the cyclical component, one-offs and other temporary measures, remained unchanged at 1.0 % of GDP for the third consecutive year. It is forecast to increase to 1.1 % in 2017, according to the Commission's 2017 spring forecast. The fiscal stance, as measured by the change in the structural primary balance, was slightly expansionary, as in 2015. This pattern reflects the intense political debate that took place at the time about the scope of further additional budgetary adjustment. In some euro area countries in particular, fiscal adjustment had become a highly contentious political issue which was seen to fuel populist and anti-EU movements.

Alongside the growing political resistance to fiscal consolidation in several countries, the economic profession was reassessing the merits and demerits of discretionary fiscal stabilisation especially in a context where aggregate demand remained sluggish and inflation below target despite an extended period of very accommodating monetary policy. A growing number of experts, including those who would not generally support any active coordination of monetary and fiscal policy, adopted the view that the current governance framework of the euro area was ill-equipped to deal with very large common and/or very large country-specific shocks. (2) In particular, the macroeconomic policy mix coming out of the framework was considered (i) to be unbalanced, with too much weight being put onto the shoulders of the monetary policy authority; and (ii) to provide insufficient support to aggregate demand for safeguarding overall macroeconomic stability.

See for instance ECB (2016) which, without calling for a fiscal expansion, recognised that the euro area fiscal stance was a relevant concept.
From this analytical perspective, the understanding that fiscal policy should play a stronger role in stabilising economic recovery and that more attention should be given to the euro area dimension of fiscal policy gained ground. The Five Presidents’ Report (June 2015) had already included an explicit reference to the euro area’s fiscal stance, referring to the need to ensure that the sum of national fiscal policies did not give rise to procyclical policies for the single currency area as a whole. The issue was subsequently taken up in general terms in the Council recommendation of July 2015 to euro area Member States (see Section 4) which included guidance for 2016. Since then, the question of how to ensure an appropriate fiscal stance for the euro area as a whole within the remit of the SGP has become a regular feature of the euro area agenda.

The EFB discussed the euro area fiscal stance appropriate for 2018 in its report published on 20 June 2017. (3)

2.2. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN 2016

Since 2011, the application of the EU’s fiscal rules — the SGP — has been embedded in the European Semester, the EU’s annual cycle of economic policy coordination. (4) Although fairly complex in terms of institutional and procedural details, the European Semester boils down to a process in which the Council first issues policy guidance to the individual countries, the Commission then monitors implementation and, depending on the follow-through by national governments, suggests new policy guidance or recommends the enforcement of previously issued guidance (see Graph 2.3). Within the framework of the European Semester, the Council also issues annual recommendations on the economic policy of the euro area as a whole. The aim is to take better account of euro area-wide considerations when designing national policies. The Eurogroup takes into account the recommendations to the euro area when drawing up its work programme, while the euro area countries are expected to take them into consideration both when drafting their SPs and National Reform Programmes (NRP) and when implementing the country-specific recommendations (CSRs) issued by the Council.

Providing an overview that is both comprehensive and readable of how the SGP has been applied in a given year — 2016 in this case — is a major challenge. Since its inception in the late 1990s, the Pact has become increasingly intricate. It sets out a complex set of rules and procedures that are increasingly demanding to grasp in their entirety, except for those who deal with them every day.

Notes: (1) EA17 refers to the euro area excluding Greece and Cyprus. In line with Regulation (EU) 472/2013, Greece and Cyprus did not submit a stability programme in 2015. Member States undergoing a macroeconomic adjustment programme are exempt from the general monitoring and assessments under the European Semester. (2) Yellow triangle: the outturn if nominal growth had been in line with the 2015 stability programme is estimated as the sum of (i) the budgetary balance outturn in 2016 and (ii) the product of the semi-elasticity of the budget balance with the difference between actual nominal GDP growth in 2016 minus nominal GDP growth for 2016 included in the 2015 stability programme.

Source: European Commission, 2015 Stability Programmes.
A large proportion of the facts concerning the implementation of the SGP can be found in the many legal acts adopted by the Commission and the Council in the course of a year. The rest are to be found in an equally extensive set of Commission notes and deliberations to which the EFB and its secretariat had access when preparing this report.

There are several publicly available documents that regularly offer summaries of how certain aspects of the rules and procedures have been applied. (7) However, they are often fairly technical and do not offer a full overview of the individual annual assessment cycle of fiscal surveillance for the euro area countries.

This section summarises the results of an effort made by the EFB and its secretariat to provide what is, we believe, a more general yet intelligible review of the implementation of the SGP. The review falls into two parts: (i) an in-depth presentation of selected issues; and (ii) a synthetic overview. The first part focuses on a number of issues the EFB considers particularly important and indicative of the implementation of the SGP in 2016. It highlights cases that stand out partly because they may have set precedent for the future application of the rules. The second part offers an overview in the form of tables with a concise chronology of the annual fiscal surveillance cycle for all euro area countries in 2016. (8) Following the structure of the SGP, both the presentation of selected issues and the chronological overview are divided into subparts covering the preventive and the corrective arm of the SGP.

2.2.1. The preventive arm of the Stability and Growth Pact

The preventive arm in a nutshell

The preventive arm of the SGP requires national governments to progress towards their medium-term budgetary objective (MTO) at an appropriate pace and to meet that objective subsequently. The MTO is country specific and expressed in structural terms, i.e. corrected to take account of the economic cycle and temporary and one-off factors. It is defined to allow automatic fiscal stabilisers to operate freely, while preventing the headline deficit from breaching the Treaty threshold of 3% of GDP under normal economic circumstances. It is also meant to ensure that the debt ratio progresses towards the Treaty reference value of 60% of GDP, given the economic and budgetary impact of ageing populations.

The required annual structural adjustment towards the MTO varies around a benchmark of 0.5% of GDP, as a function of prevailing cyclical conditions and government debt. The structural adjustment is expected to be higher than 0.5% of GDP when the economy is favourable, the debt-to-GDP ratio is high, or the Commission judges there to be high medium-term risks to sustainability; it can be less demanding under unfavourable economic conditions. The structural adjustment requirements are detailed in a matrix of adjustment. (9)

Under certain conditions, the SGP allows for temporary deviations from the MTO or the adjustment path towards it. In particular, subject to certain eligibility conditions, national governments can apply for flexibility to support spending on investment or to cater for the cost of major structural reforms, under the flexibility clauses. Deviations are allowed if they result from measures that ultimately improve the sustainability of public finances; this is taken to be the case for certain structural reforms and for certain categories of public investment. Moreover, in the case of specific unusual events outside government control, national governments can also benefit ex post from some fiscal leeway compared to the adjustment requirements as per the matrix of adjustment. (9)

Procedurally, the Council grants allowances under both the structural reform and investment clauses in the relevant CSR, following a proposal from the Commission based on its assessment of the SPs, in spring. If a national government invokes the clause in autumn, the ‘Commonly agreed position on flexibility in the SGP’ foresees that an allowance may be granted, provided the Council endorses it in the autumn of the same year as an updated CSR. (9) In practice, however, the Commission gives an indication of its assessment in its opinion on the Draft Budgetary Plan (DBP) in autumn and the CSR is updated in the spring of the following year. The granting of the unusual event clause is somewhat different, given the extraordinary and unforeseen nature of events covered. In this case, the Commission makes a real-time preliminary assessment of the country’s eligibility to take account of the additional expenditure linked to unusual events. (9)

See footnote 7.
See footnote 7.

(7) The most prominent example is the Commission’s annual Public Finances in EMU report. See European Commission (2016) for the latest edition.
(8) Apart from Greece, which was subject to a macroeconomic adjustment programme.
eligibility and the exact costs can only be confirmed in the ex-post assessment. Then, the exact amount related to the unusual event clause is subtracted from the required structural adjustment of the CSR.

Since the 2011 reform of the SGP through a legislative package known as the Six-Pack, the required structural adjustment towards the MTO has also been expressed in terms of an expenditure benchmark, which sets a maximum growth rate for government spending. It applies to a specific expenditure aggregate which excludes components that are not directly under government control, such as interest payments, and where investment expenditure is smoothed over four years, and it is net of discretionary revenue measures. The expenditure benchmark is meant to ensure that, when a country has reached its MTO, expenditure does not grow faster than potential GDP in the medium term, unless backed by discretionary revenue measures. For Member States that have not attained their MTO, the expenditure growth rate is reduced by a convergence margin. Both metrics for the annual structural adjustment, that is, the change in the structural budget balance and the cap on expenditure growth, are meant to yield equivalent targets and outcomes. (11)

Compliance with the required annual structural adjustment towards the MTO is assessed ex ante, in-year and ex post. For the euro area countries, this is done on the basis of the SPs and the DBPs that they submit in spring and autumn, respectively. A country is said to be at risk of some deviation if it is expected to deviate from the MTO or the adjustment towards it by less than 0.5% of GDP in one year and less than 0.25% of GDP on average over two consecutive years. If the expected deviation is larger, the risk is said to be significant. If, in the ex-post assessment, a euro area country is found to have recorded a significant deviation, this can lead to sanctions. By contrast, an observed deviation below the significance threshold does not trigger any procedural steps.

In most cases, the Commission assessment of compliance does not result in automatic conclusions. Rather, its conclusions are based on the two metrics described above: the change in the structural budget balance and the expenditure benchmark. Unless both

(11) For more details see sections 1.3.2.2 and 1.3.2.6 of the Vade Mecum on the SGP.
point to compliance, the Commission conducts an overall assessment before reaching a conclusion.

In the spring of 2017, the Commission added on its own initiative an important new element to its assessment of compliance: the ‘margin of discretion’ which will be applied to the assessment of 2018. An observed adjustment may be considered adequate even if it significantly departs from the required structural adjustment defined in the matrix of adjustment. According to the Commission, the ‘margin of discretion’ in assessing deviations is expected to balance member countries’ stabilisation and sustainability needs in an objective and predictable manner. The EFB will assess the implementation of the margin of discretion in its future reports.

The country-specific fiscal requirements for 2016

The annual adjustment requirements towards the MTO are set in the CSRs in the context of the annual surveillance cycle. In the spring of each year, euro area countries present their SPs with their medium-term budgetary plans. The Commission assesses the programmes alongside the macroeconomic and fiscal outlook of its spring forecast. Following the Treaty-based procedure laid down in Article 121, the Council then adopts CSRs on the basis of Commission recommendations, including fiscal CSRs for the current and following year where relevant. The national governments are then expected to adjust their budgetary policies accordingly, in particular their budgetary plans for the following year.

In 2015, the Commission adopted its recommendations for CSRs on 13 May and the Council finally adopted the CSRs on 14 July. As detailed in Table 2.1, fiscal CSRs were addressed to 10 out of 14 euro area countries (Belgium, Estonia, Ireland, Italy, Latvia, Lithuania, Malta, Austria, Slovenia and Finland) which, in the spring of 2016, were expected to fall under the preventive arm of the SGP in that year. In the case of Italy, the requirement was less than what was implied by the matrix of adjustment, as a result of the allowance granted under the structural reform clause. For Latvia and Lithuania, it was stipulated that the deviation from the MTO was to remain limited to the allowances associated with their systemic pension reforms.

For some Member States with high debt-to-GDP ratios (Belgium, Ireland and Italy), the CSRs also called on governments to use any windfall gains, particularly any resulting from lower-than-anticipated interest payments, to cut the debt ratio as appropriate.

By contrast, no fiscal CSRs were formulated for three countries whose structural budget balance met the MTO (Luxembourg) or exceeded it (Germany and the Netherlands) and was not expected to deviate from it according to the Commission forecast. The SGP is not prescriptive in such cases; countries are considered compliant as long as they do not fall short of their MTO. Exceeding an MTO is neither required nor in conflict with the SGP. Non-fiscal CSRs, however, called on Germany and the Netherlands to increase public investment – especially in infrastructure, education and research – with a view to boosting potential growth.

Finally, there was no fiscal CSR for Slovakia, although its structural balance was expected to progress only very slowly towards the MTO. According to the expenditure benchmark, this was because the country was expected to comply with the SGP.

Following the established annual surveillance cycle, the adjustment requirements for 2016 were reviewed in the spring of 2016 on the basis of the 2016 SPs and the Commission’s 2016 spring forecast. As a result, the requirements were updated for six euro area countries, and set for Cyprus, whose macroeconomic adjustment programme had ended in March 2016. The requirements were tightened up for three countries. Netherlands and Slovakia were assessed as being at risk of some deviation from their MTO and adjustment path, respectively, in 2016 and therefore received a fiscal CSR. The required adjustment for Finland rose from 0.5% of GDP to ‘at least 0.5 %’, reflecting the need to comply with the debt reduction benchmark (see Section 2.2.2). The requirements were reduced for three countries. The allowed deviation in Italy was increased on account of additional allowances granted for 2016 under the flexibility clauses (see Table 2.1). Austria was allowed to deviate from its MTO, as the amount granted ex post for 2015 under the unusual event clause was carried over to 2016. The fiscal CSR for Estonia was removed as, on the basis of updated estimates, the country was found to have exceeded its MTO in 2015 and was not expected to deviate from it in 2016.

(requested by Italy under the structural reform clause, the revised adjustment requirement was 0.1% of GDP.)
The recitals of the some countries’ CSRs also took note of the extra spending expected in response to the exceptional inflow of refugees and to security needs in 2016 under the unusual event clause in these countries. They indicated, however, that the exact amounts would be assessed on an ex-post basis in the spring of 2017.

**Draft budgetary plans for 2016**

Since the adoption of the Two-Pack reform of the SGP in 2013, every year in autumn euro area countries are required to present their DBPs for the following year to the Commission and the Eurogroup. The Commission assesses the DBPs against the requirements of the SGP and the fiscal CSRs published in spring, and issues opinions. The Commission opinion, an autonomous legal act that does not involve the Council, concludes whether the DBP is ‘compliant’, ‘broadly compliant’ or ‘at risk of non-compliance’ with the provisions of the SGP.

The Commission assesses the DBPs in order to identify and correct at an early stage any risks of deviating from the recommended budgetary targets. This inherently forward-looking exercise determines the probability of draft budget implementation leading to a significant deviation under the preventive arm of the SGP, or to a new or more stringent excessive deficit procedure (EDP).

The DBP process is meant to improve the surveillance and coordination of fiscal policies in the euro area. It empowers the Commission to issue a negative opinion if it identifies a case of ‘particularly serious non-compliance’ which would require the country to submit a revised DBP. (19)

In the autumn of 2015, 14 euro area countries under the preventive arm of the SGP presented a DBP. (17) The Commission issued its opinions on 16 November 2015. (18) While flagging up insufficient fiscal effort in a number of Member States, the Commission issued no negative opinions of ‘particularly serious non-compliance’. In more detail, nine countries under the preventive arm of the SGP were assessed as falling short of the requirements to various degrees and were asked to take the necessary measures to ensure compliance. Three were found to be ‘at risk of non-compliance’, meaning that the Commission’s assessment indicated a significant deviation from the required adjustment path (Italy, Lithuania and Austria, although the latter would not be included if the unusual event clause were granted ex post). The other six countries (Belgium, Ireland, Latvia, Malta, Slovenia and Finland) were assessed as ‘broadly compliant’, meaning that the Commission predicted some deviation from the required adjustment path. Only five DBPs, were found to be compliant with the provisions of the SGP (Germany, Estonia, Luxembourg, the Netherlands and Slovakia), including three countries whose structural balance exceeded the MTO (Germany, Estonia and Luxembourg).

Following the Commission opinions, the existence of risks to the achievement of fiscal requirements led the Eurogroup to issue statements. On 23 November 2015 the Eurogroup called on Member States to ensure compliance with the SGP. Regarding countries under the preventive arm of the SGP, it called on those whose DBPs risked non-compliance to take timely additional measures addressing those risks. (19) On 7 March 2016, the Eurogroup stated that, according to the Commission 2016 winter forecast, risks in some Member States had further increased since the autumn 2015 assessment. As regards countries under the preventive arm of the SGP, this included risks in Belgium, Italy, Slovenia and the Netherlands. The Eurogroup also reiterated its call to implement the necessary measures to ensure compliance with the SGP in 2016.

**Ex-post assessment in the spring of 2017**

In early 2017, the Commission and the Council made their final assessment of compliance for 2016. Overall, compliance with the requirements of the preventive arm of the SGP in 2016 exceeded the expectations expressed in the ex-ante and in-year assessments. The reasons for this were revenue developments and the fact that the flexibility and unusual event clauses made requirements less demanding. Based on outturn data for 2016, 10 of the 15 countries under the preventive arm of the SGP were found to have complied with the fiscal requirements. All but Slovenia and Finland had a structural budget balance above the MTO. The

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(19) Regulation (EU) No 473/2013: “In the exceptional cases where, after consulting the Member State concerned, the Commission identifies in the draft budgetary plan particularly serious non-compliance with the budgetary policy obligations laid down in the SGP, the Commission, in its opinion on the draft budgetary plan, should request a revised draft budgetary plan, in accordance with this Regulation. This will be the case, in particular, where the implementation of the draft budgetary plan would put at risk the financial stability of the Member State concerned or risk jeopardising the proper functioning of the economic and monetary union, or where the implementation of the draft budgetary plan would entail an obvious significant violation of the recommendations adopted by the Council under the SGP.” The Two-Pack Code of conduct gives examples of situations which could be considered as particularly serious non-compliance.

(17) Of which Ireland and Slovenia were under the corrective arm of the SGP at the time, though they were expected to correct their excessive deficit by the end of 2015. See Tables 2.1 and 2.4.


(19) This concerned compliance with both the adjustment path towards the MTO and the debt rule.
remaining five showed some deviation from the MTO or the adjustment path towards it in 2016 — in Belgium, Ireland, Italy and Austria — or, in the case of Slovakia, in 2015 and 2016, considered together. The Commission and Council assessment did not conclude that any Member State had recorded a significant deviation. Consequently, no euro area country faced a significant deviation procedure.

Implementation of the flexibility and unusual event clauses

As mentioned above, the preventive arm of the SGP can accommodate temporary and limited deviations from the MTO, or the adjustment path towards it, under the flexibility clauses for structural reforms and investment. As described in the ‘Commonly agreed position on flexibility in the SGP’ endorsed by the ECOFIN Council on 12 February 2016 (21), the flexibility clauses are subject to eligibility conditions. These are meant to ensure that sustainability is not at risk in the medium term and is strengthened in the longer term. The Member State must (i) remain in the preventive arm of the SGP, (ii) maintain a safety margin with respect to the 3% of GDP threshold for the deficit; and (iii) achieve its MTO within four years. (22) In addition, to be eligible, structural reforms must be (i) major and with positive long-term effects on growth and the sustainability of public finances, and (ii) either already fully implemented or part of a dedicated structural reform plan described in sufficient detail in the NRP or in the Corrective Action Plan. (23) As regards the investment clause, (i) the expenditure under consideration must be on projects that are co-funded by the EU under certain programmes, (ii) co-financed expenditure should not replace nationally financed expenditure, so that total public investment does not decline, and (iii) the country must be in bad economic times. (24)

The clauses can be activated at the request of the country concerned, provided that it supplied the relevant information together with its SP. The deviation allowed under each clause may not exceed 0.5% of GDP. If both clauses are granted, the cumulated deviation may not exceed 0.75% of GDP. This cap was allowed in seven euro area countries. Tabl

incremental amount is carried over for three years. Eligibility is assessed ex ante by the Commission in its assessment of the SP or the DBP when the request is submitted in autumn. As a safeguard, some criteria are assessed again ex post. These include the actual implementation of structural reforms and the actual level of and changes in investment. By contrast, the initial distance to the MTO, the expected short-term costs implied by the structural reforms and the expected impact on potential growth and sustainability are not checked ex post.

Besides the flexibility clauses, temporary deviations from the MTO or the adjustment path towards it may also be allowed on the back of unusual events outside the government control. (25) While temporary deviations under the unusual event clause may be envisaged ex ante, in which the country concerned sends to the Commission an estimate of the expected costs entailed by the unusual event, they can only be confirmed in the ex post assessment. The deviation must result from a situation meeting the three criteria defined in the Regulation (EC) 1466/97, i.e. (i) an unusual event, (ii) outside the control of the country concerned, and (iii) with a major impact on the financial position of the general government. An important additional condition is that the deviation must not endanger fiscal sustainability in the medium term. The eligible expenditure corresponds to the additional costs related with the unusual event, in the year the unusual event occurs, and to the incremental costs in subsequent years, where events with effects lasting several years are concerned.

Although the unusual event clause had initially been intended for events such as natural disasters, it was first activated in spring 2016 (ex post for 2015) to provide for the incremental budgetary costs associated with the exceptional inflows of refugees in 2016.

For 2016, temporary deviations under both the flexibility clauses and the unusual event clause were allowed in seven euro area countries. Table 2.1 sets out the amounts concerned. With the exception of the allowances for systemic pension reforms in Latvia and Lithuania the only country which benefited from flexibility clauses was Italy, for a total of 0.71% of GDP. In addition, deviations between 0.04 and 0.25% of GDP were granted ex post in spring 2017 to several countries under the unusual event clause. There were two reasons for this: the exceptional inflows of refugees and the security costs incurred in tackling the terrorist threats.

(21) See footnote 7.
(22) This is expected to be guaranteed if the difference between the initial structural balance and the MTO does not exceed 1.5% of GDP.
(23) Systemic pension reforms that introduce a multi-pillar system are a special case and require a specific assessment by Eurostat; see Article 5(1) of Council Regulation (EC) No 1466/97.
(24) Economic unfavourable times are characterised by negative GDP growth or a negative output gap exceeding 1.5% of GDP.
(25) See Articles 5(1) and 6(3) of Council Regulation (EC) No 1466/97.
The allowances approved by the Council are largely in line with those requested by Member States. The main exception is Finland, which had requested a deviation of 0.5% of GDP under the structural reform clause and a deviation of 0.1% of GDP under the investment clause. However, it was not considered eligible, as it did not have a sufficient safety margin with respect to the 3% of GDP threshold for the deficit.

Italy qualified as eligible for the flexibility clauses ex ante, although subject to conditions for part of the allowance. It was found to meet the eligibility criteria for the first allowance requested in spring 2015 for 2016, namely a deviation of 0.4% of GDP under the structural reform clause. As the qualifying reforms were not yet fully implemented, Italy was considered to qualify for the allowance provided that it “adequately implement[ed] the agreed reforms, which would be monitored under the European Semester”. (25) In its 2016 DBP, Italy requested an additional deviation of 0.1% of GDP under the structural reform clause and a deviation of 0.5% of GDP under the investment clause. The latter was limited to 0.25% of GDP as the total deviation could not exceed 0.75% of GDP. For this additional deviation of a total of 0.35% of GDP under the two clauses, Italy was assessed as provisionally eligible, conditional on: (i) the existence of credible plans for resuming the adjustment path towards the MTO as of 2017, (ii) the effective use of a deviation from the adjustment path to increase public investment, and (iii) progress with the structural reform agenda (26), taking into account the Council recommendations. (27)

The role of different indicators in the assessment of compliance

Under the preventive arm of the SGP, compliance with the required structural adjustment is assessed on the basis of two complementary pillars, namely the change in the structural balance and the expenditure benchmark. Conceptually speaking, both are equivalent, as they measure the fiscal effort of the government to achieve the required structural adjustment, but they gauge it from a different angle: the structural budget balance by removing from the headline budget all the policy measures relevant for the correction of macroeconomic imbalances; the expenditure benchmark by comparing the growth rate of discretionary government expenditure, (iv) civil justice; (v) education; (vi) a tax shift; and (vii) spending review as financing measure. (28) These three conditions were first mentioned in the Commission Opinion of 16 November 2015 on Italy’s 2016 DBP and consistently recalled in the Commission’s assessments of the 2016 and 2017 stability programmes for Italy, on 26 May 2016 and 23 May 2017, respectively.


Notes:

* Granted ex-post, in the spring of 2017. ** 0.60 in cumulative terms, which was relevant to set the allowed deviation from the MTO. *** 0.34 including the carryover from 2015.

Source: European Commission.

Table 2.1: Flexibility and unusual event clauses granted to euro area countries for 2016 (in % of GDP, in incremental terms)

<table>
<thead>
<tr>
<th>Continent</th>
<th>Investment clause</th>
<th>Structural reform clause</th>
<th>Pension reform clause</th>
<th>Refugee*</th>
<th>Security*</th>
<th>Total</th>
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<td>BE</td>
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<td>0.05</td>
<td></td>
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<td></td>
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<td>IT</td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>0.30**</td>
</tr>
<tr>
<td>LT</td>
<td>0.10</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.10</td>
</tr>
<tr>
<td>AT</td>
<td>0.25**</td>
<td></td>
<td></td>
<td>0.04</td>
<td></td>
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<td>0.17</td>
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</tr>
</tbody>
</table>

Note: * Granted ex-post, in the spring of 2017. ** 0.60 in cumulative terms, which was relevant to set the allowed deviation from the MTO. *** 0.34 including the carryover from 2015.

Source: European Commission.


[26] Details on the content, state of implementation and impact assessments of Italy’s major structural reforms with a positive impact on the long-term sustainability of public finances had been detailed in its 2015 NRP and summarised in the 2015 SP. According to the Commission assessment of Italy’s 2016 DBP, the reform areas having an impact on public finance sustainability put forward in the SP included: (i) public administration and simplification; (ii) product and service markets; (iii) labour market; (iv) civil justice; (v) education; (vi) a tax shift; and (vii) spending review as financing measure.

[27] These three conditions were first mentioned in the Commission Opinion of 16 November 2015 on Italy’s 2016 DBP and consistently recalled in the Commission’s assessments of the 2016 and 2017 stability programmes for Italy, on 26 May 2016 and 23 May 2017, respectively.

net of discretionary revenue measures, with potential output growth over the medium term.\(^{(9)}\) This conceptual equivalence is not observable in practice because — in line with the methods agreed by the Council committees responsible — the two indicators have been implemented with different aggregates and data inputs. As a result, for a given country and a given year, they do not provide the same estimate and can diverge quite substantially.

Unless both indicators point to compliance with requirements, in practice the Commission always conducts an overall assessment, even when both indicators point to a significant deviation. The full dataset underpinning the overall assessment is shared with the national governments. The overall assessment is meant to clarify (i) whether and how specific factors may affect one or both indicators, and (ii) if the two indicators do not support the same conclusions, which indicator may provide a more accurate assessment in the given context. The overall assessment relies mainly on the know-how and ultimately judgement of the country experts in the Directorate-General for Economic and Financial Affairs of the Commission, who are expected to appreciate the relevant details.

However, the Code of Conduct of the SGP endorsed by the ECOFIN Council\(^{(5)}\) and the Vade Mecum on the SGP published by the Commission\(^{(3)}\) are not entirely aligned on when an overall assessment is necessary. On the one hand, the Code of Conduct considers that, when both pillars point to a significant deviation, this should automatically lead to the conclusion that there is a significant deviation. On the other hand, the Vade Mecum on the SGP argues that this creates a strong presumption of a significant deviation but that an overall assessment is still needed. This is an important point; if the ex-post assessment concludes that there is a significant deviation, this may potentially lead to financial sanctions.

Until early 2016, the cases in which both indicators pointed to a significant deviation in 2016 or 2015-2016 automatically concluded that there was a risk of significant deviation for that period. This was the case, for instance, with Belgium, Italy and Slovenia. By contrast, from the spring of 2016 onwards, the conclusions were no longer automatic but derived from an overall assessment. In the case of Malta, the spring 2016 assessment concluded that there was only some deviation in 2015, although both indicators signalled a significant deviation; similarly the joint assessment of 2015 and 2016 identified a risk of some deviation, while both indicators suggested a risk of a significant deviation.

Turning to the relative appreciation of the two indicators in the context of the overall assessment, there has been an apparent shift in practice. In autumn 2015, when looking at projections for 2016 there was a tendency to identify problems with one indicator and to conclude by deduction that the other indicator would be more appropriate or reliable; in most cases, the change in the structural balance. Later on it became common practice to check both indicators for special factors that may have impacted their measurement in a given year. In autumn 2016, almost all overall assessments relied on careful checks of both indicators. Finally, in the ex-post assessment of spring 2017, the overall assessment gave more prominence to the expenditure benchmark after correcting for the impact of one-off factors. This follows the decision by the competent Council committee in late 2016 to put a stronger focus on the expenditure benchmark. \(^{(3)}\)

The arguments put forward in the overall assessment mainly referred to methodological differences between the two indicators. The structural balance pillar has well-known weaknesses which were often raised in the overall assessments. An observed change in the structural budget balance may be affected negatively by revenue shortfalls or positively by revenue windfalls; the consolidation effort appears misleadingly larger when interest payments decline; it is computed on the basis of an estimate of potential growth for only one year, which can be a source of uncertainty and volatility. On the other hand, the measurements derived from the expenditure benchmark can also be affected by a number of factors, which were regularly flagged up in the overall assessments. In particular, the expenditure benchmark includes the impact of one-offs, it is computed on the basis of an estimate of potential growth over the medium term, which is more stable than the estimate of potential output growth of one year, but may be biased if it includes ‘outliers’, especially in the wake of a deep crisis — and it is based on a GDP deflator that is frozen in spring T-1 and may no longer

\(^{(5)}\) A detailed account of the theoretical equivalence is provided in Box II.2.1 of European Commission (2011).


\(^{(3)}\) ‘Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm’, Opinion adopted by the Economic and Financial Committee on 29 November 2016 and endorsed by the ECOFIN Council on 6 December 2016, Annex 3 of the SGP Code of Conduct, ibid.
be relevant at the time of the ex-post assessment two years later. (3)

While in most cases the arguments were relatively clear, on some occasions the conclusions were not fully replicable for an independent assessor. Notably, in some cases the overall assessment does not quantify the impact of each factor affecting the indicators.

Moreover, from the viewpoint of an independent assessor, some arguments may not always have been consistently used in the same direction over time or across countries. Two examples are the revisions of real-time potential growth estimates and the volatility of public investment. Depending on the country and the timing of the assessment, these arguments were used to defend either the results of the structural balance or the expenditure benchmark. For instance, in the autumn of 2016 the overall assessment for Finland argued that it was more prudent to use an estimate of potential growth over the medium term — as in the expenditure benchmark — than the current estimate used for the structural balance. In spring 2016, however, the assessment for the same country had come to the opposite conclusion. Similarly, for some countries (including Lithuania, Malta, Slovenia and Slovakia) it was argued, until the autumn of 2016, that the assessment of 2016 under the expenditure benchmark pillar was negatively affected by the smoothing of investment expenditure. (34) In the spring of 2017, however, the assessment for Slovenia and Slovakia flagged up the fact that the volatility of investment distorted the structural balance pillar in 2016 and that the expenditure benchmark pillar was therefore considered to reflect more appropriately the underlying fiscal effort.

The issues highlighted above do not put into question the know-how of the country experts in the Directorate-General for Economic and Financial or of the service as a whole. They are rather the direct consequence of using two indicators for one and the same purpose: expert judgement becomes inevitable. In many cases the differences between the two measurements can be explained, at least in qualitative terms. However, there is no complete mapping and even if there were, expert judgement would still be needed to establish which factors tilt the balance towards one indicator or the other and to what extent they need to be corrected for specific factors. Given that the choice ultimately determines whether a country complies with the EU fiscal rules or not, the degree of discretion involved in the overall assessment will always be controversial and sensitive. In particular, it may be prone to inevitable errors of judgement or other considerations which are ultimately difficult to distinguish ex-post from the outside.

As a reminder, the two-pillar approach was introduced in 2011 with the Six-Pack reform of the SGP. The initial legislative proposal was designed to replace the change in the structural budget balance with the expenditure benchmark. The two-pillar approach emerged during the legislative process and was finally adopted. More recently, also in light of the evident problems with using two indicators, the Commission and the Council have been moving towards a stronger focus on the expenditure benchmark. However, the room for manoeuvre under current legislation remains limited as, formally speaking, both indicators are on an equal footing.

2.2.2. The corrective arm of the Stability and Growth Pact

The corrective arm in a nutshell

Under the corrective arm of the SGP, excessive deficits are regarded as gross policy errors and must be corrected. In particular, the budget deficit and the gross debt of the general government must not exceed 3% and 60% of GDP respectively. If gross debt is above the threshold, it must fall towards it at a satisfactory pace. Whenever this is not guaranteed, Article 126 of the Treaty lists a series of surveillance steps which can be used by the Council to restore sound public finances, on the basis of a recommendation or proposal of the Commission. EU surveillance under the corrective arm of the SGP essentially involves two broad tasks: (i) establishing whether a Member State is effectively running an excessive deficit; and (ii), if it is, monitoring fiscal policy towards the correction of the excessive deficit against the recommendations of the Council. (35)

(3) In the case of Italy, the expenditure benchmark for 2016 was based on a GDP deflator inflated by a VAT hike that had already been legislated as a safeguard at the time of the calculation but was subsequently repealed. As the GDP deflator could not be reduced to reflect it, this resulted in the expenditure benchmark overestimating the actual fiscal effort. This distortion was, however, taken into account and corrected in the overall assessment.

(34) Under the provisions of the SGP, government investment expenditure is included in the expenditure benchmark by averaging it over four years. The averaging is meant to address the volatility of government investment, especially in smaller countries. The idea is not to penalise large increases in investment but, equally, not to favour sudden drops compensated by an increase in current expenditure. In small countries, investment projects are largely co-funded by EU programmes. As EU co-funded investments had surged in 2015, due to the high absorption of EU funds towards the end of the programming period, and were expected to fall substantially in 2016 at the start of a new programming period, the smoothed value of investment expenditure for 2016 was higher than the actual value for the year.

(35) On top of the provisions of Article 126 TFEU, the EDP is detailed in Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. Practical
Whenever the Commission observes a breach in either the deficit or the debt criterion, it will prepare a report under Article 126(3) TFEU to establish whether an excessive deficit has occurred. The assessment contained in the report is expected to also take into account all 'other relevant factors' which have gained increasing prominence over the years. If, based on its assessment, the Commission considers that an excessive deficit exists or may occur it addresses a proposal to the Council. Where the Council decides that an excessive deficit exists it adopts a recommendation to the Member State, upon a recommendation from the Commission, setting out a deadline for the correction of the excessive deficit, together with the necessary adjustment path for both nominal and structural budget balances.

A Member State in EDP is required to take effective action so as to achieve the budgetary targets towards the correction of the excessive deficit recommended by the Council. The Commission continuously monitors compliance with the Council recommendations and provides detailed updates on the back of its forecast exercises three times a year, in the context of the European Semester cycle.

The assessment of effective action begins by considering whether a Member State in EDP has achieved the required targets for the headline deficit and the underlying improvement in the structural deficit. If the Member State has achieved both, the EDP is held in abeyance; otherwise, a careful analysis will determine whether the Member State concerned has delivered the required policy commitments and the budget shortfall with respect to the recommended targets is due to events outside of its control.

The careful analysis will determine whether the Member State has implemented the required policy measures on the basis of two indicators. The first indicator is the change in the structural deficit which is corrected for the impact of events outside the control of the government, mainly unexpected revenue windfalls and shortfalls and revisions of potential growth, compared to the forecast underpinning the Council recommendation. The second indicator measures the direct budgetary impact of individual revenue measures, together with the dynamics of discretionary expenditures, again compared to the forecast underpinning the EDP recommendation. (36)

If the careful analysis indicates that the Member State concerned has delivered the required fiscal effort, despite a possible shortfall in the headline deficit and the structural adjustment, the assessment will conclude that effective action has been taken and the EDP recommendation is held in abeyance. Otherwise, the assessment will be of no effective action, which will lead to a stepping-up of the EDP and to the potential imposition of sanctions.

In practice, since the corrective arm of the SGP is centred on the 3 % of GDP threshold for the headline deficit, the EDP is held in abeyance as long as the nominal deficit targets are achieved, even if other metrics indicate a shortfall in the required structural adjustment. This would typically be the case when economic developments turn out better than the macroeconomic forecasts underpinning the Council recommendation. (37)

In October 2015, when Member States submitted their DBPs for 2016 in accordance with Regulation (EU) 473/2013, five euro area Member States were subject to an EDP: Ireland, Portugal and Slovenia were required to correct their excessive deficit by the end of 2015, while Spain and France were expected to correct their excessive deficit by the end of 2016 and 2017 respectively.

Assessing the existence of an excessive deficit

Under Article 126(3) TFEU, the Commission may issue a report whenever a Member State appears to be in breach of the deficit and/or debt criteria, in order to assess whether an EDP should be launched. In 2016 and 2017, the Commission has issued such reports for Italy, Belgium and Finland following an observed breach with the debt criterion.

A breach of the debt criterion can occur under two circumstances: (i) if the debt ratio increases above the 60 % of GDP threshold and remains above it throughout the forecast horizon; or (ii) if the debt ratio is above the threshold and the excess debt has not decreased at an average rate of 1/20th per year as a benchmark. The average rate is computed either over the previous three years, or over the three-year period centred on the year of the assessment, while also taking into account the influence of the cycle. (38)

Although part of the initial SGP, the debt criterion was made operational only in 2011 with the Six-Pack reform. The coexistence of two separate rules within the SGP, one for the deficit and one for the debt, is a source of potential complexity, especially in a low nominal growth

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(36) For a detailed explanation of the two indicators and how they are applied see Annex 4 of the Code of Conduct on the SGP (see footnote 30).

(37) The implications of this asymmetry in the assessment of effective action are further discussed in Section 5.

(38) For further information, see the Code of Conduct of the SGP, (see footnote 30).
environment. (8) The country-specific MTO takes into account the stock of debt, ageing costs and long-term growth. Hence, being at the MTO is generally supposed to ensure compliance with the debt criterion under the corrective arm of the SGP. However, the unfavourable economic environment of recent years, particularly as regards low inflation, has negatively impacted debt dynamics to such an extent that compliance with the debt rule for some high-debt countries would require a structural surplus which is well above their MTO.

This apparent complication has been addressed by considering the so-called other relevant factors, which can be relied upon when assessing whether to open an EDP or not. Article 126(3) TFEU specifies that the Commission report must take into account all relevant factors, including the medium-term economic and budgetary position of the Member State. Over the years, especially through the successive SGP reforms, the concept of other relevant factors has been further clarified. (9) Under current legislation and practice, the Commission considers three key aspects when assessing compliance with the debt criterion: (i) the implementation of structural reforms; (ii) the presence of unfavourable macroeconomic conditions which may hamper the reduction of the debt ratio; (iii) adherence to the MTO or the adjustment path towards it.

For Finland, a breach of the debt criterion was observed in the context of the Commission 2017 spring forecast. At 60.2% of GDP in 2014, government debt had exceeded the reference value from below, and had further increased to 63.6% of GDP in 2016. In line with the provision of the SGP, the Commission issued a report under Article 126(3) TFEU in May 2017. (41) At the time of the assessment, government debt was projected to further increase in 2017 under both the Commission forecast and the SP.

The Commission issued two additional reports under Article 126(3) TFEU, namely for Italy and Belgium in February and May 2017 respectively. In these two reports the Commission noted that the gross debt of both Member States, which was well above the 60% of GDP threshold, was not diminishing at the average rate mentioned earlier, even when taking into account the influence of the cycle.

In the assessment of relevant factors, the reports noted that Belgium and Finland had made progress on the structural reforms agenda. For Italy, the Commission noted that while the implementation of adopted reforms had broadly continued, the adoption of new reforms had significantly slowed down, as confirmed in the Commission 2017 Country Report of 22 February 2017.

The Reports under Article 126(3) TFEU also noted that all three Member States had been affected by adverse economic conditions which negatively impacted their compliance with the debt criterion. In the case of Finland, the debt ratio was assessed to have been slightly below 60% of GDP in 2016 once corrected for the effect of the cycle. Belgium and Italy were considered to have suffered from a prolonged period of low nominal growth which had worsened their debt dynamics. The Commission noted that, while economic conditions were improving, the cumulative effect of low nominal growth had rendered compliance with the debt criterion too demanding. In particular, the adjustment needed to comply with the debt rule was considered significantly higher than the fiscal effort recommended by the Council in spring 2015.

In the case of Finland the Commission assessed that the country had complied with the required adjustment towards the MTO in 2016, 2017 and 2018. For 2017, the assessment of compliance hinged on granting a temporary deviation of 0.6% of GDP from the adjustment path towards the MTO, on the basis of the flexibility clauses for structural reforms and investment.

For Belgium, the Commission report highlighted some deviation from the adjustment path towards the MTO in 2016, which per se would support an assessment of broad compliance. However, as regards 2017, the Commission assessment pointed to the risk of a significant deviation over two years yet argued that Belgium could still take corrective measures. Overall, the Commission report concluded that Belgium was compliant with the debt criterion, but highlighted the need to take additional fiscal measures to ensure compliance with the adjustment towards the MTO in 2016 and 2017 together. However, as the Belgian government considered the 2017 budget to be broadly on track with an expected structural improvement of 0.9% of GDP, no additional measures were taken during the July budget review.

In the case of Italy, the Commission assessment showed some deviation from the required adjustment in 2016, after considering 0.75% of GDP of flexibility under the structural reforms and investment clauses. However, close to half of that flexibility (0.35% of GDP) had been granted conditionally on Italy resuming the budgetary adjustment towards the MTO in 2017. Yet,

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(8) Prior to the post-2007 crises the deficit criterion was de facto more binding due to comparatively high nominal economic growth. The situation changed in the wake of the crisis when due to a sharp increase in government debt levels combined with a significant slowdown in potential growth the respect of the deficit criterion no longer ensured the respect of the debt criterion in some countries.


(41) This report followed an earlier report under Article 126(3) TFEU which was issued in May 2016.
the Commission determined in its report that Italy was at risk of significant deviation in that year, even after considering an allowance of 0.32% of GDP, to be assessed ex-post, in relation to the projected budgetary impact of the inflow of refugees and of a preventive investment plan for the protection of the national territory against seismic risks in 2017. (4) Since there were risks to the resumption of the adjustment towards the MTO in 2017, the Commission was of the view that the 0.35% of GDP extra flexibility for 2016 could not be considered at that stage. As a result it concluded that there was a risk of significant deviation also in 2016. (4)

The Commission requested Italy to deliver an additional 0.2% of GDP of fiscal effort by spring 2017. This was meant to ensure that the deviation in 2017 would be non-significant, although solely on the basis of the expenditure benchmark, and only if the additional allowance of 0.32% of GDP mentioned earlier was granted ex-post. By spring 2017, Italy was assessed to have implemented the required 0.2% of GDP adjustment for 2017, thereby averting an assessment of non-compliance with the debt criterion at that point in time.

The 2016 draft budgets

The DBPs for 2016 submitted in autumn 2015 by two countries subject to the corrective arm of the SGP raised issues regarding the timing. The Spanish DBP was submitted on 11 September 2015, well ahead of the deadline of 15 October that is indicated in Article 4 of Regulation (EU) No 473/2013. Although not in conflict with the Regulation, the early submission was considered problematic, especially as it put the Commission in the position of assessing a DBP submitted by an outgoing government ahead of general elections. Portugal, by contrast, did not submit a DBP by the deadline, due to the temporary absence of a new government after the general elections of 5 October. It submitted a DBP only on 22 January 2016 and announced additional consolidation measures on 5 February.

In autumn 2015 the Eurogroup asked for a codification of how to deal with such cases. This resulted in an update of the Code of Conduct of the Two-Pack on 30 September 2016. (4) Under the updated Code of Conduct, DBPs may not be submitted earlier than 1 October or later than 15 October. Furthermore, in case a government is not enjoying full budgetary powers, for instance as a caretaker government, the Member State should submit a DBP prepared on a no-policy-change basis. The incoming government should submit an updated DBP once it takes office.

In the draft budget, the Portuguese authorities expected a deficit of 4.2% of GDP in 2015, thereby missing the deadline for correcting the excess deficit. For 2016, Portugal planned to reduce the deficit to 2.6% of GDP, while the Commission, based on its 2016 winter forecast, projected a government deficit of 3.4% of GDP. This large difference was partly due to the fact that the Commission forecast did not include a number of deficit-reducing measures which had not been specified with a sufficient degree of detail by the national authorities. Furthermore, the Commission noted that the macroeconomic scenario in the DBP for 2016 appeared optimistic. Overall, the Commission considered the DBP to be at risk of non-compliance.

The 2016 DBP of France was assessed to be broadly compliant with the requirements of the SGP, as France planned to respect the headline deficit target of 3.4% of GDP in 2016. The Commission, however, noted that the fiscal effort fell significantly short of the recommended level under both indicators, namely the change in the structural budget balance and a direct assessment of individual measures. Rather than relying on structural measures, the budgetary strategy of France was largely based on the improving cyclical conditions which went beyond the projections underpinning the Council recommendation.

The 2016 DBP of Spain was assessed to be at risk of non-compliance. The draft budget planned to reach a headline deficit of 2.8% of GDP in 2016, in line with the EDP recommendation. Similar to the case of France, the planned correction of the excessive deficit relied on stronger nominal growth than expected at the time of the EDP recommendation, while the structural deficit for 2016 was projected to remain unchanged at 1.6% of GDP. The Commission noted that the macroeconomic scenario for 2016 in the DBP appeared "somewhat optimistic"; its own forecast of nominal GDP growth in 2016 was 0.5 percentage point lower than the one of the national authorities. (4) Under the

(4) In its opinion on Italy’s 2017 DBP, the Commission stated that it is ready to consider a ‘broader approach’ when it comes to the specific treatment of earthquake-related expenditures, due to the integrated nature of emergency expenditures and expenditures for prevention intervention.

(4) At the time of the Commission report, outturns for 2016 were not available yet; they are normally available at the end of March and validated by Eurostat in late April. Hence, the conclusion of ‘risk’ for a year that was already closed.


(4) Since Spain submitted its DBP earlier due to general elections, the Commission based its opinion on an ad-hoc forecast with a cut-off date 29 September 2015.
Commission forecast, neither the headline deficit target nor the recommended fiscal effort for 2016 was projected to be achieved.

The Commission invited Spain to take the necessary measures to ensure that the 2016 budget would be compliant with the SGP, and to submit an updated DBP, including up-to-date and fully specified measures for regional governments. Of note, the invitation to submit an updated DBP was not motivated by the Commission’s risk assessment: it was rather motivated by the fact that, due to its early submission, the Spanish DBP was incomplete and not up-to-date. Against the backdrop of the political impasse after the general election in December 2015, the incumbent Spanish caretaker government did eventually not follow-up on the specific invitation. Instead it included some additional measures (expenditure cuts at central and regional level) in its 2016 SP.

Overall, the Spanish and the French DBPs for 2016 highlight how Member States under an EDP have an incentive to substitute cyclical windfalls for fiscal consolidation, which occur from better-than-expected growth (see Section 5). Under current practice, an EDP is not stepped up if a Member State achieves the required headline deficit targets, even if the policy commitments in structural terms have not been delivered. Whenever economic growth turns out to be better than projected at the time of the Council recommendation, a Member State has the option of lowering its fiscal effort in a pro-cyclical fashion. This option is commonly referred to as a nominal strategy.

In the case of Spain the nominal strategy eventually failed in 2016. In its DBP, Spain targeted a deficit of 2.8 % of GDP, whereas the Commission forecasted a deficit of 3.5 % of GDP. Seven months later, in the Stability Programme of spring 2016, the Spanish authorities ended up revising the deficit for 2016 upward by 0.8 percentage points, to 3.6 % of GDP.

In contrast to Spain, the EDP for France has been kept in abeyance so far. However, available Commission projections highlight some risks attached to the government’s nominal strategy going forward: in spite of significant cyclical budgetary windfalls the headline deficit remains close to 3 % of GDP and a durable correction seems ensured only if additional adjustment measures are implemented.

Autonomous Commission Recommendations

Regulation (EU) 473/2013 allows the Commission to issue an autonomous recommendation to a Member State when it detects a risk of non-compliance with the EDP deadline. The autonomous recommendation can call for the full implementation of the measures foreseen in the EDP recommendation issued by the Council, or for the adoption of other measures. This recommendation does not lead to a stepping-up of an EDP: it is meant to increase pressure on the Member State concerned by publically highlighting risks of non-compliance. Within the timeframe set by the autonomous recommendation, the Member State shall report to the Commission on the additional measures taken. In its regular assessment of effective action, the Commission will then take into account whether the Member State has complied with the autonomous recommendation.

Following the publication of its 2016 winter forecast on 4 February 2016, the Commission concluded that the fiscal outlook for Spain had not improved since the assessment of the DBP. In particular, Spain was not projected to comply with the deficit targets of the EDP recommendation for either 2015 or 2016, and the fiscal effort fell short of the recommended level under all metrics in both years. As a result, on 9 March 2016, the Commission issued an autonomous recommendation to Spain, requiring the national authorities to take the necessary measures to ensure a timely and durable correction of the excessive deficit. In response to the recommendation, Spain announced additional measures in its 2016 Stability Programme.

Updating of country-specific recommendations

On 18 May 2016, the Commission published its draft CSRs. While the draft CSRs for France called for adherence to the targets of the EDP, the proposed CSRs for Portugal and Spain contained fiscal targets which were different from those contained in the relevant EDP recommendations. Specifically, the CSRs for Portugal and Spain extended the EDP deadline by one year and contained less demanding deficit targets. This approach departed from established practices as it was not preceded by a new Council recommendation under Article 126(7) TFEU. While EDP recommendations are an instrument of the corrective arm of the SGP, the CSRs are part of the preventive arm: the latter cannot amend the former.

On 12 July 2016, probably taking into account the legal intricacies involved in the original Commission proposal, the Council adopted CSRs for Portugal and Spain which no longer amended the fiscal targets of their EDP recommendations. The CSRs required Portugal and Spain to simply “Ensure a durable correction of the excessive deficit, in accordance with the relevant decisions or recommendations under the excessive deficit procedure”.

Regulation (EU) 473/2013 allows the Commission to issue an autonomous recommendation to a Member State when it detects a risk of non-compliance with the
No effective action and sanctions

On 7 July 2016, the Commission recommended to the Council to establish that Portugal and Spain had not taken effective action. Of note, the timing of the Commission recommendation was delayed compared to the usual sequencing, as in previous years new steps under the EDP had been taken right after the publication of the spring forecast.

Under the Commission 2016 spring forecast published on 4 May of that year, the headline deficit for Portugal was notified at 4.4% of GDP in 2015 and 2.7% of GDP in 2016, while the headline deficit for Spain was projected at 3.9% of GDP in 2016 and 3.1% in 2017. Portugal had therefore not corrected its excessive deficit by the 2015 deadline, and Spain was not projected to correct its excess deficit by 2016. The Commission established that the fiscal effort of both Member States fell significantly short of what was recommended by the Council, under all metrics. Furthermore, the Commission noted that the fiscal stance in Spain was even expansionary in 2015.

Following the recommendation from the Commission, on 11 July 2016 the Council adopted a decision under Article 126(8) TFEU establishing that Portugal and Spain did not take effective action in response to the EDP recommendation. Whenever the Council takes such a decision, the Commission has 20 days to issue a recommendation for a Council decision to implement a fine of 0.2% of GDP as a rule. The Commission may decide to reduce or cancel the fine on grounds of exceptional economic circumstances, or following a reasoned request from the country concerned. The Commission recommendation is considered adopted, unless the Council rejects it by qualified majority voting within 10 days. Alternatively, the Council may amend the decision by qualified majority.

On 27 July 2016, in line with relevant legal provisions, the Commission issued a recommendation to the Council concerning the sanctions for Portugal and Spain. At the same time, the Commission assessed that, while neither country suffered from exceptional economic circumstances, the reasons put forward by the national authorities warranted a cancellation of the fine of 0.2% of GDP for both countries (see Overview Table 2.3). The Council adopted the relevant implementing decisions on 5 August 2016.

A second type of sanctions exists in connection with the regulation laying down the common provisions for the European Structural and Investment (ESI) funds. (46) This regulation establishes a link between ESI funds and the economic governance framework, in order to ensure the effectiveness of expenditures under the ESI funds. (47) Whenever the Council establishes that no effective action was taken, the Commission has to make a proposal to suspend part or all of the commitments or payments related to ESI programmes. Before doing so, the Commission has to inform the European Parliament and provide details of the funds subject to suspension: the Parliament may then invite the Commission for a structured dialogue. (48) Finally, when making its proposal to the Council, the Commission needs to give due consideration to any elements arising from and opinions expressed through the structured dialogue with the Parliament. As soon as the EDP is held in abeyance or is abrogated, the Commission must lift the suspension of funds and re-budget them.

On 14 July 2016, following the Council decision on no effective action in Portugal and Spain, the Commission provided the European Parliament with a list of the funds that could be subject to suspension, in a letter from Vice-President Katainen to President Schultz. The European Parliament invited the Commission for a structured dialogue on 3 October 2016, and concluded that further information was needed before the dialogue could be closed. On 16 November 2016 the Commission determined that, in light of the action taken by Portugal and Spain in response to the Council notice under Article 126(9) TFEU (see next subsection), the EDPs were put in abeyance. As a result, the conditions for suspending ESI funds no longer applied.

Stepping up an EDP

Following a decision of no effective action in response to an EDP recommendation, the Council must issue a notice under Article 126(9) TFEU to the Member States concerned, on the basis of a recommendation from the Commission. On 27 July 2016, the Commission recommended that the Council issues notices for Portugal and Spain.

For Portugal, the Commission recommended to the Council to extend the EDP deadline to 2016 and to set a deficit target for that year of 2.5% of GDP, which was consistent with maintaining an unchanged structural balance with respect to 2015. To achieve those targets, the Commission recommended that Portugal implement additional consolidation measures of 0.25% of GDP in 2016, based on the spring forecast.

On the basis of an updated forecast, with new information up to 19 July 2016, the budgetary situation of Spain appeared further deteriorated. The headline

(48) However, no specific timeline exists for such a dialogue.
deficit for 2016 was projected at 4.6% of GDP, higher than the 3.9% of GDP projected under the spring forecast. The structural deficit was projected to deteriorate by 0.4% of GDP in 2016, against a deterioration of 0.2% projected in spring. While Regulation (EC) 1467/97 establishes a minimum annual improvement of at least 0.5% of GDP in the structural balance for Member States under EDP, the Commission noted that the baseline scenario already started with a 0.4% of GDP deterioration of the structural deficit, and it furthermore noted that the Council notice would have been adopted only in the second half of the year, leaving effectively little time to achieve significant budgetary improvements. This constraint also followed from the comparatively late timing, mentioned above, of the Commission recommendation for a Council decision that Spain had not taken effective action. For this, the Commission considered it appropriate not to request further structural measures in 2016.

Furthermore, the Commission argued that, since no structural measures were requested in 2016, correcting the deficit in 2017 would have required an annual improvement in the structural balance the growth impact of which would have been too negative. In its proposal to the Council, the Commission recommended to extend the deadline for correcting the excessive deficit for Spain until 2018, reducing the budget deficit to 4.6%, 3.1% and 2.2% of GDP in 2016, 2017 and 2018 respectively. This implied a deterioration of the structural budget balance of 0.4% of GDP in 2016, and annual structural improvements of 0.5% of GDP in 2017 and 2018. In comparison, under its EDP, France was required to deliver an improvement in the structural balance of 0.9% of GDP in 2017 despite being projected to be in worse cyclical conditions at the time of the EDP recommendation.

On 2 August 2016, the Council adopted the notices to Portugal and Spain, under Article 126(9) TFEU. On 16 November 2016 the Commission determined that the EDPs of Portugal and Spain should be kept in abeyance, as both Member States were found to have taken effective action in response to the notices.

Abrogation of an EDP

An EDP can be abrogated only on the basis of observed data, combined with the assessment that the correction of the excessive deficit is lasting, i.e. the deficit remains below the 3% of GDP threshold over the Commission forecast horizon; additionally the debt rule must be satisfied in its forward-looking dimension. Due to the introduction of a transition period following the adoption of the Six-Pack reform in 2011, this last requirement does not apply to EDPs that were already open in November 2011. In those cases, the EDP will be abrogated only on the basis of the deficit criterion.

Pursuant to the assessment of the Commission in spring 2016, the Council abrogated the EDPs of Ireland, Slovenia and Cyprus. Following the assessment of spring 2017, the Council abrogated the EDP of Portugal. All these countries were under the corrective arm of the SGP before the adoption of the Six-Pack reform: their EDPs were thus abrogated uniquely on the basis of a notified nominal deficit below 3% of GDP.

2.2.3. Overview of the 2016 EU fiscal surveillance cycle

Tables 2.2, 2.3 and 2.4 present the main stages of the 2016 fiscal surveillance cycle for all euro area countries. The overview is organised around four key moments/periods in the surveillance cycle:

1. Spring 2015, when, in line with the provisions of the SGP, the Council set the budgetary adjustment to be implemented by the Member States in 2016;
2. Autumn 2015, when the Commission assessed the Draft Budgetary Plans for 2016 submitted by the Member States, including against the requirements set in Spring;
3. 2016, the actual reference period during which the Commission and the Council took additional surveillance steps;
4. Spring 2017, when, in light of economic and budgetary outturns, the Commission and the Council assessed the actual performance of Member States against the requirements of the Pact and deliberated on whether new surveillance steps were necessary.
5. More details on how to read the Tables are provided in Box 2.1.
### Table 2.2: Application of EU fiscal rules in euro area in 2016 — The preventive arm of the SGP (See Box 2.1 on how to read the table)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Distance to MTO in 2015 % of GDP</strong></td>
<td><strong>% of GDP</strong></td>
<td><strong>Country-specific recommendations (CSRs) for 2016</strong></td>
<td><strong>Commission’s assessment of Draft Budgetary Plans (DBPs)</strong></td>
<td><strong>Steps during the reference period</strong></td>
</tr>
<tr>
<td><strong>BE</strong></td>
<td>3.1</td>
<td>At least 0.6</td>
<td>None</td>
<td>Broadly compliant: risk of some deviation</td>
</tr>
<tr>
<td><strong>DE</strong></td>
<td>1.5</td>
<td>No fiscal CSR</td>
<td>None</td>
<td>Compliant</td>
</tr>
<tr>
<td><strong>EE</strong></td>
<td>-0.4</td>
<td>Avoid deviating from MTO</td>
<td>None</td>
<td>Compliant</td>
</tr>
<tr>
<td><strong>IE</strong></td>
<td>-3.6</td>
<td>0.6</td>
<td>None</td>
<td>Broadly compliant: risk of some deviation</td>
</tr>
<tr>
<td><strong>IT</strong></td>
<td>-0.7</td>
<td>0.1</td>
<td>Structural reform clause (0.4)</td>
<td>At risk of non-compliance: risk of significant deviation</td>
</tr>
<tr>
<td><strong>CY</strong></td>
<td>0.4</td>
<td>n/a (?)</td>
<td>None</td>
<td>n/a (?)</td>
</tr>
<tr>
<td><strong>LV</strong></td>
<td>-0.9</td>
<td>Ensure deviation from MTO is limited to the systemic pension reform allowance</td>
<td>2013 Pension reform clause (?) (0.5)</td>
<td>Broadly compliant: risk of some deviation</td>
</tr>
<tr>
<td><strong>LT</strong></td>
<td>-0.9</td>
<td>Ensure deviation from MTO is limited to the systemic pension reform allowance</td>
<td>2015 Pension reform clause (?) (0.1)</td>
<td>At risk of non-compliance: risk of significant deviation</td>
</tr>
<tr>
<td><strong>LU</strong></td>
<td>0.1</td>
<td>No fiscal CSR</td>
<td>None</td>
<td>Compliant</td>
</tr>
<tr>
<td><strong>MT</strong></td>
<td>-2.1</td>
<td>0.6</td>
<td>None</td>
<td>Broadly compliant: risk of some deviation</td>
</tr>
</tbody>
</table>

(Continued on the next page)
<table>
<thead>
<tr>
<th>Country</th>
<th>Distance to MTO in 2015 % of GDP</th>
<th>Spring 2015</th>
<th>Autumn 2015</th>
<th>2016</th>
<th>Spring 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>NL</td>
<td>0.2</td>
<td>No fiscal CSR</td>
<td>None</td>
<td>Compliant</td>
<td>New fiscal CSR: 'Limit the deviation from the MTO'</td>
</tr>
<tr>
<td>AT</td>
<td>-0.3</td>
<td>Avoid deviating from the MTO</td>
<td>None</td>
<td>At risk of non-compliance: risk of significant deviation</td>
<td>Fiscal CSR revised: Limi...the budgetary impact of the exceptional inflow of refugees in 2015</td>
</tr>
<tr>
<td>SI</td>
<td>-2.4</td>
<td>0.6</td>
<td>None</td>
<td>Broadly compliant: risk of some deviation close to significant, deviation</td>
<td>None</td>
</tr>
<tr>
<td>SK</td>
<td>-1.4</td>
<td>No fiscal CSR</td>
<td>None</td>
<td>Compliant</td>
<td>New fiscal CSR: Structural adjustment of 0.25 % of GDP (in 2015)</td>
</tr>
<tr>
<td>FI</td>
<td>-1.3</td>
<td>0.5</td>
<td>None</td>
<td>Broadly compliant: risk of some deviation</td>
<td>Revised CSR: Structural adjustment of at least 0.5 % of GDP</td>
</tr>
</tbody>
</table>

Notes: (1) Regulation (EU) 472/2013 exempts euro area countries subject to a macroeconomic adjustment programme from monitoring and assessment under the European Semester for economic policy coordination for the duration of that programme. Similarly, those countries are also exempted from submitting their annual DBPs for the duration of the programme. (2) The treatment of systemic pension reforms is governed by Regulation (EC) 1466/97, Article 5(1).

Source: European Commission.
The report thus concluded that after the assessment of all the relevant factors the debt criterion should be considered as complied with.
Table 2.6: Application of EU fiscal rules in euro area in 2016 — The corrective arm of the SGP: Countries in EDP (See Box 2.1 on how to read the table)

<table>
<thead>
<tr>
<th>EDP status (Deadline)</th>
<th>Requirements</th>
<th>Procedure steps during the reference period</th>
<th>Ex-post assessment</th>
<th>Spring 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% of GDP</td>
<td>n/a</td>
<td>% of GDP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Headline budget balance</td>
<td>Structural adjustment</td>
<td>Procedural steps after the reference period</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Headline budget balance</td>
<td>Change in the structural budget balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>IE</strong></td>
<td>n/a</td>
<td>0.6</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>(2015)</td>
<td></td>
<td>See Table 2.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>2016</strong></td>
<td><strong>2017</strong></td>
<td></td>
</tr>
<tr>
<td>In absence</td>
<td></td>
<td>18/05/2016 — The Commission issued a recommendation under Art 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. The Recommendation was based on 2015 data notified by the Irish authorities and verified by Eurostat, the 2016 Stability Programme of Ireland and the Commission 2016 spring forecast indicating that the excessive deficit in Ireland had been corrected.</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>17/06/2016 — The Council adopted the Decision abrogating the Decision on the existence of an excessive deficit in Ireland.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>CY</strong></td>
<td>-2.9 (%)</td>
<td>n/a (1)</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>In absence</td>
<td></td>
<td>See Table 2.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2016)</td>
<td></td>
<td>2016 - The Commission issued a recommendation under Art 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. The Recommendation was based on 2015 data notified by the Cypriot authorities and verified by Eurostat, the 2016 Stability Programme of Cyprus and the Commission 2016 spring forecast indicating that the excessive deficit in Cyprus had been corrected.</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>17/06/2016 — The Council adopted the Decision abrogating the Decision on the existence of an excessive deficit in Cyprus.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ES</strong></td>
<td>-2.8 (%)</td>
<td>1.2 (%)</td>
<td>-1.0</td>
<td>-0.5 (%)</td>
</tr>
<tr>
<td>In absence</td>
<td></td>
<td>2016 - The Commission issued a recommendation under Art 126(12) TFEU for a Council Decision establishing that no effective action had been taken by Spain in response to its Recommendation of 21 June 2013. The Recommendation was based on 2015 data notified by the Spanish authorities and the Commission 2016 spring forecast. Spain had not reached the intermediate target for the headline deficit in 2015 and was not forecast to put an end to its excessive deficit by 2016. Moreover, the fiscal effort had fallen significantly short of what was recommended by the Council and the fiscal stance had even been relaxed in 2015.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>12/07/2016 — The Council adopted a Decision establishing that no effective action had been taken by Spain in response to its Recommendation of 21 June 2013.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Continued on the next page)
The European Commission has ongoing concerns about Portugal's economic situation, specifically related to fiscal imbalance. Following the submission of the Portuguese Draft budgetary plan and the Effective Action Report (EAR) for 2016, the Commission recommended a fine of 0.2% of GDP to be imposed on Portugal due to the non-compliance with the 2015 deadline set by the Council to correct its excessive deficit and the fiscal effort had fallen significantly short of what had been recommended.

The Council adopted a Decision establishing that no effective action had been taken by Portugal in response to the Council Recommendation of 21 June 2013. This was based on 2013 data notified by the Portuguese authorities and the Commission 2016 spring forecast, indicating that Portugal's response to the 21 June 2013 Council Recommendation has been insufficient. In particular, Portugal did not comply with the 2015 deadline set by the Council to correct its excessive deficit and the fiscal effort had fallen significantly short of what had been recommended.

The Council adopted a Decision establishing that no effective action had been taken by Portugal in response to the Council Recommendation of 21 June 2013. This was based on 2013 data notified by the Portuguese authorities and the Commission 2016 spring forecast, indicating that Portugal's response to the 21 June 2013 Council Recommendation has been insufficient. In particular, Portugal did not comply with the 2015 deadline set by the Council to correct its excessive deficit and the fiscal effort had fallen significantly short of what had been recommended.

### Table 2.4 (continued)

<table>
<thead>
<tr>
<th>Spring 2015</th>
<th>Autumn 2015</th>
<th>2016</th>
<th>Spring 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EDP status (deadline)</strong></td>
<td><strong>Requirements % of GDP</strong></td>
<td><strong>Commission Assessment of Draft Budgetary Plan (DBP)</strong></td>
<td><strong>Procedural steps during the reference period</strong></td>
</tr>
<tr>
<td>FR</td>
<td>in abeyance (2017)</td>
<td>-3.4</td>
<td>0.8 (%)</td>
</tr>
<tr>
<td>PT</td>
<td>in abeyance (2015)</td>
<td>n/a</td>
<td>0.6</td>
</tr>
</tbody>
</table>

#### FR (in abeyance (2017))

- **Headline budget balance**: -3.4%
- **Structural adjustment**: 0.8%
- **Commission Assessment of Draft Budgetary Plan (DBP)**: n/a
- **Procedural steps during the reference period**: 07/07/2016 – The Commission issued a Recommendation under Art 126(8) TFEU for a Council Decision establishing that no effective action has been taken in response to the Council of 21 June 2013. The Recommendation was based on 2013 data notified by the Portuguese authorities and the Commission 2016 spring forecast, indicating that Portugal's response to the 21 June 2013 Council Recommendation has been insufficient. In particular, Portugal did not comply with the 2015 deadline set by the Council to correct its excessive deficit and the fiscal effort had fallen significantly short of what had been recommended.
- **Ex-post assessment % of GDP**: -3.4%
- **Procedural steps after the reference period**: 22/05/2017 – The Commission issued a Recommendation under Art 126(13) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. The Recommendation was based on 2016 data notified by the Portuguese authorities, the 2017 Stability Programme of Portugal and the Commission 2017 spring forecast indicating that the excessive deficit in Portugal had been corrected.

#### PT (in abeyance (2015))

- **Headline budget balance**: n/a
- **Structural adjustment**: 0.6%
- **Commission Assessment of Draft Budgetary Plan (DBP)**: 0.3 %
- **Procedural steps during the reference period**: 07/07/2016 – The Commission issued a Recommendation under Art 126(8) TFEU for a Council Decision establishing that no effective action has been taken in response to the Council of 21 June 2013. The Recommendation was based on 2013 data notified by the Portuguese authorities and the Commission 2016 spring forecast, indicating that Portugal's response to the 21 June 2013 Council Recommendation has been insufficient. In particular, Portugal did not comply with the 2015 deadline set by the Council to correct its excessive deficit and the fiscal effort had fallen significantly short of what had been recommended.
- **Ex-post assessment % of GDP**: 0.9%
- **Procedural steps after the reference period**: 22/05/2017 – The Commission issued a Recommendation under Art 126(13) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. The Recommendation was based on 2016 data notified by the Portuguese authorities, the 2017 Stability Programme of Portugal and the Commission 2017 spring forecast indicating that the excessive deficit in Portugal had been corrected.

(Continued on the next page)
Table 2.4 (continued)

<table>
<thead>
<tr>
<th>EDP status (deadline)</th>
<th>Requirements</th>
<th>Procedural steps during the reference period</th>
<th>Ex-post assessment</th>
<th>Procedural steps after the reference period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% of GDP</td>
<td></td>
<td>% of GDP</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Headline budget balance</td>
<td>Structural adjustment</td>
<td>Headline budget balance</td>
<td>Change in the structural budget balance</td>
</tr>
<tr>
<td>SI</td>
<td>n/a</td>
<td>Broadly compliant (risk of some, but close to significant, deviation)</td>
<td>18/05/2016 – The Commission issued a Recommendation under Art 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. The Recommendation was based on 2015 data notified by the Slovenian authorities and verified by Eurostat, the 2016 Stability Programme of Slovenia and the Commission 2016 spring forecast indicating that the excessive deficit in Slovenia had been corrected.</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Notes: (1) To avoid duplication of measures set out in the Economic Adjustment Programme, there were no CSRs for Cyprus in July 2015. (2) Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Spain, 21 June 2013. (3) Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations. See Vade Mecum on the Stability and Growth Pact 2016 edition, Annex 5. (4) Council recommendation under Art 126(7) TFEU of 5 March 2015 with a view to bringing an end to the excessive government deficit in France.

Source: European Commission.
Box 2.1: Reading the overview tables 2.2, 2.3 and 2.4

The overview tables in section 2.1 of this annual report aim to provide a comprehensive view of the status and the various steps under the Stability and Growth Pact of the euro area Member States for the reference period, 2016. All overview tables are organised by columns that follow the annual cycle of fiscal surveillance.

Table 2.2. Application of EU fiscal rules in euro area in 2016: The preventive arm

**Column 1** – Distance to MTO: the difference between the country-specific medium-term objective (MTO) and the structural balance in 2015 on the basis of the spring 2015 Commission forecasts underpinning the July 2015 country-specific recommendations by the Council.

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

**Column 3** – Flexibility clauses granted ex-ante: an allowance for a reduction in the structural adjustment the country is required to deliver, granted for 2016 in the context of the assessment of the Stability Programmes in spring 2015. A Member State can be granted flexibility for structural reforms – including the specific case of pension reforms; for investments; or for the impact of adverse economic events outside its control – such as natural disasters or the refugee crisis. For example, the required structural adjustment for Italy of 0.1 percentage point of GDP in 2016 was after the 0.4 percentage point allowance under the structural reform clause had been deducted. For a comprehensive presentation of how flexibility is taken into account, see Vade Mecum sections 1.3.2.3, 1.3.2.4, 1.3.2.5.

**Column 4** – Commission overall assessment of the 2016 Draft Budgetary Plans (DBP): was issued in autumn 2015 in line with Regulation (EU) 473/2013. Every year, all euro area countries submit their DBPs by 15 October except when under a macroeconomic adjustment programme (in our reference period, Greece and Cyprus). They are assessed for (ex-ante) compliance with the provisions of the SGP. The overall conclusion of the Commission can be: compliant, risk of (some) deviation (\(^2\)) or risk of significant deviation. In case of risk of some deviation, the DBP is considered to be "broadly compliant", while in case of risk of significant deviation, the DBP is considered as non-compliant. For a comprehensive presentation of the assessment of compliance with the preventive arm of the SGP, see Vade Mecum section 1.3.2.7.

**Column 5** – Steps taken during the reference period: records procedural or other steps taken under the preventive arm of the SGP between autumn 2015 and spring 2017. For 2016, in the absence of other procedural steps taken between the DBPs assessment and spring 2017, the only information presented in this column covers cases of ‘unfreezing’. This is the term used to describe the change of the adjustment requirement to the MTO, as the Member State was found to be closer to their respective MTO in 2016 \((t)\), than expected in spring 2015 \((t-1)\) when the requirement was set and which had it been delivered it would have implied an overachievement of the MTO.

**Column 6** – Observed change in the structural balance: presents the estimated structural adjustment delivered in 2016. The assessment is done by comparing the actual change in the structural balance to the required adjustment path as a reference, including an assessment of compliance with the expenditure benchmark. If both indicators confirm the required adjustment, the overall conclusion is of compliance with the preventive arm. In all other cases, the conclusion will depend on an “overall assessment”, which includes an in-depth analysis of both indicators, see Vade Mecum section 2.

**Column 7** - Flexibility and unusual event clauses granted ex-post: includes any flexibility clauses that are granted for 2016 in the context of the assessment of the Stability Programmes in spring 2017.

\(^1\) The "Required Structural Adjustment based on matrix" is based on the matrix for specifying the annual adjustment towards the MTO under the preventive arm of the Pact, as presented in the Commonly Agreed Position on Flexibility in the SGP endorsed by the ECOFIN Council of 12 February 2016 and in the SGP Code of Conduct.

\(^2\) “Some” deviation refers to any deviation which is not significant, namely below 0.5 – as expressed by articles 6(3) and 10(3) of Regulation 1466/97.

(Continued on the next page)
Box 2.1 (continued)

**Column 8 - Procedural steps after the reference period:** records procedural or other steps taken following the spring 2017 assessment. For those cases where the country seems not to have delivered the requirements but no procedural steps to have been taken, an explanation is provided.

Table 2.3. Application of EU fiscal rules in euro area in 2016 - The corrective arm: Countries not in EDP

**Column 1 - Deficit Rule:** the Commission's assessment of the Member State's 2016 Draft Budgetary Plans (†) compliance with the 3% of GDP deficit criterion in autumn 2015.

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

**Column 3 - Procedural steps taken during the reference period:** records procedural or other steps under the corrective arm of the SGP taken between autumn 2015 and spring 2017. For 2016, this column presents Reports on the basis of Article 126 (3) TFEU, which is the first step in the EDP, analysing compliance with the deficit and debt criterion in the Treaty.

**Column 4 – Deficit Rule:** see column 1 of this table.

**Column 5 - Debt Rule (DR) / Transitional Arrangement (MLSA):** see column 2 of this table.

**Column 6 - Procedural steps after the reference period:** see Table 2.2 column 8.

Table 2.4. Application of EU fiscal rules in euro area in 2016 - The corrective arm: Countries in EDP

**Column 1 - EDP status (deadline):** presents the country's status in the EDP procedure in July 2015 and in brackets, the deadline set by the Council for the correction of the excessive deficit.

**Column 2 – Headline Budget Balance:** the Council recommends to Member States in EDP to deliver annual headline deficit targets in order to ensure the correction of the excessive deficit within a set deadline. This column presents the required headline budget balance for 2016.

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

**Column 4 - Commission assessment of 2016 Draft Budgetary Plans:** see Table 2.2 – column 4.

**Column 5 - Procedural steps taken during the reference period:** covers all steps taken under the corrective arm of the SGP in the period between autumn 2015 and spring 2017. All Articles referred to in this column are of the Treaty on the Functioning of the European Union.

**Column 6 - Headline budget balance:** presents the headline budget balance outturn in 2016 or informs that the excessive deficit has been corrected.

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

**Column 8 - Procedural steps after the reference period:** see Table 2.2 column 8.

3. INDEPENDENT FISCAL INSTITUTIONS

The establishment of independent fiscal institutions (IFIs) at the national level has been among the most significant innovations to have accompanied the reforms of the EU’s fiscal governance framework that were implemented in the aftermath of the global financial crisis. The surge in government deficits and debts during the recent crisis brought to the fore the potential benefits of IFIs. Among these benefits is the capacity of IFIs to raise the level and quality of the public debate on fiscal policy choices, which helps promote greater transparency and, in turn, greater accountability in the area of budgetary policies. As such, IFIs raise reputational costs for governments pursuing imprudent fiscal policies.

Today, IFIs are an integral part of the domestic institutional setup in almost all the EU Member States. Economic advisory councils have existed for a long time in countries such as Austria (1927), the Netherlands (1945), Belgium (1959), and Denmark (1962) as part of the national economic governance framework, but were not involved in assessing national fiscal policies vis-à-vis EU rules. While fiscal decision-making remains the ultimate responsibility of national governments, the IFIs have an important oversight and advisory role. In doing so, well-designed IFIs help improve the effectiveness of the EU’s fiscal framework and contribute to the smooth functioning of the Economic and Monetary Union (EMU) by promoting sound and predictable fiscal policies in the Member States. The tasks entrusted to national IFIs, such as preparing or endorsing macroeconomic forecasts underpinning budgetary planning as well as monitoring compliance with fiscal rules, can help address biases towards spending and deficits.

Empirical evidence suggests that the enforcement of the rule-based EU’s fiscal framework in the pre-crisis period led to rather uneven and sub-optimal outcomes. The successive reforms of the fiscal governance framework tried to address this concern via a battery of institutional arrangements, such as the setting up of IFIs. In essence, the IFIs are meant to complement fiscal rules, not substitute them, by providing an independent voice on their implementation. Empirical analysis also indicates that the effectiveness of IFIs, in combination with credible rules, is considerably stronger in countries where the government efficiency is at sufficiently high levels. Recent empirical analysis shows that IFIs can help reduce the over-optimistic bias in fiscal forecasting and increase the precision of fiscal forecasts. In addition, Beetsma et al. (2017) also find tentative evidence that the presence of IFIs promotes compliance with budget-balance rules and expenditure rules.

The IFIs vary significantly across the EU Member States in terms of their design, scope, and mandate. This heterogeneity is mainly determined by pre-existing institutional setups prevailing at the national level, including local traditions, historical experiences and country-specific policy challenges. Although national specificities are to be acknowledged in the setup of IFIs, there is also a need to ensure that they enjoy a basic degree of effectiveness and leverage vis-à-vis national governments.

The broad panorama of IFIs offers a unique opportunity to draw lessons of good practice, in line with the mandate of the European Fiscal Board. However, providing a full and comprehensive review of all EU IFIs is a daunting task that goes beyond the scope of this report. Rather, this section takes a selective approach. It first presents a portrait of two specific IFIs – the Irish and the Dutch - with the objective to identify elements of best practice.

The Irish Fiscal Advisory Council is an interesting case because it was built on a broad national consensus matured on the back of a deep financial economic crisis stressing the importance of independent scrutiny of public finances. Another element that proved instrumental in its success is its targeted and confined mandate, which for a young institution is probably a better choice than a wide spectrum of tasks.

The CPB Netherlands Bureau for Economic Policy Analysis offers other valuable lessons. The influence of a prominent founding father has a long-lasting effect on the prestige of an advisory body. Its initial success and impartiality combined with a solid track record in the early history of the institution seem to have been instrumental in the gradual expansion of its tasks beyond the boundaries of a traditional IFI.

This section finally zooms in on a cross-cutting dimension that plays a key role in shaping the effectiveness of all IFIs, namely the comply-and-explain principle. This part will look at the application of this principle at the national level, distilling some positive and negative aspects of implementation. In all, a strong case can be made for strengthening the IFIs’ legal standing on the national arena to ensure governments respond formally and publicly to the issues they raise. In particular, consideration could be given to:

be given to a more extensive and wide-ranging application of this principle, including specific details clarifying the nature of recommendations that fall under the comply-or-explain provisions, and the use of pre-defined deadlines for the government to react to IFIs' assessments in a detailed manner could be considered.

3.1. TWO ILLUSTRATIVE CASES: IRELAND AND THE NETHERLANDS

The Irish Fiscal Advisory Council (IFAC) and the CPB Netherlands Bureau for Economic Policy Analysis (henceforth referred to as the CPB) are both unique and typical within the spectrum of IFIs in the EU. The IFAC stands out as a young small and effective IFI that is representative of the new cohort of IFIs established in response to the 2010 sovereign debt crisis, and with a focused and confined mandate. By contrast, the CPB is one of the longest-serving IFIs in Europe and internationally, covering a vast range of tasks and is considered a role model for its credibility and high-quality economic analysis.

The experience with IFIs in the EU is arguably too limited and their heterogeneity too large to envisage an encompassing and robust measurement of their individual effectiveness. Keeping this in mind, some attempts to quantify the effectiveness of individual IFIs were nonetheless made. One prominent example is the indicator by Horvath (56), which encompasses seven elements to measure effectiveness. These are: (i) the breadth of the mandate; (ii) financial resources; (iii) human awareness; (iv) access to information; (v) public reaction from government; and (vi) relationship with Parliament. According to this indicator, the CPB ranks first as the most effective IFI in the EU, while the IFAC is within the upper half. The two IFIs score particularly well on public awareness and the government’s reaction to their opinions or recommendations. Moreover, Beetsma and Debrun’s signal-enhancing capacity index reveals that both IFIs are in the top third of the fiscal councils analysed for their a priori ability to provide clear and consistent signals about fiscal policy while acting in full independence from politics (57). The index is built around four components: (i) the breadth of the mandate; (ii) the ability to communicate to the public; (iii) the possibility to directly interact with participants in the budget process; and (iv) the independence from politics.

**The Irish Fiscal Advisory Council**

The IFAC is a good example of a fairly young IFI that managed to establish itself in a relatively limited period of time as a credible and effective part of the national fiscal framework. (58) The creation of the IFAC was part of the comprehensive policy response to the deep economic and financial crisis Ireland experienced after the credit and property bubble burst in 2008. The government’s aim in setting up the IFAC was to restore its credibility in the area of fiscal policy-making by adding an independent assessor. The design and *modus operandi* of the IFAC were heavily influenced by the local needs and the national institutional environment, as well as by established international practice. While no particular model was followed, its design (in terms of structure and advisory role) resembles that of the Swedish Fiscal Council.

The Council was launched on an interim basis in July 2011 as part of a larger package of significant economic and budgetary reforms under the EU-IMF financial assistance programme. (57) The creation of an independent fiscal advisory council was actually one of the structural benchmarks of the financial assistance programme. In line with the proposal in the government’s National Recovery Plan 2011-14, the programme called for the “establishment of a budget advisory council to provide an independent assessment of the government’s budgetary position and forecasts”.

The IFAC was put on a statutory basis under the Fiscal Responsibility Act of 2012, which aimed to introduce a new set of national fiscal rules, strengthening institutions, and increase transparency. The new Act entrusted the IFAC with a specific and well-defined set of tasks: (i) namely to assess and endorse the government’s macroeconomic forecasts underpinning each budget and stability programme; (ii) to assess the fiscal forecasts and the fiscal stance; and (iii) to monitor compliance with legislated fiscal rules. (59)

Compared with other EU IFIs, the IFAC is a relatively small council in terms of both its human resources and funding. There are five part-time council members, supported by a secretariat with a staff of five, including administrative personnel. The IFAC’s annual budget is capped at approximately EUR 800,000 indexed for inflation. This puts the IFAC in the same league as other European fiscal councils, such as Sweden, Finland, or

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57 For more details, see Beetsma and Debrun (2016).
Estonia, which operate on a budget of one million euro or less per year. The small size of the IFAC mainly reflects the scope of its specific mandate, which is targeted on its fiscal monitoring functions.

The IFAC has successfully overcome the common challenges associated with newly-created institutions, namely recognition and adequate attention from the general public, which are the necessary ingredients of building up institutional credibility and trust. This was achieved thanks to sound, authoritative and independent analysis pinpointing specific issues in government fiscal policy practice.

However, from the outset some tensions between the IFAC and the government arose over its stance on key fiscal policies. The build-up of these tensions is rather common for newly-created IFIs that became openly critical and issued strong value judgements against government's fiscal policy. This highlights the narrow path that these IFIs must walk between performing their watchdog function, which often entails criticizing the government, and protecting itself from the challenges this criticism can pose for its independence.

In its Pre-Budget 2016 Statement to the Parliament, the IFAC was of the opinion that the future pressures on the public finances should be accounted for in the government's budget plan. The IFAC also made the case for the provision of a reliable and regular tax base that is crucial for the government to deliver on its proposed commitments. Furthermore, the IFAC examined the government's forecasting approach used for corporation tax revenues and looked into the broader implications for medium-term expenditure planning of the associated problems in forecasting these receipts.

The IFAC expressed its concerns over the quality of the medium-term budgetary forecasts released by the government in 2016. In particular, it pointed out that the projections for deficit and debt were not realistic as they were based on purely technical assumptions, without encompassing the government's stated policy commitments. The opinion issued by the IFAC triggered a response from the government, which took these suggestions on board and incorporated the future policy intentions in its projections for the 2017 Budget.

The council’s ability to provide clear and consistent signals about fiscal policy is reflected in Horvath's public awareness indicator, as well as in the measure of signal-enhancement capacity developed by Beetsma and Debrun. This signalling role is highly relevant for an IFI, given that its influence is in primis dissuasive, translating into higher reputational costs to a government pursuing inappropriate fiscal policies.

In preparing its position, the IFAC has had relatively good and prompt access to the relevant information from the Department of Finance, including methodology and assumptions underlying the budget and other fiscal proposals. Nonetheless, in order to reduce further the asymmetry of information and increase its efficiency, the IFAC could potentially be offered stronger (statutory) rights to obtain information from all relevant public actors. According to an external evaluation conducted in 2015, this issue could be achieved via memoranda of understanding.

Initially, the government’s reaction to the opinions issued by the IFAC was rather limited. The situation has gradually improved over time; more detailed responses to the IFAC’s analyses are currently included by the government in its formal letter responding to Fiscal Assessment Reports. More importantly, representatives of the IFAC have regularly appeared before the competent parliamentary committee to present the findings of recent reports. This practice directly contributes to the domestic policy debate as it takes place in a prominent public forum involving lawmakers from the full political spectrum represented in the legislature.

Some tentative lessons can be drawn from the Irish IFI. While recommended under the EU-IMF financial assistance programme of 2011-2013, the creation of the IFAC was home-grown. It was triggered by the impact of the deep economic and financial crisis and the understanding that public finances need to be managed in a more prudent and transparent way. Hence, the IFAC confirms the conclusion that the effectiveness of an IFI very much depends on the domestic understanding of the importance of independent scrutiny.

The experience of the IFAC shows that guaranteeing independence of an IFI in a hardened political environment that has grown more polarized as a result of the recent crisis is much easier to achieve when the institution is equipped with a clear and confined mandate. Operating under a targeted mandate and thus being focused on specific areas rather than operating across a broader spectrum of tasks also helps IFIs establish their credibility faster. In particular, it helps an IFI to produce a sizeable and high-quality track record.

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For more details, see the Pre-Budget 2016 Statement.

See Casey and Hannon (2016).

See the Fiscal Assessment Reports of November 2015 and November 2016.

See Beetsma and Debrun (2016).

Jonung et al. (2015).
at the start of its lifecycle that stands up to public scrutiny and ensures its visibility.

The CPB Netherlands Bureau for Economic Policy Analysis

The CPB is one of the most prominent and longstanding benchmark cases of authoritative independent advisory bodies in Europe. (64) It was established in 1945 by the Nobel laureate Jan Tinbergen, who served as director until 1955. Under his leadership, the CPB developed the first set of macro models for analysing and forecasting the Dutch economy with the aim of aiding policy making. His fundamental contribution helped the CPB to become the leading economic planning and forecasting agency in the Netherlands as well as a reference for other countries.

The CPB managed to safeguard its reputation for independence over time not least by sticking to Tinbergen’s initial formula of producing impartial, high-quality analysis and forecasts. (65) This formula has helped the CPB to build up a strong brand that carries considerable weight in the public debate and provides a point of reference for all discussions on economic policy in the Netherlands.

The CPB is institutionally attached to the Ministry of Economic Affairs but enjoys full operational independence (66), including extensive autonomy over its annual work programme. Since 2012, the independence of the CPB is formally safeguarded in secondary legislation which bars its staff from seeking or taking instructions from any political actors or government branches. (67) The government legally anchored the CPB as the national independent forecaster in the context of the Fiscal Compact and the Two-Pack. (68)

The assessment of whether domestic fiscal policy complies with national and, where relevant, with EU law has been delegated by the government to the Advisory Division of the Council of State (Raad van State). By choosing this institutional arrangement, the government preserved the original model of the CPB which focuses on the assessment of economic developments and policies, including fiscal policy, and contributes to sound economic policy-making through impartial analyses and forecasts.

As an independent supervisory body, the Council of State has issued opinions on national budgetary practice and procedure since 1906. Since 2014, and in response to the Six-Pack and Two-Pack reforms of the Stability and Growth Pact, the Council of State has also been tasked with assessing the government’s correction plans in case of non-compliance with EU rules. Its first advice on the compliance of the national budget with the EU’s fiscal rules was released in September 2014. The CPB is only indirectly involved in the process of compliance monitoring, mainly through economic calculations concerning public finances. (69)

The reports by the Council of State are increasingly being cited in the media and have found their way into the public debate. In 2015 for instance, the Council of State was the first domestic authority to warn that the tax cuts proposed by the government for the 2016 Budget would require corrective measures in 2017. This information was based on the forecast produced by the CPB.

The CPB has a much broader scope and a less formalised mandate than other IFIs. The CPB’s remit covers a wide range of economic research activities that feed into the decision-making processes of the government, policy-makers and political parties. In the run-up to each election, the CPB provides an insight into the broad economic consequences of the political manifestos, using the same benchmark for every party. (70) This voluntary function provides a common denominator for the political debate in line with the expectations of the voters. It also has the advantage of making party manifestos much more specific and accurate. Moreover, once the elections have taken place and a new government is formed, the CPB also makes an analysis of the coalition agreement. By way of example, in 2016, the CPB worked on assessing election platforms for the period 2018-2021. (71) The CPB also looked into the fiscal policy options to be considered by the next government, for example on government balance and the debt ratio, and provided an assessment of the long-term sustainability of public finances.

References:

(64) See https://www.cpb.nl.
(65) See Beetsma et al. (2013).
(66) For more details, see the Ministerial Order Aanwijzingen voor de Planbureaus, 1 April 2012.
(67) Only the Central Planning Committee (Centrale Plan Commissie) and ministers have some ‘say’ on the work programme, as far as this is considered ‘reasonable’.
(68) The CPB’s core forecast publications include the Central Economic Plan, published in spring, and the Macro Economic Outlook, published in September, jointly with the government’s Annual Budget.

(69) The Council of State can also request economic analyses and reports from the CPB to carry out its mandate. See the Working Arrangements with CPB.
(70) This practice dates back to 1986. The CPB however strictly refrains from providing ‘normative’ statements on the election platforms.
(72) See the policy brief available at: http://www.cpb.nl/publicatie/opties-voor-begrotingsbeleid
The CPB conducts in-depth analysis of major areas of government revenue and expenditure, e.g. social security, healthcare, education, housing and taxation that indirectly contributes to policy-making. Its reports on the forward-looking sustainability of Dutch public finance account for the generational distribution of burdens and benefits using a lifecycle approach. An analysis conducted by the CPB in 2016 investigates the relation between long-term care expenditures, household composition and income over the lifecycle. (7)

A mature IFI like the CPB also provides analysis on the differences between the national budgetary framework and the European fiscal rules. For example, in 2016, the CPB compared the Dutch sustainability gap (bouthaardheidssaldo) with the European long-term sustainability indicator. The comparison revealed some differences, mainly on the treatment of policy announcements or measures that are still to be implemented (8). In particular, under the assumption of no policy changes, the European projections included only measures for which there is sufficient information to provide a reasonable and credible basis for the listing.

The CPB also undertakes cost-benefit analyses of major infrastructure projects, analysis of proposed policy measures, scenario studies and policy-relevant economic research. (9) In addition to serving the government, the CPB also has the mandate of carrying out research at its own initiative, as well as meeting requests for specific analyses from a variety of other stakeholders, such as the Parliament, opposition parties, and trade unions. (10)

This array of tasks and functions involves a considerable amount of resources. The CPB's full-time staff numbers about 130, of which roughly 100 are economists or public policy analysts with advanced university degrees. (7) They are recruited, remunerated and dismissed according to the Dutch civil service regulations. (7) The CPB employees regularly publish in academic journals or internal peer-reviewed publication series.

Some possible lessons could be drawn from CPB's 70 years of existence. In the spectrum of IFIs, the CPB is a very seasoned and trusted institution, whose credibility was built over time on the back of highly professional activity starting with the initial contribution of Tinbergen. His initial influence in the CPB was paramount in establishing an early reputation of undisputed scientific quality and independence. This suggests that a very renowned founding director can have a long-lasting impact on the prestige of an advisory body.

Early on, the CPB has established a strong position in Dutch policy-making through a solid track record of high-quality and impartial economic analysis and forecasting. This achievement paved the way for a progressive expansion of tasks and areas of analysis. Over time, the CPB has exceeded the traditional boundaries of an IFI, as it also acts as a generally respected think tank or academic research institute. The expansion of tasks would have been much more difficult, or might have failed, if the CPB had not succeeded in establishing a good track record on its original tasks. Finally, the CPB's initial success and impartiality can also be seen as a precondition for the Dutch Government's increasingly rely on it to enhance its credibility in economic policy-making. In combination with extensive checks and balances in the political system, which ensure that the decision to override the views of an independent institution is not the prerogative of a single actor, the costs of ignoring the views of an independent institution also increase with its credibility.

3.2. COMPLY-OR-EXPLAIN PRINCIPLE

National IFIs in the EU are advisory bodies; their assessments and opinions are directed at fiscal policymakers who can take them into account in their deliberations. One way to enhance the advisory role of national IFIs while preserving governments' prerogative to take fiscal policy decisions is through the comply-or-explain principle, i.e. an obligation for a government to publicly explain the reasons for deviating from an advice issued by an IFI.

The fiscal governance framework of the euro area includes elements of the comply-or-explain principle, but its legal underpinning is relatively weak. The Fiscal Compact of 2012, as enshrined in the TSCG was built around the balanced-budget rule, the observance of which is to be monitored by national independent fiscal institutions (referred to as fiscal councils). Furthermore, the Fiscal Compact authorized the Commission to develop common principles on the role and independence of these monitoring institutions, which were later endorsed by the finance ministers of the signatory parties. (11) These common principles for fiscal

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(7) See Hussem et al. (2016).
(8) Vierke and Masselink (2017).
(9) See the CPB's various publication outlets, such as Policy Briefs, Discussion Papers, and Background Documents.
(11) See the 2017 CPB Work Programme.
(12) Horvath's score for employees per task ranks the CPB at the very top.
councils included *inter alia* the comply-or-explain principle. However, although Regulation (EU) 473/2013 of the Two-Pack gave IFIs a formal role in official forecasting (by producing forecasts or endorsing the government’s forecasts) and monitoring of compliance with the fiscal rules in euro area Member States, it failed to formally acknowledge the comply-or-explain principle.

Nevertheless, most Member States which are contracting parties to the Fiscal Compact have incorporated some elements of the comply-or-explain principle into their domestic legal frameworks. The legal requirement laid down by the Fiscal Compact is relatively narrow, and applies only to: (i) the activation of the correction mechanism; (ii) monitoring the correction process; and (iii) escape clauses in relation to the budget-balance rule of the TSCG. However, a minority of Member States decided to define and establish their own particular comply-or-explain arrangements covering other national numerical fiscal rules, which occasionally exceed the remit of checking compliance with the fiscal rules. (80) In other countries, such as Luxembourg, there is no explicit legal anchor for the comply-or-explain principle.

The most powerful influence of the comply-or-explain principle is via the public debate it triggers. In particular, the activation of the explain part puts pressure on decision-makers to act transparently and responsibly in fiscal matters. This ultimately helps operationalise the enhanced transparency and accountability that comes with the scrutiny from IFIs. Once established and accepted, the comply-or-explain principle ideally plays a pre-emptive role, as decision-makers internalize the potential confrontation with the IFIs in their proposals. Such scrutiny has the advantage of transforming itself into a routine that is anticipated by the media and the public.

To date, the practical implementation of the comply-or-explain principle has raised a few significant challenges that hinder its potential for increasing the visibility and quality of fiscal policy debates. (81)

- The experience to date has shown that the written reply to the IFI’s opinions should be submitted and published in a reasonable amount of time, so as to maintain its relevance and attention for the media. In a few Member States, the legislation sets a specific timeframe for responses from the government, which typically ranges from one week to a month. (82)

- The reply should contain all the relevant information, including the proper degree of detail, to ensure its full effectiveness. The current legislation falls short on provisions on the content or extent of the response. However, a small number of IFIs such as the Spanish AIReF issued their own regulation clarifying the specific nature of recommendations.

- The response should be clear, precise and convincing, in order to facilitate the public discussion. These challenges are mainly rooted in local deficiencies, more specifically in the culture of transparency and accountability.

Similarly, the effectiveness of the comply-or-explain principle can be strengthened through the dissemination of views in parliamentary testimonies/hearings or other formal public arrangements. The distribution of observations using these channels gives rise to public pressure, which can induce the government to behave transparently and responsibly. More than two thirds of EU IFIs send their key reports to the legislature and provide evidence in parliamentary hearings. (83)

The comply-or-explain principle is a relatively new tool in the IFI’s toolbox. However, in the relatively few cases when its activation was necessary based on national comply-or-explain provisions or government commitments to apply this principle, it shows rather positive outcomes. For example, the independent assessment of the economic and financial document for 2016 conducted by the Italian Parliamentary Budget Office (UPB) showed some discrepancies with the government projections. Later on, these concerns were factored in by the government and ultimately the forecast was endorsed by the UPB. Similarly, the Slovak Council for Budget Responsibility (CBR), unlike the Ministry of Finance, concluded in its report/opinion that a significant deviation from the MTO or the adjustment path to it occurred in 2015. As required by law, the government adopted a position on the fiscal council’s assessment and issued a report explaining why it decided to ignore the findings of the CBR. Likewise, the French High Council of Public Finances (HCPF) expressed its formal reservations about the 2016 Draft Budget. (84) The government issued no official

(80) For example, in Spain, the so-called Organic Law (6/2013) on the creation of the Independent Authority for Fiscal Responsibility (AIReF) established a broad requirement which requires the government to formally respond if it disagrees with the AIReF reports.

(81) As reflected in the 2016 survey conducted by the Network of EU IFIs. For more information, see Comply or Explain Survey — EU IFIs.

(82) In the case of Ireland and Malta, the government has a two-month deadline in which to respond formally.

(83) See Jankovics and Sherwood (2017).

(84) See the Opinion of the HCPF on the Budget Bill for 2016, available at:
explanation but tried to address some of these concerns in the Stability Programme Update. Other IFIs, such as the Spanish Independent Authority for Fiscal Responsibility (AIReF) or the Malta Fiscal Advisory Council (MFAC) forced their respective governments to improve the rate of responses on budgetary risks. This progress is also reflected in the 2016 survey conducted by the EU Network of Independent Fiscal Institutions (EUNIFI), which shows an overall increase in the frequency of the government's reactions to IFI assessments. However, in most cases, the implementation of the comply-or-explain principle is still dependent on the good will of the government.

Given the current practice, there remains a need to anchor the comply-or-explain provisions in national legislation. A more extensive and wide-ranging application of this principle will improve the IFI's position vis-à-vis national governments. Furthermore, this explicit legal basis should include clarifying the nature, process and outcome of recommendations that fall under the comply-or-explain provisions, and the use of pre-defined deadlines for the government to respond to IFIs' assessments should be part of this explicit legal basis. A long-term evolution of this principle could be to allow IFIs to have the right of legislative initiative on issues related to their specific mandate. For example, where there is a breach of fiscal rules, the IFIs could be given the right to propose budgetary amendments to the Parliament.

http://www.hcfp.fr/content/download/266/1549/version%20/3/file/Opinion+of+the+high+council+of+public+finance+on%20the+budget+bill+for+2016.pdf
4. ASSESSMENT OF THE FISCAL STANCE IN 2016

Assessing the fiscal stance from an aggregate perspective is relevant in the Economic and Monetary Union (EMU). The aftermath of the post-2007 economic and financial crisis has shown that the aggregation of national fiscal policies carried out under the current economic governance framework does not necessarily result in an appropriate fiscal stance for the euro area as a whole. When fiscal policy making is decentralised, individual Member States do not take into account the effects of budgetary policies beyond national borders and/or may face narrow domestic sustainability constraints that limit their capacity to resist cyclical winds in an appropriate manner.

This section assesses the fiscal stance observed in 2016 in the euro area as a whole and in individual Member States. The assessment is carried out against both the policy guidance given at the time and the economic situation observed ex post, i.e. on the basis of outcome data. (3) The fiscal stance describes the orientation — expansionary, neutral or restrictive — that a government’s discretionary decisions may give to fiscal policy (Box 4.1). Whether this is appropriate or not depends on the assessment of cyclical conditions (Box 4.2) and of risks to the sustainability of public finances (Box 4.3).

Evaluating the fiscal stance ex post raises three questions: first, did the expectations of autumn 2015 on the macroeconomic outlook in 2016 materialise? Second, with the benefit of hindsight, was the guidance given in 2015 the right one? And third, how did national fiscal stances and the aggregate fiscal stance compare to what is deemed appropriate?

In contrast, national fiscal policies did not entirely reflect the policy guidance that had been issued to Member States. Member States with fiscal space did not use it fully while countries without fiscal space recorded budgetary slippages or made extensive use of the flexibility granted under the Stability and Growth Pact (SGP).

The SGP would have allowed for additional fiscal support in 2016 if Member States with fiscal space had made full use of it. Such additional support would still have been defensible in light of the significant degree of economic slack in the euro area economy. However, while the fiscal stance in 2016 may not have been as expansionary as it could have been, one needs to keep in mind the intertemporal dimension. If the countries with fiscal space had fully used it in the course of 2016, no ammunition would have been left for the subsequent years. In particular, the fiscal stance in 2017 could not have been expansionary while the guidance given by the Commission for that year called for a fiscal expansion in the euro area as a whole.

4.1. PROJECTIONS AND OUTFLOW

In autumn 2015, when the Commission issued policy guidance for the euro area for 2016, the macroeconomic outlook for 2016 was expected to improve with risks very much tilted to the downside. Based on the Commission 2015 autumn forecast (Table 4.1), growth was expected to increase somewhat, but output was still seen as significantly below potential for the eighth consecutive year, including a double-dip recession. Beyond the output gap, additional indicators pointed to persistent slack in the economy. Inflation (in terms of HICP) was expected to pick up, while remaining well below the ECB’s reference target. Some improvement was also expected on the labour market, but with the unemployment rate remaining above 10% in the euro area and long-term unemployment affecting more than 5% of the labour force in 2015.

The fiscal outlook pointed to a somewhat expansionary fiscal stance. The headline deficit was expected to decline to 1.8% of GDP in the euro area as a whole, mainly thanks to the expected improvement of economic conditions. By contrast, some deterioration was expected for the structural primary balance. The debt ratio was expected to go down somewhat from a very high level of more than 90% of GDP.

The assessment of sustainability suggested limited risks in the short term, as shown by the Commission's S0 indicator pointing to low risks in all Member States, and with narrower sovereign bond yield spreads indicating reduced tensions on financial markets (see Box 4.3). At the same time, both the S1 indicator and the Commission’s debt sustainability analysis pointed out that in several Member States, there were high risks to the sustainability of public finances in the medium term.

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

<table>
<thead>
<tr>
<th></th>
<th>Real GDP growth</th>
<th>Inflation</th>
<th>Output gap</th>
<th>Unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>EA-19</td>
<td>1.6</td>
<td>1.8</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>DE</td>
<td>1.7</td>
<td>1.9</td>
<td>1.7</td>
<td>1.9</td>
</tr>
<tr>
<td>FR</td>
<td>1.1</td>
<td>1.4</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>IT</td>
<td>0.9</td>
<td>1.5</td>
<td>0.8</td>
<td>0.9</td>
</tr>
<tr>
<td>ES</td>
<td>3.1</td>
<td>2.7</td>
<td>3.2</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Source: European Commission.

Monetary policy was very accommodative and was expected to remain so. Despite the very low interest rate, credit growth and investment remained subdued. This led to the observation that monetary policy was reaching its limits and that fiscal policies needed to play a role in supporting demand too, especially as, in a zero lower bound environment, the multiplier effect of fiscal policy is amplified by the absence of rising interest rates.

As indicated in Section 2.1 above, actual data for 2016, as included in the Commission 2017 spring forecast, confirmed the projections of a moderate economic recovery. Notable differences between projections and outturns were that inflation turned out much lower than expected, while unemployment declined more rapidly than expected. Real GDP growth in 2016 was in line with the expectations, but from a higher starting point due to a significant upward revision for 2015. (\(^{4}\)) As a result, at the aggregate level the debt ratio came in slightly below forecasts both in 2015 and 2016.

The headline deficit ratio at the aggregate level turned out slightly lower than had been expected in autumn 2015. This was mainly due to a revision of the impact of one-off factors in 2015 and to lower-than-expected interest payments as a result of very low policy rates (Graph 4.1). (\(^{5}\)) By contrast, the two other components evolved in line with expectations, i.e. the structural primary balance deteriorated slightly and the cyclical component weighed less on the headline balance in 2016 than in 2015.

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\(^{4}\) This was mainly due to the major upward revision to real GDP growth in Ireland to 26.3%.

\(^{5}\) In autumn 2015, one-off factors were expected to marginally improve the budget balance in 2015 and to no longer have any impact at aggregate level in 2016. What actually happened was that they deteriorated the budget balance in 2015. By contrast, the absence of aggregate impact in 2016 was confirmed.

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4.2. ASSESSMENT OF THE FISCAL STANCE IN 2016

4.2.1. Guidance given in 2015

In 2015 the Commission and the Council issued prospective assessments both in spring — when the Council adopted a recommendation addressed to the euro area Member States on the basis of a Commission proposal — and in autumn, after Member States submitted their draft budgetary plans for 2016.

On 13 May 2015 the Commission recommendation for a Council recommendation to euro area Member States did not explicitly call for a particular fiscal stance but called on the countries to “coordinate fiscal policies to ensure that the aggregate euro area fiscal stance is in line with sustainability risks and cyclical conditions”, (\(^{6}\)) This

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\(^{6}\) It also called for a growth-friendly composition of fiscal policies, in particular “improvements in the quality and sustainability of public finances”, “the prioritisation of … investment” and “making tax systems more growth friendly”, See http://eur.
recommendation was adopted by the Council on 14 July 2015, with the addition that this was “without prejudice to the fulfilment of the requirements of the SGP”. (89)

The guidance given in autumn 2015 went in the direction of a broadly neutral fiscal stance at the aggregate level. Both the Commission and the Council considered that such a stance would strike an appropriate balance between improving the long-term sustainability of public finances and reducing the negative output gap in the short term, also taking into account the requirements under the SGP. The Commission's overall assessment of DBPs published on 16 November 2015 noted that “some moderate consolidation in 2016, as required in the country-specific recommendations and suggested by sustainability indicators, would be consistent with a reduction of the output gap” while “closing the output gap at a faster pace [might] be at the expense of improving sustainability and prove incompatible with compliance with the requirements under the SGP”. (90) At the same time, the Commission acknowledged the constraints faced by monetary policy to stabilise the economy, with “nominal interest rates ... already almost at the zero limit alongside very low inflation”, which placed “further emphasis upon the importance of fiscal policy”. The assessment concluded that, “balancing these two objectives [of stabilisation and sustainability], the largely neutral aggregate euro area fiscal stance expected for next year [appeared] broadly appropriate.” On 23 November 2015, the Eurogroup statement on the draft budgetary plans for 2016 agreed with the Commission that the “broadly neutral planned fiscal stance for the euro area as a whole in 2016 … [reflected] a balance between long-term fiscal sustainability and short-term macroeconomic stabilisation”. (91)

At the same time, the guidance also recommended differentiated national fiscal stances reflecting different fiscal positions. The Member States that had outperformed their MTO were invited to use their fiscal space to support growth, while those that were in the corrective arm of the SGP or had not yet reached their MTO were asked to meet their obligations under the Pact and to make the composition of their budgets more growth-friendly. The Eurogroup statement stressed that the expected composition was not appropriate, “with four Member States at risk of not meeting their current obligations under the Stability and Growth Pact (SGP) in 2016, and others outperforming their MTO.”

4.2.2. Ex-post assessment

The EFB’s assessment of the fiscal stance follows an economic reasoning that considers the need for discretionary fiscal stabilisation subject to the sustainability constraints of public finances (see Box 4.1). Alternative fiscal stances addressing these considerations, along with the fiscal requirements under the SGP, are reported in Graph 4.2, based on both the expectations of autumn 2015 (upper panel) and the outturn observed in spring 2017 (lower panel).

There is no single optimal target that would be relevant for all countries, neither for the desirable closure of the output gap nor for debt dynamics. To account for different situations from country to country and over time while providing consistent reference points, Graph 4.2 shows possible ranges for the fiscal stance within which the most relevant points could then be picked, with due account being given to country-specific needs. Starting with the stabilisation objective, a range of stylised policies is considered when the output gap has not closed yet, namely a moderate to fast stabilisation — i.e. closing the output gap by 25 % to 50 % within the reference year. (92) Outside these indicative standardised ranges, the relevant target can also be a neutral fiscal stance — i.e. no discretionary fiscal stabilisation — e.g. when the output gap has just closed or changed sign, or when the stabilisation provided by automatic fiscal stabilisers is sufficient. For the sake of readability, this is not reported in the graph.

Similarly, as regards sustainability constraints, the fiscal adjustment can be implemented at a constant pace over several years or frontloaded; when sustainability is already ensured, no consolidation is assumed to be needed. (93) To provide more background on whether sustainability is ensured or at risk in the various Member States, Graph 4.3 shows the assessment of risks according to four different indicators as measured in autumn 2015: (i) the S1 indicator, (ii) the Commission’s debt sustainability analysis, (iii) the distance to the MTO and (iv) the primary gap, which is an indicator similar to the debt rule (see Box 4.3).

Since growth forecasts for 2016 materialised to a large extent, for most countries, the analysis is broadly unchanged from an ex-post perspective. The ranges for

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

(90) For instance, a negative value of the S1 indicator in a given country does not imply that its structural primary position should deteriorate so that its debt ratio increases to 60 %; it only means that some leeway is available for fiscal stabilisation if needed.
Notes: The ranges for stabilisation are computed assuming a uniform fiscal multiplier of 0.8. S1 measures the total cumulative adjustment needed in 2016-2020 to bring the debt-to-GDP ratio to 60% of GDP by 2030. The lower panel uses the latest available update for S1 over the same adjustment period, as calculated by the Commission based on its 2016 spring forecast. The fiscal requirements under the SGP (red and white diamonds) are recalculated in terms of change in the structural primary balance to ensure comparability.

Source: European Commission, EFB calculations.
stabilisation calculated on the basis of both the Commission autumn 2015 forecast and outturn data in Graph 4.2 convey similar messages, with relatively minor updates. Similarly, the ranges for sustainability based on outturn data for 2015 largely confirm the assessment of autumn 2015. (56)

Based on this preliminary economic analysis, the guidance given by the Commission and the Council for the euro area as a whole falls well within the range that can be seen as appropriate, both in real time and with hindsight. The sustainability constraint suggested a need for some consolidation while stabilisation considerations suggested a need for a fiscal expansion.

The Commission’s and Council’s guidance was compatible with the SGP under the assumption that Member States with available fiscal space would use it to some extent. This conclusion is supported by the calculations reported in Graph 4.2. The graph shows the fiscal stance of individual countries and of the euro area as a whole for different readings of the SGP. Red diamonds indicate the most restrictive interpretation (57), which assumes that: (i) countries subject to an excessive deficit procedure (EDP) fully deliver the recommended structural adjustment; (ii) countries with fiscal space do not make any use of it, i.e. keep their structural balance unchanged; and (iii) countries under the preventive arm of the SGP do not make use of the flexibility and unusual event clauses. The white diamonds denote the least restrictive reading of the SGP which assumes that: (i) countries in EDP achieve the targets set for the nominal budget balance; (ii) countries standing above their MTO use all of their fiscal space; and (iii) flexibility and unusual event clauses apply, i.e. countries use the flexibility granted under the structural reform, investment or unusual events clauses. In this regard, it is important to note that the adjustment requirements changed for some Member States between the country specific recommendations (CSRs) of spring 2015 and the ex-post assessment in spring 2017 (see Section 2).

At the Member State level, the situation was quite diverse. In a majority of countries, sustainability constraints were not an obstacle to some stabilisation. (58) In a few countries, however, stabilisation needs would have required a neutral to expansionary fiscal stance, while risks to sustainability pointed to a restrictive stance; this was the case in Belgium, France, Italy, Austria, Portugal and Finland. For these countries and for the euro area as a whole, the most restrictive interpretation of SGP requirements would have given rise to a restrictive fiscal stance while the least restrictive reading would have offered some stabilisation.

Finally, in autumn 2015 many Member States were not expected to fully meet their fiscal requirements in 2016; this is shown by blue crosses located below the red and white diamonds in Graph 4.2a.

Overall, a somewhat expansive fiscal stance was appropriate from an economic perspective both ex ante and with hindsight in view of the remaining economic slack, and with due consideration for risks to sustainability. At the aggregate level, this provided some macroeconomic stabilisation, which was justified in light of the considerable amount of slack after a long and deep crisis and given the constraints faced by monetary policy. Sustainability considerations, on the other hand, largely reflect country-specific risks in the euro area and thus required differentiated national fiscal policies.

A slightly expansionary aggregate stance was also the most support that fiscal policies could provide within

Notes: This graph shows three quantitative indicators (S1, the distance to MTO and the primary gap) plus the risk classification resulting from the Commission’s debt sustainability analysis (DSA), except for the euro area as a whole for which the Commission does not publish a DSA. The graph shows the euro area on the left, followed by Member States grouped by risk category according to the DSA and ranked by increasing levels of S1. S1 is expressed in terms of structural primary balance, the distance to MTO in terms of structural balance and the primary gap in terms of primary balance. S1 measures the total cumulative adjustment needed in 2016-2020 to bring the debt-to-GDP ratio to 60% of GDP by 2030. A negative distance to the MTO means that the Member State is above its MTO. The primary gap measures the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over 60% of GDP at an annual pace of 3%.

Source: European Commission, EFB calculations.
the SGP. In spring 2015 the fiscal stance resulting from available projections — a deterioration of the structural primary balance of 0.2% of GDP — was close to the most expansionary stance possible within the fiscal rules (upper panel of Graph 4.4). Further margins were granted in the course of 2016, with new EDP recommendations for Spain and Portugal and additional allowances under the flexibility clauses for Italy. Of note was the decision to grant these margins to countries for which sustainability indicators pointed to higher medium-term risks than on average in the euro area. Additional margins were also granted ex post to several Member States in spring 2017 under the unusual event clause.

Taking these additional margins into account, the fiscal stance could have been even more expansionary if the Member States with available fiscal space had used it to a greater extent (Graph 4.4b). However, one should keep in mind in this regard that fiscal space can only be used once. If the countries with available fiscal space had fully used it in 2016 and returned to their MTO, they would no longer have had any fiscal space left for 2017, when the Commission called for an expansionary fiscal impulse for the euro area as a whole. This raises the question when to best use available fiscal space: (i) as an immediate one-shot use; (ii) gradually spread over several years; or (iii) postponed as a buffer for a future negative shock.

In conclusion, the aggregate fiscal stance was broadly appropriate in 2016 but its geographical composition was not optimal. The Member States with fiscal space used it only partially; one reason for this is that there is no enforceable obligation under the EU’s fiscal rules. At the same time, other Member States implemented — or would have needed to implement — some expansion to support demand without having the necessary fiscal space for it.

It is important to note that the calculations reported in this section do not include any spillover effects. Discretionary fiscal policies in some countries may actually have a non-negligible impact on the rest of the euro area, especially if fiscal shocks in several countries go in the same direction. Moreover, fiscal multipliers are considered to be larger at a time when monetary policy is constrained at the zero lower bound and does not counteract fiscal expansions as it would in normal times. Additional factors, such as confidence effects, may also play a role. Recent literature has turned to the issue of spillovers. In particular, a model-based analysis of fiscal policies in the euro area since 2007 suggested that, compared to what pre-crisis fiscal behaviour would have implied, fiscal policy has been more supportive of economic activity and the countries in the ‘periphery’ may have benefitted from fiscal stabilisation in the ‘core’ economies. (97) Conversely, empirical analysis finds that the simultaneous fiscal tightening of 2010-2013 in many countries generated sizeable negative spillovers in the euro area through the trade channel as it was not offset by monetary easing as in normal times. This negative impact was, however, largely counteracted by other factors. (98)

(97) see Callegari et al. (2017).
(98) See Attinasi et al. (2017).
Box 4.1: Assessing the appropriate fiscal stance

This box looks at the concept of the fiscal stance in general and examines its implementation for the euro area, also against the background of the EU’s fiscal framework.

What is the fiscal stance?

To maximise social welfare, fiscal policy is usually expected to stabilise economic activity around its potential level in a countercyclical manner, subject to an inter-temporal budget constraint. The fiscal stance describes the orientation that a government gives to fiscal policy in a given year. It is expansionary if additional structural spending is larger than additional structural revenue, thus providing stimulus to support aggregate demand. In the opposite case, the fiscal stance is restrictive, generally with the aim of safeguarding the sustainability of public finances or preventing overheating in a booming economy.

The fiscal stance is deemed appropriate if it provides the necessary and temporary amount of stabilisation given the prevailing cyclical conditions in the economy while safeguarding the sustainability of public finances. In particular, the fiscal stance is appropriate if: (i) it provides temporary support for growth without putting sustainability at risk when aggregate demand and employment are considered to be too low; and (ii) it is restrictive in the event of a booming economy or when sustainability risks arise.

Fiscal policy can stabilise the economy in two manners. One operates in a mechanical way, with certain budgetary items — the automatic fiscal stabilisers — evolving in line with economic activity. For instance, in a downturn, most tax revenues automatically decline while unemployment benefits increase, supporting domestic demand. The opposite developments mechanically happen in an upturn. The other way fiscal policy can stabilise activity is through the discretionary intervention of government. This includes, for instance, changing tax rates or the eligibility conditions for social transfers, and financing or cancelling new public investment projects.

Our focus in the analysis of the appropriate fiscal stance for the euro area is on discretionary fiscal policy. Unlike the operation of automatic stabilisers, discretionary decisions reflect active policy choices. Moreover, as they are not automatically reversed when cyclical conditions change, they affect the evolution of government debt and therefore the sustainability of public finances.

The analysis of discretionary fiscal policy is centred on the evolution of the structural balance. The structural budget balance is defined as the headline balance net of elements that do not have a lasting impact on public finances, i.e. the mechanical part that results from automatic stabilisers, and some temporary or one-off factors. The budget balance can also be corrected for interest payments, as they are not directly under the control of the current government. The resulting evolution corresponds to the change in the structural primary balance.

How can we tell if the fiscal stance is appropriate in the euro area?

The analysis of the optimal fiscal stance hinges on two separate assessments. First, an assessment of the cyclical situation of the economy (see Box 4.2) and the role played by other macroeconomic tools; this assessment can be used to determine to what extent the economy needs discretionary fiscal stabilisation. Second, an assessment of the sustainability of public finances (see Box 4.3), which is used to decide to what extent discretionary stabilisation is feasible or if sustainability is a more urgent concern.

Starting with the macroeconomic situation, the economy may need discretionary stabilisation if the level of activity is far from its potential. This can traditionally be shown by large output gaps. However, as available real-time estimates of the output gap are surrounded by considerable uncertainty, to get a more accurate picture it may prove useful to use complementary indicators, including the pace of inflation, the rate of unemployment and especially of long-term unemployment, and indicators of overheating, such as booms in certain sectors of the economy.

Outside periods of crisis, discretionary fiscal policy is generally not the most effective policy tool for stabilisation. One main obstacle is that fiscal policy measures tend to have an effect on the economy only with a time lag and may therefore miss their goal. Actually, the current governance framework in the euro area was meant to ensure a policy mix — that is, the combination of fiscal policy and monetary policy — that does not involve discretionary fiscal intervention aimed at stabilising output. There is in fact abundant evidence indicating that discretionary fiscal policy...
is actually pro-cyclical or a-cyclical at best (1). Under normal economic conditions, stabilisation is supposed to be ensured both by the European Central Bank’s monetary policy, to offset shocks that affect the whole euro area, and by automatic fiscal stabilisers in each individual Member State, to absorb shocks that are specific to the country.

By contrast, there can be circumstances, clearly evidenced in the wake of the post-2007 crises, when automatic stabilisers are not enough; specifically, when common economic shocks are so large that they overburden monetary policy or when large country-specific shocks cannot be fully cushioned by national automatic stabilisers. Moreover, when interest rates are maintained at a very low level, the effectiveness of monetary policy in stabilising the economy can be reduced, whereas well-designed discretionary fiscal policy is expected to have a particularly large impact on the economy. Finally, as it takes some time for the economy to recover from a severe crisis, fiscal policy can produce its effects in due time, despite lags. Identifying such periods is therefore a crucial part of the analysis.

To be appropriate, the fiscal stance not only needs to be countercyclical when this is necessary and effective, but also needs to avert risks to the sustainability of public finances. In an incomplete monetary union such as the euro area, the assessment of sustainability risks can be affected by the absence of centralised risk sharing arrangements. In the wake of large country-specific shocks, sustainability concerns can kick in earlier and stabilisation concerns take a back seat.

Given the strong economic links within the euro area, it is also necessary to internalise the spillovers that national fiscal measures can have on other Member States. Ignoring such spillovers can lead to a suboptimal fiscal stance. Model-based simulations show that a given fiscal stimulus has a larger impact in the country of origin if it is coordinated with simultaneous fiscal impulse in other Member States.

How does this analysis square with requirements under the SGP?

Discussing the appropriate fiscal stance in the euro area involves looking at both the aggregate level and the country-specific level. Indeed, in the absence of a fiscal capacity for the euro area, the desired aggregate fiscal stance can only be achieved by coordinating national fiscal policies, as this is the level at which fiscal policy is implemented. Under the EU fiscal framework, national fiscal policies are subject to the set of commonly agreed rules of the Stability and Growth Pact (SGP) and national fiscal stances are expected to comply with these requirements.

Many provisions of the SGP are, in spirit, consistent with the economic reasoning above. In particular, under the SGP, Member States are required to improve their public finances until they have reached sound positions, but the required consolidation is modulated according to cyclical conditions, with more effort in good economic times and less in bad times. The fiscal cost of certain structural reforms and investment projects that enhance future growth can also be catered for, thus giving governments some flexibility. Discretionary fiscal stimulus is not envisaged, except in two situations: if the structural balance of a Member State stands above its medium-term budgetary objective, creating some fiscal space, and under exceptional economic circumstances such as large negative economic shocks, as was already the case in 2008-2009. Finally, although the size of the fiscal stance is limited by SGP requirements, Member States are free to choose their budgetary composition and, ideally, to target growth-friendly compositions.

However, the SGP operates in an asymmetric way. It can require Member States with sustainability needs to consolidate towards sound positions, but it cannot compel Member States with fiscal space to implement more expansionary stances than intended. Similarly, in situations identified as exceptional (e.g. if there is negative growth or very large negative output gap in a country, or if there is a severe downturn affecting the entire euro area or the EU or other unusual events), Member States may be allowed to deviate from normal requirements, but not required to do so.

Overall, a dedicated assessment of the fiscal stance appropriate for the euro area as a whole is meant to address gaps that existed in the pre-crisis governance framework. Drawing on the lessons from the post-2007 crises, the assessment provides an explicit opportunity to look at the euro area dimension of fiscal policymaking beyond the sum of national policies.

While economic activity is characterised by cyclical phases of expansion and recession, potential output reflects the idea of a trend: it is the maximum level of output that the economy can produce in a sustained manner at a constant rate of inflation. Fiscal policy can be used to manage aggregate demand so as to stabilise economic activity around its potential. The scope for doing so essentially depends on the size of the output gap, which is defined as the percentage deviation of observed GDP from its potential.

While the output gap is very intuitive in theory, determining its size is difficult in practice because potential output is unobservable. There are numerous techniques to estimate potential GDP, which can be grouped in two main categories: statistical filters and structural models. Statistical filters, such as the Hodrick-Prescott filter, estimate the output gap exclusively on the basis of assumptions regarding the statistical properties of GDP, such as the length of the economic cycle. Structural models, by contrast, attempt to estimate potential output directly on the basis of an economic model. Both types of methods have advantages and disadvantages and their assessment relies on expert judgement.

Under the EU fiscal surveillance framework, the European Commission estimates potential output and the output gap with a commonly agreed methodology endorsed by the ECOFIN Council back in 2002. The agreed methodology belongs to the category of structural models and it estimates potential GDP on the basis of a production function approach (1), which brings together the potential levels of labour, capital and total factor productivity. The potential level of labour is derived from the non-accelerating wage rate of unemployment (NAWRU), which is the unemployment rate consistent with stable wage growth. The NAWRU is estimated as the equilibrium point of the Phillips curve, which represents the process by which wages adjust to economic conditions. The structural unemployment rate is derived under the assumption that any unemployment above it will exercise a downward pressure on wage growth. Conversely, any unemployment below the structural rate will exercise upward pressure on wage growth. The existing stock of capital, i.e. the cumulative spending on buildings and machinery across the whole economy, is considered to be an indicator of available capacity in itself, and is therefore directly used as a measure of potential capital. Finally, potential productivity is derived from what is called the ‘Solow residual’ (i.e. the part of GDP growth that cannot be explained by increased labour or capital accumulation) after the effects of capacity utilisation have been filtered out.

Since potential output is unobservable, its estimation is subject to three different forms of uncertainty. First, there is uncertainty as to the statistical or economic model which best approximates the relevant macroeconomic developments. Statistical revisions are another significant source of uncertainty. As new information becomes available, past and present output gaps can be revised significantly, in particular around turning points in economic activity. A third source of uncertainty concerns the accuracy of economic forecasts. To determine where the economy stands in the cycle at a given moment requires a view of where the economy will be in the future. The macroeconomic outlook on which policymakers base their decisions in real time can turn out to be quite different in hindsight.

In recent years, established model-based estimates of potential output have been increasingly criticised for a number of reasons. In particular, some experts have pointed out that conventional methods miss the crucial impact of the financial cycle (2). During financial booms, output may be on an unsustainable trajectory even in the presence of stable inflation, as financial tailwinds may weaken supply constraints (e.g. a housing boom may lead to sizeable immigration of workers). Criticism has also been raised against estimates of the Phillips curve-based NAWRU, on the grounds that they miss large adjustment processes when wages are rigid. The traditional labour market dynamics, in which excess unemployment exerts downward pressure on wages, is stymied in the presence of wage rigidities: the Phillips curve methodology may therefore wrongly interpret a temporary increase in unemployment as the result of an increase in the NAWRU (3).

Established measures have also been criticised for providing counter-intuitive results when compared with other cyclical measures such as survey indicators. As a result, survey indicators have recently been used to estimate the size of the output gap. These indicators are not revised ex post, carry important information on the business cycle and often include a forward-looking element. A large number of survey indicators can be combined to extract a

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(1) See Havik et al. (2014).
(2) See Borio et al. (2016), Berger et al. (2015), and de Manuel Aramendia and Raciborski (2015).
(3) It has been shown that the NAWRU is significantly affected by non-structural factors, such as total factor productivity growth, real interest rates and the share of construction in overall employment. See Orlandi (2012).

(Continued on the next page)
Box 4.2 (continued)

A comprehensive measure of the cycle, either by creating a composite indicator or by relying on principal component analysis (4).

In spite of the various attempts to improve upon established methods, it is clear that no methodology is universally superior. Any modelling choice involves trade-offs and assumptions. Statistical filters, for instance, require no preconceptions about the maximum length of economic cycles, with the effect that longer cycles are attributed to changes in potential output. A high maximum length produces smoother potential output and larger output gap estimates. Conversely, a low maximum length produces more volatile potential output and smaller output gap estimates. Structural models, on the other hand, typically require explicit assumptions about the behaviour of economic agents. The estimation of the NAWRU, for instance, may vary depending on whether labour market participants are assumed to have inflation expectations which are rational or adaptive; which assumption is more appropriate depends on the structure of the labour market. Survey indicators may provide a useful or ‘intuitive’ reference but are not necessarily confirmed by hard data.

Ultimately, potential output and the output gap remain unobserved. Choosing one methodology over another amounts to risk management, i.e. assessing and weighing the risks of misclassifying the nature of economic shocks. This is particularly the case for large shocks, which could be classified as either transient or structural under different methodologies. Fiscal policy-makers need to decide which type of risk they want to minimise, such as remaining inactive in the face of a temporary downturn with rising unemployment or trying to prop up demand in the wake of structural shift.

(4) For an example of such a methodology, see the Office for Budget Responsibility (2011).
The public finances of a given country are sustainable if the current fiscal policy can be maintained in the long run without leading the country to insolvency or default. This is ensured as long as the country meets its intertemporal budget constraint, that is, as long as initial government debt plus the present value of current and future expenditure do not exceed the present value of current and future revenue (1). In fact, governments do not need to balance accounts every year. They can run deficits to stabilise the economy during downturns, provided that they run sufficient budgetary surpluses in the future or have accumulated sufficient buffers in the past. In addition to the long-term budget constraint, in the very short term governments may face a liquidity risk, which affects their ability to repay or roll over any maturing debt. Ultimately, the ability of a government to borrow the funds necessary to finance budget deficits depends on how credit markets perceive the sustainability of its public finances.

What seems fairly obvious in theory is far less straightforward in practice, because the future course of economic activity and, in turn, of budgetary developments, are shrouded in thick clouds of uncertainty. Available indicators gauging the sustainability of public finances are typically built on projections or alternative scenarios of long-term population and productivity growth and underpinned by practical assumptions about government expenditure and revenue trends.

Assessing fiscal sustainability for the euro area as a whole comes with additional complications, because there is no ‘European Treasury’ and the common currency is issued and managed by a supranational institution. The sustainability of debt in the euro area is, therefore, linked to the ability of each individual Member State to meet its own share of the overall financial liabilities (2). Hence, in the face of large country-specific shocks, credit markets may assess implications for the long-term sustainability of public finances differently from what they would do for a complete monetary union.

There is no single commonly accepted indicator of debt sustainability, and different institutions have developed different methodologies and indicators. The European Commission considers debt sustainability in a multi-dimensional way and bases its assessment around three different quantitative indicators and a debt sustainability assessment (DSA), which may lead to different conclusions. In the short term, fiscal sustainability is assessed on the basis of what is called the ‘S0’ indicator. S0 is an early-detection indicator which signals risks of imminent fiscal stress when a number of fiscal and financial-competitiveness variables exceed a certain threshold. While the analysis of liquidity risk is meaningful only at the level of individual Member States, a risk of short-term liquidity stress in one country can, due to contagion effects, increase liquidity risks for the whole euro area and lead to an impaired functioning of the monetary union.

The medium- and long-term risks to sustainability, respectively, are measured with the S1 and S2 indicators, which also take into account the implicit and contingent liabilities related to ageing costs, in connection with pension and healthcare expenditures. S1 indicates the cumulative fiscal adjustment required over 5 years to reach the 60 % Treaty reference value for the debt-to-GDP ratio in 15 years’ time. S2, on the other hand, measures debt sustainability over the long term: it indicates the upfront fiscal adjustment needed to stabilise the debt-to-GDP ratio over an infinite time horizon, regardless of the level at which it is stabilised. Since these two indicators are designed to take into account different time horizons of debt sustainability, by definition they do not necessarily support the same message. A country may be at risk of not reaching the 60 % of GDP reference value in the medium term but could nonetheless maintain a stable debt over the long term, and vice versa. In particular, using the S2 indicator the debt ratio may stabilise debt at a level which is far above the 60 % reference value.

Since 2015, the Commission’s analysis of medium-term risks to sustainability has been complemented by a DSA which is based on a comprehensive set of deterministic and stochastic projections. It incorporates information on the

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(1) The dynamics of the debt ratio is given by the formula \(d_t = (1 + y_t)d_{t-1} - b_t\), where \(y_t\) is the interest-growth rate differential and \(b_t\) is the primary balance. Solving for a starting value of the debt ratio \(d_{\text{io}}\), the above equation becomes: \(d_t = d_{\text{io}}\prod_{i=1}^{t}(1 + y_i) - \sum_{i=0}^{t-1}(b_i\prod_{i=1}^{t}(1 + y_i))\). Assuming an infinite horizon, the starting level of debt can then be expressed as: \(d_{\text{io}} = \lim_{t \to \infty} \left[ d_{\text{io}}\prod_{i=1}^{t}(1 + y_i) \right] + \sum_{i=0}^{\infty}(b_i\prod_{i=1}^{t}(1 + y_i))\). Since the government cannot repay forever its debt and interest by issuing new debt, the first member of the above equation must converge to zero (this is what is called the ‘transversality condition’), leading us to the intertemporal budget constraint, in which the current level of debt is equal to the present discounted value of all future primary balances.

(2) An exception to this can be found in the establishment of the European Stability Mechanism as a collective mechanism to cope with liquidity crises.

(Continued on the next page)
Box 4.3 (continued)

Debt structure and contingent liabilities, and performs stress tests for public debt dynamics under a wide set of alternative scenarios and sensitivity tests, e.g. on the evolution of interest rates. On this basis, it gives a qualitative conclusion, assessing risks as low, medium or high over a 10-year horizon.

In addition to the Commission’s analysis, two additional indicators can also provide information on sustainability. Both use concepts of sustainable fiscal positions which are derived from the SGP. One indicator is the primary gap, which mimics the debt reduction benchmark of the SGP as it computes the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over 60% of GDP at an annual pace of 1/20th \(^{(3)}\). A large primary gap indicates that much fiscal effort is needed to bring the debt ratio to the Treaty reference value of 60% of GDP. The other indicator is the distance between the current structural balance in a given country and its medium-term budgetary objective, which under the SGP is considered to be the structural position that ensures sound and sustainable public finances.

The indicators presented above are built around key macroeconomic variables, such as nominal growth, interest rates, ageing costs and budget balances. Getting a full picture of the overall sustainability of public finances is however not a mechanical exercise, and requires considering numerous other factors which are more difficult to quantify and require an assessment of risks. One important factor, for instance, is the ability of the government to raise extra revenues: this crucially depends on the leeway for additional tax increases given the current level of taxation, but also more generally on the efficiency of the tax system. Another important factor is the degree of market confidence in the existing national and/or euro area governance framework. In particular, as the recent sovereign debt crisis has shown, the level of bond spreads depends to a large extent on the degree of market confidence in national institutions and the various measures put in place at the European level, including the outright monetary transaction programme of the ECB. Finally, political risks may also affect the way markets assess sustainability risks in a given country.

\(^{(3)}\) See Carnot (2014).
5. FUTURE EVOLUTION OF THE EU’S FISCAL FRAMEWORK

The EU’s fiscal framework is not a static set of rules and procedures. It has been successively reformed and adapted in terms of both practice and legislation to respond to new challenges and difficulties. The ongoing debate about the future of the Economic and Monetary Union (EMU), with the Five Presidents’ Report and its follow-up as key inputs, forebodes further developments in economic policy-making in the euro area, including the Stability and Growth Pact (SGP).

While there are different and sometimes opposing views on how to move forward, there is a common understanding that the effectiveness of fiscal governance also depends on how other elements of the broader governance framework are organised or work. For example, Member States will find it easier to comply with fiscal rules if the domestic economy and the supranational institutional landscape favour the absorption of economic shocks without major delays or disruption. The effectiveness of fiscal rules may also depend on the effectiveness of financial markets in encouraging greater vigilance among fiscal policy-makers in relation to the long-term sustainability of public finances as well as absorbing rather than amplifying economic shocks. As a result, the actual benefits of reform proposals on fiscal surveillance are to some extent endogenous to the economic governance framework as a whole.

In line with the European Fiscal Board’s (EFB) mandate, this section contributes to the ongoing debate on how to strengthen or improve the EU’s fiscal framework. While taking into account the interlinkages with other parts of the EU’s economic governance framework, the objective is not to establish a comprehensive reform plan for completing the Economic and Monetary Union (EMU). This goes beyond the EFB’s mandate and the scope of this report. This section focuses on two distinct aspects. Section 5.1 pinpoints issues in the current practice of applying the EU’s fiscal rules and offers ideas on how to tackle them. Section 5.2 moves beyond the current boundaries of the EU’s fiscal framework to assess options for creating a central fiscal stabilisation function.

On the current practice of applying the SGP, four issues are highlighted: (i) fiscal rules do not provide adequate incentives to Member States to accumulate fiscal buffers to be used in difficult economic times in both the preventive and the corrective arm of the SGP; (ii) the dissuasive power of the current regime of sanctions is very limited; (iii) the capacity to sustain sound public finances, including in the wake of economic shocks, hinges on progress with structural reforms; and (iv) the EU’s fiscal framework has become very complex, raising questions of ownership, transparency and consistency across both time and countries. It also impacts on the intended rules-based nature of the framework.

The following suggestions are put forward to address these issues:

- Under the corrective arm of the SGP, allow for updating EDP recommendations in the event of an unexpected improvement of economic conditions. This would enhance the symmetry of rules and prevent a recurring practice to replace structural adjustments with budgetary windfalls.

- Under the preventive arm of the SGP, require Member States to compensate for past deviations from the adjustment path towards the medium-term budgetary objective (MTO). This would prevent Member States from systematically planning deviations within the allowed margins.

- Broaden and simplify the use of macroeconomic conditionality in the EU budget in order to strengthen the enforcement of the rules and safeguard the effectiveness of EU finances.

- Introduce in the SGP a link to the Macroeconomic Imbalance Procedure (MIP) by regulating the speed of adjustment towards the MTO in relation to Member States’ macroeconomic imbalances. This would address the risks that imbalances may pose to fiscal sustainability.

- Reduce the complexity of the SGP, while introducing well-defined escape clauses to be triggered and applied with the involvement of independent judgement. This would serve the triple aim of simplifying rules, safeguarding flexibility and enhancing transparency.

On a central fiscal stabilisation function, reflections start from the main programmatic documents of the recent past, in particular the Five Presidents’ Report of June 2015 and the Commission Reflection Paper on deepening of the economic and monetary union of 31 May 2017. Both offer compelling arguments in favour of a fiscal instrument at EU level. The goal of creating a central stabilisation function was reiterated in President Juncker’s latest State of the Union.

Section 5.2 reviews some of the ideas that have been proposed for the design of a macroeconomic stabilisation function. In particular, two main options are considered: an investment protection scheme and a common unemployment reinsurance scheme. While both have their pros and cons, a centralised fiscal stabilisation function focusing on investment is considered to offer particular advantages.

5.1. IMPROVING THE EXISTING SET OF FISCAL RULES

Ongoing efforts to deepen the EMU cover all aspects of economic governance, including the EU’s fiscal
framework. At the end of the ongoing reform process, the fiscal framework may look markedly different from what we have today, and reform of the fiscal framework should ideally be discussed and implemented in lockstep with rethinking the rest of the governance setup. Nevertheless, as long as the current arrangement characterised by centralised monetary policy and decentralised fiscal policy is in place, i.e. as long as fiscal policy-making remains largely in the hands of sovereigns, common fiscal rules of some sort will be needed. Experience with the current framework therefore also points to issues that are of a very general nature.

With this in mind, the EFB’s evaluation in Section 2 of the implementation of the SGP supports a number of suggestions for the future evolution of the Union framework. Some are incremental in nature, while others are more far-reaching.

5.1.1. Creating sufficient buffers for bad economic times

In order to stabilise economic activity, while safeguarding the sustainability of public finances, the general orientation of fiscal policy should be counter-cyclical. During good economic times the government can take advantage of revenue windfalls for deficit and debt reduction and build up fiscal buffers. During bad economic times, fiscal buffers can be used to generate additional demand, in support of the economy.

In practice, policy-makers are subject to political constraints that often result in a pro-cyclical fiscal stance and in the accumulation of government debt. During good economic times, revenue windfalls are seldom used to create adequate fiscal buffers: when the economy enters a downturn, the lack of such buffers leads to further increases of debt and, depending on sustainability risks, to pro-cyclical fiscal tightening.

As Graph 5.1 shows, the three largest fiscal adjustments since the introduction of the euro occurred during an economic downturn, in 2011-2013; at the same time, there were not enough improvements in fiscal balances across in the euro area during economic expansions. One of the main objectives of fiscal rules is therefore to reign in the deficit bias of fiscal policy-making by encouraging governments to take advantage of good times to reduce deficits and debt.

A second and equally important objective of the EU’s fiscal framework is to ensure the smooth functioning of the monetary union. Fiscal coordination at the euro area level is necessary to avoid negative cross-country spillovers, which could for instance arise whenever an excess deficit in one Member State leads to an increase in average euro area inflation, prompting a tightening of monetary policy for all other Member States. At the same time, the EU’s fiscal framework is aimed at avoiding a situation of fiscal dominance, where excess deficits in one Member State could pressure the ECB to use monetary policy to ensure the solvency of this particular country, leading to higher inflation for the whole euro area.

The first set of EU fiscal rules was introduced in the Maastricht Treaty of 1992; it established thresholds for government deficits and debts at 3% and 60% of GDP respectively. The SGP, which entered into force in 1997, was built around these two key figures, and required Member States to achieve and maintain an MTO of close to balance or in surplus.

The main objective of the original SGP was to curb government debt levels in the individual Member States. It did not include explicit provisions on output stabilisation. Participating countries were expected to move towards or stay at the MTO irrespective of cyclical conditions, with automatic stabilisers supposed to provide sufficient stability. The drawback of an approach based on headline deficits became apparent just a few years after the SGP was established; during the economic downturn of the early 2000s, Member States were repeatedly asked to ratchet up their consolidation efforts to compensate for the cyclical shortfalls in the budget. The result was pro-cyclical fiscal tightening, which in turn gave rise to growing criticism among Member States of the lack of economic rationale of the SGP.

Starting in 2005, the SGP has undergone a number of reforms that were meant among other things to strengthen its economic rationale in particular by introducing safeguards against pro-cyclical fiscal tightening. However, while successive reforms have led...
to numerous improvements, there are still important elements of asymmetry in both the corrective and the preventive arms of the SGP. These inhibit Member States from taking advantage of good economic times to reduce deficits and debt. These remaining elements of asymmetry contribute to the overall pro-cyclical stance of fiscal policymaking in the euro area; Graph 5.1 shows that periods marked by a positive output gap tend to coincide with fiscal relaxation, and vice versa. (9)

The essence of the remaining asymmetries is that fiscal targets are typically adjusted in the event of an unexpected adverse shock, while positive economic shocks do not lead to corresponding tightening. Addressing these asymmetries is important to improve both the stabilisation properties of fiscal policy-making in the euro area and to safeguard the long-term sustainability of public finances.

This section presents two proposals on how to overcome the asymmetries in the current set of EU fiscal rules: (i) allow for an update of Council recommendations under an EDP whenever economic conditions improve to a sufficient degree; and (ii) ask Member States under the preventive arm of the SGP to compensate for past shortfalls with respect to the required fiscal adjustment.

5.1.2. Proposal I: Updating EDP recommendations if economic conditions improve

As discussed in Section 2, compliance with the corrective arm of the SGP is ultimately defined in nominal terms: an EDP is held in abeyance as long as the nominal deficit targets are achieved even if other metrics indicate a shortfall in the required fiscal effort. In addition, irrespective of whether a Member State has implemented the structural adjustment recommended by the Council, an EDP is abrogated if the headline deficit is below 3% of GDP and the debt ratio is declining at an appropriate pace.

The assessment of the discretionary fiscal effort plays a significant role only when the nominal deficit targets are at risk: in this case, the Commission carries out an analysis of effective action to determine whether the prospective or actual shortfall from the required fiscal targets is due to insufficient fiscal measures or to exogenous factors. If a Member State is found to have taken effective action but missed a nominal target against the backdrop of an unexpected adverse economic event, the deadline for correcting the excessive deficit is extended. By contrast, if a Member State has not taken effective action and the nominal fiscal targets of the Council recommendation are met solely due to better than expected economic developments, the current practice does not envisage a new step under the EDP.

The outcome-based nature of the corrective arm of the SGP prevents pro-cyclical tightening during stronger-than-expected downturns. However, it does not encourage Member States to take advantage of a stronger-than-expected economic recovery, thereby offsetting automatic stabilisers in part. A Member State may well achieve the required nominal fiscal targets without taking additional fiscal measures if the economic situation improves substantially with respect to the forecast underlying the Council recommendation. In fact, Member States have an incentive to pursue a ‘nominal strategy’, whereby they substitute cyclical windfalls for actual fiscal consolidation rather than take advantage of those windfalls for an early correction of an excessive deficit. Such a strategy leaves the Member States more exposed to the budgetary risks of subsequent downturns.

As discussed in Section 2.2, some Member States currently under the corrective arm of the SGP were pursuing such a nominal strategy in 2016; similar strategies were also observed earlier than that. A nominal strategy also leads to an inconsistency within the SGP, whereby a Member State may meet the requirements of the corrective arm of the SGP by making a fiscal adjustment that is inferior to what would have been requested under the preventive arm of the SGP under the same macroeconomic conditions. This is because the requirements of the preventive arm are defined in structural terms only and compliance is therefore assessed in terms of actions rather than outcomes, making it impossible to pursue a nominal strategy. A Member State benefitting from unexpected positive economic developments may conclude that it is more favourable to remain under the EDP for as long as possible.

The Commission is well aware of the asymmetry in the corrective arm of the SGP. In its Communication ‘on steps towards completing economic and monetary union’ of October 2015 it announced that it “will explore the possibility of updating multi-year Council recommendations to reduce excessive deficits in order to take into account not only conditions of unforeseen deterioration of the economic environment – as it is explicitly envisaged in the Stability and Growth Pact –, but also in case of unforeseen improvements.” (10) The Communication further stated that “such an approach

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(9) The pro-cyclical nature of fiscal policy in the euro area, especially in good times, is well documented in the literature. Turrini (2008) provides evidence for the period preceding the post-2007 crisis while Eyraud et al. (2017) cover the period 1999-2015.

would support the objective of the Excessive Deficit Procedure to ensure a timely correction of excessive deficit situations.” While discussions have taken place with the Member States in the committees of the Economic and Financial Affairs Council (ECOFIN), the proposal has not been implemented in the current framework.

A consistent and transparent way of implementing this proposal would be to move towards a symmetric revision of multi-year Council recommendations. The revised recommendation could set new fiscal targets and may decide to bring forward or postpone the EDP deadline in response to unexpected positive or negative economic shocks.

In practice, such a proposal could be implemented in the following way:

- For a multi-year EDP with a deadline in year T or later, the Council could issue a revised EDP recommendation in the spring of year T-1 based on a new assessment of economic conditions and effective action.

- The revised recommendation would determine whether the EDP deadline should be postponed, in case of a worsening of economic conditions, or brought forward if conditions are better than expected.

- This proposal would reduce the asymmetric treatment of unexpected economic developments under the corrective arm of the SGP and would provide Member States with the necessary incentive to take advantage of good economic times to reduce deficits and debt. It would also address the current ‘discontinuity’ in the transition from the corrective arm to the preventive arm of the SGP.

Whether current legislation would support or allow for a symmetric revision of multi-year Council recommendations is an open and largely legal issue; the legal experts in the Commission and the Council appear to hold diverging views. While symmetric revisions of Council recommendations would clearly support the EDP’s overall objective of ensuring a timely correction of an excessive deficit, there are those who insist that revisions should be ruled out if there are unexpected improvements because they are not explicitly envisaged in the relevant legal provisions.

5.1.3. Proposal II: Compensating for deviations from the adjustment path towards the MTO

Under the preventive arm of the SGP, Member States must ensure that their public finances converge towards their MTO, which is defined in structural terms since the 2005 reform of the SGP and is country-specific. Member States which are not at their MTO must be on the adjustment path towards it. In the spring of each year, the Commission sets the fiscal requirements that each Member State must implement in the following year on the basis of the cyclical position of the economy, the size of the debt ratio and medium-term sustainability risks. Compliance with the required adjustment is then assessed based on two indicators: the change in the structural budget balance and the expenditure benchmark; the latter imposes a cap on the growth rate of primary expenditures net of discretionary revenue measures. The assessment leads to either ‘compliance’, ‘some deviation’ or a ‘significant deviation’ from the adjustment path towards the MTO. A deviation is ‘significant’ if it is in excess of 0.5 % of GDP in a single year, or cumulatively over two consecutive years: this leads to the opening of a Significant Deviation Procedure (SDP). (101)

By explicitly stipulating that some deviation from the adjustment path towards the MTO does not lead to new procedural steps, the preventive arm of the SGP provides for a margin of error. The reason for this margin is that measuring discretionary fiscal policy is inherently difficult, and the two indicators used in the preventive arm (the structural balance and the expenditure benchmark) are subject to uncertainty.

However, it is not stipulated that Member States should compensate for past deviations, which provides for skewed incentives. First, Member States are not rewarded for being more prudent in their budgeting process: if it turns out that the government has overachieved its fiscal targets, this does not lead to less demanding requirements in the future. Second, Member States are not penalised for budgetary slippages within the margin of error, and they may accumulate non-significant deviations over time.

If Member States are not required to compensate for past non-significant deviations, the fiscal requirements of the preventive arm of the SGP effectively become asymmetric targets. A Member State may have an incentive to ‘plan’ a non-significant deviation, and a systematic shortfall of 0.25 % of GDP per year from the adjustment path may become the new target. Based on the Commission assessment of draft budgetary plans, it appears that a number of Member States have planned systematically to deviate from the required adjustment towards the MTO (see Table 5.1). In the benchmark case of an adjustment towards the MTO of 0.5 % of

(101) See Articles 6(3) and 10(3) of Regulation (EC) 1466/97.

As discussed in Section 2.2, since spring 2016 the existence of a significant deviation is always determined on the basis of an overall assessment.
GDP per year, it may take twice the number of years to reach the MTO if a Member State simply decides to target non-significant deviations each year.

To address this problem and encourage Member States to be more prudent, the methodology currently employed to set fiscal requirements under the preventive arm of the SGP could be modified to take into account past deviations. Some national fiscal frameworks include such a mechanism. For example, the Swiss debt brake provides for a ‘compensation account’ where deviations from an expenditure ceiling have to be compensated in subsequent years. The German debt brake also provides for a ‘control account’, which is used to compensate for deviations from the upper deficit limit. The control account is debited whenever actual net borrowing exceeds the ceiling, and is credited if the opposite happens; in addition, the annual debits and credits in the control account are netted out. Whenever the account reaches a cumulative negative balance of 1 % of GDP, net borrowing must be reduced to compensate for the deviation. However, the obligation to reduce net borrowing applies only during an economic upturn, and the amount of the reduction is limited to 0.35 % of GDP per year. (102)

Table 5.1: Assessment of compliance of the draft budgetary plans with the preventive arm of the SGP

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
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<td></td>
<td>-1.8</td>
<td>-1.6</td>
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</tr>
</tbody>
</table>

(1) Green, yellow and red correspond respectively to an assessment of ‘compliance’, ‘broad compliance’ and ‘risk of non-compliance’.
(2) ‘SB’ refers to the structural balance; ‘EB’ to the expenditure benchmark.
(3) The numbers of the planned cumulative deviation do not automatically map into the colour code of compliance reported on the left hand-side. The assessment of compliance is based on an ‘overall assessment’, which includes also deviations over two years and the possible role of expenditures under the ‘unusual event clause’.
Source: European Commission.

Within the EU’s fiscal framework, a possible compensation for past underperformance would imply that in the ex-post assessment of a given year T, which is usually undertaken in the spring of year T+1, the Commission quantifies deviations from fiscal requirements, and Member States have to implement corrective measures for the ongoing year T+1 and/or for future years. To avoid a pro-cyclical policy, Member States could be requested to implement the necessary measures to compensate for past deviations only during economic upturns. In addition, a maximum threshold could be set to limit the number of additional measures that need to be taken in a single year in order to spread compensation over several years.

Such compensation would also correct the intrinsic asymmetry that exists in the way fiscal targets can be revised ex-post following unexpected adverse economic developments. Fiscal requirements for a given year T are currently set in spring of year T-1 and then ‘frozen’ for all successive assessments. However, the requirements can be ‘unfrozen’ during later assessments if the economy enters into recession or the output gap declines to less than -3 % of GDP, leading to an easing of the fiscal targets. Under the proposed modification, this practice would become more symmetric as the fiscal targets could be ‘unfrozen’ and tightened for each year during the spring assessment if, on the basis of outturn data, a deviation is observed in the preceding year(s).

Implementing this change may not require a change in legislation, although agreement with the relevant Council committees would be required.

5.1.4. Strengthening the enforcement of fiscal rules

The credibility and effectiveness of a fiscal framework involves two fundamental requirements. First, fiscal rules need to be economically reasonable and provide incentives for governments to pursue a counter-cyclical policy. As discussed earlier, a government can be expected to credibly ensure the sustainability of its finances during bad economic times only insofar as it has set aside the necessary fiscal buffers during good times. The second requirement is the presence of an enforcement mechanism, to dissuade the government from deviating from the rules.

There are currently two parallel systems of sanctions aimed at enforcing EU fiscal rules. The first has been an integral part of the SGP since its inception. The SGP was further strengthened in 2011 by the Six-Pack regulations, one of which added a graduated system of financial sanctions for euro area Member States. The second system of sanctions exists outside of the SGP legal framework in connection with the regulation laying down common provisions for the European Structural and Investment (ESI) funds. (103) This regulation introduces a system of conditionality by establishing a link between ESI funds and the economic governance

(102) For more information, see: http://www.bundesfinanzministerium.de/Content/EN/Standardarticle/Topics/Fiscal_policy/Articles/federal-debt-brake-01-background-basic-structure.html
(103) Regulation (EU) 1303/2013 on the common provisions of the European Structural and Investment Funds.
framework, with the ultimate objective of ensuring that ESI funds are used effectively. (104)

Under the preventive arm of the SGP, when a Member State fails to take effective action in the context of a SGP, the Commission must issue a recommendation for the Member State involved to set aside funds equal to 0.2% of its GDP in an interest-bearing deposit. This recommendation enters into force unless the Council rejects it by qualified majority. In addition, if the Council establishes the existence of an excessive deficit, the deposit is converted into a non-interest bearing deposit.

Under the corrective arm of the SGP, failure to take effective action during an EDP will lead the Commission to recommend the imposition of a fine equal to 0.2% of GDP as a rule. The recommendation is approved unless the Council rejects it by qualified majority. In exceptional economic circumstances or following a reasoned request by the Member State, the Commission may however decide to reduce or cancel the fine. Further non-compliance with successive EDP notices may lead to additional fines of up to 0.5% of GDP per year. In this case, the Commission recommendation needs to be approved by the Council with a qualified majority.

Finally, under the ESI regulation, when a Member State subject to an EDP fails to take effective action, the Commission automatically issues a proposal for a suspension of future ESI commitments, starting from 1 January of the following year, or for a suspension of their ongoing payments. A suspension of commitments is automatically adopted unless the Council rejects it with a qualified majority; a suspension of ongoing payments needs to be approved with a normal qualified majority vote by the Council due to its greater severity. The suspension ends when the EDP is held in abeyance or is abrogated, and the suspended funds are re-budgeted. (105)

To guarantee democratic legitimacy, the Council is the ultimate decision-maker in the EU legal set-up. Both under the SGP and under the ESI regulation, any Commission recommendation for sanctions needs to be either unopposed or adopted by a qualified majority of Council Members. Under the ESI regulation, the imposition of sanctions is also subject to a structured dialogue with the European Parliament. In addition, the Council can revise any Commission recommendation and therefore modify or eliminate any imposition of sanctions with a qualified majority vote. (106) This implies that, in essence, the enforcement of fiscal rules relies on the willingness of the Council ministers to sanction themselves, which raises doubts about the credibility of the EU legal framework. (107) The 2003 case is very revealing; the Council decided to replace the Commission recommendations of no effective action for France and Germany with its own recommendation to hold their EDPs in abeyance, a decision that was subsequently struck down by the European Court of Justice on procedural grounds but which eventually led to the first reform of the SGP.

A second potential limit to the credibility of sanctions, beyond the commitment of finance ministers, is the discretion awarded to the Commission in setting the level of the fine following a lack of effective action by a Member State under the EDP. This discretion was exercised in the aftermath of the Council decision in 2016 when Spain and Portugal did not take effective action following the Council recommendations of 21 June 2013. In both cases, the Commission decided to set the fine to zero following a reasoned request from both Member States, after having established that the lack of effective action was not driven by unexpected adverse economic events. Since this was the first time that the issue of fines was raised following the implementation of the Six-Pack, such a decision establishes an important precedent: any future request for fines may be subject to criticism for lack of equal treatment.

The cases of Spain and Portugal highlight another important difficulty in implementing fines. Neither the Council nor the national parliaments and the European Parliament voiced strong support for imposing fines on the two countries, which put the Commission in a difficult position. Against the backdrop of a steady but still fragile economic recovery, the rationale of fiscal consolidation had been increasingly questioned by the Council (or at least important parts of it), the European Parliament and more generally by growing anti-EU, anti-euro sentiments in several Member States. In a purely national context, where governments directly derive their legitimacy from a political majority in parliament, a decision to exploit or not to exploit the margins of a given law in line with the prevailing preference of the majority might possibly trigger the reaction of the opposition, but would be viewed as perfectly normal.

When the Commission decided to recommend that the Council reduce the sanctions for Spain and Portugal to zero, reactions were mixed. The Commission was criticised by some for not playing its role as ‘Guardian

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(104) See recital 24 of Regulation (EU) 1303/2013 on the common provisions of the European Structural and Investment Funds.
(105) Under Article 9 of Regulation (EC) 1467/97, an EDP is held in abeyance when the Member State acts in compliance with an EDP recommendation or with a Council notice under Article 126(9) TFEU.
(106) A qualified majority consists of 55% of Member States, representing at least 65% of the EU population.
(107) In fact, such doubts were raised very early on. See for instance: Eichengreen and Wyplosz (1998).
of the Treaty’, a role that ideally requires the Commission to act as a fully impartial entity when applying the provisions of the SGP. By contrast, others believed that the Commission had either acted in good faith or simply responded to concerns of democratic legitimacy.

This episode highlights a more fundamental problem inherent in the current EMU architecture: the imbalance between economic and financial integration on the one hand and political integration on the other. While an increasing number of economic policy tasks have been moved to the EU level, political integration has been lagging; the Commission remains caught between its role as the impartial ‘Guardian of the Treaty’ on the one hand and an executive that is ultimately accountable to the EU legislators on the other. The importance of enhancing political integration is well recognised in the ongoing debate on the future of EMU; it features prominently in all relevant documents such as the Five Presidents’ Report and its follow-up documents.

5.1.5. Proposal IV: Introducing conditionality in the EU budget

As discussed in Section 2.2, the effectiveness of the current system of sanctions within the SGP is questionable. The experience of Spain and Portugal in 2016 suggests that economic conditionality may be more effective in strengthening compliance with fiscal rules: to this end, the Council could agree to introduce stronger conditionality in the EU budget, linking the disbursement of EU funds to compliance with EU fiscal rules. The use of the EU budget to strengthen the support of EU policies is also mentioned as an option in the Commission Reflection Paper on the deepening of the EMU. Importantly, policy conditionality does not constitute a form of sanction; rather it is an instrument or incentive to ensure the effective use of EU funds.

The scope of the current system of conditionality, which is exclusively linked to the disbursement of structural funds, is both fairly limited and in parts very cumbersome. It is limited because it only applies to ESI funds. Many euro area Member States do not receive significant amounts of ESI funds: their suspension would therefore not constitute a sufficient incentive.

In theory, the current system of conditionality goes beyond the assessment of effective action under the corrective arm of the SGP. The common provisions of the ESI funds include several possibilities to review the use of ESI funds in relation to the implementation of country-specific recommendations issued under the European Semester. In other words, there are provisions of conditionality also in relation to the preventive arm of the SGP and the Macroeconomic Imbalance Procedure (MIP). (108)

However, the conditions for launching such a review of ESI funds are less specific than in the case of non-effective action under an EDP. In principle, the Commission can ask for a review whenever it believes that a Member State’s policies involving ESI funds are not supportive of relevant Council recommendations issued under the EU governance framework. However, to make such a case is obviously much more difficult than establishing non-effective action under an EDP. In addition, the process for performing a review is fairly lengthy and complex and has never been tried. As a result, the wider conditionality provisions have never been tested in practice.

Going forward, conditionality could be strengthened in two ways. First, it should go beyond ESI funds and cover all funds in the EU budget that are spent on EU policies. This conditionality would act as a tool to safeguard the objectives of EU policies. Second, the implementation of conditionality should be made more automatic. Once non-compliance with EU fiscal rules is established, funds would be suspended as long as non-compliance persists. Member States could establish ex-ante, when a multiannual financial framework is being prepared, the amount of EU funds that could be withheld from the Member State as soon as the Council issues a decision establishing lack of effective action under the corrective arm of the SGP or under the SDP of the preventive arm.

An automatic system of conditionality could raise concerns of pro-cyclicality. If a Member State is non-compliant with fiscal rules because of adverse economic circumstances, suspending EU funds might lead to a further deterioration of economic conditions. This is especially true if ESI funds (rather than e.g. direct farm transfers) are withheld. To address such concerns, EU funds would not be suspended if, in analogy to current provisions, non-compliance with fiscal rules resulted from exogenous factors, i.e. from an unusual event outside the control of the Member State and with a major impact on public finances, or from a severe economic downturn.

As indicated above, macroeconomic conditionality has been a feature of the EU budget for quite some time and has been extended somewhat over the years. It was introduced with the multiannual financial framework of 2007-2013, which provided for the first time the possibility to suspend Cohesion Funds commitment in case of non-effective action under an EDP (see Article 4

(108) Regulation (EU) 1303/2013 on the common provisions of the European Structural and Investment Funds.
of Regulation (EC) 1084/2006). In March 2012, the Council made use of this tool and applied it to Hungary. (109) The role of conditionality was expanded to all ESI funds with the adoption of the Common Provisions Regulations in 2013, and the suspension of EU funds became an obligation in the event of non-effective action under an EDP.

In 2016, when presenting the results of the mid-term review of the ongoing multiannual financial framework 2014-2020, the Commission highlighted the importance of macroeconomic conditionality. It explicitly noted that “the link of EU funds with economic governance will deserve renewed attention in the context of the next MFF [...].” (110) A review of current provisions is certainly needed and desirable, and should lead to a further expansion of macroeconomic conditionality.

5.1.6. Strengthening economic resilience

The adjustment capacity of the economy has a strong impact on the fiscal performance of the government. Euro area Member States can therefore improve their fiscal position directly, by pursuing greater fiscal discipline, as well as indirectly, by strengthening the efficiency and resilience of their economies. Many euro area Member States continue to be plagued by chronically high unemployment, low participation rates and stagnant productivity growth, which, given prevailing welfare systems, weigh on the sustainability of public finances.

Member States may strengthen the resilience of their economies to shocks by pursuing appropriate structural reforms. Positive contributions may come from reforms aimed at boosting competition in product and service markets, reducing the tax wedge on labour, strengthening active labour market policies and providing tax incentives for innovation. (111) There is not a one-size-fit-all approach to structural reforms: each Member State should strive to strengthen economic efficiency by taking into account country-specific features and by safeguarding domestic needs for inclusive growth and social fairness.

Higher potential growth is the first channel through which structural reforms can improve fiscal performance. The legacy effects of the economic crisis are still evident in the record-high levels of government debt in the euro area coupled with growth rates that are persistently below those experienced in the pre-crisis years. Some studies have suggested that, in the absence of a return to strong economic growth, highly indebted EU countries will struggle to reduce their debt ratios to 60 % of GDP over the next 20 years. In particular, Eichengreen and Panizza (2016) show that the kind of large and persistent primary surpluses that are required of some EU countries are exceptionally high by historical standards.

A second channel through which structural reforms improve fiscal performance is by restoring external competitiveness. Adjustment to asymmetric shocks, i.e. shocks that affect only some Member States within the monetary union, requires sufficiently rapid changes in relative prices and wages: since euro area Member States can no longer rely on currency depreciation to bring about such an adjustment, the adjustment capacity of the economy needs to be strengthened by means of greater price and wage flexibility. The rigidity of many euro area economies, which lack the necessary capacity to adjust to asymmetric shocks, has led to a steady loss of competitiveness during the pre-crisis years. The accrual of imbalances led to a sudden stop in capital flows, which triggered a severe economic and financial crisis and, ultimately, also a fiscal crisis in several Member States.

A clear link therefore exists between fiscal performance and economic resilience; pursuing a disciplined fiscal policy alone is no guarantee of sustainable public finances. Structural reforms can foster greater economic convergence and prevent unsustainable imbalances by boosting competitiveness and shortening the adjustment to shocks. Liberalising product and service markets will help restore price competitiveness, while labour market reforms aimed in particular at improving the wage-setting mechanism can correct lasting imbalances between wage growth and productivity. Non-price competitiveness is also important: incentivising R&D and investments in human capital, for instance, enhances product quality and technological advantage.

Resilience is also determined by the existing EU institutional framework. Despite the tremendous progress made in the last few years, the EMU remains an incomplete and imperfect monetary union. The lack of an effective capital market union, together with an incomplete banking union, are major sources of amplification of country-specific economic shocks.

5.1.7. Proposal V: Linking the SGP with the MIP

The introduction of the MIP in the aftermath of the crisis was an important step forward, raising awareness of the build-up of unsustainable developments beyond public finances. Yet the MIP differs from the SGP in one important aspect: macroeconomic imbalances are

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(111) For further discussion, see IMF (2016) and OECD (2012).
not directly under the control of Member States’ authorities as is the case for taxation and government spending decisions. However, the SGP and the MIP remain closely linked.

The annual cycle of MIP surveillance starts with the publication of the Alert Mechanism Report by the Commission, which assesses the economic situation within EU countries on the basis of a scoreboard of 14 headline indicators and 25 auxiliary indicators. These indicators cover both external and internal imbalances, such as unemployment developments, excess private sector leverage, government debt, price and cost imbalances. An in-depth review is then carried out for those Member States whose situation warrants particular attention. This review assesses the existence and severity of imbalances and produces an overall assessment of ‘no imbalances’, ‘imbalances’, ‘excessive imbalances’ or ‘excessive imbalances with corrective action’, which may trigger the excessive imbalance procedure.

A possible link between MIP and SGP could be included in the methodology used to establish the required adjustment towards the MTO. The matrix of adjustment currently takes into account cyclical conditions, whether the debt ratio is above the 60% of GDP threshold and whether there are medium-term risks to debt sustainability. An additional parameter that could be used to define the speed of the adjustment towards the MTO could be the presence of macro imbalances more generally. Depending on the type of imbalance, this could modify the speed of adjustment towards the MTO. For example, Member States with large private debts and current account deficits could be required to speed up their adjustment towards the MTO or even to achieve a higher MTO. Conversely, Member States with persistent current account surpluses could be allowed to slow down their adjustment towards the MTO or to aim for a lower MTO.

5.1.8. Complexity of the EU’s fiscal rules

Since its inception, the EU’s fiscal framework has been reformed numerous times giving rise to an increasing degree of flexibility and complexity. The first reform of 2005 moved the focus from nominal to structural fiscal balances as well as to country-specific characteristics. The 2011 Six-Pack reform introduced the expenditure benchmark alongside the structural budget balance, made the debt rule operational introduced the Significant Deviation Procedure in the preventive arm of the SGP and established a graduated system of financial sanctions for non-compliance with the rules. The coordination of national fiscal policies was further strengthened in 2010 with the introduction of the European Semester, and in 2013 with the assessment of Draft Budgetary Plans introduced by the Two-Pack reform.

Partly as a result of the strengthening of the EU’s fiscal rules and surveillance, additional degrees of flexibility were introduced. This is particularly the case for the debt benchmark under the corrective arm of the SGP, where the concept of ‘relevant factors’, i.e. factors that can justify non-compliance with fiscal requirements, has been clarified and broadened. Further flexibility was introduced also in the preventive arm of the SGP, following a Commission Communication in 2015 on flexibility.

In parallel to the successive legislative reforms, existing legislation has been continually clarified and interpreted. Over the years, the Commission and the Council agreed or reviewed a wide range of operational aspects within the existing rules, in particular (i) how to use and interpret indicators or statistics used to assess compliance with the SGP; and (ii) how to define the annual adjustment requirements as a function of macroeconomic conditions and/or contingencies. The results of such agreements and reviews have been regularly summarised and documented in the Code of Conduct. Since 2013, the Code of Conduct has been complemented by the Vade Mecum on the SGP, a document that aims to make the functioning of the SGP accessible to practitioners or anyone wanting an in-depth understanding of how the SGP works.

One of the initial drivers of successive reforms was to make the EU fiscal rules more ‘intelligent’ by strengthening their economic rationale. EU fiscal rules were gradually amended and complemented to account for a series of economic and policy contingencies as well as country-specific circumstances. In this sense, complexity is not necessarily a negative feature of fiscal rules: simplicity limits their economic rationale and weakens national ownership. The most prominent expression of this view is the famous statement by the then President of the European Commission Romano Prodi, who in 2002 characterised the original set of SGP rules, based only on simple measures of public deficit and debt, as ‘stupid’. (113)

Successive SGP reforms have also strengthened the role of the Commission, most notably through the possibility of issuing autonomous recommendations – legal acts


(113) In an interview with Le Monde, Commission President Romano Prodi states “I know very well that the stability pact is stupid, like all other decisions that are rigid.”
that do not require the approval of the Council – and the reverse qualified majority voting provisions to impose sanctions. As explained above, Commission recommendations to the Council for imposing sanctions are considered to be automatically approved unless the Council rejects them with a qualified majority vote within a certain deadline. (115) Member States, or at least some of them, reacted to the strengthened role of the EU’s executive branch by inviting the Commission to clarify ex-ante in the greatest possible detail how additional powers or instruments would be deployed to ensure transparency and equal treatment.

Overall, the quest for more intelligent and flexible rules has led to an ever-increasing degree of complexity, which is nowadays perceived as excessive. Assessments to that effect abound, including those in the Five Presidents’ Report and in a note by the Dutch EU presidency prepared for an informal ECOFIN in April 2016. (116) Recent methodological improvements, which aim to emphasise the expenditure benchmark more than the structural budget balance, have provided some degree of simplification; however, the overall complexity of the framework remains high. The Vade Mecum on the SGP testifies to this: the 2017 edition is more than 200 pages, many of which include long mathematical expressions or involve intricate decision trees.

- The current set of rules and provisions highlights the curse of rules that are ‘too intelligent’. Whilst increased complexity allows for a high degree of flexibility, it reduces transparency and effectively reintroduces discretion through the backdoor. Accounting for a growing number of contingencies within a rules-based system does not eliminate the need for economic judgement; it rather adds new instances where judgement and ultimately discretion are needed, especially when it comes to interpreting the growing number of relevant indicators or economic circumstances that need to be taken into account when policy guidance is both formulated and assessed. This can be seen in almost all stages of the annual EU fiscal surveillance cycle, in particular:

- In the preventive arm of the SGP, when setting the required fiscal adjustment as a function of cyclical conditions and debt sustainability; when assessing the eligibility for the various flexibility clauses ex-ante and ex-post; when carrying out the overall assessment of the annual fiscal adjustment on the basis of the structural budget balance and the expenditure benchmark.

- In the corrective arm of the SGP, when assessing compliance with the forward and backward-looking debt rule; when reviewing all relevant factors prior to opening an EDP or when determining an EDP deadline; when setting the annual targets for the headline and the structural budget balance; or when assessing effective action under the EDP.

- In the use of other relevant factors when assessing compliance with the debt criterion which, as described in Section 2.2, provides examples of the growing importance of discretion. When the debt criterion in the corrective arm of the SGP became binding for high debt countries, the assessment of the adjustment path towards the MTO de facto turned into the main relevant factor for establishing compliance. In other words, compliance with the preventive arm of the SGP prevailed, including derogations under the flexibility provisions agreed by the Commission and the Council in 2015. One could rationalise this practise by arguing that nominal growth was exceptionally low in 2016 and that under such circumstance it would not have made economic sense to blindly impose the debt criterion. The jury is still out as to whether low nominal growth was effectively exceptional or more of a structural feature of the countries concerned.

- In essence, the increased degree of complexity of the EU fiscal rules highlights a fundamental conflict in a system that was designed to be rules-based. Some flexibility within the rules is necessary to ensure economic rationale and, in turn, ownership by the Member States represented in the Council. However, growing flexibility increases the role of discretion and creates room for considerations that may run counter to the economic rationale underlying a fiscal framework.

Greater flexibility and discretion produce an additional side effect that became apparent in the 2016 EU fiscal surveillance cycle. They create or heighten friction between different institutional players at EU level over who ultimately sets the course within the range of options created by discretion. A case in point is the flexibility in relation to structural reforms and investment. The debate started with a Commission

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(115) The most prominent autonomous Commission act under the SGP is its opinion on the Draft Budgetary Plans (DBPs). The Commission’s assessment of the DBPs de facto sets the tone for subsequent assessment and decisions involving the Council, notably the assessment underpinning the country-specific recommendations.

States face difficult cyclical conditions, are affected by events outside their control or when governments implement major structural reforms with a budgetary impact. Under such circumstances, the adjustment requirements can be modulated as a function of estimated economic slack and/or Member States can be allowed to deviate from the adjustment path towards the MTO in the preventive arm of the SGP, possibly avoiding an EDP being opened under the corrective arm of the Pact.

While flexibility is desirable, the growing number of flexibility provisions under the SGP is increasingly perceived as lacking transparency and, at times, to be determined in an ad hoc manner including in response to political considerations. Prominent observers have repeatedly highlighted the risks to the credibility of the EU fiscal rules associated with weak enforcement and lack of even-handedness. (117)

To restore the credibility of the rules-based nature of the EU surveillance framework while safeguarding the necessary degree of flexibility, a two-pronged approach is needed:

1. simplify in a radical manner the set of rules, in particular by identifying one fiscal anchor (deficit or debt), by resolving the inconsistencies between the preventive and the corrective arm of the SGP, and by agreeing on one operational method/indicator for assessing compliance; and

2. return to a clear benchmark for the required annual fiscal adjustment, complemented with well-defined escape clauses including the way they are triggered.

Such a two-pronged approach, based on simple rules with escape clauses, could also enhance the internal consistency of the EU’s fiscal framework, thereby obviating some of the issues highlighted earlier. To maximise effectiveness, two additional elements are to be considered. First, a simplified set of rules can and should be embedded in the European Semester; relying on an established sequencing of surveillance steps as opposed to putting in place a completely new calendar is preferable. Second, rather than potentially scattering

See the IMF staff reports for the 2016 and 2017 Article IV consultations:

Communication of January 2015 in which the Commission provided new guidance on how it intended to interpret existing SGP provisions. A detailed discussion followed in the competent Council committees, which eventually led to a commonly agreed position at the end of 2015 in the form of a dedicated document. This recorded the agreement between the Commission and the Council on how to apply the flexibility clauses. (116) Such a dedicated document is quite unique in the application of EU fiscal rules. Although the commonly agreed position was subsequently incorporated in the Code of Conduct, its application remained contentious in specific cases. An issue that conceivably played a role in the debate was that the new Commission guidance was not yet reflected in the Code of Conduct, which is the agreed reference for interpreting the SGP.

Another example is the interaction between the European Commission and the National Fiscal Councils. A number of Fiscal Councils have argued that in instances where judgment is required (e.g. assessing discretionary revenue measures or even estimating the output gap) they have more and better expertise.

Similarly, in spring 2017 the Commission introduced a ‘margin of discretion’ when defining the fiscal requirements for the following year. The CSRs themselves no longer include a quantification of the required fiscal adjustment in 2018. Instead, only the recitals of the legal act refer to the appropriate structural adjustment. In addition, for all countries with structural adjustment requirements of 0.5 % of GDP or more, the recitals state that the required adjustment may be reviewed in autumn when the draft budgetary plans are assessed and during the ex-post assessment.

The stated aim of this qualification is to take due account of the goal to achieve a fiscal stance that contributes both to strengthening the ongoing recovery and to ensuring the sustainability of the respective Member State’s public finances. However, Member States remain divided within the Council and questions are raised on how predictability and equal treatment can be ensured with the new margin of discretion. Additional discussions between the Council and the Commission are foreseen.

5.1.9. Proposal VI: Simpler rules, well-defined escape clauses and an independent assessment

The SGP contains a large number of provisions aimed at allowing margins of flexibility for when Member
responsibilities, the surveillance of EU fiscal rules should be carried out by one institution.

The first steps towards a more predictable and more transparent application of the SGP were taken in 2016 in response to the Five Presidents’ Report, which acknowledged the complexity of the rules and saw scope for improving clarity and transparency. In particular, the Council adopted two decisions on 6 December 2016 aimed at simplifying the current methodology. One decision simplified the assessment of effective action under the EDP by replacing the existing top-down and bottom-up approaches with a single expenditure-based indicator in the careful analysis. The other decision strengthened the role of the expenditure benchmark in the preventive arm of the SGP, which is a more predictable indicator for fiscal policy. While these initial steps towards simplification have already led to a significant improvement in the current set of fiscal rules, the EU governance framework remains complex, and further steps are needed.

To address the trade-off between rules-based commitment and flexibility, ongoing or prospective simplifications of the EU fiscal rules need to be accompanied by systematic and judicious use of escape clauses. Escape clauses provide the leeway to avoid pro-cyclical fiscal policies or to address major unforeseen events. They would act as an effective alternative to the excessive and ultimately futile over-codification of fiscal rules aimed at catering to the ever-changing and complex economic reality.

Clearly, the use of escape clauses would give an explicit role to discretion, possibly even more so than is currently the case. However, discretion per se is not the problem. As long as discretion is exercised with economic judgement and is shielded from short-term political opportunity, the credibility and integrity of the rules is not at risk. As a result, the credibility and effectiveness of a simplified rules-based system with more systematic and transparent use of escape clauses crucially depends on how and by whom escape clauses are triggered, and how policy guidance is formulated in the escape clauses.

In concrete terms, escape clauses should satisfy a number of conditions. They should:

(i) be limited to truly exceptional circumstance when the application of pre-defined rules would undermine credibility;

(ii) specify as clearly as possible the nature and magnitude of the shocks to be accommodated;

(iii) define the responsibility for activating the clause and monitoring its implementation; and

(iv) detail the length of the period during which the rule could be relaxed or put into abeyance; and define a path of return to full observance of the rule.

To avert an opportunistic use of escape clauses points (iii) and (iv) should crucially involve independent advice. In particular, the activation of a clause should be made dependent on the assessment by an independent body, which would determine whether the pre-defined conditions for suspending the rules are fully or partially satisfied. The same independent assessor should determine ex-ante how long the ‘grace period’ will last or how exceptions are to be phased out. Last but not least, the independent assessor should also be involved in defining the modified fiscal requirements during the grace period.

Independent judgement in the implementation of the EU’s fiscal framework will also play an increasing role in the future process towards more political integration at EU level. In its current configuration, the EU executive is a hybrid between an independent executive agency and a political government; its composition does not necessarily reflect the political majority of the legislators, at least not in the same way as it does at national level. To the extent that political integration progresses at EU level, the independence of the executive will logically have to give way to political accountability vis-à-vis the legislator that defines all national or federal governments. Within such a process of political integration, the effectiveness of a rules-based system of fiscal surveillance will therefore be strengthened by the involvement of an independent body that provides economic advice independent of short-term political considerations.

Such a setup would be similar to that of individual Member States where governments, which retain the ultimate power to take executive decisions, are often complemented by fiscal institutions that provide independent judgement. The Commission Reflection Paper on the deepening of the economic and monetary union recognises this line of reasoning. Under the heading ‘Strengthening the EMU Architecture and Anchoring Democratic Accountability’, it presents the idea of entrusting fiscal surveillance of both the euro area and its Member States to a euro area Treasury, which would be supported by the independent European Fiscal Board. (118) In expressing its judgement on the specific conditions of the country under

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conditions, this independent body could also rely upon the experience and the knowledge accumulated by the corresponding national fiscal council.

5.2. REFLECTIONS ON THE CREATION OF A EURO AREA STABILISATION FUNCTION

The suggestions outlined in the previous sections may be considered by some to be bold and may well require a change in current practice and possibly also existing legislation. However, they could easily be incorporated into the existing overall architecture of EU economic governance. More far-reaching reforms are needed in the medium and long term to properly address the gaps laid bare by the post-2007 crises which still distance us from a complete monetary and economic union (EMU).

The Five Presidents’ Report initially proposed a number of far-reaching reforms deemed necessary for strengthening the euro area over the short and medium-term. The reforms cover four main areas: (i) economic union, to restart and make more binding the process of economic convergence across Member States; (ii) financial union, with particular focus on completing the banking union and launching a capital market union; (iii) fiscal union, aimed at establishing a macroeconomic stabilisation function for the euro area; and (iv) institutional reforms, in particular the creation of a euro area Treasury to strengthen democratic accountability and legitimacy. These four types of reforms were seen as essential for strengthening the resilience of the euro area and improving the capacity of Member States’ economies to absorb economic shocks rather than amplify them.

In his Letter of intent to President Antonio Tajani and to Prime Minister Jüri Ratas following the State of the Union address of 2017, President Juncker presented a roadmap for a deeper and fairer EMU. (119) The roadmap includes a proposal for the creation of a dedicated euro area budget line within the EU budget providing for (i) structural reform assistance; (ii) a stabilisation function; (iii) a backstop for the banking union; and (iv) a convergence instrument to give pre-accession assistance to Member States with a derogation on their way towards adoption of the single currency.

This section focuses on why there is a need for a euro area macroeconomic stabilisation function and on how such a function could be designed. While there are undoubtedly several other aspects to the debate on EMU deepening, it is clear that the EFB should focus on this function as it has important implications for both elements at the core of the Board’s mandate: the implementation of fiscal rules and the appropriateness of the fiscal stance for the euro area.

In the current framework, contributions to macroeconomic stabilisation derive mainly from monetary policy and are supplemented by the sum of national fiscal policies, which are monitored but hardly coordinated by the rules of the SGP. It is then important to clarify why the coordination of national fiscal policies was left at a very limited stage in the Treaty 25 years ago and what might prompt a different attitude today.

It was recognised back then as it is today that the centralisation of monetary policy would increase the need for national fiscal and structural actions, and that some of these actions were likely to be geared to compensating for the inadequacy in the EMU of some of the adjustment mechanisms that characterise an optimum currency area – a high degree of price and wage flexibility and cross-border mobility of factors of production, including labour. However, while both cyclical and structural arguments justified close monitoring of national fiscal policies, mandatory forms of monitoring and ‘coordination’, and even more so a joint effort to adjust the aggregate fiscal stance beyond the sum of national recommendations, were deliberately left aside.

The reason for this was not only the political argument that the emphasis in the EMU should be on national responsibility for all non-monetary policies. Two economic arguments also helped to swing the balance in favour of a fiscal framework as decentralised as possible. The first was that the impact of national fiscal policies would tend to be largely confined to the country concerned, in sharp contrast to monetary policy where years of experience had revealed major spill-over effects. The second argument against assigning any fiscal stabilisation role to the EMU level was that it would be too difficult and focus too much on smoothing short-term fluctuations in economic activity. Stabilisation had proved to be difficult enough at national level; adding a European dimension could well increase the risk of procyclicality. Joint efforts were also seen as likely to become too uniform across countries that would often need to pursue differentiated national fiscal policies.

What has changed in the past quarter-century to shift the balance of the arguments reflected in the Treaty for and against a role for the euro area in fiscal stabilisation? The preference for designating fiscal responsibilities only at national level has not changed, although the lessons of the past decade have tempered it. Monetary policy has proved that it can help sustain demand and


European Fiscal Board
avoid deflation over the last five years. However, even accommodation on an unprecedented scale, combined with national fiscal policies that have become neutral or expansionary since 2014, can be overwhelmed by the size of shocks, whether to the euro area as a whole or more asymmetrically, and by the problems of handling the legacy of large shocks. With both real growth and in particular inflation likely to remain at historically low levels, monetary policy will run more often into a lower bound in the foreseeable future due to its ability to influence interest rates. This leaves a greater role for fiscal policy to sustain demand. This may not be evident as fiscal policies are planned for 2018; the EFB concluded in its June 2017 report on the euro area fiscal stance for the coming year that the prospective stance seemed to be appropriately neutral for the coming year. But it will become evident at some time in the not too distant future; the current calmer period would be a good time to prepare for it.

The two economic arguments against a euro area stabilisation function also look different and weaker today than they did when the framework was first decided. Spill-overs through demand and trade from national fiscal policies became very real in 2011-13 as almost all Member States greatly consolidated their public finances. At the very same time, financial spill-overs took the form of both contagion and flight to safety in euro area bond markets. Crisis controlling mechanisms were put in place in 2012: the European Stability Mechanism (ESM) as a lender to sovereigns and the ECB’s announcement of support to national bond markets, which was conditional upon an adjustment programme with the ESM. However, the experience of heightened interdependence as the two types of spill-over became highly visible also suggested that responsibility at euro area level for taking an aggregate fiscal perspective before the crisis management stage is reached was becoming increasingly desirable. As long as inherited, very high national sovereign debt ratios only decline slowly, there is a case for such a joint euro area perspective to temporarily ease the constraints on national fiscal policy of maintaining sustainability. However, to avoid high-debt Member States benefitting from systematic transfers due to their greater likelihood of facing budgetary stress, access to a euro area stabilisation function should be conditional on full compliance with EU fiscal rules.

The EFB sees the potential tasks of a euro area fiscal stabilisation tool as different to those 25 years ago. In particular, there should be less emphasis on stabilisation of shorter-term demand swings and more emphasis on crisis prevention. This allows for close interaction with a rules-based framework for national fiscal policies that, going forward, should become more targeted and transparent. Such interaction will also build confidence that the use of the euro area stabilisation mechanism will be a complement in difficult times to fiscal rules, and not a substitute for observing them.

Minimising the risk of moral hazard inherent in setting up a euro area fiscal stabilisation capacity remains a central and delicate challenge for any framework that combines surveillance of national performance with a supranational fiscal capacity. The challenge is to strike a balance that avoids on the one hand guaranteeing access to the stabilisation facility only to countries that do not really need it, and on the other widening access to such an extent that it weakens national efforts to avoid drawing on it. In addition, the scheme ought to be designed so as to avoid permanent one-way transfers among Member States, which would undermine the political viability of the scheme. The International Monetary Fund (IMF) has developed access to financing facilities prior to the crisis stage, but these have remained largely unused. For example, the IMF Flexible Credit Line was designed for crisis-prevention and is aimed at countries with strong economic fundamentals and solid policy track records. To date, Colombia, Mexico and Poland have been the only beneficiaries. The advantage of the euro area in this respect is that it has a more detailed surveillance process in place in the shape of the European Semester. This makes it easier to design a joint stabilisation facility to interact with and reinforce national surveillance. Observing a (simplified) set of national fiscal rules will be the qualification for drawing on the joint stabilisation mechanism.

From the EFB’s perspective, this interaction must be the main criterion for evaluating the design of a future euro area stabilisation function. It should aim to increase the scope for stabilisation in bad times by reducing the need for pro-cyclical cuts in public expenditure and by helping to safeguard a less defensive and growth-supporting composition of the latter. The knowledge that such a capacity exists will also enhance the scope for enforcing the national fiscal rules in containing the build-up to crises while making the rules more politically acceptable.

The Commission’s Reflection Paper on the deepening of the EMU advances the debate by reviewing briefly two main possible options for a macroeconomic stabilisation function: an investment protection scheme to remedy the pro-cyclicality of public investment, and an unemployment reinsurance fund to provide more breathing space to national public finances in a downturn when unemployment benefits tend to rise sharply and differentially between countries. The Reflection Paper mentions also in passing two other

options: a rainy-day fund, and a dedicated euro area budget, in the latter case going beyond the purpose of stabilisation.

In the following, the EFB comments mainly on the two main options, both on how they meet the criteria reviewed above and on their financial implications.

5.2.1. Options for a centralised fiscal stabilisation function

Introducing a European element to unemployment insurance has been proposed on a number of occasions since the mid-1970s: in the Marjolin Report of 1975, in the MacDougall Report of 1977 and in a large number of studies by think tanks and academics. It has obvious political appeal and would appear to have promising stabilisation features in the face of sizeable and nationally divergent shocks. The unemployment rate is clearly a cyclical indicator and is relatively easily to measure, which may raise hopes that building on it could resemble a rules-based criterion.

However, there are major difficulties in designing how a system of temporary transfers from Member States that are doing relatively well – measured by changes in the unemployment rate – to those that are doing less well could look. More structural features of the very heterogeneous national labour markets in the euro area have a strong impact on the measured national rates; insurance would have to be based on unemployment fluctuations around country-specific equilibrium levels to allow for this observation, and such levels are not directly measurable. There is clearly a risk of relying again on unobservable variables in designing a policy rule which has led to frustrations in the existing framework, but a more careful judgment requires waiting for more of the analysis illustrating the feasibility of an unemployment insurance fund and, ideally, for more harmonization of national labour markets. (121)

The investment protection proposal reflects the observation that public investment is usually the first item to be cut and/or postponed in a downturn, as happened after the crisis (see Graph 5.2): the share of government consumption and transfers in GDP both rose, while that of investment shrank. This shift towards more defensive expenditures has consequences not only for demand, as the multiplier effect tends to be larger for investment than for other expenditures, but also for potential growth directly and indirectly through the impact on private investment.

A protection against such shifts could prove helpful and has already been in place to some extent since 2015 under the Juncker Plan which builds on the idea that modest public guarantees can trigger substantial private sector participation and can leverage the effort. A number of infrastructure investments – in transportation, energy and digital networks – as well as funding for innovative small and medium-size enterprises have moved ahead, and the total framework for spending has been raised to EUR 500 billion. There is some scope for widening and extending these elements of investment and growth protection; and, as the output gap is being eliminated, the attention of policy-makers is shifting towards the longer-term perspective of defending potential growth nationally and in the EU.

However, there is also hesitation. The planning and execution of major new investment projects – in contrast to better maintenance of the existing capital stock - are very time-consuming, so it may stretch terminology to label the scheme a stabilisation effort. Furthermore, to preserve the essential partnership with private investors and with the European Investment Bank in project selection and financing, stabilisation vis-à-vis shocks that impact Member States differentially cannot be a prime consideration, though protection against a general (symmetric) weakness of investment would be targeted. Experience since the crisis has shown that the best-performing economies have also reduced the share of public investment in GDP, so designing the protection scheme proportionally across Member States does not appear indefensible.

![Graph 5.2: Average change in government expenditures by category](image)

<table>
<thead>
<tr>
<th>Consumption</th>
<th>Investment</th>
<th>Transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.0</td>
<td>1.8</td>
<td>1.7</td>
</tr>
<tr>
<td>1.5</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>0.2</td>
<td>-0.4</td>
<td>-0.6</td>
</tr>
</tbody>
</table>


Source: European Commission.

Some will ask why the objective of investment protection could not be achieved more directly through a ‘golden rule’, i.e. by exempting public investment from the fiscal rule. Though such a rule has worked well in some national contexts in the past, including in

(121) A recent paper (Carnot et al. 2017) simulates an unemployment-based stabilisation instrument for the euro area that addresses some concerns often raised against such ideas.
Germany, it has pitfalls as it would (i) incentivize creative accounting by the part of the Member States, and (ii) weaken the requirement that all public expenditure is paid for in the medium to long term. These pitfalls seem absent from the present investment protection proposal. Limiting the golden rule only to some subsets of investments (for instance maintaining public good stocks during slumps, or investments for sectors with high productive potential and high social returns) would be a way to minimize pitfalls.

As mentioned, the Reflection Paper also refers to two other ways of deepening the EMU. A rainy-day fund would accumulate regular contributions from Member States and disburse them to cushion a large shock; contributions might have to be supplemented by a capacity to borrow. The scheme would fall in the intermediate category of stabilization prior to the full outbreak of a crisis when the ESM is called upon to provide conditional lending, as this section has described above. It could be the clearest example of a supplement to the national efforts referred to, and as such would have to be contingent on the compliance of a recipient country with the SGP rules, and, particularly, on its record in using good times to consolidate public finances.

Finally, the Commission refers to a dedicated euro area budget, subsequently modified in President Juncker’s State of the Union Address to a dedicated euro area budget line in the EU budget. This idea clearly goes beyond a stabilisation function and points to more general long-term objectives for the euro area and for the EU-27.

Nevertheless, debate on the far-reaching range of options which visions for the budget open up is already underway among Member States. Although these visions go way beyond the mandate and horizon of the EFB, as economists involved in the analysis of public finance more generally the Board welcomes a broader perspective on the role of fiscal policy than that of ‘only’ macroeconomic stabilisation, particularly in terms of improving the efficiency and growth prospects of European economies. In the earlier days of European integration this broader perspective on fiscal policy and hence on the role of a central fiscal capacity was important in the debate. At a time when some national policymakers are beginning to ask whether some tasks – external and internal security, migration and energy and climate challenges – might be addressed more efficiently by European rather than by national public expenditures, an examination of earlier perspectives on the potential use of a central fiscal capacity is warranted. The analytical approach of fiscal federalism would be as relevant at the level of the EU as it would at the level of the euro area.

Overall, leaving aside the possibility of achieving a longer-run optimum of a larger central budget, the Board believes that a central capacity to protect investment levels is the most promising way to build a stabilisation function in the medium term. It has the advantage of building more closely on experience and of leveraging resources from the private sector; and it promises to have some positive impact both on demand and on the longer-run growth potential. In contrast to the unemployment reinsurance fund (and the rainy day fund), it could be financed by borrowing in order to finance specific projects; this would be easier to implement than tax transfer financing, which would be required for the two funds.

A priori, both the unemployment reinsurance and rainy day funds may have greater potential for stabilisation, particularly in the face of large shocks that are to some extent country-specific. But they both need much further elaboration as to feasibility with respect to the interaction with the existing rules and with the financing required for them.
Glossary

Automatic fiscal stabilisers: Features of the tax and spending regime of a government budget which react automatically to the economic cycle and reduce its fluctuations. As a result, the government budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Corrective arm of the Stability and Growth Pact: The part of the Stability and Growth Pact that deals with correcting excessive budgetary imbalances. These include government deficits exceeding 3% of GDP and government debt exceeding 60% of GDP and not sufficiently diminishing or approaching 60% at a satisfactory pace. The Commission and the Council monitor the correction according to the Excessive Deficit Procedure (EDP) (see also debt reduction benchmark).

Country-specific recommendations (CSRs): Policy guidance tailored to each EU country based on the provisions of the Stability and Growth Pact and the Macroeconomic Imbalance Procedure. The recommendations are put forward by the European Commission in May, then discussed among the governments in the Council, endorsed by EU leaders at a summit in June, and formally adopted by national finance ministers in July.

Debt reduction benchmark: The reduction of a country's government debt above 60% of GDP by 1/20th per year on average. This is the criterion used to assess whether excessive government debt is sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The pace of reduction is assessed over both the past three years and the next three years, and after correcting for the cycle. Compliance in at least one of the three cases is sufficient to ensure compliance with the debt criterion (see corrective arm of the SGP).

Discretionary fiscal policy: A government decision that leads to a change in government spending or revenue above and beyond the effect of existing fiscal policies. Its effect is usually measured as the change in the budget balance net of the effect of automatic fiscal stabilisers, one-off measures and interest payments (see also structural balance and structural primary balance).

Draft budgetary plans (DBPs): Governments submit DBPs to the Commission and the Council to ensure the coordination of fiscal policies among Member States who have the euro as their currency and because the EU Treaty recognises economic policy as “a matter of common concern”. They submit their DBPs for the following year between 1 and 15 October. The requirement was introduced in 2013 with the Two-Pack reform of the Stability and Growth Pact.

European Semester: A framework for the coordination of economic policies across the European Union. It is organised around an annual timeline that allows EU countries to discuss their economic and budgetary plans and monitor progress at specific dates throughout the year.

Expenditure benchmark: One of the two pillars used to assess compliance with the preventive arm of the Stability and Growth Pact, along with the change in the structural balance. It specifies a maximum growth rate for public expenditure (i) corrected for certain non-discretionary items, such as interest expenditure, (ii) including a smoothed measure of public investment, and (iii) adjusted for discretionary revenue measures. The growth rate may not exceed potential GDP growth over the medium term and is further constrained for Member States that have not yet achieved their medium-term budgetary objective.

Fiscal Compact: The fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), an intergovernmental treaty, aiming to reinforce fiscal discipline in the euro area. The TSCG was signed on 2 March 2012 by all Member States of the European Union, except the Czech Republic, the United Kingdom, and Croatia, which joined the EU only in 2013. Out of the 25 contracting parties to the TSCG, 22 are formally bound by the Fiscal Compact: the 19 euro area Member States plus Bulgaria, Denmark and Romania. They are required to have enacted laws requiring their national budgets to be in balance or in surplus. These laws must also provide for a self-correcting mechanism to prevent their breach.

Fiscal stance: A measure of the direction and extent of discretionary fiscal policy. In this report, it is defined as the annual change in the structural primary balance. When the change is positive, the fiscal stance is said to be restrictive. When it is negative, the fiscal stance is said to be expansionary.

Five Presidents’ Report: A report on ‘Completing Europe’s Economic and Monetary Union’, prepared by the President of the European Commission in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank, and the President of the
European Parliament. Published on 22 June 2015, the report defines a roadmap towards the completion of the Economic and Monetary Union.

**Macroeconomic Imbalance Procedure (MIP):** The macroeconomic imbalance procedure aims to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances that could adversely affect economic stability in a particular EU Member State, the euro area, or the EU as a whole. It was introduced in 2011, after the financial crisis showed that macroeconomic imbalances in one country — such as a large current account deficit or a real estate bubble — can affect others.

**Matrix of adjustment:** A double-entry table detailing the structural adjustment required under the preventive arm of the Stability and Growth Pact since 2015. It modulates the benchmark annual adjustment of 0.5% of GDP depending on (i) cyclical conditions, as indicated by the level of the output gap and whether GDP growth is above or below potential, and (ii) the level of government debt and sustainability risks as measured by the S1 indicator.

**Medium-term budgetary objective (MTO):** According to the Stability and Growth Pact, EU Member States are required to specify a medium-term objective for their budgetary position in the Stability and Convergence Programmes. The MTO is country specific, to take into account the diversity of economic and budgetary developments as well as of fiscal risks to the sustainability of public finances. It is defined in structural terms (see structural balance).

**Output gap:** The difference between actual output and estimated potential output at any particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see potential GDP). A standard business cycle usually lasts up to eight years, suggesting that the output gap is normally expected to close roughly every four years.

**Overall assessment:** The analysis of the information conveyed by the two indicators used to assess compliance with the preventive arm of the SGP, namely the change in the structural balance and the expenditure benchmark. An overall assessment is conducted whenever at least one of the two indicators does not point to compliance with the requirements. It is meant to clarify (i) whether and how specific factors may affect one or both indicators, and (ii) if the two indicators do not support the same conclusions, which indicator would provide a more accurate assessment in the given context.

**Potential GDP (or potential output):** The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity begin to show and inflationary pressures build. If output falls below potential, resources are lying idle and inflationary pressures abate (see also production function approach and output gap).

**Preventive arm of the Stability and Growth Pact:** The part of the Stability and Growth Pact that aims to prevent gross policy errors and excessive deficits. Under the preventive arm, Member States are required to progress towards their medium-term budgetary objective at a sufficient pace and maintain it after it is reached.

**Production function approach:** A method of estimating an economy’s sustainable level of output, compatible with stable inflation based on available labour inputs, the capital stock and their level of efficiency. Potential output is used to estimate the output gap, a key input in estimating the structural balance.

**S0 indicator:** A composite indicator published by the European Commission to evaluate the extent to which there might be a risk of fiscal stress in the short term, stemming from the fiscal, macro-financial or competitiveness sides of the economy. A set of 25 fiscal and financial-competitiveness variables proven to perform well in detecting fiscal stress in the past is used to construct the indicator.

**S1 indicator:** A medium-term sustainability indicator published by the European Commission. It indicates the additional adjustment, in terms of change in the structural primary balance, required over five years to bring the general government debt-to-GDP ratio to 60% in 15 years’ time, including financing for any future additional expenditure arising from an ageing population.

**S2 indicator:** The European Commission’s long-term sustainability indicator. It shows the upfront adjustment to the current structural primary balance required to stabilise the debt-to-GDP ratio over an infinite horizon, including financing for any additional expenditure arising from an ageing population.

**Six-Pack:** A set of European legislative measures — five Regulations and one Directive — to reform the Stability and Growth Pact. The Six-Pack entered into force on 13 December 2011. It aims to strengthen the procedures for reducing public deficits and debts and to address macroeconomic imbalances.

**Stabilisation:** Economic policy intervention to bring actual output closer to potential output. In the Economic and Monetary Union, in normal economic times, this is
expected to be achieved through the ECB's monetary policy (for common shocks) and national automatic fiscal stabilisers (for country-specific shocks). When this is not sufficient, discretionary fiscal policy can also play a role.

**Stability and Convergence Programmes (SCPs):** Every year in April, EU Member States are required to set out their fiscal plans for the next three years and to submit them for assessment to the European Commission and the Council. This exercise is based on the economic governance rules under the Stability and Growth Pact. Euro area countries submit stability programmes; non-euro area countries convergence programmes.

**Stability and Growth Pact (SGP):** A set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies. The SGP is based on an agreement reached by the EU Member States in 1997 to enforce the deficit and debt limits established by the Maastricht Treaty.

**Structural balance:** The actual budget balance corrected for the impact of the economic cycle and net of one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance and of the overall orientation of fiscal policy (see also fiscal stance).

**Structural primary balance:** The structural balance net of interest payments (see also fiscal stance).

**Sustainability of public finances:** The ability of a government to service its debt. From a purely theoretical point of view, this basically assumes that the government debt level does not grow faster than the interest rate. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve. The European Commission uses three indicators of sustainability with different time horizons (S0, S1 and S2). They are complemented by a debt sustainability analysis including sensitivity tests on government debt projections and alternative scenarios.

**Two-Pack:** Two European regulations adopted in 2013 to introduce stronger fiscal surveillance including under the Stability and Growth Pact. The new mechanisms aim to increase the transparency of Member States' budgetary decisions, strengthen coordination in the euro area starting with the 2014 budgetary cycle, and recognise the special needs of euro area Member States under severe financial pressure.

**Zero lower bound (ZLB):** When the short-term nominal interest rate is at or near zero, the central bank is limited in its capacity to stimulate economic growth by further lowering policy rates. To overcome the constraint imposed by the ZLB, alternative methods of stimulating demand are generally considered, e.g. asset purchase programmes. The root cause of the ZLB is the issuance of paper currency, which effectively guarantees a zero nominal interest rate and acts as an interest rate floor. Central banks cannot encourage spending by lowering interest rates, because people would choose to hold cash instead.
### Table A.1: Gross domestic product at 2010 reference levels (annual percentage change, 2000-2018)

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Note: (1) Weighted in common currency.

Source: Commission 2017 spring forecast.
Table A.2: Harmonised index of consumer prices (percentage change on preceding year, 2000-2018)

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Note: National index if not available.
Source: Commission 2017 spring forecast.
Table A.3: Net lending (+) or net borrowing (−), general government (as a percentage of GDP, 2000-2018)

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Source: Commission 2017 spring forecast.
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**Source:** Commission 2017 spring forecast.
Table A.7: Debt dynamics components (as a percentage of GDP)

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Notes: (1) The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator); (2) The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source: Commission 2017 spring forecast.
REFERENCES


Committee for the Study of Economic and Monetary Union (1989), Report on economic and monetary union in the European Community (commonly called the ‘Delors Report’).


International Monetary Fund (2014), ‘Is it a time for an infrastructure push? The macroeconomic effects if public investment’, *IMF World Economic Outlook*, October.


