European Fiscal Board

Annual Report 2020

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ABBREVIATIONS

Member States

BE	Belgium
BG	Bulgaria
CZ	Czechia
DK	Denmark
DE	Germany
EE	Estonia
EI	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
HR	Croatia
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom
EA	Euro area
EU	European Union
EU-28	European Union, 28 Member States
EA-19	Euro area, 19 Member States

Other

AEA	American Economic Association
AIReF	Independent authority of fiscal responsibility
BICC	Budgetary Instrument for Convergence and Competitiveness
CP	Convergence programme
CSR	Country-specific recommendation
DBP	Draft budgetary plan
DG ECFIN	Directorate-General for Economic and Financial Affairs
DSA	Debt sustainability analysis
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive deficit procedure
EERP	European economic recovery plan
EFB	European Fiscal Board
EFC	Economic and Financial Committee

EFC-A	Alternates of the Economic and Financial Committee
EISF	European Investment Stabilisation Function
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
ESM	European Stability Mechanism
GDP	Gross domestic product
GFCF	Gross fixed capital formation
HCF	High Council of Finance
HCPF	High Council of Public Finance
IFIs	Independent financial institutions
IMAD	Institute of Macroeconomic Analysis and Developments
IMF	International Monetary Fund
MFF	Multiannual Financial Framework
MIP	Macroeconomic imbalance procedure
MTBF	Medium-term budgetary framework
MTFS	Medium-term fiscal strategy
MTO	Medium-term budgetary objective
NAWRU	Non-accelerating wage rate of unemployment
NGEU	Next Generation EU
OECD	Organisation of Economic Co-operation and Development
OGWG	Output Gap Working Group
PBO	Parliamentary Budget Office
RQMV	Reverse qualified majority voting
SB	Structural balance
SDP	Significant deviation procedure
SGP	Stability and Growth Pact
SIFI	Scope index of fiscal institutions
SP	Stability programme
SCPs	Stability and convergence programmes
SPB	Structural primary balance
SURE	Support to mitigate Unemployment Risks in an Emergency
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance

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FOREWORD

Prof. Niels Thygesen

Chair of the European Fiscal Board

The year 2019 turned out to mark the end of a six-year long recovery from the financial and sovereign debt crises. Economic growth, though slowing relative to the two previous years, seemed broadly in line with potential; average EU unemployment had been reduced to 7%; government deficits, although increasing slightly on the previous year, had been reduced to levels observed in 2007; the debt ratios in most highly-indebted Member States continued to edge down. And for the first time in almost two decades, no EU country was subject to the corrective arm of the SGP.

Nevertheless, our analysis identifies a number of critical elements in the implementation of the EU fiscal rules. The very high number of significant deviations under the preventive arm of the Pact confirmed a trend where many countries rather than making progress towards their medium-term budgetary objective, used favourable conditions to loosen their fiscal stance, including in their plans, unfortunately not to support government investment.

The most striking observation, only nine months after the year ended, is how radically conditions have changed. The deepest recession since the Great Depression, prompted by the Covid-19 pandemic and the lock-down measures taken to contain the spreading of the virus, triggered a massive fiscal effort in all countries. The Commission and the Council wisely activated the general escape clause in the fiscal rules; a number of common initiatives were agreed, involving also the European Stability Mechanism and the European Investment Bank, while the European Central Bank helped greatly to maintain financial stability through expansionary policies. The Commission prepared SURE, a mechanism to provide low-cost loans to finance temporary employment-protection measures. Lastly, the July European Council agreed on a package, as unprecedented in size as innovative in modalities, to assist the recovery over the next few years. The new recovery instrument, the Next Generation EU (NGEU), will mitigate two deficiencies of the highly decentralised framework: a limited fiscal capacity (1) to mitigate large exogenous shocks, and (2) to sustain growth-enhancing government expenditures.

The challenge for 2021 and beyond is to sustain the recovery, while seeking a new balance between EU and national elements in the EU fiscal rules and governance. The uncertainties of the 2021 outlook and the heavy loss of output relative to 2019 and the pre-pandemic prospects, fully justify the flexibility of the general escape clause. An agreement on the mechanism to deactivate the clause should ideally be reached by spring 2021.

Even before that, the Commission's consultations on a possible reforms of the fiscal rules – started in February 2020, but put on hold as the pandemic struck – should begin anew. In the relatively benign years up to and including 2019, deficiencies in the rules gradually became evident: complications and ambiguities; difficulties in sustaining fiscal stabilisation within sustainability constraints; and the inability to protect growth-enhancing government expenditures. The EFB provided an extensive overview of these weaknesses in our assessment report of August 2019. Our review of the most recent experience confirms this assessment, not least with respect to the inability to build fiscal buffers in good times. From the current perspective, the deficiencies identified seem more obvious: the short-term policy indicators relied upon have become even less observable; the responsibility for sustaining investment has temporarily been assumed by the NGEU, but will require national follow-up; fiscal stabilisation subject to sustainability constraints must be reassessed to leave more room for sustaining demand in the low interest-rate environment.

Some prominent observers are arguing that numerical rules have become too difficult to apply and might be replaced by more qualitative standards of fiscal behaviour. The EFB shares the diagnosis but not the proposed cure. We would be concerned to provide temptations to free-ride on ECB policies which over time would undermine

the effectiveness of monetary policy. At a time of increasing EU responsibility for spending and debt, it would be paradoxical to give up quantitative commitments to a long-run anchor for national government debt. We continue to see well-designed and quantitative fiscal rules as desirable underpinnings in EMU, as well as in the EU as a whole. The fact that, on average, countries with more fiscal space were able to implement stronger support packages in the first half of 2020, strengthens our view.

In our view, however, it would be counterproductive to try to reintroduce the existing rules in substantially unchanged form when the general escape clause is deactivated. The current situation offers a major opportunity to address past weaknesses in the SGP. The issue of what is activated seems at least as important as the timing of the decision. If so, the review of the rules has to reach the agenda very soon in order to avoid a vacuum in which excessive elements of discretion will be difficult to avoid.

Marking out the direction in which the rules and governance should be modified will obviously be a difficult process, but that is not an argument for waiting. It seems likely that trying to revise the rules after deactivation could prove even more contentious.

The EFB updates some of the proposals made earlier: to limit complexities and ambiguities, to offer better and more permanent protection for growth-enhancing government expenditures, and to set realistic targets for debt reduction in Member States far above the 60% reference value. Since we already reviewed potential approaches to investment protection in our June 2020 report, the focus in the current report is mainly on debt reduction strategies.

The operationalisation of the 'satisfactory pace' of debt adjustment defined in the six pack has become a less realistic guidepost with the major worsening of public finances. We believe it is important to move towards further differentiation of the pace of debt reduction for countries far above the Treaty reference value, while easing the monitoring of those well below it. We illustrate how that might be done under different assumptions regarding the level of debt and the difference between the interest cost of debt servicing and the nominal growth rate of the economy. That difference has been helpfully negative for many countries in recent years, alleviating sustainability concerns. Nevertheless, it remains, in the EFB's view, desirable to maintain a debt target, even if it is very far below the high debt ratios of some countries, and the adjustment path extends over a long span of years. Without such a commitment, interest rates on government debt are more likely to increase ultimately threatening solvency of sovereigns.

The NGEU has the potential for making the EU economies more cohesive and resilient. The EFB hopes the contributions of the NGEU (and the SURE) to both the stabilisation and better quality of government expenditures will be more than temporary. But even if they were to be permanent, the main responsibility for fiscal and structural policies will remain in the hands of national governments, subject only to the gentle guidance of Council recommendations. It is essential that, at a time when EU efforts are being stepped up, eligibility to benefit from these efforts is made contingent on compliance with a revised framework for guiding national policies. The revised framework should complement the EU efforts as long as these are in place, and prepare to take over their role beyond that. The debate on updating the framework is in our view urgent and the agenda clear: make the rules simpler, more readily accepted and more enforceable, while implementing them flexibly, but in an economically more meaningful way than in the past. Future implementation should end the frequent practice of accommodating for the political expediencies of national governments who find it hard to take more structural measures to reduce their country's deficit and contain the rise of debt.

EXECUTIVE SUMMARY

This annual report documents the work of the European Fiscal Board for the 2019 cycle of EU fiscal surveillance. In accordance with the mandate assigned by the Commission to the Board, this report offers a comprehensive assessment of the implementation of the Stability and Growth Pact (SGP). The assessment covers the 2019 fiscal surveillance cycle, which is the most recent complete annual cycle of economic surveillance in the EU ([1]). It starts with the stability and convergence programmes (SCPs) submitted by Member States in April 2018 and ends with the final assessment of compliance performed in spring 2020. The report also assesses whether the aggregate fiscal stance in the euro area was appropriate in 2019 and how individual fiscal policies of euro area Member States contributed to the aggregate stance.

While slowing for the second year in a row, economic growth in 2019 was positive and around potential in both the EU and the euro area. The economy grew by 1.2% in the euro area and 1.5% in the EU, broadly in line with current estimates of potential growth. Growth entirely relied on domestic demand, especially as private investment proved particularly dynamic in some countries. By contrast, net exports weighed on activity. Despite the mild economic growth, labour markets in Europe remained strong and the rate of unemployment hit an historical low. In the face of persistently low inflation, the ECB's monetary policy remained highly accommodative.

Macroeconomic forecasts were on the optimistic side. Although still sustained, economic growth turned out lower than in the macroeconomic scenarios underpinning the SCPs of spring 2018, especially in euro area countries. This is a recurrent issue: over the course of the last recovery, governments' growth assumptions have proved too optimistic in a number of countries. In the specific case of 2019, all main forecasters had joined a wave of optimism in spring 2018, fuelled by the very strong outturn of 2017. Although the upbeat growth expectations did not materialise, 2019 can still be considered a year of good times, with growth broadly in line with post-crisis averages and the level of economic activity above potential in the vast majority of EU countries.

The budget deficit in the EU and the euro area as a whole increased for the first time since 2011. The deficit increased from 0.5% to 0.6% of GDP in the euro area and from 0.7% to 0.8% of GDP in the EU. While the increase was contained, it marked a trend reversal after eight years of decline and in spite of continued economic growth. Moreover, the budgetary outcome missed the target implied by the SCPs of spring 2018, which envisaged a slight reduction of the deficit on aggregate. At the country level, the budgetary outturn was below target in almost half of the Member States.

Government revenue-to-GDP declined on the previous year but was slightly higher than planned on aggregate. The discretionary tax cuts observed in some countries were already largely planned in the SCPs. The tax cuts translated, on aggregate, into a slight drop of revenue as a share of GDP compared to 2018. The drop was nonetheless not as large as it could have been, because in most EU countries the revenue ratio came out slightly higher than envisaged in governments' plans. This occurred especially in countries where governments' initial growth assumptions proved prudent or where tax revenues turned out more buoyant than what economic growth would normally imply.

Expenditure slippages, especially in countries with limited fiscal space, largely explain the deficit increase in 2019. In the EU as a whole, public expenditure turned out 2.4% higher than envisaged in the spring 2018 SCPs. Sizeable slippages took place in countries with limited fiscal space: countries that had a high debt, that were not at their medium-term budgetary objective or that did not fully offset the slippages by higher revenue. In some cases, expenditure overruns were even coupled with lower-than-expected revenues, part of which resulted from discretionary tax cuts. Overall, if the level of public expenditure in all countries had been in line with governments' plans, the budget deficit would have almost vanished in the euro area as a whole, and it would have narrowed substantially in the EU.

([1]) Given the backward-looking nature of this report, the UK is still part of the analysis, and references to EU Member States include the UK.

Slippages were biased towards current expenditure. Much of the additional expenditure was concentrated on current spending while only a small fraction was allocated to government investment. Although investment increased as a share of GDP, the increase was only sufficient to cover for capital depreciation, thus maintaining the existing stock of capital broadly unchanged.

Standard indicators signal an expansionary fiscal stance in the euro area. Expenditure growth net of revenue measures, and the change in the structural balance net of interest payments, are the two most prominent tools to measure the fiscal stance, as they are based on the two indicators of compliance under the SGP. We present a retrospective analysis going back to 2004, which shows that the two approaches often point in the same direction. However, our analysis also shows that due to methodological differences, net expenditure growth tends to suggest more ample swings in discretionary fiscal policy over the cycle. The year 2019 offers another example: like in 2018, net expenditure growth signals a more pro-cyclical fiscal expansion than the change in the structural primary balance. This is mainly because the unusually buoyant part of revenue is treated as structural in the calculation of the structural balance, suggesting more consolidation, while these revenues are not taken into account in the calculation of net expenditure growth.

The observed fiscal expansion was not in line with the guidance issued by the EFB, the Commission and the Council for 2019. All three institutions provided their guidance on the background of the country-specific fiscal recommendations of spring 2018, which on aggregate amounted to a slightly restrictive fiscal stance for the euro area as whole. The Commission, the Council and the Board expressed a consensus view on the need to reduce high debt levels and build fiscal buffers wherever needed. As for countries with available fiscal space, the Commission invited Germany and the Netherlands to run a domestic fiscal expansion, suggesting an aggregate broadly neutral fiscal stance. The EFB chose not to give any specific guidance for these two countries, given the positive growth outlook, and therefore recommended a slightly restrictive aggregate fiscal stance. Based on the latest economic developments, the EFB stands by its guidance.

Confirming established trends, favourable economic conditions were not used to improve public finances: fiscal policy was pro-cyclical. In retrospect, slower but still sustained economic growth in 2019 did not warrant a fiscal expansion. Most euro area countries implemented an expansionary fiscal stance regardless of their budgetary situation. In a year of still sustained growth, such a distribution across countries was not appropriate. This confirms, more generally, a tendency to relax the fiscal adjustment effort in a pro-cyclical manner. It also highlights an underlying issue of time inconsistency in the application of the EU fiscal framework. Not all countries take advantage of good times to improve public finances. In part, this can be explained by their experience that in spite of stricter legislation, the implementation of the rules tends to be adjusted in the case of shocks or in the event of major economic difficulties.

In contrast to previous years, the Commission assessed many cases of significant deviation without resorting to elements of discretion. In its final assessment carried out in spring 2020, the Commission concluded that there was a significant deviation from the recommended adjustment path in 10 Member States. Unlike in previous years, it reached those conclusions without conducting any elaborate overall assessment. The Commission directly drew conclusions from the signals of the two compliance indicators, namely the structural balance and the expenditure benchmark. The only exception was Italy, for which the indicators gave conflicting signals as to whether there was a significant deviation; the Commission argued that there was no robust evidence and did not draw any conclusions.

On the back of the Covid-19 crisis, non-compliance in 2019 remained largely inconsequential. In March 2020, the Commission activated the general escape clause with the Council's approval, thus allowing Member States to deviate temporarily from the adjustment requirements of the SGP in order to deal with the Covid-19 crisis. Although the clause does not apply to 2019, the Commission and the Council agreed that the exceptional impact of the pandemic in 2020 did not warrant any follow-up to non-compliance in the preceding year. Similarly, the Commission finally closed the case of Belgium for both 2018 and 2018-2019 and concluded on non-compliance, but again without any further consequences. In the same vein, the Commission

concluded that Hungary had significantly deviated from its adjustment path in 2019, but it still did not propose a new significant deviation procedure under which the country had been since 2018.

The only procedural step in early 2020 was to place Romania under the corrective arm of the SGP. Before the activation of the general escape clause on 23 March 2020, the Commission prepared an Article 126(3) report for Romania in February 2020. This occurred before the official statistical data were published but one month after the government itself announced that it would breach the deficit criterion in 2019 by a large margin. The Council subsequently adopted a recommendation under Article 126(7) of the Treaty in April 2020, with a view to bringing an end to the situation of excessive deficit in Romania. In May 2020, the Commission issued reports concluding that Belgium, Spain and France had breached the debt criterion in 2019, but this time the subsequent procedural step (the opening of debt-based EDPs) was postponed to at least autumn 2020 due to the Covid-19 pandemic.

The current approach in implementing the EU fiscal rules contrasts with the situation in the wake of the Great Recession of 2008-2009. The general escape clause does not suspend the rules but allows temporary deviations. The provisions of the escape clause were introduced with the six-pack reform, following the experience of 2009-2010. At the time, the Commission and the Council opened EDPs for most countries that included an initial stimulus phase under the coordinated European economic recovery plan and a predefined, gradual consolidation path for subsequent years, with the objective of safeguarding credibility. The coordinated stimulus was therefore part of a medium-term strategy aimed to safeguard the sustainability of public finances. In spring 2020, by contrast, the Commission and the Council, rather than formulating time-limited deviations from the required adjustment path, decided to put procedures on hold.

Deferred procedures and temporary fiscal support at EU level offer some breathing space to Member States with difficult fiscal conditions. At the height of the first wave of Covid-19 infections, countries with better budgetary positions and lower government debt implemented, on average, larger discretionary stabilisation measures. The EU response combines two types of measures that temporarily alleviate fiscal constraints in countries that did not manage to sufficiently improve public finances in the last recovery. First, procedural follow-up under the SGP has been put on hold, mostly on account of the very high degree of uncertainty about the short-term economic and fiscal outlook. At the same time, national fiscal constraints have been eased primarily by the initiatives of the ECB and, going forward, by the sizeable temporary EU initiatives; these include Next Generation EU (NGEU) and the Support to mitigate Unemployment Risks in an Emergency (SURE) which together provide up to €850 billion in funding.

The unprecedented number and the size of deviations in 2019 are a source of concern. Both the number and the average size of significant deviations from the requirements under the preventive arm of the SGP were the largest since at least 2014. An additional concern is that half of them took place in high-debt countries, where sustainability concerns and, in turn, consolidation needs are the highest. Beyond the temporary relief offered by the NGEU and SURE, fiscal imbalances will have to be addressed at some point.

The observed lack of compliance partly originates in the planning phase. Since the entry into force of the two-pack legislation in 2013, euro area countries have been required to present draft budgetary plans (DBPs) every autumn for the following year. More than half of the euro area countries have regularly presented plans that the Commission assessed as only 'broadly complying' – that is, deviating within a pre-defined margin of 0.5% of GDP – or at risk of non-compliance with fiscal requirements. The DBPs for 2019 followed the same trend: the Commission assessed the plans as compliant in only 9 countries out of 19.

For the first time the Commission rejected a draft budgetary plan. In autumn 2018, the Commission rejected Italy's DBP for 2019, which it assessed as pointing in the direction of particularly serious non-compliance: the DBP planned a large deviation from the recommended adjustment path and was based on an unrealistic macroeconomic scenario that had not been endorsed by the national independent fiscal institution. The Commission therefore requested the Italian authorities to submit an updated plan. This was followed by a dialogue between the Commission and the Italian authorities, which ultimately improved the budgetary outcome. The

EFB acknowledges the positive outcome following the bilateral negotiations but notes that they go against the spirit of multilateral surveillance as defined in the Treaty.

This report reviews more closely the set-up and role of independent fiscal institutions (IFIs) in Germany and Czechia. Both countries have an IFI that is given a formal role by EU legislation, along with other IFIs that also contribute to the domestic budgetary process. Germany's core IFI, the Independent Advisory Board to the Stability Council, is a lean body of nine recognised experts supported by a small secretariat. It is embedded in a complex system of technocratic and political bodies, including four long-established non-core IFIs that provide advice on economic policy issues and fiscal policy, produce tax revenue forecasts and endorse the Ministry of Finance's macroeconomic projections. The cornerstone of this system is institutional cooperation, and its success is partly attributable to a large political support to fiscal prudence. The Czech Fiscal Council, established in 2018, is the most recent core IFI in the EU. It conducts fiscal surveillance sequentially with a non-core IFI, the Committee on Budgetary Forecasts. The two bodies are independent from each other and, like in Germany, their functioning relies on cooperation with other bodies.

In the 2019 EU surveillance cycle, IFIs continued to play an important role while facing difficulties. IFIs' replies to a dedicated questionnaire highlight serious challenges, such as the presence of caretaker governments with limited powers to take measures and the uncertainty surrounding the Commission's use of discretion in fiscal surveillance. Still, IFIs proved useful by fostering transparency on risks of deviations from fiscal rules, which increased the reputational costs for some governments. In addition, in some countries IFIs either did not endorse overly optimistic official macroeconomic forecasts or expressed reservations about them. Finally, some IFIs issued recommendations to improve the quality of budgetary planning.

The Covid-19 crisis has put on hold the Commission's review of economic governance. Just before the pandemic, in early February 2020 the Commission had launched a public consultation on economic governance in the EU. While noting progress in the coordination of fiscal policies, the Commission identified weaknesses, such as high levels of public debt in some countries, a tendency towards running pro-cyclical fiscal policies, and the complexity of EU fiscal rules. On this basis, it listed issues for a public debate on how to improve the EU fiscal framework and left the next steps open. While the pandemic has postponed the review, for the European Fiscal Board the crisis underscored three missing elements in the current EMU architecture.

First, EMU needs a permanent fiscal capacity to address large shocks. The Covid-19 crisis showed the costs of not having a permanent and genuine central fiscal capacity that can be deployed in a timely manner to deal with a large, exogenous shock. The capacity should ultimately take the form of a larger EU budget financed by own tax resources, with a meaningful size, the capacity to borrow in the event of large shocks and a focus on EU investment priorities. Disbursements could be based on a combination of indicator-based automaticity and independent assessment.

Second, the EU fiscal framework needs to be simplified and more effective. The surge in public debt stresses the need for realistic and country-specific adjustment paths to ensure debt sustainability in each country once the general escape clause is deactivated. The EU fiscal framework should be rebuilt on three principles: (i) a debt anchor, (ii) an expenditure rule laying down credible, country-specific adjustment speeds to reach the debt anchor, and (iii) a general escape clause. To strengthen governments' incentives to abide by the rules, compliance with them should be a precondition to have access to the proposed central fiscal capacity.

Third, growth-enhancing expenditure needs to be protected. The crisis underlined how certain items of government expenditure that are essential to support growth, such as investment, have declined over time, especially during periods of fiscal consolidation. This expenditure therefore needs an effective shield in the future, notably by allowing certain increases in investment when assessing compliance with the expenditure rule.

These elements should go hand in hand with improved governance. In particular, the reformed framework would benefit from enhanced transparency and a clearer role for independent economic assessment.

1. MAIN MACROECONOMIC AND FISCAL DEVELOPMENTS IN 2019

Highlights

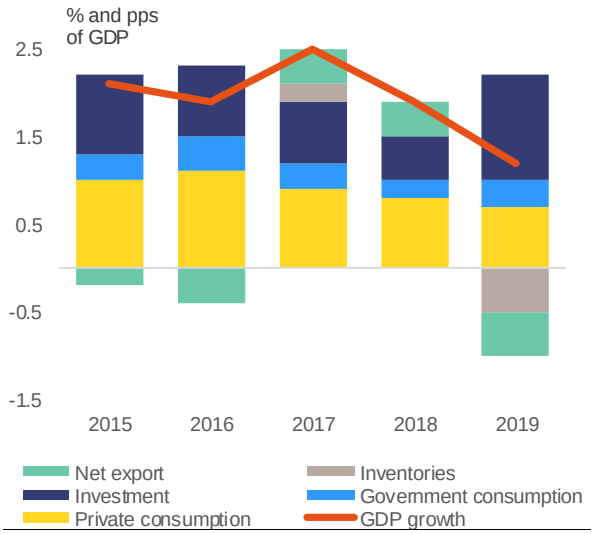
- In 2019, real GDP growth slowed in both the euro area and the EU for the second year in a row, yet remained close to current estimates of potential of around 1½% per year.
- In spite of slowing economic growth, the labour market remained strong. Unemployment rates in the euro area and the EU reached their lowest levels on record.
- Economic growth turned out somewhat below the projections underpinning the stability and convergence programmes of spring 2018. Overly optimistic growth projections have been common in the last six years in several countries, contributing to budgetary slippages.
- The year 2019 marked a reversal for public finances. Following eight consecutive years of improvement, the aggregate deficit of the euro area and the EU posted a marginal increase reaching 0.6% and 0.8% of GDP respectively, and falling short of the targets implied by the stability and convergence programmes of spring 2018 by around ¼% of GDP.
- The deterioration of public finances in the face of slower, but still positive economic growth largely resulted from expenditure-increasing measures, which more than offset further savings on debt servicing costs.
- Government revenues declined as a share of GDP on the back of discretionary measures, – off-setting some windfalls – while expenditure grew faster than potential output.
- Overall, the structural primary budget balance of the euro area and EU aggregate weakened by a ¼% of GDP.
- If all Member States had implemented their original spending plans, the headline deficit would have almost vanished in the euro area and narrowed to 0.3% of GDP in the EU.
- Upward revisions in initial spending plans were significant and broad based. Slippages occurred especially in countries with fiscal consolidation needs as defined by the SGP. With very few exceptions, no country revised expenditure downwards.
- Confirming a pattern observed in previous years, the lion's share of higher-than-planned spending went into current expenditure. In spite of evident needs and the opportunity provided also by higher than projected revenues, only a very small fraction (less than 1/10th) was allocated to government investment in 2019.
- Over the last four years, cumulative deviations from spending plans amounted to around 3% of GDP, but only 0.1% of GDP went into additional government investment compared to plans.
- As a result, and in spite of a gradual recovery, government investment was still below its average pre-crisis level, and significant gaps persist across countries.
- Numerical compliance with EU fiscal rules worsened for the second year in a row, mainly on account of deviations from the expenditure benchmark, a rule designed to cut through cyclical swings. A similar pattern was observed in the run-up to the 2008-2009 crisis, when windfalls of the recovery were used to loosen the fiscal policy stance.
- Growing deviations from the expenditure benchmark were particularly evident in high-debt countries.

1.1. MAIN MACROECONOMIC DEVELOPMENTS IN 2019

In 2019, and after peaking in 2017, real GDP growth in the euro area and the EU slowed for the second year in a row. Still, the aggregate level of economic activity increased by 1.2% in the euro area and 1.5% in the EU, down from respectively 1.8% and 2.1% a year earlier.

Domestic demand, and especially investment, remained the main driver of growth, while changes in stocks had a significant negative impact. A sharp increase in investment mainly reflected exceptional developments in Ireland, related to the activities of multinationals, and a marked increase in machinery and equipment in Germany. Net export produced a negative contribution to GDP growth, narrowing the current account surplus.

Graph 1.1: **Real GDP and its components (euro area)**



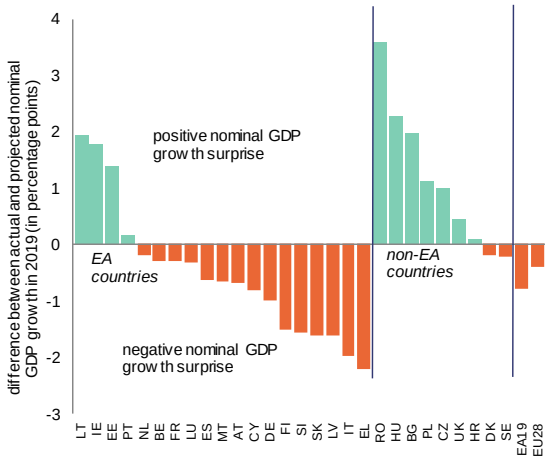
Source: European Commission

In spite of the lower pace of output growth, labour markets in Europe remained strong. Employment grew by 1.2% and 1.0% in the euro area and the EU respectively. As a result, the number of people looking for work declined by 0.6 percentage points to 7.5% and 6.3% of the labour force in the euro area and the EU. These figures are very close to or below the lowest unemployment rates recorded for the two aggregates since its measurement by the labour force survey ([2]). A tighter labour market led to growing wages, which in the absence of productivity gains affected firms' profit margins.

Headline inflation in the euro area decreased by 0.6 percentage points to 1.2% compared to 2018, primarily reflecting a fall in energy prices. Despite domestic inflationary pressures coming from robust wage growth and high employment levels, core inflation remained low at 1.1% in the euro area. The GDP deflator posted a more dynamic increase of 1.7% on account of improved terms of trade.

Monetary policy remained highly accommodative in the euro area, and the ECB announced additional monetary stimulus measures in autumn 2019 ([3]). Furthermore, very low funding costs ensured private sector lending continued to expand at a sustained, albeit slightly slower pace than in 2018.

Graph 1.2: **Nominal GDP growth surprises in 2019 with respect to the stability and convergence programmes (SCPs) presented in 2018**



Notes: (1) The chart shows the difference between actual nominal GDP growth in 2019 and the forecast of nominal GDP growth in spring 2018. (2) Greece was exempted from submitting a stability programme in 2018, because it was still under the macroeconomic adjustment programme. Therefore, GDP growth projections are from the government's medium-term fiscal strategy (MTFS) 2019-2021 of May 2018.
Source: European Commission, 2018 stability and convergence programmes, own calculations

GDP growth in the euro area and the EU turned out lower than assumed in spring 2018. Compared to the projections underpinning the 2018 stability and convergence programmes (SCPs), nominal

([2]) The European Labour Force Survey (EU-LFS) unemployment data for the EA and the EU have been available since 1997 and 2000, respectively. Data for all Member States are mostly available from 1998 onwards (for the former EU-15 from 1992 onwards.

([3]) The autumn 2019 easing package included a 10 bps cut in the deposit facility rate to -0.50% and a restart of open-ended net asset purchases at a pace of EUR 20bn per month from November 2019. The ECB also announced a strengthening of its forward guidance on policy rates to reinforce the impact of the cut in the deposit facility rate as well as the signalling effect of asset purchases.

GDP growth came 0.8 percentage points lower than expected in the euro area and 0.4 percentage points in the EU (Table 1.4). Notable exceptions were Estonia, Ireland, Lithuania and Portugal in the euro area, as well as most non-euro area countries (see Graph 1.2). In the case of non-euro area countries, better-than-projected nominal GDP growth was mostly driven by a positive inflation surprise.

A shortfall of GDP growth compared to plans can mean two different things: (i) an unexpected economic slowdown, or (ii) over-optimism in the forecast. Box 1.1 looks at the average forecast errors of nominal GDP growth in 2013-2019, the years after the euro area sovereign debt crisis. It shows a tendency towards sizeable and persisting over-optimism in a number of countries with average errors close or larger than -1%. For a small number of countries a similar 'bias' in the year-ahead GDP growth projections can be found in the Commission forecasts ([4]). In 2000-2017 a negative bias (i.e. forecasts were on average too optimistic) was found for Belgium, France, Italy and Portugal, while a positive bias (i.e. forecasts were on overage too pessimistic) was found for Denmark and Malta. Over-optimism in growth projections underpinning budgetary plans typically lead to budgetary slippages, as expenditure levels are generally not adjusted downward for the shortfall of GDP growth ([5]).

Table 1.1: **Revision in potential and actual GDP levels in 2019 (spring 2018 vs spring 2020 forecast)**

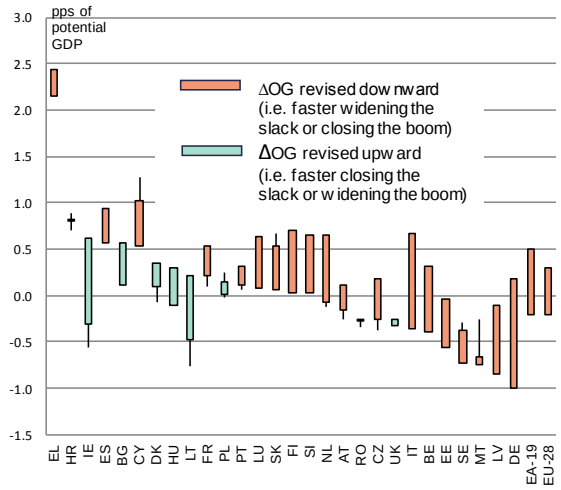
	Pot. GDP level (% change) (A)	Real GDP level (% change) (B)	Output gap % pot. GDP (pps change) (C)		Pot. GDP level (% change) (A)	Real GDP level (% change) (B)	Output gap % pot. GDP (pps change) (C)
IE	-1.7	0.0	1.7	IT	-0.2	-1.0	-0.8
FR	-0.8	-0.3	0.5	EE	1.9	3.3	1.4
LV	-2.3	-0.9	1.5	CY	2.0	4.6	2.6
LU	-2.0	-0.8	1.3	PT	0.6	1.6	1.1
AT	-2.0	-1.0	1.0	BE	0.1	0.6	0.4
SK	-3.6	-2.1	1.5	FI	0.1	0.0	-0.1
DE	-2.3	-1.9	0.4	LT	-0.3	2.0	2.4
ES	-1.1	-1.2	0.0	MT	-0.7	2.8	3.5
NL	-0.2	-0.5	-0.3	EL	1.3	-0.4	-1.6
SI	-0.5	-1.5	-1.0	EA	-0.9	-0.9	0.2

Source: European Commission

The 2019 fiscal surveillance cycle was, once more, characterised by quite large revisions in potential GDP levels, which have important implications for the estimation of the output gap ([6]) and, in turn, for the estimation of the structural balance, a key indicator in the assessment of compliance.

Table 1.1 shows the revisions in potential GDP and in real GDP levels for 2019 between the Commission 2018 and 2020 spring forecast. Although, at aggregate level, the revisions in potential GDP largely followed those in real GDP (i.e. the output gap slightly improved compared to its initial estimate), the situation varies significantly across Member States. For most of the countries, revisions in potential GDP levels resulted in a more positive output gap than the output gap estimated in spring 2018 ([7]). However, in order to assess whether revisions have also affected the estimated fiscal effort, which is measured by the *year-on-year change* of the structural balance, it is necessary to also look at the *year-on-year change* of output gap, as revisions in GDP also concerned previous years.

Graph 1.3: **Revisions in output gap yearly changes in the 2019 surveillance cycle (spring 2018 to spring 2020 rounds of Commission forecasts)**



Notes (1) The chart shows different estimates of the output gap year-on-year change (ΔOG) for 2019. (2) Red (green) bars = downward (upward) revisions in the output gap change; for a country with a positive output gap, it means a faster closing (widening) of the upturn; for a country with a negative output gap, it means a faster widening (closing) of the slack. (3) Bar's height equals to the difference between spring 2020 and spring 2018 vintages of Commission forecasts; straight lines = maximum and minimum values from the intermediate rounds of Commission forecasts.
Source: European Commission

([4]) Chabin et al. (2020). In the authors' analysis, the year-ahead forecasts and realisations are taken from the Commission's autumn forecasts, which are published in November.

([5]) See Jonung and Larch (2006); Frankel and Schreger (2013).

([6]) The output gap is defined as the difference between actual output and the potential level of output. The latter is commonly defined as the level of output that an economy could potentially achieve under certain circumstances – typically in a theoretical situation in which the economy is not constrained by nominal rigidities in price and wage setting.

([7]) For Greece and Italy, the only two countries with output estimated below their potential, the slack increased compared to spring 2018 estimates.

Box 1.1: Forecast errors in the medium-term budgetary plans

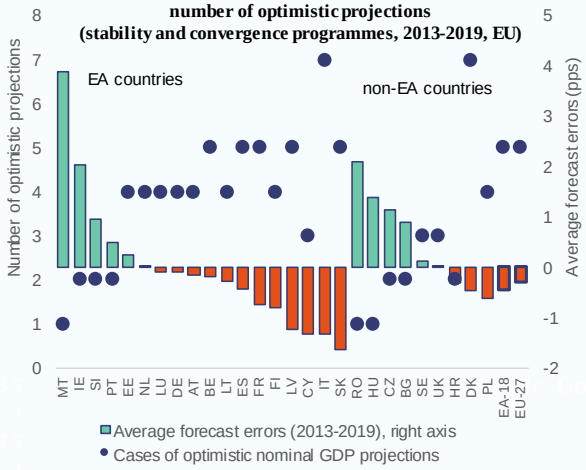
This box examines the difference between actual GDP growth (one-year-ahead) and the projections presented in the stability and convergence programmes during the last recovery phase. In 2013-2019, the governments' nominal GDP projections were overoptimistic in most of the cases (Graph 1a). The average forecast error was -0.4 percentage point for the euro area and -0.3 for the EU as a whole ([1]).

Forecast errors for the euro area and the EU as a whole mask significant differences across countries. Forecasts were on the high side in five out of seven years in Belgium, France, Spain, Latvia and Slovakia; in Italy in all the years, and the average forecast error amounted to -1.3 percentage points. Based on a back-on-the-envelope-calculation, the systematic overestimation of GDP growth in Italy translates into an impact on the general government budget of more than 0.5% of GDP per year. By contrast, growth forecasts were on average prudent compared to outcomes in five euro area countries (Malta, Ireland, Slovenia, Portugal and Estonia). Among the non-euro area countries, projections have proven overoptimistic half the time in Poland and in all the years in Denmark, but errors were smaller compared to euro-area countries.

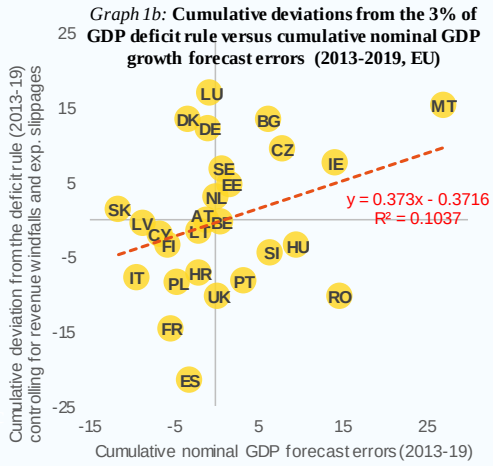
Of note, although comparatively accurate and unbiased in general, forecasts of the European Commission display a statistically significant optimism bias in the one-year-ahead projections for a few Member States including those whose governments tend to be on the optimistic side too, notably Belgium, France and Italy ([2]).

Taking the cumulative forecast error in 2013-2019, Graph 1b shows a positive relation with the observed deviation from the 3% of GDP deficit reference value over the same period, after controlling for a number of other determinants: More conservative growth assumptions go, on average, with a better fiscal performance, as measured by the headline balance even in this very simple set-up with cumulative data for a small cross section of countries. This finding is not surprising and confirms a nexus revealed by several much more comprehensive studies covering longer periods of time ([3]).

Graph 1a: **Average nominal GDP forecast errors and number of optimistic projections (stability and convergence programmes, 2013-2019, EU)**



Graph 1b: **Cumulative deviations from the 3% of GDP deficit rule versus cumulative nominal GDP growth forecast errors (2013-2019, EU)**



Notes: (1) Forecast errors refer to the difference in percentage points between actual nominal GDP growth and the one-year-ahead projections underlying the stability and convergence programmes (SCP). (2) Aggregate data do not include Greece, Cyprus (2015-2016) and Croatia (2013). (3) In Graph 1.b, deviations from the deficit rule are calculated as the difference between the actual budget balance in percent of GDP and -3% of GDP; a positive (negative) sign means the budget balance is above (below) -3% of GDP. Values on the y-axis are the residuals of a regression where the deviation from the deficit rule is controlled for revenue windfalls (see Glossary) and the expenditure slippages (i.e. the difference between actual and projected government expenditure in percent of GDP in the 2018 SCP.

In most cases, the one-year-ahead growth forecasts become more accurate over the course of the planning year (Graph 2a). In particular, overoptimistic governments see their forecast converge slightly towards the outturn while

([1]) Aggregate values do not include Greece (2013-2019), Cyprus (2015-2016) and Croatia (2013). The former two countries were under a macroeconomic adjustment programme and, therefore, exempted form submitting stability programmes.
([2]) Although time periods are not fully comparable, other international organisations also have or had the tendency to over-predict GDP growth. See, for example, IMF (2014) and OECD (2014).
([3]) Strauch et al. (2004); Jonung and Larch (2006); Beetsma et al. (2011); Frankel and Schreger (2013).

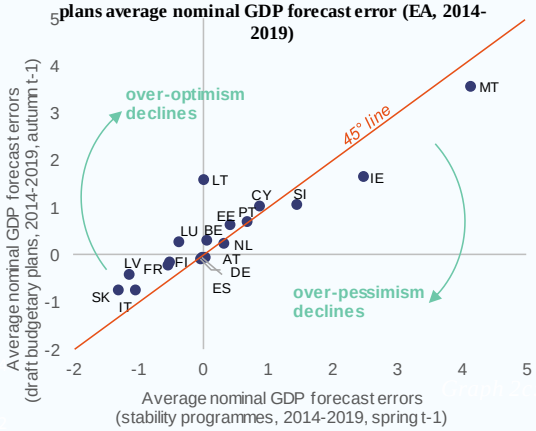
(Continued on the next page)

Box (continued)

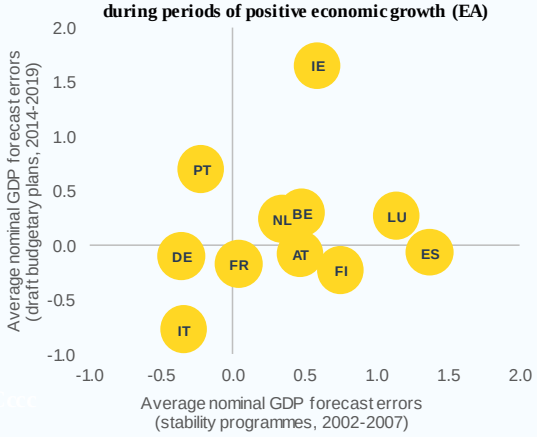
those with positive growth surprises see these exacerbated. However, results show that overoptimistic forecasts remain so despite some improvements towards the end of the year.

Overoptimistic forecasts have been more prevalent in the last recovery phase compared to the expansion prior to the financial crisis (Graph 2b). Between 2002 and 2007 only Germany, Italy and Portugal had, on average, produced optimistic forecasts; For Germany and Italy this still holds true during the recent phase but they have been joined by four other Member States (Austria, Spain, Finland and France).

Graph 2a: **Stability programmes vs draft budgetary plans average nominal GDP forecast error (EA, 2014-2019)**



Graph 2b: **Average nominal GDP forecast errors during periods of positive economic growth (EA)**



Notes: (1) in Graphs 2.a and 2.b, sample has been reduced to the orginal euro area countries (i.e. EA-11, excluding Greece) for which data is available in both periods. (2) In Graph 2.b, in order to ensure comparability with 2002-2007 stability programmes - which during that period had been published in autumn - 2014-2019 forecast errors are based on the draft budgetary plans, which are equally submitted during autumn.

Graph 1.3 shows revisions in the year-on-year change of output gap (i.e. the difference, in percent points of potential GDP, of output gap estimates for 2019 with respect to 2018) as estimated throughout the surveillance cycle. For most of the countries, the change in output gap was revised downwards; this means either i) a smaller improvement (e.g. Spain and France); ii) a larger worsening (e.g. Estonia and Latvia); or iii) a sign reversal (e.g. Belgium, Italy and Germany) in output gap's changes compared to the Commission's initial estimates.

In terms of assessing compliance with SGP requirements, such downward revisions translated – other things being equal – in a more benign reading of fiscal efforts as measured by the change in the structural balance. Such continuous revisions and their impact on the assessment of compliance vindicate those like the EFB, who have expressed preference for a single operational rule, namely the expenditure benchmark, which is less affected by point-in-time estimates of potential GDP.

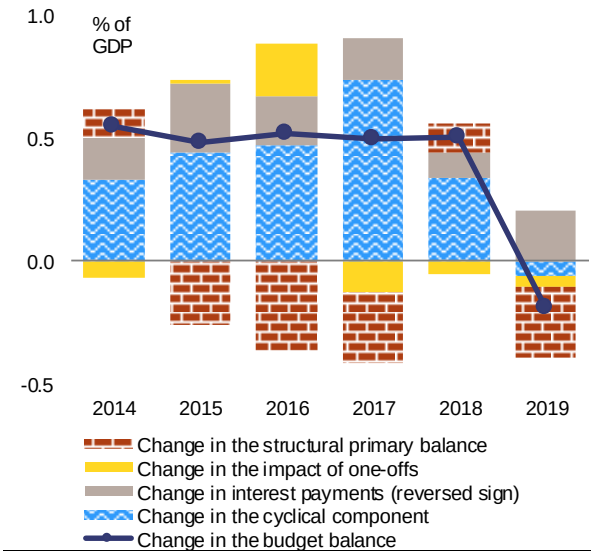
1.2. MAIN BUDGETARY DEVELOPMENTS IN 2019

The year 2019 marked a change in trend. Following significant improvements in the budget balance since 2011, the aggregate budget deficit posted a small increase of 0.1 and 0.2 percentage point, to 0.6% and 0.8% of GDP in the euro area and the EU, respectively, compared to 2018 (Table 1.4).

The contained deterioration of headline balances hides a somewhat larger decline in the structural primary balance (Graph 1.4), which worsened by 0.3 percentage point to 0.5% of GDP. The difference in the change of the two balances is primarily due to increased savings in interest payments. While developments in 2019 marked a turning point in terms of the budget balance, government primary expenditure has been growing faster than medium-term potential GDP since 2016 (Graph 1.5). This points to a continued deterioration of the underlying fiscal position unless it was offset by revenue-increasing policy

measures, which was not the case over that time (see below).

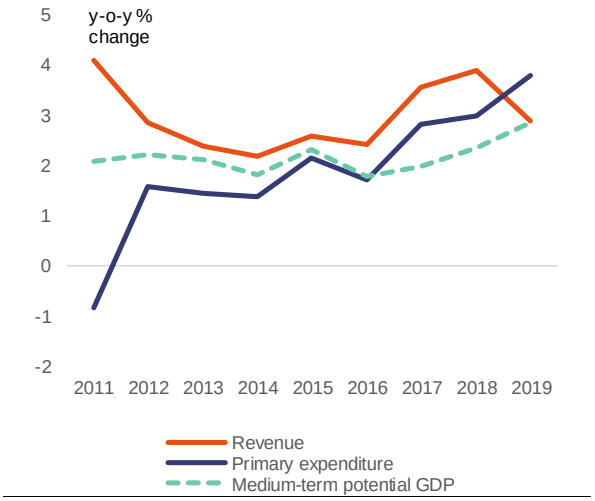
Graph 1.4: **Drivers of changes in the general government budget balance (euro area)**



Notes: (1) A decrease in interest payments is shown as an improvement in the headline balance.
Source: European Commission

The strong increase of public expenditure is also evidenced by the fact that for the second year in a row, the fiscal effort estimated by the expenditure benchmark provides a bleaker picture than the change in the structural balance.

Graph 1.5: **Revenue vs primary expenditure growth rates (euro area)**

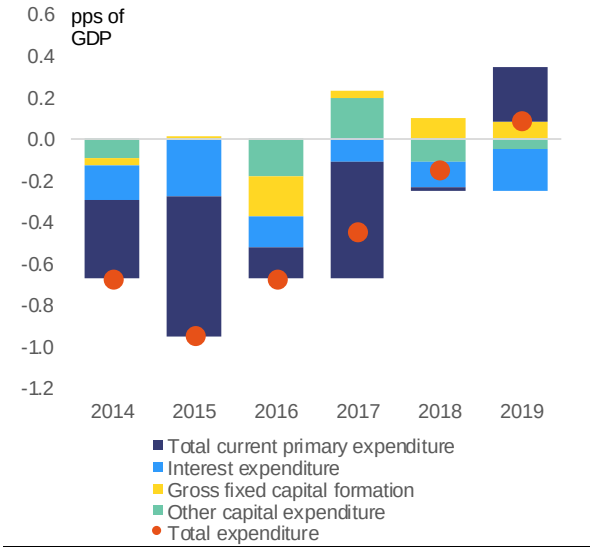


Notes: (1) The medium-term potential GDP is in nominal terms. It is calculated as the 10-year average of real potential output growth rates plus the estimated GDP deflator.
Source: European Commission

The aggregate structural balance, which was affected by revenue and interest-rate windfalls, decreased in 2019 by 0.1 percent point of GDP in both the EU and in the euro area, suggesting a broadly neutral fiscal stance. However, the fiscal effort estimated on the basis of the expenditure benchmark points to an expansion by 0.6 percent points of GDP in both areas (see Chapter 4 for more details).

In terms of composition, the increase in the expenditure-to-GDP ratio was mainly driven by a surge in current primary expenditure, both as a share of GDP and in absolute terms again in both the euro area and the EU as a whole, offsetting the savings arising from a further reduction of debt-servicing costs (Graph 1.6).

Graph 1.6: **Year-on-year change to the expenditure-to-GDP ratio (EU, 2014-2019)**



Notes: (1) Other capital expenditures include capital transfers payable (i.e. capital taxes, investment grants and other capital transfers), change in inventories and acquisitions (e.g. finished goods) less disposals of valuables (e.g. precious metals) and acquisitions less disposals of non-financial, non-produced assets (e.g. land and other tangible non-produced assets).
Source: European Commission

For the third year in a row, government investment, measured as government gross fixed capital formation, increased as a share of GDP, albeit only moderately. However, government investment is still below the average observed in 1995-2005, before the 2008-2009 global economic crisis, especially for the euro area (see Box 1.2). When depreciation is taken into account, the euro area capital stock remained broadly unchanged in 2019 and increased only slightly in the EU.

Box 1.2: Government investment, analysis and perspectives

In the euro area, government investment is gradually recovering from historical lows in 2016. Government investment expenditure is commonly considered a key driver of long-term economic growth. It is also associated with high fiscal multipliers in the short term, particularly during recessions ([1]). As the sovereign debt crisis unfolded in 2011-2012, government investment spending collapsed in most EU countries, particularly in those that had to undergo sizeable fiscal adjustments. The subsequent sluggish recovery led to widespread calls for boosting government investment. The need for rebalancing government expenditure towards growth-enhancing investment gained prominence in the EU's policy priorities and strategies, e.g. the Investment Plan for Europe, known as the 'Juncker Plan', first announced in November 2014, or the Commission communication on 'Making the best use of the flexibility within the existing rules of the SGP' of January 2015. Government investment in the EU (measured as government expenditure on gross fixed capital formation) reached its lowest level in 2016 (i.e. 2.7% of GDP) before returning to the average pre-crisis level in 2019, i.e. 3.0% of GDP, the average observed in 1995-2005. However, in the euro area, government investment is still 0.4 pps below its average pre-crisis level of 3.2% of GDP (Graph 1.a).

When depreciation is taken into account, the government capital stock in the euro area has barely changed in the last six years. Although data on capital depreciation are estimated rather than directly observed, developments in government net fixed capital formation are nonetheless indicative of the likely impact of persistently low investment on capital stock levels (Graph 1.b). The upward trend in net government investment stopped abruptly in 2012. In the euro area, aggregate net investment even became negative, undermining the productive capacity of its existing capital stock.

The slow recovery in aggregate investment levels masks important differences across EU Member States. The countries most affected by the economic crisis continue to show significant investment gaps when compared to their average pre-crisis levels in 1995-2005 (Graph 1.c). This holds, in particular, for countries that were subject to economic adjustment programmes (i.e. Ireland, Greece, Spain, Cyprus and Portugal) or that implemented major fiscal consolidations (e.g. Czechia, Italy, France, Slovakia). Investment by regional and local governments posted the sharpest decline. Although the European statistical classification for industries (NACE) does not provide a clear split between private and government, it nevertheless offers a clear indication that the investment gap mainly relates to infrastructure and, to a lesser extent, machinery and equipment other than transport (Graph 1.d).

The need for policy actions becomes even more urgent when focusing on the broader concept of growth-enhancing expenditure. A number of empirical studies show that, besides the accumulation of physical capital, government spending in areas such as education, research and innovation, transport and communication (and to a lesser extent health), could provide support to long-term economic growth ([2]). Data on the functional classification of government expenditure (COFOG) show that the crisis led to a sizeable cut in both education, transport and communication. In the euro area, aggregate government expenditure in these areas remains significantly below the average pre-crisis level by 0.3 and 0.4 pps of GDP, respectively (Graph 1.e). Investment gaps are particularly acute in some EU Member States also in relation to environmental protection and R&D.

Tackling the EU's new demanding policy priorities will require a significant increase in investment, both private and government. The new European Green Deal ([3]) sets ambitious goals for the Union. Preparing for the zero-carbon transition, keeping pace with the digital revolution, rebuilding Europe's social cohesion, will require major investment efforts. The Commission estimated that achieving the current 2030 climate and energy targets will require €260 billion of additional annual investment, about 1.5% of 2018 GDP in total, i.e. private and government. The EIB sees an overall infrastructure investment gap of about €155 billion per year (about 1% of 2018 GDP) to attain the goals the EU wishes to achieve by 2030 in various areas, including 'climate and energy' and broadband penetration. A similar gap exists in information and communications technology (ICT) equipment ([4]).

([1]) The economic literature, notably from the 1990s, abounds with research on the contribution of government investment to economic growth (e.g. Aschauer, 1989; Berndt and Hansson, 1992; Barro, 1991; Easterly and Rebelo, 1991). Horn et al. (2014) find that multipliers of government investment, estimated between 1.3 and 1.8, are higher than for other types of government spending. Nevertheless, empirical evidence on the contribution of government capital increases to long-term growth remains rather mixed. See European Commission (2016) for a more exhaustive analysis.
([2]) See European Commission (2012).
([3]) COM(2019) 640 final, https://ec.europa.eu/info/sites/info/files/european-green-deal-communication_en.pdf
([4]) EIB (2019).

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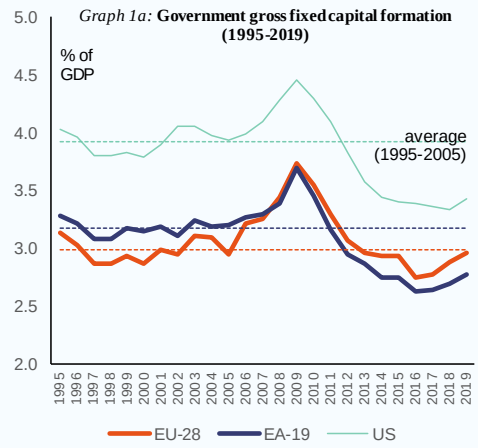
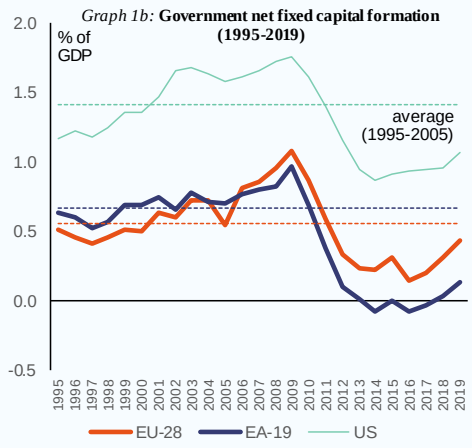
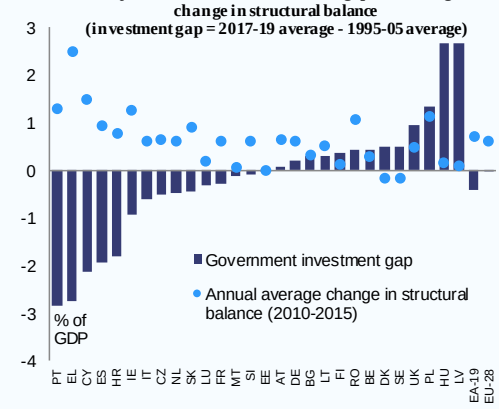
Box (continued)



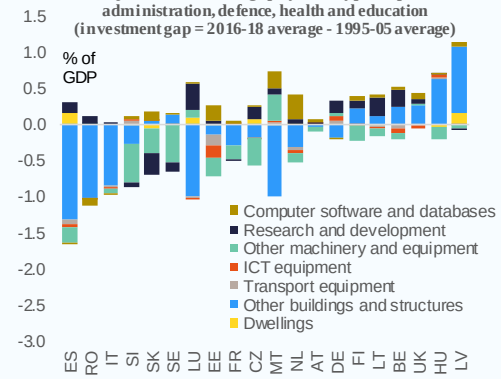
Graph 1a: **Government gross fixed capital formation (1995-2019)**



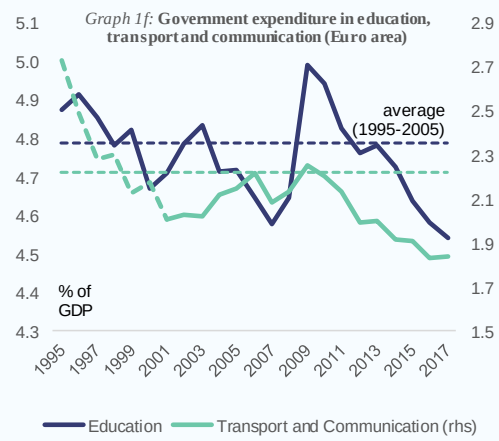
Graph 1b: **Government net fixed capital formation (1995-2019)**



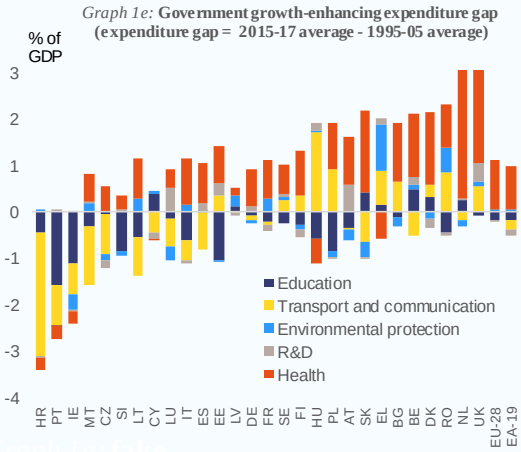
Graph 1c: **Government investment gap and average change in structural balance (investment gap = 2017-19 average - 1995-05 average)**



Graph 1d: **Investment gap by asset types in public administration, defence, health and education (investment gap = 2016-18 average - 1995-05 average)**



Graph 1f: **Government expenditure in education, transport and communication (Euro area)**

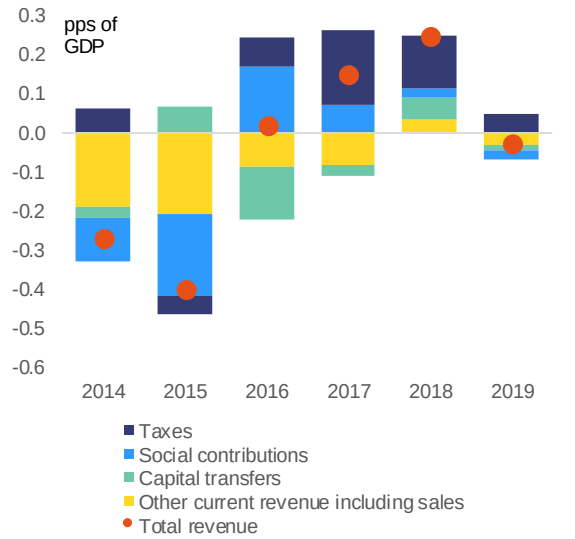


Graph 1e: **Government growth-enhancing expenditure gap (expenditure gap = 2015-17 average - 1995-05 average)**

Notes: (Graph 1.a) Up to year 2000, aggregate data do not include Croatia and Romania. (Graph 1.b) Up to year 2000, aggregate data do not include Croatia and Germany. (Graph 1.c) The investment gap is calculated as the difference between the 2017-2019 average and the 1995-2005 average of government gross fixed capital formation. For Croatia and Romania, the 2001-2005 average is taken as the pre-crisis average level. (Graph 1.d) The chart uses the European statistical classification for economic activities (NACE Rev.2) for the O-Q sectors (Public administration, defence, education, human health and social work activities) where the public sector can be expected to play a major role, but it can also include data for private providers. Member States for which a breakdown by asset types is not available (BG, DK, IE, EL, HR, CY, PL) are not included in the graph. (Graph 1.e and 1.f) The charts use the Eurostat functional classification of government expenditure (COFOG). More precisely Education = GF09; Transport and Communication = GF0405 + GF 0406; Environmental protection = GF05; Health = GF07; Research and development (R&D) = F0105+GF0204+GF0305+GF0408+GF0505+GF0605+GF0705+GF0805+GF0907+GF1008.
Sources: European Commission, own calculations

On the revenue side, the aggregate revenue-to-GDP ratio declined in 2019, in both the EU and the euro area. This decrease represents a turning point after three years of gradual but steady increases. Without policy interventions, revenue-to-GDP ratios would have continued to rise.

Graph 1.7: **Year-on-year change to the revenue-to-GDP ratio (EU, 2014-2019)**



Notes: (1) Taxes include taxes linked to imports and production (indirect taxes) and taxes on income and wealth (direct taxes); (2) Social security contributions include both actual and imputed contributions; (3) Capital transfers include capital taxes (e.g. inheritance taxes), investment grants and other capital transfers (e.g. donations, cancellation of debts); (4) Other current revenues include sales, subsidies on production received, property income and other current transfers.
Source: European Commission

The Commission estimated the aggregate effect of discretionary revenue measures at around -0.2% of GDP for both the EU and the euro area. The most significant impact came from France's tax reform. On 1 January 2019, a company tax credit for low-income earners was replaced by a permanent reduction in social contributions ([8]).

Gross government debt declined for the fifth year in a row by 1.8 percentage point to 86.0% of GDP in the euro area in 2019. The debt ratio remained unchanged in Italy and France, two high-debt countries.

The Commission's latest update of the fiscal sustainability risk indicators ([9]) point to an improvement of the medium and long-term debt related risks in comparison with earlier reports ([10]). Over the medium term, four countries improved their risk classification (Croatia, Cyprus, Hungary and Slovenia), and two countries deteriorated (Romania and Finland). In the long term, five countries were deemed to face less acute risks compared to the 2018 update (Spain, Hungary, Croatia, Cyprus and Poland), while two countries (Germany and Romania) saw a deterioration. The improvements were explained by a more favourable initial budgetary position, while the deteriorations were mainly driven by a projected increase in ageing costs, or by the unfavourable initial budgetary position. According to the latest IMF Article IV reports, seven euro area countries were assessed with high public debt sustainability risks over the medium term (Belgium, Cyprus, Greece, France, Italy, Portugal and Spain). The IMF suggested that countries with limited fiscal space should prioritise debt sustainability over an expansionary fiscal plan, while those with ample fiscal space should use it to lift potential growth.

1.2.1. Budgetary plans versus outturns

In 2019, the headline budget balance in the euro area and the EU fell short of the targets implied by the 2018 stability and convergence programmes. The shortfall was around 0.3% of GDP. Budgetary outturns were below targets in almost half of the EU Member States. In some cases such as Italy, Slovakia and Finland, budgetary shortfalls appear to be associated with nominal GDP growth forecast errors, i.e. in Graph 1.8 the yellow triangle coincides with the dark blue dot ([11]).

Upward revisions of initial spending plans were significant and broad based. In the euro area, primary expenditure grew by 3.8% year-on-year, one-and-a-half percentage points higher than implied by the 2018 stability programmes. If all euro area countries had implemented their expenditure plans in levels for 2019, the aggregate headline budget deficit everything else equal would have almost balanced as opposed to an actual outturn of 0.6% of GDP. Similarly, for the EU as a whole, the aggregate budget deficit would have

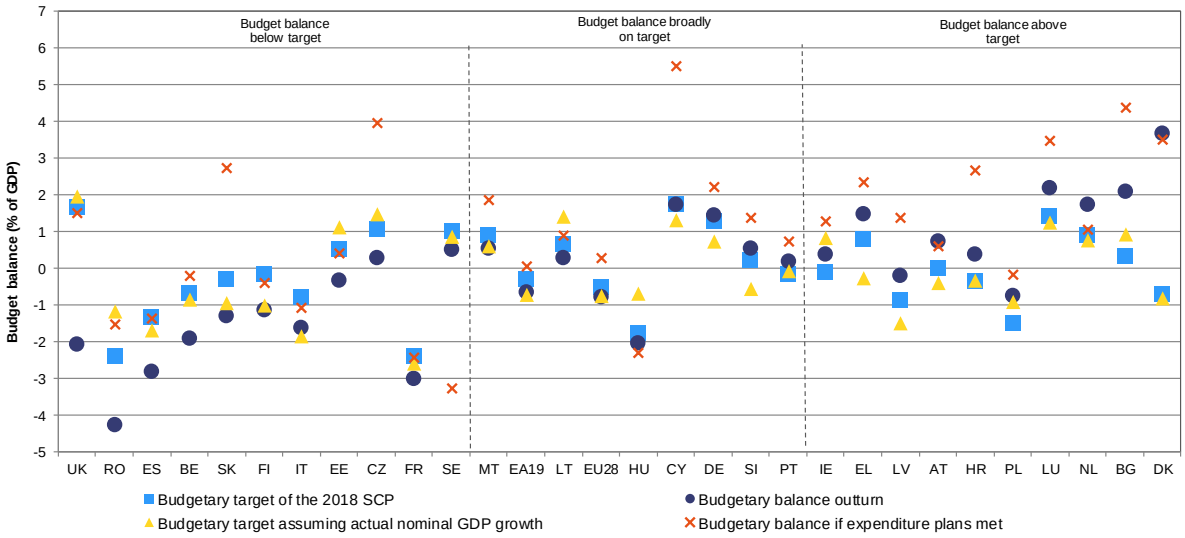
([8]) The Competitiveness and Employment Tax Credit (CICE) was introduced in 2013. It was a tax credit that most companies could benefit from, irrespective of their sector of activity, and was based on gross wages paid in the course of the year up to 2.5 times the minimum wage.

([9]) See European Commission (2019b).

([10]) See European Commission (2019a).

([11]) In the case of the UK, the deficit for 2019 came in higher than originally planned (i.e. -2.1% vs -1.7% of GDP) despite nominal GDP growth, which surprised on the upside. This was largely due to methodological changes and revisions in the official data, which occurred in October 2019. In recent years, deficit increases have been mostly driven by changes to the treatment of student loans, public sector pensions and corporate tax data.

Graph 1.8: **General government budget balance in 2019; outturn vs target in the 2018 stability and convergence programmes (SCPs)**



Notes: (1) Greece did not submit a stability programme in 2018 because Member States undergoing a macroeconomic adjustment programme are exempt from the reporting requirements of the European Semester. Therefore, budget balance target set in spring 2018 refer to the government's 2019-2021 medium-term fiscal strategy (MTFS) of June 2018. (2) Countries are ordered by increasing difference between the outturn and the 2018 SCP target. (3) Yellow triangle=budgetary target assuming actual nominal GDP growth. It aims to show what the 2019 budgetary targets could have been, if national authorities had known the actual rate of nominal GDP growth for 2019 when preparing the 2018 SCPs. It is calculated as the sum of: (i) the budgetary target for 2019 and (ii) the product of the semi-elasticity of the budget balance and the difference between actual nominal GDP growth and the forecast of nominal GDP growth for 2019. A yellow triangle above the light blue square indicates a positive growth surprise. (4) Red cross=budgetary target if expenditure plans were met. It aims to show what the 2019 budgetary targets could have been if government had adhered to the level of expenditure planned in their stability and convergence programmes.
Source: European Commission, 2018 stability and convergence programmes, own calculations

narrowed to 0.3% of GDP instead of showing a deficit of 0.8% of GDP.

Although nominal GDP growth surprised on the downside, euro area aggregate revenues came in higher than initially expected by around 0.3% of GDP. Compared to the policy measures already known at the time of the stability programmes, actual discretionary revenue measures for the euro area, as estimated by the Commission in the 2020 spring forecast, can explain a third of the difference compared to initial projections.

However, the situation differed markedly among Member States (see Table 1.2). Germany alone accounts for almost the whole amount of the euro area revenue surprise.

Conversely, in some other countries, revenues fell short of initial government projections albeit discretionary revenue-increasing measures were adopted after the 2018 stability programmes (e.g. France and Italy), most likely because of the overoptimistic nominal GDP growth projections. Also for the EU as a whole, revenues came in better than projected (around 0.8% of GDP). This was mainly due to a large revenue surprise in the UK ([12]).

Table 1.2: **Revenue surprise and spending revisions (net of one-offs, % of GDP)**

country	Revenue surprise	*of which:* Δ in DRM	Spending revision	*country*	Revenue surprise	*of which:* Δ in DRM	Spending revision
	(A)	(B)	(C)		(A)	(B)	(C)
BG	4.4	0.7	2.5	**RO**	0.8	0.1	2.7
DK	4.3	0.0	0.4	**AT**	0.6	-0.1	-0.1
CY	4.0	1.0	2.6	**EL**	0.5	-0.6	0.9
UK	3.2	-0.5	3.6	**BE**	0.4	0.1	1.7
HR	3.0	-0.6	2.3	**LT**	0.4	-0.2	0.7
SK	3.0	0.0	3.9	**NL**	0.0	0.2	-0.7
CZ	2.9	-0.1	3.7	**ES**	0.0	0.2	1.2
LU	2.3	-0.1	1.4	**EE**	-0.1	-0.3	0.8
LV	2.2	0.0	1.6	**FR**	-0.1	0.1	-0.3
IE	1.4	0.1	0.9	**FI**	-0.2	-0.4	0.7
PL	1.3	0.2	0.6	**IT**	-0.4	0.6	0.6
SI	1.1	-0.2	0.8	**HU**	-0.6	-0.2	-0.4
MT	1.0	-0.2	1.3	**SE**	-4.3	-0.3	-3.7
PT	0.9	-0.1	0.0	**EA-19**	0.3	0.1	0.7
DE	0.9	-0.1	0.7	**EU-28**	0.8	0.0	1.0

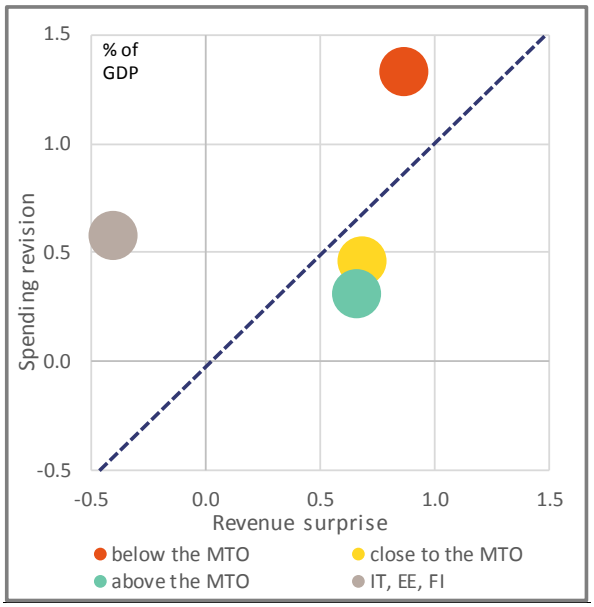
Notes: (1) Revenue surprise (column A) is defined as the difference between actual revenues and those projected in the 2018 stability and convergence programmes (SCP). (2) The change in discretionary revenue measures (Δ in DRM, column B) shows the difference between the actual Commission's assessment of DRM and the one underlying the Commission spring 2018 forecast. A positive sign (+) indicates a revenue-increasing change in policy measure. (4) Spending revision (column C) is the difference between the actual and projected expenditure in the 2018 SCPs. (5) All the amounts in the table exclude one-off measures.
Source: European Commission, 2018 SCPs, own calculations

Revisions of spending plans largely disregarded fiscal consolidation needs under the SGP. Graph 1.9 shows that while countries with fiscal

([12]) In UK, these large revenue surprises were mainly driven by higher-than-anticipated income taxes, due to stronger-than-expected employment and earnings growth.

space – with structural balances estimated to be above, or close to, their MTOs – revised their spending plans prudently in line with revenue surprises, those with consolidation needs – with structural balances estimated to be below their MTOs – allocated better-than-expected revenue and more to additional spending.

Graph 1.9: **Use of revenue surprise and fiscal space**

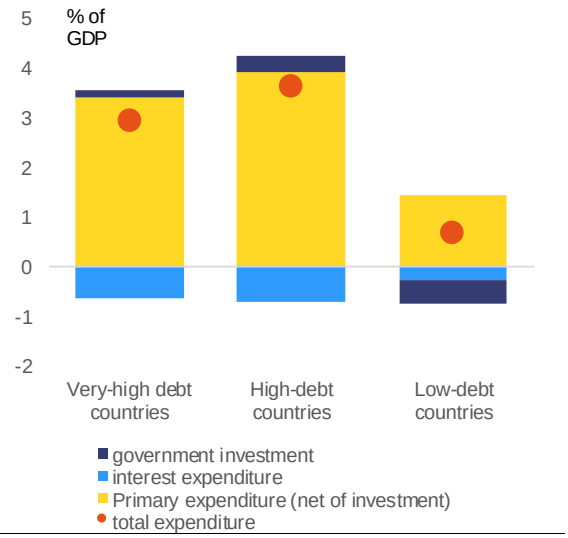


Notes: (1) Revenue surprise is defined as the difference between actual revenues and those projected in the 2018 SCP. (2) Spending revision is the difference between the actual and projected expenditure in the 2018 SCP. (3) Countries are grouped according to their position with respect to their specific MTOs as estimated in spring 2018: a) countries below MTO = ES, RO, HU, FR, IT, UK, BE, PT, SI, PL, LV, EE, SK; b) Countries close to MTO = FI, AT, IE, LT; c) Countries above MTO = NL, MT, CY, DK, LU, HR, BG, DE, SE, CZ, EL. (4) The average values for Estonia, Italy and Finland are highlighted by the grey circle because they revised expenditure upwards in spite of lower-than-expected revenues.
Source: European Commission, own calculations

Expenditure overruns were particularly large in Romania, which was subject to a significant deviation procedure and breached the 3% of GDP deficit reference value (see Section 2.3). The same holds also for Belgium, Spain and Slovakia, which the Commission had assessed at risk of non-compliance with the SGP already in autumn 2018. Some countries (i.e. Estonia, Italy and Finland) revised expenditure upwards in spite of lower-than-expected revenues (i.e. the grey circle in Graph 1.9).

The largest part of the additional spending compared to the plans set out in the 2018 stability and convergence programmes, went into current expenditure (i.e. around two thirds of which was social payments), and only a very small fraction (i.e. less than one tenth) was allocated to investment. Over the last four years, cumulative deviations from spending plans, as presented in the stability and convergence programmes, were around 3% of GDP, but only 0.1% of GDP went to additional government investment. Countries with very high and high debt levels showed the largest cumulative spending slippages, while revisions of investment plans were negligible (Graph 1.10).

Graph 1.10: **Revisions of government spending plans by government debt level (cumulative, 2016-2019)**



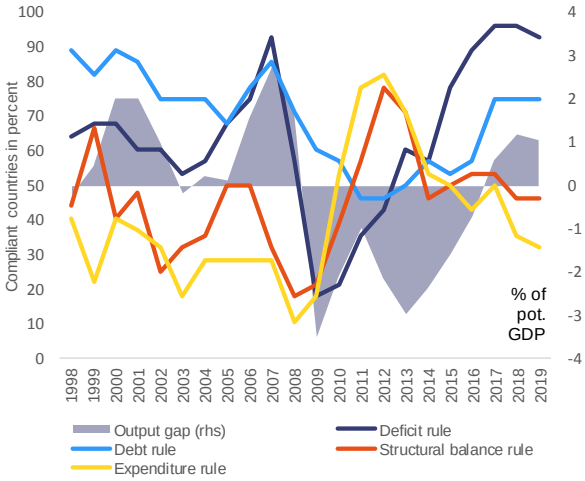
Notes: (1) The graph shows the cumulative difference between government expenditure outturn and spending plans in the stability and convergence programmes over 2016-2019 as a share of GDP (2) The classification of countries by debt level is based on the average debt-to-GDP ratio over 2011-2018. Very high-debt countries = above 90% of GDP (i.e. BE, EI, ES, FR, IT, CY, PT); High-debt countries = between 60% and 90% (i.e. DE, HR, HU, MT, NL, AT, SI, UK); Low-debt countries = below 60% (i.e. BG, CZ, DK, EE, LV, LT, LU, PL, RO, SK, FI, SE).
Source: European Commission, own calculations

1.2.2. Numerical compliance

In 2019, average numerical compliance with the EU fiscal rules – as measured by the compliance tracker of the secretariat of the European Fiscal Board ([13]) – decreased for the second year in a row to close to 60%. Thanks to eight years of economic growth, and in line with the well-known pro-cyclical pattern of headline figures, compliance with the deficit rule was the highest, at over 90%. While compliance with the debt and the structural balance rule remained broadly unchanged, lower overall compliance or a lack of compliance was largely driven by growing and important deviations from the expenditure benchmark rule (Graph 1.10). Only 32% of all EU countries run expenditure policies in line with the SGP's expenditure benchmark; 4 and 18 percentage points less than in 2018 and 2017, respectively.

([13]) See Larch and Santacroce (2020) for a detailed description of the compliance database of the EFB secretariat.

Graph 1.11: **Numerical compliance with fiscal rules and output gap developments (EU-28, 1998-2019)**

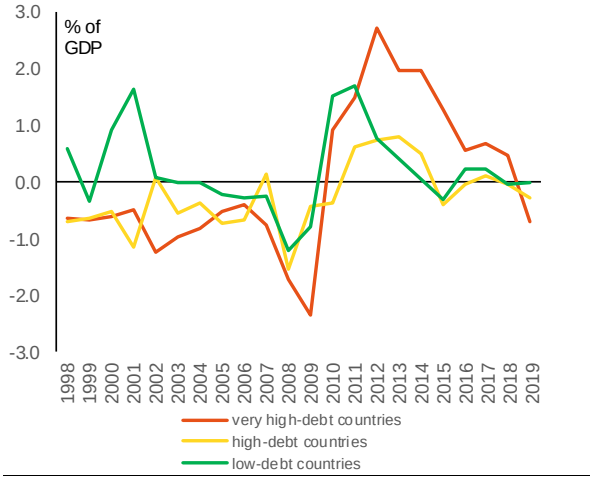


Source: European Commission, own calculations

As a result, the compliance gap between rules based on headline numbers (i.e. deficit and debt rules) and those taking into account the budgetary effect of the economic cycle (i.e. the structural budget and the expenditure rules) widened considerably.

A very similar pattern was observed in the run-up to the 2008-2009 global financial and economic crisis. The largely automatic improvement in the headline deficit and debt seems to give rise to a sense of safety and triggers relaxation with respect to rules that aim to keep a steady and prudent course of action over the cycle. Therefore, 2019 was another missed opportunity to take advantage of economic good times to reduce government debt-to-GDP ratios and create fiscal buffers.

Graph 1.12: **Deviations from the expenditure rule by level of government debt**



Notes: (1) The chart shows the average amount of deviation from the expenditure benchmark rule for each group of countries, expressed as a percentage of GDP. A positive deviation means that, on average, the annual growth in net primary expenditure was below the expenditure benchmark ceiling. (2) The classification of countries by debt level is based on the average debt-to-GDP ratio over 2011-2018. Very high-debt countries = above 90% of GDP (i.e. BE, IE, EL, ES, FR, IT, CY, PT); High-debt countries = between 60% and 90% (i.e. DE, HR, HU, MT, NL, AT, SI, UK); Low-debt countries = below 60% (i.e. BG, CZ, DK, EE, LV, LT, LU, PL, RO, SK, FI, SE).
Source: European Commission, own calculations

There are notable and important differences across countries: lower numerical compliance with the expenditure benchmark is largely, although not exclusively, attributable to the EU Member States with the highest debt-to-GDP ratios. Graph 1.12 highlights the issue zooming in on the magnitude of the deviations. Countries such as Belgium, France, Italy, Spain or Portugal, all with a debt ratio of more than 100 of GDP, displayed deviations from the expenditure benchmark of 0.6% of GDP or more.

Table 1.3: **Forecasts, targets and outturns in the euro area and the EU: 2019**

		Spring 2018		Autumn 2018		Spring 2020	Revisions			
		Commission forecasts (SF18)	Stability and convergence programmes (SCPs)	Commission forecasts (AF18)	Draft budgetary plans (DBPs)	Outturn	**Outturn vs SF18**	**Outturn vs AF18**	**Outturn vs SCPs**	**Outturn vs DBPs**
Euro area - 19 (1)		**year-on-year % change**					**percentage points**			
	Real GDP	2.0	2.1	1.9	2.0	1.2	-0.8	-0.6	-0.8	-0.7
	Nominal GDP	3.7	3.8	3.7	3.8	3.0	-0.7	-0.7	-0.8	-0.8
	Potential GDP	1.5	1.6	1.6	1.6	1.4	-0.2	-0.2	-0.3	-0.2
	Total revenue	2.6	3.2	2.9	3.2	2.9	0.3	0.0	-0.3	-0.3
	Total expenditure	2.5	2.2	3.3	3.6	3.3	0.8	0.0	1.1	-0.3
	Primary expenditure	2.6	2.3	3.4	3.7	3.8	1.2	0.4	1.5	0.1
		billion euro					**percent change**			
	Real GDP	10797	10897	10788	10867	10702	-0.9	-0.8	-1.8	-1.5
	Nominal GDP	12028	12041	12030	12035	11907	-1.0	-1.0	-1.1	-1.1
	Potential GDP	10705	-	10721	-	10604	-0.9	-1.1	-	-
	Total revenue	5468	5494	5497	5511	5536	1.2	0.7	0.8	0.4
	Total expenditure	5544	5528	5598	5608	5613	1.2	0.3	1.5	0.1
	Primary expenditure	5330	5312	5378	5392	5418	1.7	0.8	2.0	0.5
	Effect of discretionary revenue measures	*-43.0*	*-22.9*	*-24.1*	*-18.6*	*-26.9*	-	-	-	-
	one-off on the revenue side	*2.0*	*2.6*	*5.7*	*-16.2*	*6.7*	-	-	-	-
	one-off on the expenditure side	*-2.2*	*-24.8*	*-24.2*	*-5.8*	*-27.2*	-	-	-	-
		% of GDP					**% of GDP**			
	Output gap, % of potential GDP	0.9	0.7	0.6	0.7	1.1	0.2	0.4	0.3	0.3
	Budget balance	-0.6	-0.3	-0.8	-0.8	-0.6	0.0	0.2	-0.4	0.2
	Primary balance	1.1	1.5	1.0	1.0	1.0	-0.2	0.0	-0.5	0.0
	Structural primary balance	0.7	1.3	0.8	0.8	0.5	-0.1	-0.2	-0.8	-0.2
	One-off and other temporary measures	*0.0*	*-0.2*	*-0.2*	*-0.2*	*-0.2*	-	-	-	-
EU-28 (1)		**year-on-year % change**					**percentage points**			
	Real GDP	2.0	2.1	1.9	-	1.5	-0.6	-0.4	-0.6	-
	Nominal GDP	3.8	3.8	3.7	-	3.4	-0.4	-0.3	-0.4	-
	Potential GDP	1.7	1.8	1.7	-	1.5	-0.2	-0.2	-0.3	-
	Total revenue	3.0	3.8	3.1	-	3.3	0.3	0.2	-0.5	-
	Total expenditure	2.9	2.5	3.4	-	3.6	0.7	0.2	1.1	-
	Primary expenditure	3.0	2.6	3.5	-	4.1	1.1	0.6	1.5	-
		billion euro					**percent change**			
	Real GDP	14789	15093	14775	-	15098	2.1	2.2	0.0	-
	Nominal GDP	16686	16546	16681	-	17059	2.2	2.3	3.1	-
	Potential GDP	14673	-	14682	-	14950	1.9	1.8	-	-
	Total revenue	7317	7282	7347	-	7414	1.3	0.9	1.8	-
	Total expenditure	7446	7368	7481	-	7544	1.3	0.8	2.4	-
	Primary expenditure	7148	7070	7181	-	7274	1.8	1.3	2.9	-
	Effect of discretionary revenue measures	*-31.1*	*-10.2*	*-11.9*	-	*-27.7*	-	-	-	-
	one-off on the revenue side	*2.0*	*4.1*	*5.7*	-	*6.7*	-	-	-	-
	one-off on the expenditure side	*-4.0*	*-29.7*	*-26.3*	-	*-27.7*	-	-	-	-
		% of GDP					**% of GDP**			
	Output gap, % of potential GDP	0.8	0.7	0.6	-	1.2	0.4	0.5	-0.3	-
	Budget balance	-0.8	-0.5	-0.8	-	-0.8	0.0	0.0	-0.3	-
	Primary balance	1.0	1.3	1.0	-	0.8	-0.2	-0.2	-0.4	-
	Structural primary balance	0.6	1.1	0.8	-	0.3	-0.3	-0.4	-0.8	-
	One-off and other temporary measures	*0.0*	*-0.2*	*-0.1*	-	-0.1	-	-	-	-

Notes: (1) Greece was exempted from submitting a stability programme in 2018 because still under the macroeconomic adjustment programme. Therefore, data of spring 2018 refer to the government's Medium-Term Fiscal Strategy (MTFS) 2019-2021 of June 2018.
Source: European Commission, stability and convergence programmes, draft budgetary plans.

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

Highlights

- The year 2019 was a year of notable contrasts. For the first time since 2002, no EU country was under an excessive deficit procedures (EDP). At the same time, the Commission's final assessment detected 10 cases of significant deviation under the preventive arm of the Pact (i.e. Belgium, Estonia, Spain, France, Hungary, Poland, Portugal, Slovenia, Slovakia and the United Kingdom).

- The unprecedented number of significant deviations occurred in a context of slowing but still sustained economic activity. Output growth in the euro area was around potential posting the sixth consecutive annual increase.

- Unlike in previous years, the Commission's assessment of significant deviations was largely straightforward with a very limited recourse to judgement. Only in the case of Italy, did the Commission not reach a conclusion motivated by conflicting signals from the two compliance indicators of the Pact.

- The Commission's final assessment of budgetary implementation in 2019 took place during deep economic crisis when fiscal corrections were considered to make little economic sense from a stabilisation perspective.

- In March 2020, following the Covid-19 outbreak, the Commission, in agreement with the Council, activated the SGP's general escape clause, which in principle allows Member States to deviate temporarily from the adjustment requirements of the Pact.

- Although the escape clause did not apply to 2019, the sharp economic impact of Covid-19 pandemic led the Commission and the Council not to proceed with any formal procedure for non-compliance. As a result, the Commission's assessment for 2019 remained largely inconsequential.

- The combination of a forbearing interpretation of the EU rules in good times coupled with additional leeway in the event of major shocks is one of the main and recurring predicaments of the multilateral surveillance framework in the EU.

- Cases of non-compliance were not limited to the preventive arm of the SGP. Early 2020, an EDP was opened for Romania for a planned breach of the 3% of GDP deficit reference value in 2019. The Commission's final assessment also highlighted that Belgium, Spain and France had deviated from the debt reduction benchmark in 2019. However, while preparing reports under Treaty Article 126(3), conclusions were postponed to autumn 2020.

- After two years of forbearing evaluations, the Commission's final assessment of Belgium eventually concluded that the effect of a legislated change in the timing of corporate income tax payments was temporary and, hence, that the country had not complied with both arms of the Pact in 2019 and 2018-2019 taken together. However, the general escape clause made this conclusion inconsequential.

- Italy's draft budgetary plan for 2019 was the first to be rejected on the grounds of particularly serious non-compliance. Although budgetary outcomes in 2019 were better-than-expected, bilateral negotiations between the Commission and a country's government go against the spirit of multilateral surveillance as defined in the Treaty.

- The current wait-and-see approach with EDPs stands in contrast with the avenue taken in the wake of the 2008-2009 crisis. At the time, the Commission and the Council decided to open EDPs, combining fiscal expansions in the early phase with a drawn-out and gradual path of fiscal adjustment after that.

This chapter assesses how the SGP was implemented in 2019. It provides a full overview of the annual fiscal surveillance cycle, as outlined in Graph 2.1. The cycle starts in spring of the preceding year, when the Council on a proposal of the Commission issues fiscal policy guidance, and ends in spring of the subsequent year with the final assessment of compliance.

This chapter highlights cases and developments that stood out in the implementation of the SGP. The analysis is based on a careful study and review of all relevant documents produced by the Commission and the Council. Annex A includes tables showing a complete chronological overview of the 2019 annual fiscal surveillance cycle for all EU countries.

Following the successful completion of the economic adjustment programme in August 2018, Greece is covered for the first time in the annual report alongside the other EU Member States (see Box 2.1). The 2019 surveillance cycle was also the first since 2002 with no Member State subject to an excessive deficit procedure (EDP).

2.1. INNOVATIONS IN THE SURVEILLANCE METHOD AND PRACTICE

Compared to previous years, a very limited number of methodological and interpretative innovations to the EU fiscal framework were introduced in the 2019 cycle. Most of them are adjustments to the commonly agreed method to estimate the output gap, which plays a crucial role in the current framework ([14]).

First, in autumn 2019, the trial period for using what is know as the plausibility tool coupled with constrained judgement was extended by another year. In autumn 2016, on the back of growing criticism from Member States, the Economic and Financial Committee (EFC) approved the use of a plausibility tool, which, as the name suggests, is meant to assess the plausibility of the output gap estimates from the commonly agreed methodology by using past errors. If the output gap estimate derived from the commonly agreed method falls outside the range suggested by the plausibility tool, the Commission can use judgement in choosing the output gap estimate for the purposes of fiscal surveillance. The degree of judgement is constrained by the range implied by the plausibility tool (for a more detailed discussion, see Section 2.2.1 of the EFB 2018 annual report).

The Economic Policy Committee motivated the decision to extend for another year the trial period of the plausibility tool in combination with constrained judgement by the lack of robust evidence on the effectiveness of the tool.

Second, in 2019 the Commission and the Member States continued to work on country-specific changes to the commonly agreed methodology to estimate potential GDP and the output gap ([15]). However, they did not agree on any new amendments. In particular, the Output Gap Working Group (OGWG) discussed a request of Estonia to align the time period of the capacity utilisation indicator – a key measure of slack in the commonly agreed method – with the time period used for the other two Baltic countries. The aim of the proposed change was to reduce the large volatility of the output gap estimates for Estonia. Although the OGWG agreed with the proposed change, the Commission did not find sound economic reasons to justify the country-specific amendment to the commonly agreed methodology ([16]). In April 2020, the Economic Policy Committee (EPC) referred the issue back to the OGWG, with a view to re-examining the issue in autumn.

Third, in 2019 the OGWG also continued to work on general modifications of the commonly agreed methodology for estimating potential output. The focus of the work was on the estimation of the unemployment rate consistent with stable wage inflation (NAWRU) and, in particular, on the value to which the NAWRU should converge over the medium-term ([17]). The Group identified an

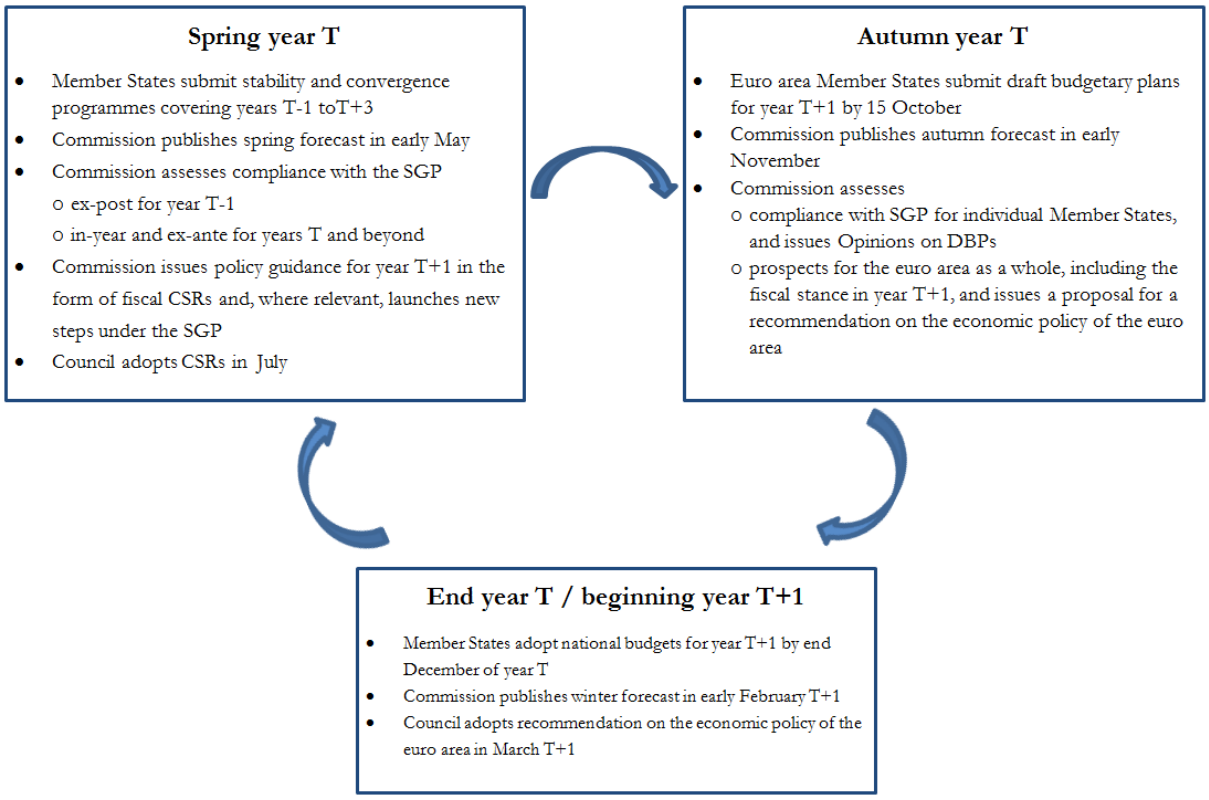
([14]) Under the EU fiscal surveillance framework, the European Commission estimates potential output and the output gap with a commonly agreed methodology endorsed by the ECOFIN Council back in 2002. The commonly agreed method is based on a production function approach, which brings together the potential levels of labour, capital and total factor productivity. For more details, see Box 4.2 of the EFB annual report 2017.

([15]) In September 2017, the EFC approved the principles and rules for a new procedure enabling more country-specific changes to the commonly agreed method for estimating potential output and the output gap (for more details, see Section 2.2.1 of the EFB annual report 2018).

([16]) The Commission argued that the proposed change gave rise to significant divergent estimations of the output gap at the end of the sample period (2019-2021) compared to the current methodology; differences which were not supported by the plausibility tool.

([17]) Under the commonly agreed method the NAWRU is designed to converge to an anchor estimated from a series of structural labour market indicators (e.g. the unemployment benefits replacement rate, the labour tax wedge, the degree of union density, the

Graph 2.1: **The annual cycle of EU fiscal surveillance**



Source: European Commission

alternative specification with the aim of reducing the pro-cyclicality of potential output estimates ([18]), notably by using information also from the post-2004-accession countries, and by taking into account intra-country labour mobility and differences in demographic structures for all Member States; measurements that are relatively more stable over time. In February 2020, the EPC approved the new approach. The new specification was first used in the Commission 2020 spring forecast. It implied a lower value for the NAWRU's converging value, especially for countries where, according to the Commission, the estimate of the anchor was implausibly large. The implications for the output gap estimates were not shown, although one may assume that a lower NAWRU entails – other things being equal – a worsening of the output gap.

Lastly, in February 2020 the Commission updated the minimum benchmarks, the country-specific lower bound of the structural balance that provides a safety margin against the risk of breaching 3% of GDP for the headline deficit during normal cyclical fluctuations. The update followed a new approach adopted early in 2019, which uses a combination of country-specific and EU-wide variations of the cyclical component of the budget balances. Compared to the previous year's update, the minimum benchmark was unchanged for 23 Member States. It became slightly more stringent (by 0.1% of GDP) for Hungary and Portugal and slightly looser (by 0.1-0.2% of GDP) for Spain, Romania and Finland. Although the new methodology produced quite stable results compared to past updates, the EFC decided to keep, for the time being, the frequency of the minimum benchmark updates on an annual basis, instead of moving, as suggested by the Commission, to three-year reviews, in conjunction with the updates of the minimum MTO ([19]).

expenditure on active labour market policies). The convergence is meant to reduce the pro-cyclicality of NAWRU estimates, which may otherwise respond too strongly to changing economic data.

([18]) Pro-cyclicality occurs when potential output estimates rise too much when the economy is in the upward phase of the cycle or go down too much when it is in the downward phase (European Commission, 2019)

([19]) The minimum MTO is the lower bound for the country-specific MTO. If followed, it ensures that debt ratios converge towards a prudent level. It also takes into account the projected budgetary impact of ageing populations while allowing for the free operation of the automatic fiscal stabilisers. The new minimum MTOs were published in the 2019 edition of the Vade mecum on the SGP.

Box 2.1: Greece's position in the EU fiscal surveillance framework

In August 2018, Greece completed the European Stability Mechanism's macroeconomic adjustment programme. In July 2015, at the expiry of the second programme funded by the European Financial Stability Facility (EFSF), the Greek authorities requested financial assistance from the European Stability Mechanism (ESM) to help Greece to cope with the ongoing severe economic and financial turmoil. The Eurogroup reached a political agreement on 14 August 2015 ([1]), paving the way for mobilising up to €86 billion in financial assistance over 3 years (2015-2018). The policy conditions for the ESM financial assistance programme were laid down in Council Implementing Decision (EU) 2016/544 ([2]), which was subsequently amended by Council Implementing Decision (EU) 2017/1226 ([3]). Since 2010, Greece has received financial assistance from the euro area Member States under three macroeconomic adjustment programmes. Overall, since 2010, the amount of financial assistance to Greece has totalled €275.8 billion, including €32.1 billion received from the IMF.

The completion of the ESM programme was not the end of commitments for Greece, which continued to be monitored under a special surveillance regime. As part of the comprehensive agreement reached on 22 June 2018 with its euro-area partners, Greek authorities made commitments to continue and complete all key reforms adopted under the programme, as set out in the annex to the Eurogroup statement ([4]). The arrangement also included a commitment by Greece to maintain the primary surplus of 3.5% of GDP until 2022 and to continue to comply with the EU fiscal framework after that ([5]). In addition, on 11 July 2018, the Commission adopted a decision to place Greece under enhanced surveillance, pursuant to Article 2(1) of Regulation (EU) 472/201, given the still significant sources of medium-term vulnerabilities. The decision was intended to address residual sustainability risks, support the continuation of reforms agreed under the programme and monitor its progress.

Some of the Eurogroup's debt relief measures were made conditional on Greece's continuous implementation of reform measures beyond the programme. On June 2018, the Eurogroup also agreed to provide incentives to Greece to ensure it continued implementing the reforms. To this end, the Eurogroup decided to provide some of the debt relief measures to Greece subject to compliance with its commitments. These policy-contingent debt relief measures consist of: (i) the return of amounts equivalent to the net interest income ([6]) earned on Greek securities purchased by the Eurosystem national central banks under the securities markets programme and the agreement on net financial assets; and (ii) a waiver to the step-up interest margin for certain loans provided by the EFSF from 17 June 2019 to 31 December 2019. The income-equivalent amounts are being transferred to Greece in semi-annual tranches up to mid-2022. Up to now, the release of these policy-contingent debt relief measures have amounted to €1.7 billion.

Post-programme commitments added to fiscal requirements under the preventive arm of the Pact. Since August 2018, Greece is back to the European Semester framework of economic and social policy coordination and subject to the preventive arm of the Pact. In addition, as the debt-to-GDP ratio was 178.5% in 2016 (the year in which Greece corrected its excessive deficit), Greece is also subject to the three-year transitional arrangement to make sufficient progress towards compliance with the debt

(1) https://www.consilium.europa.eu/en/press/press-releases/2015/08/14/eurogroup-statement/
(2) https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32016D0544
(3) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2017.174.01.0022.01.ENG
(4) https://www.consilium.europa.eu/media/35749/z-councils-council-configurations-ecofin-eurogroup-2018-180621-specific-commitments-to-ensure-the-continuity-and-completion-of-reforms-adopted-under-the-esm-programme_2.pdf
(5) Maintaining a sizeable medium-term primary balance has been the main fiscal target of the programme. Targets were based on an assessment of the debt sustainability, with reference to the agreed benchmarks for gross financing needs and taking into account the expected growth rates of the Greek economy. The 3.5% of GDP primary surplus target has been set in terms of primary budget balance, excluding one-off costs of bank recapitalisations, Securities Markets Programme and Agreement on Net Financial Assets revenues as well as part of the privatisation proceeds (for more details see Chapter 3 of the First enhanced surveillance report; European Commission, 2018).
(6) The net interest income from securities is composed of the coupon earned and the amortised discount accruing on the SMP holding of Greek government bonds.

(Continued on the next page)

Box (continued)

reduction rule. At the same time, Greece should continue to ensure compliance with the primary surplus target of 3.5% of GDP up to 2022. The assessment of compliance in 2019 was further complicated by two factors. First, given that in spring 2018 Greece was still under the macroeconomic adjustment programme, the country was exempted from submitting a stability and convergence programme. Therefore, no medium-term budgetary objective (MTO) was established for 2019. Second, for the same reason, no specific Council recommendations for 2019 were addressed to Greece. In this context, in light of the provisions of the two-pack on the consistency between the macroeconomic adjustment programme and the SGP and with the aim of avoiding undue burdens on the administration, the assessment of compliance with the EU fiscal rules in 2019 took into account several factors, notably the compliance of Greece with the primary surplus target of 3.5% of GDP monitored under the enhanced surveillance.

Only in July 2019, in the context of the 2020 European Semester, Greece received its first Council recommendation. While no specific requests were made in the fiscal area (i.e. in spring 2019 the estimated structural balance was well above the MTO, which was defined as a structural surplus of 0.5% of GDP, therefore no adjustment was needed), the Council recommended that Greece 'achieve a sustainable economic recovery and tackle the excessive macroeconomic imbalances by continuing and completing reforms in line with the post-programme commitments given at the Eurogroup of 22 June 2018'. The implementation of this recommendation is monitored under the enhanced surveillance framework. In turn, the Council recommendations clarified the scope and synergies of the enhanced surveillance and European Semester frameworks. Overall, in light of Greece's macroeconomic conditions, the Commission considered that compliance with the target of 3.5% of GDP primary surplus appears appropriate also to ensure compliance with both the MTO and the debt reduction rule.

For completeness, in spring 2019, on the basis of the updated minimum MTOs, EU Member States set their MTOs for 2020-2022 ([20]). Of note, more than half of the countries chose a more stringent MTO (i.e. corresponding to a higher structural surplus or lower structural deficit), with an average difference of 0.3% of GDP ([21]).

2.2. MEDIUM-TERM BUDGETARY PLANS IN THE STABILITY AND CONVERGENCE PROGRAMMES

Budgetary plans presented in the stability and convergence programmes (SCPs) in spring 2018 implied a small improvement in the aggregate budget balance of the EU: from 0.9% of GDP the year before to 0.6% of GDP in 2019. For the euro area, the planned improvement was slightly larger, from a deficit of 0.7% of GDP in 2018 to 0.3% of GDP in 2019. In view of stable growth projections, the planned profile of the headline balances translated into an improvement of the structural budget balance of a similar size.

Countries that had not yet achieved their MTO, planned sizeable adjustments of 1.6% of GDP over the 2019-2021 SCP horizon. However, in line with a well-established pattern, efforts were largely back loaded.

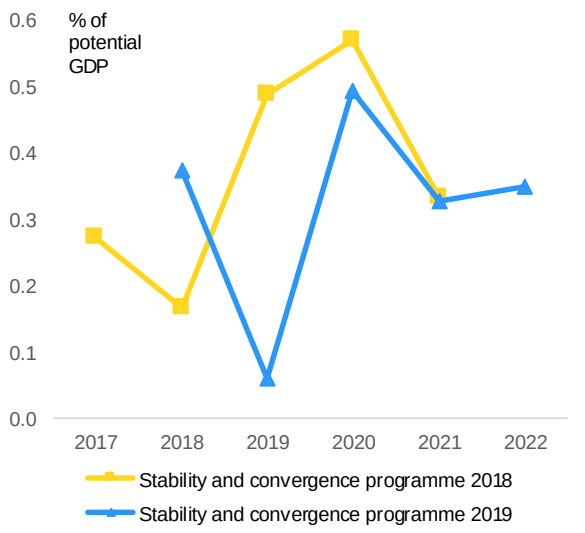
Based on the information provided in the SCPs presented in spring 2018, the Commission concluded that in 2019 the medium-term budgetary plans of 11 Member States - Belgium, France, Spain, Italy, Latvia, Hungary, Poland, Portugal, Romania, Slovenia and Slovakia - pointed to a risk of significant deviation from the requirements under the preventive arm of the SGP. In the final assessment, most of these countries were found to have significantly deviated from the adjustment requirements or, as in the case of Romania, entered in an excessive deficit procedure (EDP) before the Commission final assessment (see Section 2.5) ([22]). Furthermore, it broadly represents the same group of countries assessed at risk of significant deviation at the beginning of the previous surveillance cycle, i.e. in spring 2017. Slovenia's stability programme implied a structural deterioration in 2019.

([20]) For more details, see Chapter 2.2.1 of the EFB 2019 annual report, pp. 17-18.

([21]) The countries were Bulgaria, Denmark, Germany, Estonia, Ireland, Spain, France, Croatia, Cyprus, Malta, the Netherlands, Austria, Poland, Romania, Finland and Sweden.

([22]) The only exceptions were Latvia, whose structural balance was estimated in the proximity of its MTO after taking into account the allowances linked to the structural reform clause, and Italy, for which the Commission found no robust evidence to conclude that a significant deviation existed in 2019.

Graph 2.2: **Planned fiscal adjustments in subsequent stability and convergence programmes (EU countries not at MTO)**



Notes: (1) Structural fiscal adjustments (i.e. change in structural budget balance) are recalculated by the Commission based on the information contained in the stability and convergence programmes, following the commonly agreed methodology. (2) European countries not at MTO at the beginning of the 2019 surveillance cycle: BE, EE, IE, ES, FR, IT, LV, HU, AT, PL, PT, RO, SI, SK, FI, UK.
Source: European Commission

In spring 2019, several Member States, required to achieve a fiscal consolidation under the preventive arm of the SGP, revised their medium-term plans and reduced the adjustment targeted in 2019 from on average 0.5 to 0.1% of GDP (Graph 2.2). The reduction was particularly large in Italy (from +0.7 to -0.2% of GDP), Spain (from +0.4 to -0.1% of GDP) and Poland (from +0.6 to -1.3% of GDP).

The Commission's assessment of the stability and convergence programmes pointed to such a systematic delay in achieving the budgetary objectives, which were explained by both the downward revision of macroeconomic projections as well as to the impact of discretionary measures. Conversely, Council recommendations remained silent on this point.

These patterns are reflective of a more general trend. Medium-term budgetary plans, as presented in the SCPs, have failed to get the attention they deserve. Although subsequent reforms to the EU fiscal framework, in particular the six-pack reform of 2011, aimed to strengthen the link between medium-term fiscal plans and national budgetary procedures, SCPs continue to have a weak impact on national budgetary decisions because their role in EU surveillance has declined ([23]).

In addition, with the two-pack reform, the obligation for the euro-area Member States to submit their draft budgets to the Commission and the Eurogroup by 15 October before their adoption by national parliaments has shifted political attention to the annual budget. Consequently, under the European Semester, attention has shifted from medium-term plans to short-term fiscal policy action ([24]).

2.3. POLICY GUIDANCE: DEFINING FISCAL REQUIREMENTS

This section focuses on the policy guidance issued in spring 2018, in the form of country-specific recommendations (CSRs), for 2019. The CSRs represent the starting point of the annual fiscal surveillance cycle of the EU.

The Commission issued its country-specific recommendations (CSRs) for 2019 on 23 May. At the time of the assessment, 15 Member States close to or below their MTOs received guidance taking the form of quantitative fiscal adjustment requirements or were asked to achieve their MTOs. As in previous years, Germany and the Netherlands, which were estimated well above their MTOs, were recommended to use their available fiscal space to raise investment in specific areas. In particular, the Council invited Germany to increase investment on education, research and innovation and broadband infrastructure. In the case of the Netherlands, the Council identified research, development and innovation as priority investment areas.

No CSR was issued for Greece because the macroeconomic adjustment programme officially ended in August 2018. As a reminder, countries under an adjustment programme are exempt from some requirements of normal fiscal surveillance. Moreover, the country had taken commitments under the adjustment programme that went beyond the end of the programme period and extended into post-programme surveillance (see Box 2.1).

Contrary to 2018, and in line with established practice, the fiscal requirements were quantified in

([23]) See European Commission (2007).
([24]) EFB (2019).

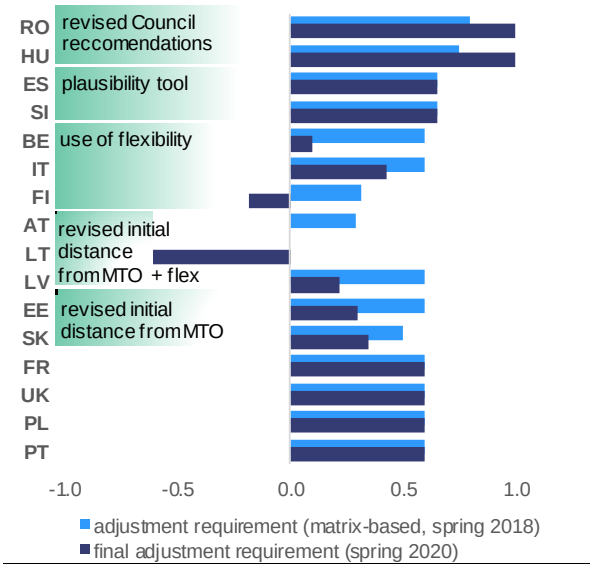
the enacting part of the recommendation, i.e. the part of the fiscal CSR that is legally binding. As a reminder, the recommended fiscal efforts for 2018 were quantified only in the recitals – the descriptive and introductory part – in order to prepare the ground for the 'margin of discretion' ([25]). The objective of the margin was to introduce additional elements of judgement in the final assessment of compliance. As a result, a country can be considered compliant even if the established indicators measuring the fiscal effort pointed to a shortfall with the Council recommendation.

Fiscal requirements in the preventive arm of the SGP are set on the basis of a matrix, which modulates the benchmark annual adjustment of 0.5% of GDP according to cyclical conditions, economic growth and the government debt-to-GDP ratio. It follows the principle that under favourable economic times, high government debt warrants larger fiscal adjustments.

Fiscal requirements for 2019 were based on the matrix except for Spain and Slovenia. According to the output gap estimates available in spring 2018, the two countries were experiencing 'good times' – i.e. the output gap was estimated to be above 1.5% of GDP – and, with a debt-to-GDP above 60%, the matrix would have required an adjustment of 1% of GDP. However, CSRs for both countries only asked for a structural fiscal effort of 0.65% of GDP, as the Commission and the Council considered the uncertainty surrounding the output gap estimates as particularly high. In the case of Slovenia, the plausibility tool corroborated the high degree of uncertainty. In the case of Spain, the deviation from the matrix was based on judgement, notably by referring to the high rate of unemployment.

In the case of Romania, by contrast, the fiscal CSR asked for an adjustment that went beyond the indications of the matrix of adjustment. The recommendation included a top-up of 0.3% of GDP compared to the matrix-based requirement of 0.5% of GDP after the country had been assessed not to have taken effective action in response to the Council recommendation of December 2017.

Graph 2.3: **Fiscal adjustment requirements for 2019 (EU Member States not yet at MTO)**



Notes: (1) Fiscal adjustment requirements are expressed in terms of year-on-year change of the structural budget balance, as a percentage of potential GDP. (2) The initial adjustment requirements are based on the matrix of requirements using the Commission spring 2018 forecast.
Source: European Commission

The recommended fiscal adjustment for Romania was further increased to 1% of GDP in autumn 2018, due to a lack of effective actions in response to previous Council recommendations and the cumulated high deviation from the recommended fiscal adjustment. A similar decision was taken for Hungary.

To possibly account for the uncertainty surrounding real-time estimates of the output gap, initial fiscal requirements – those determined in the spring of year t for year t+1 – can be revised if : (i) a country experiences a worsening of its economic conditions (i.e. the output gap falls below -3% of GDP); or (ii) a country is assessed to have achieved, or have come close to, the MTO. This provision is known as 'unfreezing' ([26]). In autumn 2018, the requirements for Ireland, Estonia and Slovakia were lowered because of a smaller than initially estimated distance of the countries structural budget balance to their respective MTOs.

In spring 2019, the adjustment requirement for Latvia was exceptionally 'unfrozen' in view of the updated draft budgetary plan, which was submitted

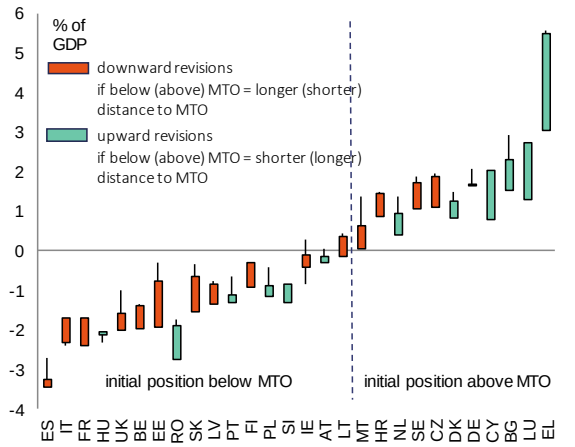
([25]) The margin of discretion was introduced by the Commission in the 2018 surveillance cycle as an extra element of discretion in assessing compliance with the preventive arm of the SGP. Allowing for a margin of discretion means that a Member State may be found compliant even if the established indicators, that is, the change in the structural budget balance and the expenditure benchmark, point to a significant deviation from the MTO or the adjustment path towards it (see EFB 2019b).

([26]) For more details, see Annex 5 of the Code of Conduct on the Stability and Growth Pact (May 2017 edition).

on 19 February 2019 ([27]). Finally, in spring 2020, Austria's distance to the MTO turned out to be smaller than assumed at the beginning of the surveillance cycle, and therefore, the requirement was reduced to zero, *ex post*, from the initial 0.3% requirement (Graph 2.3).

Due to the asymmetric nature of the unfreezing rule, fiscal requirements remained unchanged for the rest of the EU countries, although for most of them, in spring 2020 the initial distance to the MTO turned out to be larger than the one estimated at the beginning of the surveillance cycle (i.e. in spring 2018). Graph 2.4 shows the revisions of the initial distance to the MTO (i.e. the difference between the estimated structural balance in 2018 and the country-specific MTO for 2019). Especially for countries whose starting point was below the MTO, the estimated distances increased (the red bars in Graph 2.4). The revised distance would have implied a more demanding requirement for some countries, namely Estonia, Ireland, Latvia, Slovakia and Finland.

Graph 2.4: **Revisions of initial distance to MTO in 2019 surveillance cycle (spring 2018 to spring 2020 rounds of Commission forecasts)**



Notes: (1) The chart shows different estimates of the initial distance to MTO, that is the difference between the estimated structural balance in 2018 and the country's medium-term budgetary objective (MTO) for 2019. (2) Bar's height equals the difference between spring 2020 and spring 2018 vintages of Commission forecasts. (2) Red (green) bars = downward (upward) revisions in the initial distance to MTO; it means that for a country with a structural balance below its MTO, the estimated distance has increased (decreased). (3) Straight lines = maximum and minimum values from the intermediate rounds of Commission forecasts.
Source: European Commission

In a number of cases, fiscal requirements as per the matrix of adjustment were lowered on account of the structural reform or unusual events clause. In the case of Belgium, an allowance of 0.5% of GDP was granted *ex ante* in autumn 2018 – and confirmed *ex post* in spring 2020 – under the structural reform clause for the implementation of a package of measures in several areas, including the pension system, tax system, labour market and public administration. In the case of Italy, the unusual event clause was applied in the final assessment for: the (i) budgetary impact of the extraordinary road network maintenance following the collapse of the Morandi bridge in Genoa; and (ii) the preventive plan to limit hydrogeological risks following the exceptionally adverse weather conditions in 2018.

Fiscal adjustment requirements in the 2018 CSRs for Latvia, Lithuania, Finland and Austria took into account previously granted allowances under the flexibility or unusual event clauses ([28]).

2.4. ASSESSING DRAFT BUDGETARY PLANS FOR 2019

In autumn 2018, all euro area members, including Greece ([29]), presented draft budgetary plans for 2019. In comparison with the stability programmes presented in spring of the same year, when the aggregate deficit was still expected to decline to 0.3% of GDP in 2019, the draft budgetary plans implied an increase in the aggregate deficit to 0.8% of GDP and a deterioration of the structural budget balance by 0.3% of GDP.

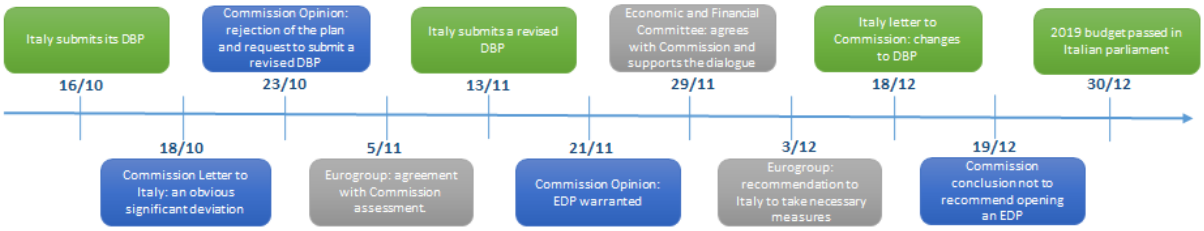
Output growth projections were also revised down following the slowdown in economic growth during the summer of 2018. Nevertheless, the increase in the deficit was larger than implied by lower growth projections. In addition to somewhat slower economic growth, euro area countries appear to have followed a twofold strategy of increasing expenditure plans while abandoning some previously announced tax cuts. The year-on-year increase in planned spending accelerated to 3.6% from the 2.2% in the stability programmes. At the same time, the announced discretionary

([27]) Since the 2018 surveillance cycle, fiscal requirements can only be reviewed twice: ex ante, in autumn t-1; or ex post, in spring t+1 at the time of the final assessment.

([28]) As a reminder, the granted flexibility applies for three consecutive years. The allowances apply to either the change or level of the structural balance, whichever leads to the least stringent requirement. When the estimated structural balance stands near the MTO, as in the Member States mentioned above, the allowed deviation is in level and refers directly to the distance from the MTO.

([29]) This was the first submission of the draft budgetary plan for Greece since its introduction in 2013. In the previous years, Greece was under a macroeconomic adjustment programme and was not obliged to submit a plan.

Graph 2.5: **Autumn 2018 developments in the assessment of the Italian draft budgetary plan**



Source: EFB 2019 Annual report.

revenue measures almost halved, keeping the expected aggregate revenue level broadly unchanged.

In line with the procedure outlined in the Code of Conduct of the two-pack ([30]), the Commission first assesses whether, based on the content of the draft budgetary plans, a country is intentionally planning either a significant deviation from the MTO or from the adjustment path towards it, or a breach of the deficit ceiling or the debt rule.

In autumn 2018, the Commission for the first time assessed that the Italian draft budgetary plan was heading in the direction of particularly serious non-compliance and requested that the Italian authorities submit an updated plan ([31]). The Commission's rejection was motivated by the very large planned deviation from the recommended adjustment path towards the MTO and an unrealistic macroeconomic scenario, which had not been endorsed by the national independent fiscal council ([32]). On 13 November 2018, the Italian government presented a revised plan, which did not include any substantial change compared to the first submission (see Box 2.5 of EFB 2019 annual report).

The Commission also started consultations in the form of an exchange of letters with five countries that had been found at risk of non-compliance based on the content of their draft budgetary plans, notably Belgium, France, Portugal, Slovenia and Spain. The letters requested additional information including on the underlying macroeconomic assumptions. Most of the Member States replied by giving reassurance to the Commission of their commitment to abide by the SGP rules. They also provided additional information on their planned structural reforms and different measures that they planned to adopt.

On 21 November 2018, the Commission issued its opinions on the draft budgetary plans of the euro-area countries. It found Italy at a risk of particular serious non-compliance and Belgium, France, Portugal, Slovenia and Spain at a risk of non-compliance ([33]). Of note, the medium-term budgetary plans submitted by these countries earlier in spring had also been assessed at risk of non-compliance.

In the case of Italy, the Commission also issued a report under Article 126(3) TFEU in view of the planned breach of the 3% of GDP deficit threshold (see Section 2.6). For the other five countries, following normal practice, the Commission invited the authorities to take the necessary measures within the national budgetary process to ensure that the 2019 budget would be compliant with the SGP.

On 3 December 2018, when discussing the Commission opinions on the draft budgetary plans, the Eurogroup issued a detailed statement inviting Member States at risk of non-compliance to consider, in a timely manner, additional adjustment measures The Eurogroup also called on the countries with fiscal space to use their favourable budgetary situation to boost investment and growth. Regarding Italy, the Eurogroup agreed with the Commission's assessments and supported a dialogue between the Commission and the Italian

([30]) 'Specifications on the implementation of the Two Pack and Guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports': http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

([31]) Article 7(2) of Regulation (EU) 473/2013 empowers the Commission to issue a negative opinion if it identifies a case of 'particularly serious non-compliance'.

([32]) Article 4(3) of Regulation (EU) 473/2013 states that draft budgets should be based on independent macroeconomic forecasts, and should indicate whether the budgetary forecasts have been produced or endorsed by an independent body.

([33]) Based on its 2018 autumn forecast, the Commission also concluded that Germany, Ireland, Greece, Cyprus, Lithuania, Luxembourg, Malta, the Netherlands, Austria and Finland were fully compliant with the requirements of the SGP, while Estonia, Latvia and Slovakia were found to be broadly compliant with the SGP 2018.

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

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

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

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

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

Compliance indicators: Compliance with the requirements of the preventive arm is assessed using a two-pillar approach. The assessment of the estimated annual change of the structural balance (the first pillar) is complemented by an expenditure benchmark (the second pillar), which limits the increase of government spending relative to potential GDP growth in the medium term, unless funded by new revenue measures. Since 2018, the Commission motivates its overall conclusions by referring to a number of factors beyond the reading to the two established indicators (see Box 2.3 of the EFB 2019 annual report).

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

Significant deviation: A deviation from the MTO — or the adjustment towards it — is significant if it is larger than 0.5% of GDP in 1 year or 0.25% of GDP on average over 2 consecutive years.

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

Sanctions: If a Member State under an SDP fails to take appropriate action by the given deadline, a decision on no effective action and the imposition of sanctions for euro area countries, in the form of an interest-bearing deposit, are possible. The interest-bearing deposit is turned into a non-interest bearing deposit if an excessive deficit procedure is launched (see Box 2.4).

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

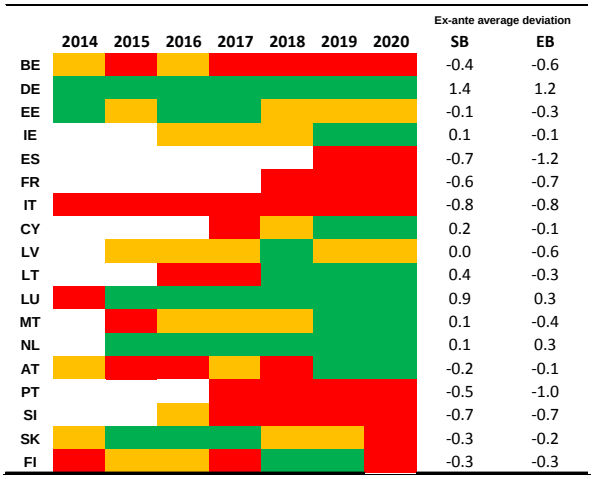
authorities in order for Italy to take the necessary measures to be compliant with the SGP.

Latvia, Luxembourg and Slovenia submitted updated budgetary plans in 2019 due to new governments. In the case of Latvia and Luxembourg, the Commission assessed the updated draft budgetary plan to be broadly and fully compliant with the SGP, respectively. As regards Slovenia, the Commission requested additional information on the precise composition of the planned structural effort and expenditure developments envisaged in the updated DBP. In its final opinion, the Commission concluded that Slovenia's updated draft budgetary plan was at risk of non-compliance with the SGP.

Lack of compliance with fiscal requirements at the planning stage of annual budgets is a recurrent feature of the EU fiscal framework. According to Table 2.1, since 2013, more than half of all euro area countries have regularly planned a deviation

from the required adjustment laid down in the Council's fiscal recommendations. The average planned deviation per year from the required change of the structural budget balance amounts to 0.3% of GDP and 0.4% of GDP for the expenditure benchmark. As argued in previous annual reports, the application of the margin of broad compliance – a tolerated deviation from the adjustment requirement – in assessing budgetary plans, is largely responsible for this trend ([34]).

Table 2.1: **Assessment of compliance of draft budgetary plans with the preventive arm of the SGP**

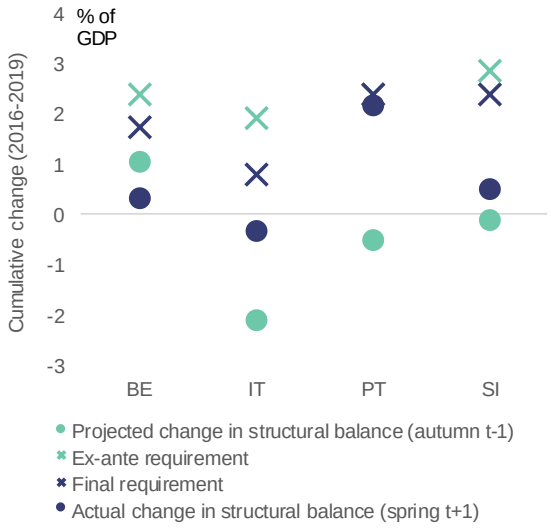


Notes: (1) Green, yellow and red correspond respectively to an assessment of 'compliance', 'broad compliance' and 'risk of non-compliance'. (2) The assessment of compliance following the Commission's 'overall assessment' also includes deviations over two years and the possible application of unusual event clauses. (3) 'SB' refers to the structural balance; 'EB' to the expenditure benchmark. Deviations from the MTO, or from the annual adjustment requirements for both the SB and the EB, are expressed in % of potential GDP and averaged over the years. (4) For countries above the MTO, requirements consider the use of fiscal space. In other words, if a country's structural balance is estimated at 1% of GDP above its MTO, the requirement considers the possibility of a deterioration of its underlying fiscal position up to 1% of GDP. Therefore, if the structural balance worsens by 0.5% of GDP, the table still shows a positive deviation from the requirement of 0.5% of GDP. (5) Only euro area countries submit draft budgetary plans.
Source: European Commission

These *ex ante* deviations, which are dubbed as broadly compliant, generate a general perception that the budgetary plans are sounder than they actually are and subsequently lead to a more lenient budget execution. Looking at the four countries that have never planned to comply with the required adjustments over the last four years (i.e. Belgium, Italy, Portugal and Slovenia), Graph 2.6 shows how shortfalls in budgetary plans are associated with significant slippages in budgetary execution.

Among the four countries, Portugal appears to be the only one that ensured a fiscal adjustment in line with requirements, despite deviations planned ex-ante. However, the same analysis using the expenditure benchmark as a measure of the fiscal effort would align Portugal with the other countries.

Graph 2.6: ***Ex ante* vs *ex post* fiscal adjustments and fiscal requirements under SGP (2016-2019)**



Notes: (1) The projected changes in the structural balances refer to the Commission forecast of the autumn preceding the year of reference. (2) The graph shows the cumulative change in the structural balances (projected and actual) and the adjustment requirements under the Stability and Growth Pact.
Source: European Commission, own calculations

2.5. FINAL ASSESSMENT OF COMPLIANCE

Based on outturn data, the Commission's final assessment found that 10 countries (i.e. Belgium, Estonia, Spain, France, Hungary, Poland, Portugal, Slovenia, Slovakia and the United Kingdom) had deviated significantly from the MTO, or from the required adjustment path towards the MTO, in 2019 or in 2018 and 2019 taken together ([35]). The Commission's final assessment also found that

([34]) Since the six-pack legislative reform of 2011, the Commission applies a margin of error when assessing compliance with the preventive arm of the SGP. A Member State is considered to be broadly compliant if the observed deviation from its MTO, or from the recommended adjustment towards it, does not exceed 0.5% of GDP in a single year, or cumulatively over two consecutive years.

([35]) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period, lasting until 31 December 2020. During this period, Union law — including that related to the European Semester — continues to apply to and within the United Kingdom. The Commission's overall assessment confirmed a risk of significant deviation from the recommended adjustment path towards the MTO in 2019-2020 and over 2018-2019 and 2019-2020 taken together. The UK's financial year, which runs from April 1 to the following March 31, does not coincide with the calendar year. Outturn data for 2019-2020 will be available in autumn 2020.

prima facie Belgium, Spain, Greece, France, Italy and Cyprus did not comply with the debt-reduction rule in 2019 and issued reports under Article 126(3) TFEU (see next section). However, the Commission did not recommend to the Council the opening of any formal correction procedures owing to the significant impact of the Covid-19 outbreak on the economic and fiscal outlook.

On 20 March 2020 – two months before the publication of the Commission's spring package – in light of the worsening of the Covid-19 health crisis and its expected economic impact, the Commission proposed to the Council the activation of the general escape clause. The Commission justified the activation of the general escape clause with the aim of accommodating, and better coordinating, more general fiscal policy support ([36]). On 23 March, EU Ministers of Finance concurred with the Commission view that the conditions for using the general escape clause had been fulfilled.

Although activation of the general escape clause did not formally refer to the 2019 outcomes, it had *de facto* an impact on the implementation of the SGP for 2019. The Commission considered that, due to the unprecedented economic shock resulting from the Covid-19 pandemic and the need to maintain a supportive stance, the opening of SGP procedures would not have been justified from a stabilisation perspective. The Commission also referred to the exceptional degree of uncertainty surrounding the economic and fiscal outlook. Furthermore, the Commission argued that the significant deviation procedure (SDP) under the preventive arm of the Pact, which provides for the correction of deviations in a period of one year, would have overlapped with the general escape clause.

It is worth noting that in 2009, the coordinated fiscal stimulus agreed in response to the global economic and financial crisis, known as the European economic recovery plan (EERP), was combined with the opening of EDPs. The coordinated fiscal expansions at the national level were presented as the first part of a comprehensive strategy embedded in a medium term adjustment plan for each Member State ([37]). The combination of short-term stabilisation followed by medium term adjustment was meant to enhance credibility and anchor expectations, although the fiscal support effectively deployed by Member States in 2009 did not reflect adequately the underlying weaknesses in the public finances of several economies ([38]). The six-pack reform of 2011 specifically modified the general escape clause to formally allow the type of guidance issued at the time of the EERP, notably a combination of fiscal support followed by a gradual fiscal adjustment over the medium term ([39]).

2.5.1. Compliance with the preventive arm of the Pact

The most striking feature of the final assessment of compliance with the preventive arm of the Pact in 2019 was the unusually large number of significant deviations from the adjustment path towards the MTO, especially in light of moderate but still positive economic growth and largely positive output gap estimates. In comparison, in 2018, the final assessment pointed to seven cases of significant deviation based on the reading of the two established indicators (i.e. the change in the structural balance and the expenditure benchmark), that is, before taking into account other factors, and including a non-conclusive assessment for Belgium (see the EFB 2019 annual report).

The number of EU countries significantly deviating from their requirements in 2019 was the highest since the six and two-pack legislative reforms of 2011-2013. Graph 2.8 shows the number of countries that have fallen short of numerical requirements since 2014 and the size of the deviations, measured in terms of both the expenditure benchmark and the structural balance – thus abstracting from the Commission's formal conclusions, which since 2013 involve a growing

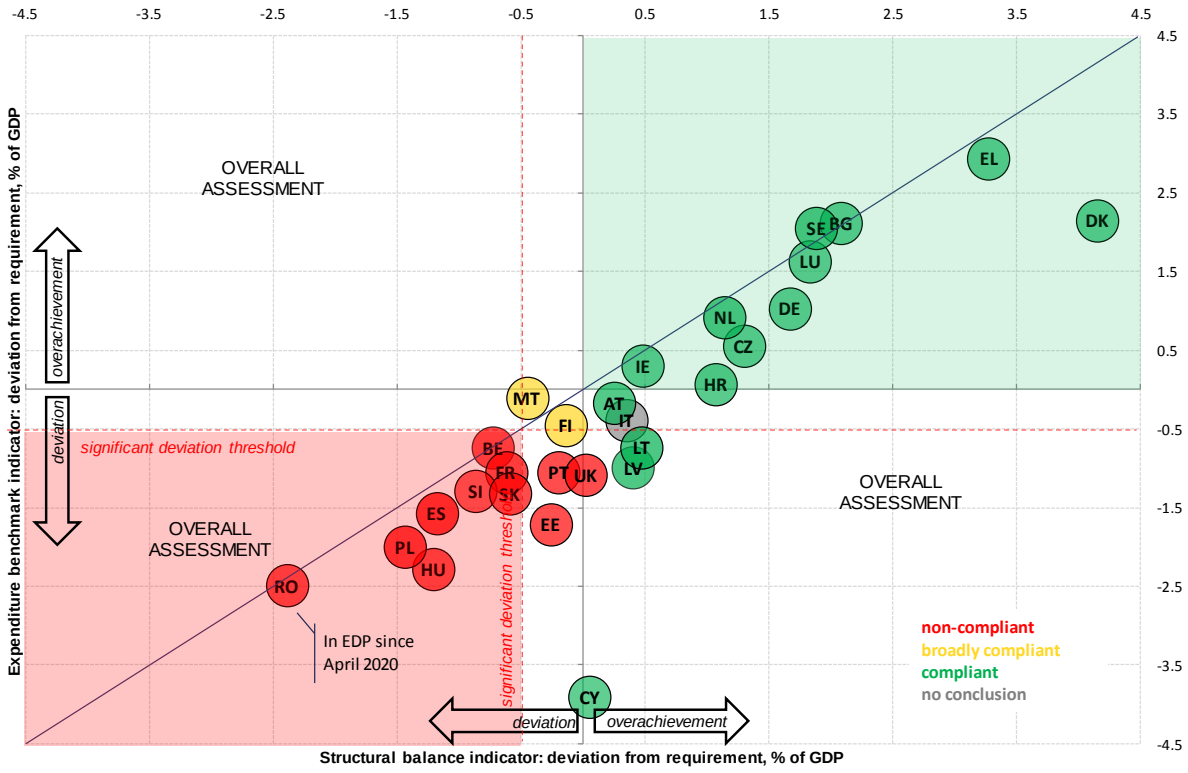
([36]) The clause allows the EU to suspend Member States' fiscal requirements under both the preventive and corrective arms of the SGP. Specifically, for the preventive arm, Articles 5(1) and 9(1) of Regulation (EC) 1466/97 state that *in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term.* For the corrective arm, Articles 3(5) and 5(2) stipulate that in the case of a severe economic downturn in the euro area or in the EU as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory.

([37]) On 20 October 2009, the ECOFIN Council concluded that '[p]rovided that the Commission forecasts continue to indicate that the recovery is strengthening and becomes self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest. (See Council conclusions on fiscal exit strategies, 20 October 2009).

([38]) In particular, where revenues had been inflated by extraordinary booms in non-traded activity, mainly construction.

([39]) The legacy of the effort to stimulate the economy regardless of its initial position was a major contributor to the subsequent pro-cyclical contraction.

Graph 2.7: **2019 final assessment of compliance with the preventive arm of the Stability and Growth Pact**

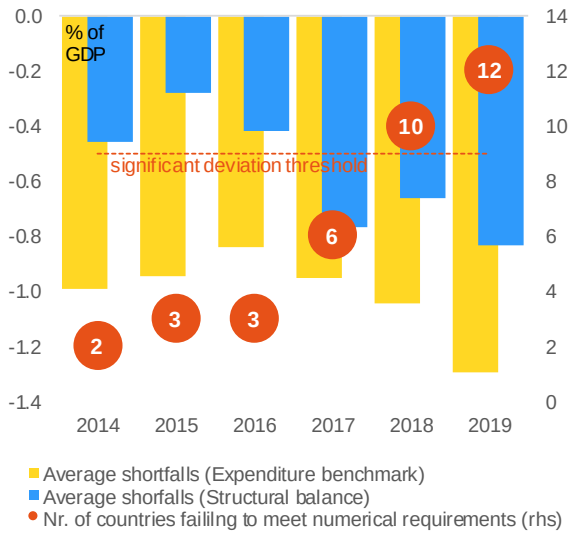


Notes: (1) A negative number represents a deviation from the required fiscal adjustment. A deviation is considered 'significant' if greater than 0.5% of GDP (the red area). A positive number indicates an overachievement (the green area). (2) Circle colours: green, yellow and red correspond respectively to an assessment of 'compliance', 'broad compliance' and 'non-compliance', based on the Commission's spring 2020 assessment. A grey circle is used for Italy where the Commission's assessment was not conclusive. (3) Deviations for Greece are based on a MTO of -0.5% of GDP as established for 2020.
Source: European Commission

degree of judgement, given the use of a multiplicity of competing compliance indicators. The chart shows a worrying increase not only in terms of countries deviating from requirements (i.e. both the established indicators showed a deviation), but also in terms of the size of the deviations: it was the highest since 2014, in particular when measured in terms of the expenditure benchmark.

The intensification of both the number of non-compliant cases and the size of the gaps in a year of moderate, yet positive, economic growth contrasts with the objective of a fiscal framework which should lead countries to build fiscal buffers during good times, in particular those with fiscal sustainability needs. Novel interpretations and practices in the implementation of the Pact, which the EFB documented in previous reports, in particular those diluting the assessment of compliance by adding new factors and elements of judgement, contributed to this trend.

Graph 2.8: **Deviations from fiscal requirements (2014-2019)**



Notes: (1) A country is considered to fall short of its requirement under the preventive arm of the SGP when both the established compliance indicators (i.e. the structural balance and the expenditure benchmark) show a deviation from the MTO or from the adjustment towards it. (2) The chart excludes countries in EDP.
Source: European Commission; own calculations

Table 2.2: **Countries deviating from the recommended adjustment path**

2019	Observed deviation from the required adjustment				Fiscal sustainability risks			Government debt (% of GDP)	Gov. budget balance (% of GDP)	Distance to MTO (% of pot. GDP)	Numerical compliance (2011-2019)	Nominal pot. GDP growth (10y average)	Current primary expend. (4y average growth)	Government investment (4y average growth)	Government investment (% of GDP)	Output gap (% of pot. GDP)	Investment growth (y-o-y, total economy)	Employment growth (y-o-y)	Unemployment rate (% of LF)	Inflation (y-o-y)	Current account balance (% of GDP)
	2019		2018-19		short-term	medium-term	long-term														
	ΔSB	EB	ΔSB	EB	S0	S1	S2	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(L)	(M)	(N)	(O)	(P)
BE	-0.7	-0.7	-0.6	-0.7	LOW	HIGH	HIGH	98.6	-1.9	-2.1	39%	2.9	3.1	4.3	2.6	0.9	3.9	1.5	5.4	1.2	-0.7
EE	-0.3	-1.7	-0.3	-1.2	LOW	LOW	LOW	8.4	-0.3	-1.1	66%	5.5	7.9	7.3	4.9	4.3	17.8	1.0	4.4	2.3	2.3
ES	-1.2	-1.6	in EDP	in EDP	LOW	HIGH	MEDIUM	95.5	-2.8	-3.1	42%	1.0	3.2	-1.0	2.0	2.3	6.7	2.1	14.1	0.8	2.0
FR	-0.6	-1.0	-0.5	-0.7	LOW	HIGH	MEDIUM	98.4	-3.0	-2.3	24%	1.9	2.1	4.2	3.6	1.1	5.2	1.3	8.5	1.3	-0.1
IT	0.4	-0.4	0.0	-0.5	LOW	HIGH	HIGH	134.8	-1.6	-2.2	30%	0.9	1.8	0.5	2.3	-0.3	2.4	0.6	10.0	0.6	3.0
HU	-1.2	-2.3	-1.3	-1.8	LOW	LOW	MEDIUM	66.3	-2.0	-1.8	40%	3.4	4.8	13.3	6.0	4.1	22.1	1.0	3.4	3.4	-0.9
PL	-1.4	-2.0	-0.7	-1.0	LOW	LOW	LOW	46.0	-0.7	-1.2	52%	4.9	6.1	6.6	4.3	4.0	8.5	-0.1	3.3	2.1	0.4
PT	-0.2	-1.0	0.0	-1.3	LOW	HIGH	MEDIUM	117.7	0.2	-0.7	32%	1.5	2.5	1.5	1.9	2.4	8.3	0.8	6.5	0.3	0.0
SI	-0.9	-1.3	-0.8	-1.2	LOW	LOW	MEDIUM	66.1	0.5	-1.2	46%	2.3	4.2	1.9	3.8	3.0	5.7	2.3	4.5	1.7	6.8
SK	-0.6	-1.3	-0.7	-1.2	LOW	LOW	MEDIUM	48.0	-1.3	-1.1	54%	3.3	4.8	-6.2	3.6	2.7	5.7	0.7	5.8	2.8	-2.6
UK	0.0	-1.1	0.2	-0.7	LOW	HIGH	HIGH	85.4	-2.1	-2.1	35%	3.4	-2.0	0.4	2.8	1.1	5.0	1.1	3.8	1.8	-3.8

Notes: (1) The observed deviation from the required structural adjustment (or MTO) presents the observed deviation from the fiscal requirement according to both compliance indicators: (i) the ΔSB and (ii) the EB. It includes the deviation in one year and on average over two consecutive years (i.e. 2018 and 2019). Colours: green, yellow and red, corresponding respectively to the indicator pointing to compliance, some deviation or a significant deviation to the MTO or the required path towards it. The deviation is considered significant if it exceeds 0.5% of GDP in a single year, or 0.25% of GDP on average over two consecutive years. (2) S0, S1 and S2 refer respectively to short-term, medium-term and long-term sustainability indicator published by the European Commission. For their definition, refer to the Glossary. Green, yellow and red correspond respectively to the 'low', 'medium' and 'high' sustainability risk. (3) The overall compliance score (column D) is based on a numerical exercise that compares budgetary outcomes against a set of predefined numerical fiscal rules. The score is the frequency of compliant cases across all rules and years between 2011 and 2018 for a given country. Fiscal rules include: i) deficit rule; ii) debt rule; iii) structural balance rule; and iv) expenditure rule (for more details see Chapter 3 of the EFB assessment report, 2019). (4) Nominal potential GDP growth (column E) is calculated as a sum of the potential GDP growth (as estimated by the European Commission) and GDP price deflator.
Source: European Commission

In 8 out of the 10 cases, both compliance indicators (i.e. the change in the structural balance and the expenditure benchmark) pointed to a significant deviation. For these 'clear-cut' cases (i.e. Belgium, Spain, France, Hungary, Poland, Slovenia, Slovakia and the United Kingdom) the Commission's assessment of compliance was unusually short and unambiguous. In the case of Estonia and Portugal, the deviation measured by the expenditure benchmark was significant, while the shortfall measured by the change in the structural balance was not significant. The Commission assessed the various factors affecting the calculation of the two indicators. The diverging signals were, in both cases, solved in favour of the expenditure benchmark.

In contrast with 2018 – and probably because conclusions would not have triggered any infringement procedure – the Commission did not use other factors beyond the reading of the two established indicators. It was only in one case, Italy, that the Commission did not reach a conclusion when assessing compliance with the preventive arm of the SGP: the Commission was of the view that there was no robust evidence to conclude on a significant deviation. Based on outturn data and the Commission forecast, the growth of primary government expenditure, net of discretionary revenue measures and one-offs, exceeded the recommended ceiling, pointing to some deviation in 2019 (0.4% of GDP), and to a significant deviation over 2018-2019 taken together (0.5% of GDP). At the same time, the structural balance improved in 2019 (by 0.8 pps), thus pointing to compliance with the recommended adjustment towards the MTO both in 2019 and over 2018-2019 taken together ([40]). Hence, unlike in the case of Estonia and Portugal, where the two indicators also pointed to different directions, the Commission did not favour the expenditure benchmark.

According to the Commission's analysis, the difference between the two indicators was mainly due to revenue windfalls and the decline in interest expenditure. The Commission considered that both factors were somewhat attributable to government policy actions (e.g. the positive labour market developments largely related to permanent contracts; policy measures to fight tax evasion a positive market perception of budgetary measures reflected in lower debt-servicing costs), which were possibly to be regarded as structural, as opposed to temporary.

In spring 2019, Belgium was granted a temporary deviation from the adjustment path towards its MTO of 0.5% of GDP for reforms of the pension

([40]) These deviations took into account the unusual event clause for the budgetary impact of the exceptional road network maintenance following the collapse of the Morandi bridge in Genoa and the preventive plan to limit hydrogeological risks following adverse weather conditions, which amounted to 0.18% of GDP.

system, the tax system and the labour market. In its final assessment of spring 2020, the Commission noted that '[w]hile the Stability Programme does not report on the implementation of these structural reforms, their implementation in 2019 followed the announced plans' without further details. As indicated in previous reports, the Commission assessment of the long-term impact of structural reforms is limited to an *ex ante* plausibility analysis, which remains largely of a qualitative nature, without *ex post* verification.

Although the Commission assessment of compliance for 2019 was conducted under exceptional circumstances and did not lead to the opening of formal procedures, it is nevertheless relevant for future analysis to provide a more detailed assessment of non-compliant cases. The aim is to identify gross errors and inform the reader of possible differences between cases of numerical non-compliance on the basis of a more comprehensive economic judgement.

Table 2.2 shows a set of potentially relevant macroeconomic indicators for the group of countries that the Commission assessed as having deviated significantly from their fiscal requirements in 2019. It also includes Italy, for which the Commission assessment was inconclusive. Four countries, namely Belgium, Spain, France and Italy, appear in a worse fiscal position than the others. They stand out along all dimensions considered. In the EU, they rank among the top seven countries in terms of government debt, deficit, distance to MTO and lack of past compliance with fiscal rules ([41]), pointing to substantial fiscal sustainability risks. While Portugal has a relatively high debt-to-GDP ratio, its headline deficit and its underlying fiscal position with respect to the MTO point to smaller fiscal risks than the four mentioned above. Conversely, Estonia, Hungary, Poland, Slovenia and Slovakia, appear to be in a different position also showing higher rates of numerical compliance with the EU fiscal rules in the past.

In the last four years current primary expenditure has grown above the medium-term potential output (i.e. the average over 2010-2019) for all countries in Table 2.2, except the UK. At the same time, the growth of government investment was minimal between 2016 and 2019, especially in Slovakia, Spain and Italy.

The case of Italy is particularly noticeable: a slightly negative output gap estimate goes hand in hand with significant sustainability risks, heightened by persistently low nominal GDP growth.

Apart from cases of significant deviation from the fiscal requirements, a few other cases of SGP implementation in 2019 are worth mentioning here.

In the cases of Latvia and Lithuania, the Commission concluded that both countries were compliant with the preventive arm of the SGP, given the estimated proximity to their respective MTO (with gaps of 0.2 and 0.1% of GDP, respectively). The proximity to the MTO was assessed after taking into account the allowances linked to the structural reform clause, which were granted in the previous years (0.5% of GDP for both countries). However, the assessment largely disregarded the significant deviations from the expenditure benchmark (gaps of 1% and 0.7% of GDP, respectively). In normal circumstances, the assessment would have warranted a careful analysis of the possible impact of revenue windfalls. In addition, for both countries, the estimated structural balance lies below its minimum benchmark (i.e. the lowest value of the structural balance that provides a safety margin against the risk of breaching the Treaty reference value of 3% of GDP for the deficit during normal cyclical fluctuations). As specified in the 2016 'Commonly agreed position on flexibility within the SGP' ([42]), such a safety margin should be continuously preserved during the application of the flexibility clause.

Lastly, in the case of Hungary, which has been under a significant deviation procedure (SDP) since 2018, the Commission's overall assessment confirmed a significant deviation in 2019 as well as in 2018 and 2019 taken together ([43]). The Commission did not propose a new significant deviation procedure. In light of the activation of the general escape clause for 2020, the Commission

([41]) Compliance with fiscal rules refers to a numerical exercise that compared budgetary outcomes against a set of predefined numerical fiscal rules (for more details see Chapter 3 of the EFB assessment report, 2019).

([42]) http://data.consilium.europa.eu/doc/document/st-14345-2015-init/en/pdf.

([43]) A significant deviation procedure (SDP) for Hungary was launched in spring 2019. On 14 June 2019, the Council recommended that Hungary ensure that the nominal growth rate of net primary government expenditure not exceed 3.3% in 2019 and 4.7% in 2020; this corresponded to an annual structural adjustment of 1% of GDP in 2019 and 0.75% of GDP in 2020.

also decided that Hungary could be considered to have complied with the Council recommendation of 5 December 2019 ([44]).

2.5.2. Compliance with the corrective arm of the Pact

On 20 May 2020, the Commission issued six reports under Article 126(3) TFEU for Member States that did not comply with the debt rule in 2019. These reports were issued for France, Belgium, Cyprus, Greece, Italy and Spain. The Commission reports concluded that while Greece and Cyprus complied with the debt criterion, Belgium, France and Spain failed to meet the required debt benchmark. While there was a decision not to recommend the opening of an excessive deficit procedure at that time for any Member State in view of the Covid-19 crisis, the reports differed in tone and messages. Earlier this year, on 14 February 2020, the Commission adopted an Article 126(3) TFEU report for Romania.

In the case of Italy, the report was not conclusive. According to the data notified in April 2020, the debt-to-GDP ratio remained unchanged in comparison with 2018. Although Italy achieved encouraging fiscal results in 2019, especially on the revenue side, this was not enough to offset low nominal GDP growth. Thus, Italy did not comply with the debt reduction benchmark. For this reason, the Commission issued an Article 126(3) report. It considered that, due to the diverging signals coming from the two established indicators of compliance, there was no robust evidence that Italy had significantly deviated from the required adjustment towards the MTO (see Section 2.5).

This was the first time that the Article 126(3) TFEU report for Italy was inconclusive. This newly established 'fourth' category of compliance has become a recurrent practice over the last three years. As indicated above, the Commission's judgement seems to have attached more importance to the structural budget balance despite the declared intention to give more prominence to the expenditure benchmark.

For the sake of completeness, the report issued in spring 2020 was the second Article 126(3) TFEU for Italy pertaining to budgetary developments in 2019. The first one was issued in autumn 2018, due to a very large planned deviation from the recommended adjustment path towards the medium-term objective (MTO). As indicated above, the Commission assessed that a risk of *particular serious non-compliance* existed and rejected Italy's draft budgetary plan (DBP). Following subsequent revisions of Italy's initial plans, and amendments to the budget law the Commission concluded that a debt-based EDP was not warranted at that stage (for a detailed assessment of the events see the EFB 2018 annual report, Box 2.5).

Based on outturn data for 2019, it seems that dialogues between the Commission and the Italian authorities had a positive effect on the budgetary outcomes. Therefore, from an economic perspective, the EFB acknowledges the potential value of negotiations as part of the process of fiscal surveillance. However, the interaction between the Commission and Italy contrasts with the multilateral nature of the EU fiscal surveillance as defined in the Treaty.

In the case of Belgium, outturn data for 2019 showed that the decline of the debt-to GDP ratio was not sufficient to comply with the debt reduction benchmark. In addition, outcomes for 2019 also showed that tax increases in 2017 and 2018, whose purported structural nature had led the Commission not to open an EDP procedure earlier, were temporary and, therefore, a stepping up of the procedure would have been warranted (see EFB 2018 annual report for more details). The Commission report on Belgium under Article 126(3) TFEU confirmed a significant deviation from the recommended adjustment path towards the MTO for 2019 and over 2018 and 2019 taken together. After taking the relevant factors into account, the Commission concluded that Belgium had not complied with the debt rule in 2019. However, in light of the high uncertainty linked to the Covid-19 pandemic the excessive deficit procedure for Belgium was eventually not triggered.

([44]) Following the Council Decision establishing that no effective action was taken by Hungary in response to the Council Recommendation of 14 June 2019, on 5 December 2019 the Council issued a revised recommendation to Hungary. The Council recommended that Hungary ensure that the nominal growth rate of net primary government expenditure not exceed 4.7% in 2020, which corresponded to an annual structural adjustment of 0.75% of GDP in 2020.

Box 2.3: The corrective arm of the Stability and Growth Pact (SGP) in a nutshell

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

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

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

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

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

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

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

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

Greece, France and Spain exited the excessive deficit procedure (EDP) in 2017, 2018 and 2019, respectively. At the time of abrogation, in all three countries, their debt-to-GDP ratio was higher than the Treaty reference value of 60% of GDP. Therefore, they became subject to a three-year transitional debt rule period. During this period, the countries are expected to ensure sufficient

progress towards compliance with the debt rule reduction benchmark. According to the data notified in April 2020, they did not make sufficient progress. As a result, the Commission prepared Article 126(3) TFEU reports and reached the following conclusions:

- Greece was found compliant with the debt criterion. The treatment of Greece differs from other countries since the target set out by the Council in July 2019 was to ensure a sufficient effort in order to reach a primary surplus of 3.5% of GDP (see Box 2.1). The outturn data for 2019, showed that Greece had reached this target. As a result, and after taking other relevant factors into account, the Commission assessed that Greece was compliant with its the fiscal targets.

- France was found not to comply with the debt rule in 2019. The data notified in April 2020 showed that the debt-to-GDP ratio had remained unchanged mainly due to one-off deficit-increasing measures: the tax credit for competitiveness and employment (CICE) was transformed into a permanent reduction of the social contributions. The Commission overall assessment pointed to a significant deviation from the recommended adjustment path towards the medium term budgetary objective in both 2019 and 2018-2019 taken together.

- Spain was found not to comply with the debt criterion in 2019. The outturn data showed that the debt-to-GDP ratio decrease was insufficient in relation to the target set out by the Council in July 2019. Both the estimated change in the structural balance and the expenditure benchmark, pointed to a risk of a significant deviation of broadly the same magnitude.

Romania is currently the only country subject to an EDP procedure. In December 2019, the Romanian government announced in its new budgetary plan a deficit of 3.8% of GDP in 2019. Based on this planned breach, the Commission issued an Article 126(3) TFEU report in February 2020. The Commission concluded that the deficit criterion should be considered as not complied with, and that an EDP was warranted. It is worth noting that the Commission assessment report is very critical in tone ([45]). It stated that *'the government has systematically and repeatedly derogated from many fiscal rules, thereby rendering them largely ineffective'*. Moreover, the Commission observed this negative attitude also between institutions within the county, where Romanian authorities did not send its medium-term fiscal strategy update to the Parliament by the deadline. On 3 April 2020, the Council recommended to Romania ([46]) to correct its excessive deficit by 2022 at the latest. The first report by the Council on action taken is expected in the autumn 2020.

([45]) https://ec.europa.eu/info/sites/info/files/economy-finance/commission_report_on_romania_126-3.pdf

([46]) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020H0408(01)&qid=1586876526355&from=EN

3. INDEPENDENT FISCAL INSTITUTIONS

Highlights

- We take a closer look at the role of independent fiscal institutions (IFIs) in medium-term planning and in the production or endorsement of macroeconomic forecasts underpinning governments' budgets. There is empirical evidence that:

- over longer time periods, the presence of IFIs is associated with more accurate budgetary forecasts;

- an effective medium-term budgetary framework and the existence of an IFI strengthen the positive effect of fiscal rules on budgetary discipline; and

- IFIs positively contribute to the prudence of official forecasts by endorsing or producing of macroeconomic forecasts.

- We review the IFIs in Germany and Czechia, two countries where the tasks of fiscal councils are allocated to more than one institution. The main findings are:

- The German setting is characterised by a high degree of fragmentation where the IFI – the Independent Advisory Board to the Stability Council – is embedded in a complex system of technocratic and political bodies. Established in 2013, the German IFI is a very lean body with a Board of nine experts supported by a small secretariat. The breadth and depth of its mandate is, by law, limited and the IFI can carry it out thanks to institutional cooperation with other bodies. Beyond its expertise, its effectiveness crucially depends on broad-based political support for fiscal prudence.

- Established in 2018, the Czech Fiscal Council is the youngest IFI in the EU. Fiscal surveillance in Czechia is conducted sequentially by two mutually independent bodies, the Committee on Budgetary Forecasts and the Czech Fiscal Council. This institutional setting enables the highest degree of independence at every step of each body's mandate. Like in Germany, the setting operates thanks to high-level institutional cooperation with other bodies. Coordination costs are limited, as the two bodies are fairly small.

- We also examine the role of IFIs in the 2019 EU fiscal surveillance cycle, using information collected by the EFB through a dedicated questionnaire. Our conclusions are:

- The role of IFIs in assessing compliance with fiscal rules by caretaker governments is challenging because there is no authority that can formulate and implement the necessary measures to achieve the medium-term fiscal plans, as in the case of Belgium.

- IFIs continue to play an important role in warning of risks of deviation from EU rules and assessing the plausibility of macroeconomic forecasts. Some IFIs did not endorse their government's macroeconomic scenario (Italy) or expressed reservations (France, Portugal) as they deemed it too optimistic.

- The European Commission's use of discretion to assess budgetary plans and requirements complicates the tasks of IFIs at the national level, especially when the Commission and IFIs come to different conclusions about compliance with EU fiscal rules. An additional difficulty is that some IFIs have to assess compliance with domestic fiscal rules that are not fully consistent with the SGP.

- The opinions and recommendations of IFIs did not lead directly to the adoption of corrective measures, although they generally helped to increase the reputational costs of governments whose fiscal plans were not compliant with EU fiscal rules. This was particularly the case in Italy and Romania.

- IFIs continue to foster the quality of budgetary plans by issuing recommendations, in particular by stressing the need for consistent annual and multi-annual plans, and by making recommendations to improve the accuracy of revenue forecasts.

This chapter includes three parts: (i) the role of IFIs in medium-term planning and the production or endorsement of macroeconomic forecasts underpinning governments' budgets; (ii) portraits of IFIs in two countries, namely Germany and Czechia; and (iii) an evaluation of the role played by national IFIs in the 2019 assessment cycle in countries for which the Commission had indicated risks of non-compliance with EU fiscal rules or which had not taken action to correct deviations from EU rules.

3.1. MEDIUM-TERM BUDGETARY FRAMEWORKS AND PLANNING AND THE PRODUCTION OR ENDORSEMENT OF MACROECONOMIC FORECASTS

This section discusses how IFIs help to improve the quality of medium-term budgetary planning. IFIs are a main building block of national fiscal frameworks, along with national fiscal rules and medium-term budgetary frameworks. IFIs play a role in having reliable budgetary forecasts, which is crucial for effective medium-term planning. Recent analysis suggests that both forecast errors for budgetary variables and the optimistic bias of budgetary forecasts are lower in the presence of an IFI, although the causality is not entirely clear. There is also tentative empirical evidence of the contribution of IFIs on compliance with fiscal rules and therefore on budgetary discipline. These results stress the complementarity of IFIs and fiscal rules.

Moreover, IFIs have a positive impact on the quality of official macroeconomic forecasts, which they have to either produce or endorse. Processes and methodologies are now well-established and country-specific to ensure adequate ownership. We report empirical evidence that the accuracy of macroeconomic forecasts underpinning budgets has improved since the establishment of IFIs in the EU.

3.1.1. Contribution to medium-term planning

The benefits of robust medium-term fiscal planning are widely acknowledged in the economic literature. Thanks to medium-term planning, the impact of governments' plans and policies over several years can be presented, prioritising new policy areas and enhancing budgetary discipline through better expenditure control.

International institutions and the literature use various terms to refer to the instruments of multiannual fiscal planning. For example, the European Commission, the network of EU IFIs and the IMF use the term 'medium-term budgetary framework' (MTBF) to refer to multiannual macro-fiscal objectives and targets ([47]).

The Council Directive 2011/85/EU on national budgetary frameworks, adopted as part of the six-pack legislation in November 2011, introduced the requirements for credible, effective MTBFs across Member States ([48]). Consequently, all Member States have introduced, when it was not already in place, a national medium-term fiscal planning document that is distinct from the stability and convergence programmes, grounded in national legislation and connected to the annual budget process.

As a result of the legislative innovations at EU level, the features of MTBFs have improved in recent years. MTBFs are overall stronger in terms of coverage, connectedness of targets with the annual budget process, involvement of national parliaments and of IFIs, and the level of detail included in fiscal planning documents ([49]).

However, despite efforts to strengthen the effectiveness of countries' medium-term budgetary plans, systematic shortfalls of outcomes with regard to fiscal targets remain a recurring feature ([50]). These shortfalls can originate in an opportunistic behaviour postponing the fiscal adjustment.

IFIs help to improve medium-term planning in two ways. Firstly, IFIs can help to improve the accuracy of budgetary forecasts. Secondly, they can promote fiscal discipline and compliance with fiscal rules.

([47]) The MTBF is a set of institutional arrangements in the budget process governing the requirement to present macro-fiscal objectives and targets, procedures for making multiyear forecasts and plans for revenue and expenditure, and obligations to set numerical expenditure limits beyond the annual budget horizon. See Harris et al. (2013).

([48]) The MTBF has to provide a fiscal planning horizon of at least 3 years and include procedures for establishing the following items: comprehensive and transparent multiannual objectives in terms of the general government deficit, debt and any other summary fiscal indicator; projections for each major expenditure and revenue item of the general government; a description of medium-term policies envisaged and their impact compared to projections based on unchanged policies as well as their impact on long-term sustainability of public finances. The medium-term fiscal planning document must be based on realistic macroeconomic and budgetary forecasts.

([49]) European Commission (2019), p. 137-138.

([50]) https://ec.europa.eu/info/sites/info/files/economy-finance/12_it_sp_assessment_0.pdf

Both elements are pillars of medium-term planning and they are both scrutinised by IFIs through their assessment of the stability and convergence programmes or of the corresponding national medium-term fiscal planning documents. By providing an independent assessment of the governments' budgetary forecasts and plans, IFIs foster transparency and accountability, improving the quality of public information about fiscal policy.

In principle, the assessment of medium-term budgetary forecasts covers two levels: the underlying macroeconomic forecasts and the budgetary projections. Producing or endorsing macroeconomic forecasts is the basis of the assessment of budgetary plans, as macroeconomic variables are a key determinant of fiscal projections. If the macroeconomic scenario is biased, this affects the budgetary plans. The role of IFIs in improving the quality of macroeconomic forecasts is discussed in the next subsection.

A strand of the literature has recently sought to identify the impact of IFIs on the accuracy of budgetary forecasts. Empirical analysis carried out by Beetsma et al. (2019) shows that the existence of IFIs is associated with more accurate budgetary forecasts: the study shows that establishing an IFI reduces the magnitude of the primary balance forecast error by a full percentage point of GDP on average. The study also shows that the presence of an IFI is associated with a lower optimistic bias for budgetary forecasts. The results of a panel regression show that (i) the more fiscal rules are likely to bind, the more optimistic the forecast of the budget balance, presumably because the government has a stronger incentive to give the illusion of compliance; ([51]) and (ii) the presence of an IFI mitigates this optimistic bias, although this finding is statistically weak ([52]).

IFIs also contribute to medium-term planning by promoting compliance with fiscal rules. Fiscal councils and effective medium-term planning are, together with fiscal rules, important elements of a good fiscal framework. Therefore, by including IFIs and MTBFs in the analysis, a more pronounced effect on the fiscal variables can be expected. Nerlich and Reuter (2013) indeed find that the positive effect of numerical fiscal rules on the primary balance can be further strengthened in the presence of an IFI and an effective MTBF: they are complementary.

IFIs influence compliance with fiscal rules by monitoring adherence and publicly exposing compliance failures. With the exception of the Dutch CPB, all EU IFIs are tasked with monitoring compliance with fiscal rules ([53]). Beetsma et al. (2019) find tentative econometric evidence that the presence of an IFI is associated with a sizeable and statistically significant effect on compliance with fiscal rules.

Lastly, the European Commission (2019) identifies a large positive and statistically significant impact of MTBFs on the cyclically-adjusted primary balance. This latter study uses the MTBF index, which measures the average strength of MTBFs across five relevant characteristics, in a panel regression. An increase in the index of the MTBFs can improve the cyclically-adjusted primary balance by about 1 percentage point of GDP.

3.1.2. Producing or endorsing macroeconomic projections

Reliable macroeconomic forecasts are a cornerstone of realistic budgetary planning and thus of strong and sustainable public finances. Member States' arrangements for the production or endorsement of macroeconomic forecasts underpinning the government's budget are country-specific in order to foster ownership at the national level.

The Council Directive 2011/85/EU, which is part of the six-pack reform of 2011, sets certain requirements for government forecasts underpinning budgetary planning, e.g. in terms of their transparency (methodologies, assumptions, comparisons with other forecasters and sensitivity analyses) as well as evaluation of their accuracy. However, it is only Regulation (EU) No 473/2013, as part of the two-pack reform of 2013, that introduced the formal requirement for the macroeconomic forecasts underlying both annual budgets and medium-term national fiscal plans to

([51]) This result is consistent with similar previous studies like Frankel (2011) who suggests that countries subject to the SGP produce even more biased budgetary forecasts than other countries and that this relative bias is larger during boom periods.

([52]) The mitigation of optimism in fiscal forecast due to the presence of an IFI has a statistical significance only at the 10 percent threshold. The statistically weak effect may be the result of the rather limited sample size.

([53]) This task is not only carried out through the assessment of the MTBF but also through IFIs' other related activities such as policy costing, long-term sustainability analysis and supporting the legislature in budget analysis.

be either produced or endorsed by independent bodies in the euro area.

Out of the 19 euro area Member States, five (Austria, Belgium, Luxembourg, the Netherlands and Slovenia) chose to continue relying on macroeconomic forecasts produced by independent forecasters as a natural continuation of a long-standing tradition. In Finland, the Ministry of Finance prepares macroeconomic forecasts underpinning the budgetary planning without an external endorsement process. However, the management of the Economics Department and the Budget Department of the Ministry of Finance are separate, and the Economics Department is functionally independent in its forecasting activities. Hence, the forecast process itself is separated from the budgetary policy in order to guarantee adequate independence.

In the remaining 13 euro area Member States, ministries of finance retained the remit for producing the official macroeconomic forecasts that are then assessed by independent fiscal councils through an endorsement process. Progress has been made over time, and almost all IFIs issue a dedicated open letter or a statement at the time of the endorsement. These letters or statements are usually straightforward, indicating the result of the endorsement process and the reasoning behind it.

On the process, some Member States followed the good practice to spell out the forecast endorsement process in a dedicated memorandum of understanding (MoU) between IFIs and ministries of finance. For example, the process currently applied in Italy involves a formalised two-step approach for the endorsement of the official macroeconomic trajectory underlying both the medium-term plans and the annual budget, and it is considered a good practice. In the first step, the Italian *Ufficio Parlamentare del Bilancio* (IT-UPB) validates the official no-policy change or trend scenario for economic growth. In the second step, the impact of the new measures on the macroeconomic projections is submitted to the IT-UPB for endorsement. This two-step approach allows for more transparency and a clearer identification of the sources of discrepancies in the forecasts separating the no-policy change scenario from the scenario taking into account the measures. The parameters of the endorsement process are also set out in a detailed way in MoUs between the ministries of finance and IFIs in Ireland and Latvia. In both cases, the MoUs define the scope of the forecasts to be submitted, the type of additional information that IFIs should be provided with and the calendar of interactions between the two institutions ([54]).

As regards methodology, two groups can be observed: IFIs whose endorsement is based on the comparison with their own model-based projections (examples are the Spanish AIReF, the Portuguese Public Finance Council, the IT-UPB and the Irish Fiscal Advisory Council) and others who compare the government's forecasts with a set of forecasts produced by international institutions.

IFIs also have a role in preparing regular evaluations on forecasting performance. Article 4(6) of Council Directive 2011/85/EU requires the macroeconomic and budgetary forecasts for fiscal planning to be subject to 'regular, unbiased and comprehensive evaluation'. Until now, less than half of Member States have issued some form of relevant publication. Despite the slow take-up of *ex post* forecast evaluation, there are already some good practices in various administrative settings. The typical solution has been to delegate that function to an IFI. For example, in the UK, the OBR has published the annual 'Forecast evaluation report' to take stock of the accuracy of its own forecasts since 2011. Every 3 or 4 years, the Swedish Fiscal Policy Council includes in its 'Annual Report' a dedicated section with *ex post* evaluations of the government's forecasts. In Finland, Portugal and Spain, IFIs were charged with producing this evaluation and first reports were recently issued. In Austria and Luxembourg, the national fiscal councils are tasked to evaluate the forecasting performance of the national forecasting institutions ([55]).

Jankovics and Sherwood (2017) present some tentative findings of the possible impact of the role of IFIs on the prudence of official forecasts. Their results show a small optimistic bias in 2000-2007 for the EU Member States without independent forecasters, which turned towards a conservative stance in 2014-2016 after IFIs were set up in many countries. The mean forecast error was practically zero in both periods for the control group of countries with independent forecasters (Austria, Belgium, Luxembourg and the Netherlands),

([54]) Jankovics and Sherwood (2017), p. 22.
([55]) https://ec.europa.eu/info/sites/info/files/economy-finance/swd_2020_211_en.pdf

confirming the literature of showing no statistically significant bias.

Beetsma et al. (2019) find that real GDP growth forecast errors exhibit over-optimism in the presence of fiscal rules, and that this over-optimism is marginally lower in the presence of an IFI. However, there is no strong statistical evidence indicating that the presence of an IFI explains the lower real growth forecast error. The interaction between the presence of an IFI and a lagged fiscal rule index produces a (statistically weak) reduction in the real growth forecast error. Overall, there appears to be some complementarity of IFIs with the fiscal rules as previously observed.

3.2. TWO ILLUSTRATIVE CASES: GERMANY AND CZECHIA

Case studies are one way to assess the effectiveness and the impact of fiscal councils. By looking at individual fiscal councils, it is possible to identify elements of good practices. This analysis also matters because empirical studies suggest that only well-designed IFIs are associated with better fiscal outcomes ([56]).

In the EU, the Commission's fiscal governance database distinguishes two groups of IFIs: core and non-core ([57]). Core IFIs play a formal role in the domestic budgetary process by virtue of EU legislation, such as assessing or preparing macroeconomic and fiscal forecasts and monitoring and evaluating fiscal plans and outcomes. In a few EU countries, other tasks are assigned to non-core IFIs. These activities range from policy costing to long-term fiscal sustainability analysis (see Box 3.1 for Germany).

This section aims at identifying elements of good practice from the experience of two core IFIs, namely the Independent Advisory Board to the Stability Council in Germany and the Fiscal Council of Czechia. Both cover some but not all tasks of a fully-fledged fiscal council. In particular, both independent institutions are tasked principally with assessing of compliance with domestic and European fiscal rules. However, the economic projections underlying Germany's draft budgetary plans (DBPs) are prepared by the federal government and endorsed by a non-core IFI, the Joint Economic Forecast project group. Similarly, in Czechia, the government's economic projections underpinning the convergence programme are assessed by a non-core IFI, the Committee on Budgetary Forecasts. Lastly, non-core fiscal institutions in Germany carry out other activities such as revenue forecasting.

3.2.1. Core and non-core IFIs in Germany

The institutional setting of core and non-core IFIs in Germany is unique because of its federal framework. ([58]) German federalism is historically different from that in other European countries, like Spain, or in the United States. In fact, the German federation works under the principle of cooperation, but federal laws are executed at the State level. The federal government is assigned a greater legislative role and the states have a greater administrative role and central administrative functions. This differs from Spain, where regions have both legislative and administrative powers. The Spanish IFI has indeed broader fiscal surveillance tasks over the federal and state governments compared to the German IFI ([59]). In Germany, the lack of trust in the political system and the historical reliance on rules-based policies administered by civil servants largely explain the creation of the non-core independent bodies in the 1960s, well before the 2008-2009 economic and financial crisis.

As a result, budget institutions in Germany are composed of a relatively large number of non-core IFIs created over the last 50 years as independent counterweights to a potential deficit bias resulting from the political process. The more recent need to adapt home-grown fiscal councils to the new requirements entailed by the EU legislation has completed the last layer of this complex institutional setting through the establishment in 2013 of the Advisory Board to the Stability

([56]) Debrun and Kinda (2017), using the IMF Fiscal Council dataset, show that 'countries with better designed fiscal rules exhibit stronger fiscal performance. (…) The results also suggest that the mere existence of fiscal councils is not by itself conducive to stronger fiscal balances. Interestingly, it is only by focusing on certain characteristics of fiscal councils that a significantly positive association arises. (…) This suggests that fiscal councils exhibiting certain features could complement and add to the discipline-enhancing role of numerical fiscal rules.' (p. 690-691).

([57]) The database collects regularly information only on core IFIs.

([58]) Germany is a federal parliamentary republic, with laws and key institutions of state grounded upon a Basic Law (*Grundgesetz*). This Basic Law lays down certain fundamental requirements of the budget process, and prescribes the fiscal relationship between the federation (i.e. the federal level of government) and the states which enjoy a high level of autonomy. The states also participate in the legislative process of the federation through their representation in the Bundesrat (upper house of the bicameral legislature).

([59]) See European Fiscal Board (2019b), p. 39-42.

Council, Germany's core IFI. Responsibilities and tasks are fragmented among different fiscal institutions within a federal and decentralised system that provides general political support for fiscal prudence.

The German system is represented in Graph 3.1. The base is composed of a set of well-established non-core independent institutions that have been operational for decades.

At the top of the graph, the core IFI is the Independent Advisory Board to the Stability Council, a very lean body with a large Board supported, for administrative purposes, by the Stability Council's Secretariat. The Advisory Board is embedded in a system of non-core IFIs that over time have increased in size and enhanced the quality of their independent analysis. This system is kept together by institutional cooperation: the core IFI draws and benefits from formal and informal arrangements with non-core IFIs. Representatives of non-core IFIs have a seat on the Board of the core IFI. Informally, the core IFI also has access to the analysis and staff of the non-core IFIs.

This system of interconnections between core and non-core IFIs and other independent institutions (such as the Deutsche Bundesbank) constitutes a major strength but can also be a point of fragility. In fact, the breadth and depth of central surveillance by the Advisory Board to the Stability Council is first of all limited by its mandate. In practice, however, it also hinges upon institutional cooperation. The Advisory Board has limited powers to access data without the institutional cooperation of each State. An example of this is the difficulty in accessing information on the States' public pension systems.

The Advisory Board is an independent body of experts attached to the Stability Council. The Stability Council (*Stabilitätsrat*) is a national political body composed of the Ministers of Finance at both the federal and state level and of the Federal Minister for Economic Affairs and Energy. It was established in 2009 as part of the second stage of Germany's federal reforms and is enshrined in Article 109a of the Basic Law (*Grundgesetz*), Germany's constitution. Together with Germany's debt rule, the Stability Council strengthens the institutional framework for safeguarding the sustainability of public finances at the federal and state level. As part of its regular budgetary monitoring to prevent budgetary emergencies, the Stability Council reviews the budgetary situation of the federation and states, basing itself on of stability reports produced by the individual government levels. Since 2013, the Stability Council has monitored whether Germany complies with the requirements of the Fiscal Compact.

Since January 2020, the Stability Council has additionally been tasked with reviewing the debt brake ([60]) pursuant to Article 109 (3) of the German constitution, which also includes an escape clause in emergency situations approved by the legislative. ([61])

The Advisory Board's mandate covers the tasks set out in Fiscal Compact and includes the issuance of recommendations for corrective action in the event of non-compliance ([62]). The Board issues statements twice a year, in June and December, on compliance with the upper limit of the structural deficit of Germany's public sector as a whole. The statements focus on the assessment of the fiscal projections over the current year and the 4 following years. To this end, the Board also comments on the plausibility of macroeconomic developments as projected by the federal government, including potential growth and output gap. The statement also touches upon sources of risks and mitigating measures. In specific cases, the statement also tackles methodological issues ([63]).

([60]) The national debt brake (*Schuldenbremse*) is part of the institutional framework with which the implementation of the European Fiscal Compact is ensured in Germany. It requires all states to balance their budgets (structurally), starting in the year 2020, and to contribute in this way to compliance with the European rules. The debt rule for the Federal Government means that annual structural net borrowing may not exceed 0.35 % of GDP. Its implementation is anchored in different laws and regulations. The states regulate the implementation of the principle of having (structurally) balanced budgets autonomously. Some states have adopted a system comparable to the Federal Government's debt rule: compliance with the debt rule is documented in the control account at the end of the relevant fiscal year. This control account is created for the Federation. This account records 'deviations from the structural deficit ceiling in budget execution and cumulates them over time. A negative balance of the control account exceeding 1.5% of GDP requires corrective action. The implementing provisions set out in ordinary legislation reduce the threshold to 1% of GDP. (...) There is no such system for the general government sector as a whole' (European Commission, 2017b).

([61]) On 1 July 2020, upon request of the federal government, the parliament authorised a supplementary budget for 2020 which exceeds the upper limit for the borrowing issuance by €118.7 billion. This provision, included in the German constitution, was justified by the emergency measures adopted following the Covid-19 crisis.

([62]) This is not clearly stated in the Advisory Board's relevant legislation, but it is the result of a chain of legal references (Section 7 of the Stability Council Act; Section 51(2) of the Budgetary Principles Act and Article 3(2) of the TSCG).

([63]) For instance, in the 2019 Spring statement, the Independent Advisory Body raised some concerns about the harmonised

By contrast, assessing compliance with the debt brake and assessing the stability reports of the federation and the states is not part of the Board's mandate. Hence, the Board only participates in the Stability Council's deliberations to assess compliance with the structural budget limit.

According to the European Commission's scope index of fiscal institutions (SIFI) ([64]), its remit appears to be aligned with the EU average. This is mainly because the Advisory Board does not engage in costing policies nor does it produce its own macroeconomic and budgetary forecasts.

According to the OECD index of IFI independence, the leadership's appointment is based on merit and competencies. The length of the mandate is clearly defined. The Board formally has full control of the hiring process for staff, although the number of staff is very limited given the limited budget.

The Advisory Board's members are nine experts. The states and the federal government appoint four experts for a period of 5 years. The remaining five experts are chosen from non-core IFIs and other institutions ensuring the representation of the associations of local authorities and the national organisations of the social security funds: one representative each from the Deutsche Bundesbank and the German Council of Economic Experts; one representative from the research institutes involved in preparing the Joint Economic Forecast.

While the Board is composed of nine members, the Secretariat is composed of only one full-time employee and shared with the Stability Council. The limited staff in relation to the large number of Board members is unique. The Board's effectiveness in delivering on its mandate resides in the vast representation of various institutions and their relevant expertise. This guarantees a fair representation of all relevant views. Public and private economic research centres, together with experts appointed by local governments and social security funds, cooperate to carry out the bulk of the mandatory duties. The Board uses the reports and expertise of the Joint Economic Forecast Project Group, the leading independent German economic research institutes, the German Council of Economic Experts and the Bundesbank.

The Board convenes as necessary but at least twice a year, usually in May and November, and its meetings are not public. The Advisory Board has to provide its statements and recommendations to the Stability Council in due time prior to the Council's meetings.

According to its rules of procedure, the Stability Council must always take into account the assessment and recommendations of the Advisory Board and publicly explain diverging assessments and recommendations, in line with what is referred to as the comply-or-explain principle.

The Fiscal Compact Implementation Act (Article 2(7)(1)) requires functioning costs to be shared in equal parts by the Federation and the states. On that basis, the Advisory Board is currently provided a budget capped at €150,000 per year that is primarily used for funding academic staff members and external experts, since members of the Board provide their contribution on a *pro bono* basis.

Provisions on access to information are included in Stability Council's rules of procedure (Section 7a(2)). The Advisory Board is not empowered to request information directly from institutions other than the Stability Council. Hence, the Advisory Board's access to information is channelled through the Stability Council's working group ([65]), which provides its estimates. However, experts from the Federal Ministry of Finance and other federal ministries regularly report as guests of the Board's meetings.

As to its capacity to communicate, Section 7(5) of the Stability Council's rules of procedure stipulates that the Advisory Board's opinions and recommendations are public. The Advisory Board has a dedicated section within the Stability Council's website. However, its statements are not sent formally to the legislature, with the exception of failure to comply with the deficit ceiling and of failing to meet the Stability Council's agreement on measures recommended to eliminate the excessive deficit.

analysis system adopted by the Stability Council to monitor the debt rule. See https://www.stabilitaetsrat.de/EN/Beirat/Dokumente/Dokumente_node.html. In the second statement issued in December 2014, the Independent Advisory Body pointed out that the transparency of the situation and projections on the future development of state and local government finances needed to be improved considerably. See https://www.stabilitaetsrat.de/EN/Beirat/Dokumente/Dokumente_node.html.

([64]) European Commission (2020a).

([65]) It is a working group established to prepare the meetings of the Stability Council.

Box 3.1: Non-core IFIs in Germany

According to the 2018 update of the fiscal governance database, ECFIN classifies as non-core IFIs in Germany the following bodies: the Scientific Advisory Council to the Federal Ministry of Finance, the Working Party on Tax Revenue Estimates, the German Council of Economic Experts and the Joint Economic Forecast project group.

The **Scientific Advisory Council to the Federal Ministry of Finance** is an expert body that has been providing, for more than 70 years, proposals on Germany's economic and fiscal policies, including budgetary consolidation ([1]).

The **Working Party on Tax Revenue Estimates** (Arbeitskreis Steuerschätzungen, AKS) is a purely technocratic body advising the Federal Ministry of Finance and established to mitigate the bias of politics in handling public finance objectives and targets. ([2]) It prepares two forecasts a year – in May and November – on tax revenue for the current and for the coming year. These forecasts play an important role in preparing the budgets of the federal government, the state governments, and municipal and county governments. In May, the forecast also takes the 3 subsequent years into account. Since 1955, the federal government has included the results of the AKS in its budget plans and since 1968 in its medium-term fiscal plans. The Working Party on Tax Revenue Estimates does not provide recommendations on fiscal policy. Buettner and Kauder (2015) examined forecast errors made by the working party using data for federal tax revenues covering the period from 1971 to 2013. They did not find evidence of a bias over that timespan but they found that the GDP forecast error explained a substantial fraction of the revenue forecast error. By contrast, according to a recent study ([3]), the working party has systematically underestimated tax revenue since 2009 while, before 2009, forecasters tended to be too optimistic and the deficits generally turned out higher than forecast. One driver of the underestimation of revenue in recent years could be that Germany's growth has systematically exceeded expectations. However, since Germany's debt brake became applicable in 2011, Midões and Wolff (2019) suggested that the systematic shift in the bias in revenue and GDP projections could also aim at easing compliance with the tough new fiscal rule.

The **German Council of Economic Experts** is an academic body that provides advice on economic policy issues. Set up by law in 1963, it is mandated with the task of providing an impartial experts' view in the form of periodic assessments of macroeconomic developments in Germany, thus helping economic policymakers and the general public to make informed decisions. The members are chosen by the federal government, but the Council is fully independent in its advisory role and operates in a transparent manner. It describes the current economic situation and its likely future developments, highlighting any adverse trends and possible ways of averting or mitigating them. To this end, it discusses various indicators of economic output, quality of life, sustainability, and politically defined targets. It also analyses the progress, opportunities and risks of current economic policies and identifies potentially conflicting objectives ([4]).

The **Joint Economic Forecast project group** is composed of representatives from the five most prominent private and public economic research centres. It is based on a contract awarded by the Ministry of Economy. It has historically played the key role of impeding the political system from finding 'shortcuts', changing the economic outlook to reduce the required fiscal effort imposed by the German institutional setting. As of July 2018, it is the independent body in charge of assessing and endorsing the economic projections underlying the draft budgetary plans (DBPs) and the stability programmes within the meaning of national legislation and Regulation (EU) No 473/2013 ([5]). The Joint Economic Forecast project group endorsed the projection underlying the 2019 DBP on 16 October 2018 in a statement published on its website (gemeinschaftsdiagnose.de). This was the first time that the official forecast of Germany was endorsed by an independent body ([6]).

([1]) On its website, the Scientific Advisory Council defines itself as 'the academic "conscience" of the government – not least because of its independence, which is stipulated in its statutes. It has always been part of the board's role, and still is today, to challenge policy-makers. (…) The board advises the German finance minister in an independent capacity, with its members serving on a voluntary basis. It has a free hand when it comes to selecting the issues to focus on.'

([2]) The Working Party was created in 1955 as a result of a disagreement over expected tax revenue between the Federal Ministry of Finance and the Ifo Institute. The government realised that using scientific methods for estimating and forecasting tax revenue in Germany can be very useful in budget planning. In addition, the composition of the Working Party ensures the independence of the forecasts. See https://www.ifo.de/en/node/42930.

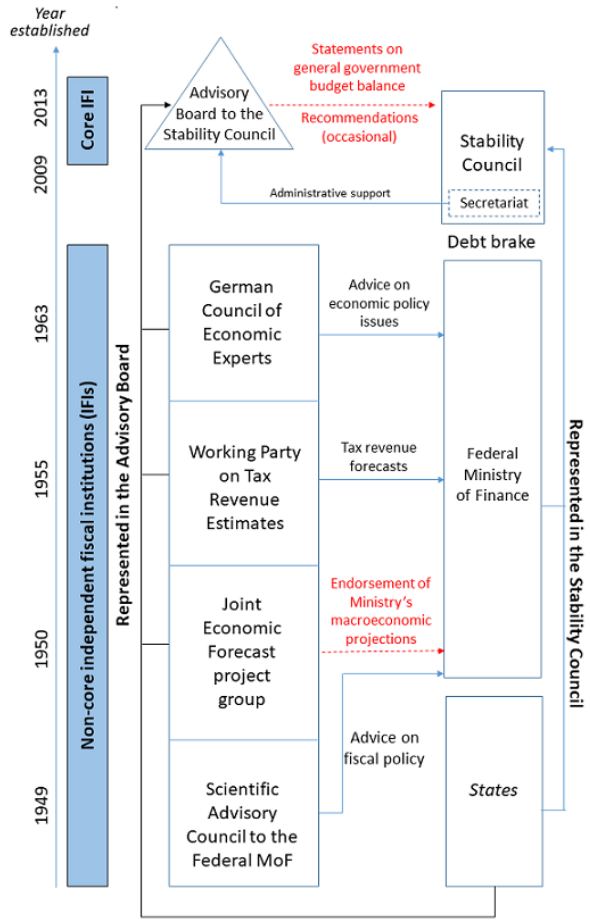
([3]) Midões and Wolff (2019).

([4]) https://www.sachverstaendigenrat-wirtschaft.de/en/about-us/objectives.html.

([5]) https://ec.europa.eu/info/sites/info/files/economy-finance/swd-2018-de_en.pdf, Box 1, p. 3.

([6]) European Parliament (2020), p.2.

Graph 3.1: **Core and non-core IFIs in Germany**



Source: European Fiscal Board

From an analysis of reports issued by the various budget institutions operating in Germany, the following can be summarised:

- The non-core IFIs are mainly advisory bodies to the federal Ministry of Finance. They traditionally benefit from a relatively large degree of independence. They contribute to the preparation of the macroeconomic and fiscal forecasts and provide policy advice.

- The federal government's macroeconomic projections are formally assessed and endorsed by the Joint Economic Forecast project group.

- The Independent Advisory Board to the Stability Council assesses the plausibility of the federal government's macroeconomic and fiscal projections twice a year and issues a statement regarding compliance with the upper limit of the structural general government budget deficit.

- Core IFI functions are effectively carried out by an independent Board composed of nine members and one full-time employee. This system hinges on intense institutional cooperation: an Advisory Board of recognised experts appointed by a plurality of institutions with a strong technocratic background reports to the highest political Council composed of federal and state ministers of finance.

- The endorsement of macroeconomic forecasts draws its design from the long lasting tradition of the Joint Economic Forecast project group.

- The Advisory Board's assessment of compliance with the structural deficit limit, beyond being mandated by the Fiscal Compact, is also an attempt to create an independent arbiter within the delicate constitutional balance of power between the federation and the states within the Stability Council.

- The functions assigned to the IFI is the 'compromise solution' to keep together a central surveillance with the strong autonomy of the states vis-à-vis the federation.

- The mandate of the core IFI is to assess public finances over the short to medium term. Issues of long-term fiscal sustainability are only addressed by non-core IFIs.

- In conclusion, the German system is characterised by a high level of fragmentation and not safe from forecast bias, as shown in Box 3.1. As observed by the OECD, the preponderance of bodies, with their varying degrees of independence and competing voices, at times arguably fails to take into account widely agreed international good practice found, for example, in the OECD Principles for Independent Fiscal Institutions ([66]). However, the system is the historical result of an evolution of technocratic bodies whose culture of independence is deeply rooted as a counterweight to political discretion. The Advisory Board represents the compromise solution to adapt to the new system of checks and balances designed according to the Fiscal Compact and the six and two-pack legislation

([66]) OECD (2015), p. 47.

within the constitutional federal system ([67]). In this system, the Advisory Board is effectively carrying out its limited mandate thanks to institutional cooperation, the uniqueness of which is its strength. However, this is also its potential weakness. The effectiveness of the Stability Council may reflect a deeper national preference for prudent fiscal policy-making. As long as it benefits from political support, the core IFI can carry out its duties despite its lean structure. This setting might show its limits under two circumstances: if the non-core institutions depart from their culture of independence for any reason and if the political support for fiscal prudence ends. These two circumstances would endanger institutional cooperation, which is the cornerstone of the current system, and require strengthening the central fiscal surveillance capacity.

3.2.2. The Czech Fiscal Council

Established in 2018, the Czech Fiscal Council is the youngest fiscal council in the EU. Until 2017, the fiscal framework in Czechia was considered to be among the weakest in the EU ([68]). In January 2017, the fiscal responsibility law, approved by the country's national parliament, transposed into national legislation Council Directive 2011/85/EU on budgetary frameworks; the law introduced for the first time a reference to the need for Member States to involve independent bodies in the budgetary processes.

The fiscal responsibility law is a wider budget reform that envisages strengthening expenditure limits and directly linking them to the medium-term budgetary objective of -1 % of GDP or above in structural terms ([69]). It obliges the government to adopt a budget that safeguards long-term sustainable public finances. Additionally, it also introduces a debt rule for the general government to be activated if public debt breaches the threshold of 55% of GDP. Specific provisions for municipalities ensure a prudent level of indebtedness, requiring the municipality to repay at least 5% of the debt exceeding 60% of average municipal revenues.

Finally, the reform established an Independent Fiscal Council and provided for more credible and transparent reporting. In addition, an expert forecasting body (the Committee on Budgetary Forecasts) was also set up to assess the Ministry of Finance's macroeconomic and fiscal forecasts.

As a result, Czechia is one of the EU Member States where the different tasks of IFIs are carried out by more than one institution. This setup is based on a long positive experience (since 1996) with 'colloquiums' where independent institutions presented their own macroeconomic forecasts that were then compared to the forecast of the Ministry of Finance. The Czech Fiscal Council is now an independent expert body whose primary mission is to evaluate whether the State and other public institutions comply with the domestic rules of budgetary responsibility.

The opinions and reports issued by the Czech Fiscal Council are formally presented to the country's parliament and to the press. But they also serve as guidelines for the government and local and regional authorities, enabling them to plan and implement fiscal policies as accurately and responsibly as possible. In addition, the output of the Czech Fiscal Council is also expected to be useful for the public as every citizen can gain a better understanding of the state of public finances and the direction they are taking ([70]).

The tasks of the Czech Fiscal Council include in particular:

- assessing compliance with the domestic numerical fiscal rules (including a debt rule and expenditure limits), preparing a report on the performance of these rules and submitting it to the lower house of parliament;

- ascertaining and publicly declaring the level of general government debt of the previous year within 1 month from the first publication of the debt figures by the Czech Statistical Office. This task is formal as debt is calculated by the Statistical Office, but the Fiscal Council is tasked with confirming whether the published number is correct;

([67]) For this reason, some criticism has been levied at the Independent Advisory Board as being constructed with a view to narrowly complying with new EU requirements (OECD, 2015).

([68]) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-czech-en_1.pdf

([69]) On 1 April 2020, the Czech Government approved a bill amending the budgetary responsibility rules for 2021-2027. The new legislation allows the structural deficit to increase to up to 4% of GDP in 2021, followed by annual improvements of the structural balance by at least 0.5% of GDP in the following years.

([70]) See https://unrr.cz/en/.

- preparing and submitting to the chamber of deputies a report on the long-term sustainability of public finances, including an assessment of the impact of planned government policies;
- monitoring general government financial management; and
- providing an opinion on the calculation of the corrective component in case of deviation from the target.

The first months of activity were particularly challenging considering the need to set up offices and initial organisational support. Particular pressure came from a legal provision which required the Fiscal Council and the Ministry of Finance to develop a common methodology for the operationalisation of fiscal rules by April 2018. At the time of this report, the Council had three members of the Board and twelve full-time employees, and could be considered fully operational.

Given the low level of debt, the immediate challenge for the Czech Fiscal Council shifted towards analysis of the country's long-term sustainability and its pension system. The outcome attracted attention from the media. Thus, the Fiscal Council also contributes to the sustainability of public finances through greater public awareness.

The next challenge is to widen access to data through, for instance, a memorandum of understanding with the Czech Statistical Office.

The Committee on Budgetary Forecasts is the body set up within national fiscal framework to assess macroeconomic and budgetary forecasts prepared by the Ministry of Finance. It is composed of at least seven members (currently ten), who are leading economists from academia and the public and private sectors, and who are proposed by the Czech Fiscal Council and appointed by the Government. The Committee is independent from the Fiscal Council. Its independence is ensured by the level of the expertise and by some peculiar rules of procedure. For instance, once the Committee is appointed for three years, any dismissal of its members is suggested by the Committee itself or by the Czech Fiscal Council. Participation in the Committee is honorary, so members are not paid. The functioning and composition of the Committee is similar to the model of the Advisory Board and its relationship to the Stability Council in Germany whose effectiveness is based on institutional cooperation.

This institutional setting, which *prima facie* might appear as a stratification of independent bodies, has been intentionally designed with sequential building blocks of independence. This is a positive feature because, if the macroeconomic scenario is biased, then the assessment of medium-term budgetary plans underpinned by that macroeconomic scenario is also affected.

The Czech Fiscal Council entered in the European Commission's scope index of fiscal institutions ([71]) for the first time in 2018. Its ranking is broadly aligned with the EU average. This is mainly because the Fiscal Council does not engage in costing policies nor does it produce its own macroeconomic and budgetary forecasts while being tasked with long-run sustainability analysis.

Similarly to Germany, the organisation of fiscal surveillance in Czechia is designed in sequential stages, which are carried out by mutually independent bodies to achieve the highest degree of independence at each core step of the IFIs' mandate (namely to assess macro forecasts and compliance with the rules). Another analogy with Germany is that it is a system with two IFIs, of which one is fully staffed (the Czech Fiscal Council) and the other is composed uniquely of a Board (the Committee on Budgetary Forecasts). Lastly, the Committee on Budgetary Forecasts, with its lean structure, can deliver on its mandate thanks to a built-in level of institutional cooperation. In fact, the Committee has informally access to the analysis and staff of the relevant institutions (academia and the public and private sectors) represented on it, resembling somehow what has been observed in Germany, although on a smaller scale given the more limited number of entities involved.

3.3. THE ROLE OF IFIS IN THE 2019 EU FISCAL SURVEILLANCE CYCLE

This section focuses on the role played by selected national IFIs in the 2019 fiscal surveillance cycle. It is based on information gathered by a questionnaire and describes the IFIs' role in producing or assessing official macroeconomic and

([71]) European Commission (2020).

budgetary forecasts and compliance with EU and national fiscal rules.

The country selection is based on two criteria: (i) countries for which the Commission opinion on the 2019 DBP issued in autumn 2018 indicated a 'risk of non-compliance' with EU fiscal rules, and (ii) countries for which the Commission established that no effective action had been taken in response to the Council's country-specific recommendation of June 2019 ([72]).

The experience of the 2019 EU fiscal surveillance cycle leads to five general conclusions:

- First, assessing the compliance of caretaker governments with fiscal rules confronts IFIs with particular challenges. Caretaker governments can neither commit to deficit targets nor adopt measures to achieve these targets.

- Second, IFIs continue to exercise a role in mitigating optimistic macroeconomic forecasts. In some countries, IFIs did not endorse their government's macroeconomic forecasts as they deemed them too optimistic, or they endorsed them but flagged risks; this led some governments to revise their original estimates. However, the influence of IFIs on the accuracy of medium-term fiscal planning is still very limited, if any.

- Third, IFIs continue to play an important role in assessing risks of deviation from EU fiscal rules although their impact on the policy debate varies across countries. Moreover, the Commission's continuously evolving assessment of compliance and its use of discretion complicate the role of IFIs at the national level, especially in the event of diverging assessments. Moreover, differences between national and EU fiscal rules may give rise to inconsistencies between IFIs' and the European Commission's assessment of compliance. The tension between EU and domestic fiscal rules can also hamper the ownership of the fiscal framework and, ultimately, give the public the impression that the EU and the domestic frameworks work at cross-purposes ([73]).

- Fourth, the IFIs' opinions and recommendations did not directly lead to the adoption of corrective measures, but increased the reputational costs of some governments whose fiscal plans were not compliant with EU fiscal rules. Only in Italy, following the recommendations of the IFI and intense dialogue with the European Commission, was the draft budgetary plan for 2019 adjusted to come closer to compliance with EU rules.

- Finally, the IFIs continue to foster the credibility and transparency of budgets by issuing recommendations, including to increase the quality of medium-term fiscal plans.

Belgium

The High Council of Finance (HCF) was faced with specific challenges in 2019. The first challenge was the uncertainty over whether Belgium would benefit from the 'structural reform clause' ([74]). In March each year, the HCF has to elaborate advice on the budgetary objective in nominal and structural terms, for the various levels of government and for each community and region. This normative advice forms the basis for both the stability programme and inter-federal coordination. If granted, the structural reform clause allows a temporary deviation of up to 0.5% of GDP from the required adjustment path towards the medium-term objective (MTO), thus affecting the required fiscal targets. However, when the HCF had to elaborate the advice on the budgetary objective in 2019, the European Commission's decision was not yet known. Additional uncertainty came from the increasing discretion applied by the European Commission in identifying other relevant factors for assessing compliance with the debt reduction benchmark. Relevant factors are not fully codified, and hence a Member State may be found compliant by the European Commission even if the established indicator observed by the IFI points to a significant deviation from the required adjustment path.

([72]) The IFIs concerned are: the High Council of Finance and Federal Planning Bureau in Belgium, the *Haut Conseil des Finances Publiques* in France, the Fiscal Council of Hungary, the Parliamentary Budget Office in Italy, the Council for Budget Responsibility in Slovakia, the Fiscal Council and the Institute of Macroeconomic Analysis and Developments in Slovenia, the Public Finance Council in Portugal, the Romanian Fiscal Council, and the Independent Authority for Fiscal Responsibility (AIReF) in Spain.

([73]) See European Commission (2020), p. 24.

([74]) The structural reforms relevant for being granted more flexibility were related to the pension system, the tax system and the labour market.

The second and greater challenge was to carry out fiscal surveillance during and after a period of federal and regional elections. The first implication was that the Concertation Committee, a political body comprising representatives from the federal and regional level, was composed of caretaker governments and could not approve but merely take note of the overall fiscal trajectory presented by the federal caretaker government in the stability programme. In addition, the fiscal trajectory was purely indicative without clarifying the underpinning measures to achieve the targets given that this was beyond the caretaker government's mandate. As a result, the HCF had to assess a 'gap' between the government's stability programme for 2019-2022, which envisaged some consolidation efforts that were not supported by sufficiently detailed measures, and the European Commission assessment based on a no-policy change scenario.

Hence, the HCF urged 'the following governments to take the necessary structural measures during the current and coming budget years [2019-2022] so that the path retained in the stability programme can be achieved and the sustainability of the public debt can be guaranteed.' ([75])

Lastly, the HCF noted that the feeble coordination of public finances among the different levels of government in Belgium weakened the ownership of fiscal targets and, consequently, the surveillance role of the Fiscal Council.

France

The High Council of Public Finance (HCPF) has a twofold mandate: endorsing the macroeconomic forecasts underpinning the budgetary plans, and assess compliance with both EU and national fiscal rules ([76]). Compliance with the EU fiscal rules is not mandated but carried out on a voluntary basis. In particular, the national fiscal framework is centred on public finance programming laws, legal acts adopted every 2 to 5 years with the purpose of setting budgetary objectives (namely the required MTO and the structural balance trajectory) over the next 4 to 5 years. *Ex ante* compliance with domestic fiscal rules is measured by the HCPF by looking at deviations between the targets announced in the stability programme and in the draft budgetary plans and the ones adopted in the public finance programming laws. If the deviation is smaller than 0.5% of GDP in 1 year and lower than 0.25% of GDP on average over 2 years, the domestic fiscal rule is observed. Beyond these thresholds, a corrective mechanism is triggered.

In 2019, the HCPF faced two main challenges. The first challenge was to help to make the government's macroeconomic forecasts more realistic. In September 2018 ([77]), the HCPF considered that the 2019 budget was based on a plausible macroeconomic scenario but warned against uncertainty due to the international context. In spring 2019, the government presented the stability programme for 2019-2022 based on macro forecasts that were revised downwards. The HCPF welcomed the revision of the macro scenario compared to the stability programme of April 2018 as a more reasonable basis for multi-year public finance programming.

The second challenge was to reconcile compliance with EU and domestic fiscal rules between the draft and the outturn of the 2019 budget. Divergences in compliance give the impression that national and EU fiscal rules work at cross-purposes. The 2019 budget was initially found to be in compliance with domestic rules but not with the preventive arm of the SGP. Later in 2019, the macroeconomic scenario underpinning the spring 2019 stability programme and the tax reduction, which was more significant than previously envisaged worsened the 2019 fiscal outlook, causing non-compliance with EU fiscal rules, while still ensuring compliance with the domestic fiscal rule.

On fiscal prudence, the HCPF observed that the structural deficit had remained at a high level in 2019 and was non-compliant with EU fiscal rules. As for compliance with the domestic fiscal rule, the 2019 outturn pointed to a deviation of 0.2% of GDP on average over 2018 and 2019. The HCPF noted that the deviation was very close to the threshold triggering the correction mechanism, although falling within the range of compliance. In addition, it stressed that the slow decline of the structural deficit would hamper the reduction of

([75]) https://www.conseilsuperieurdesfinances.be/sites/default/files/public/publications/csf_fin_avis_2019_03.pdf

([76]) See https://www.hcfp.fr/en/liste-avis/opinion-ndeg2018-3-budget-bill-and-social-security-financing-bill for the *ex ante* assessment of 2019 and https://www.hcfp.fr/en/liste-avis/opinion-ndeg2019-1-stability-program as well as https://www.hcfp.fr/en/liste-avis/opinion-ndeg2019-3-budget-bill-2020, which include an updated assessment. For the *ex post* assessment, see https://www.hcfp.fr/sites/default/files/2020-05/Opinion-HCFP-PLR%202019-EN-summary.pdf.

([77]) See https://www.hcfp.fr/en/liste-avis/opinion-ndeg2018-3-budget-bill-and-social-security-financing-bill for the opinion on the budget bill and the social security financing bill for 2019.

the debt-to-GDP ratio in 2019. The High Council underlined that this was likely to leave little room for fiscal policy manoeuver in the event of a sharp economic slowdown.

Italy

Italy's national fiscal framework is centred on a balanced budget principle ensuring the consistency of national budgetary targets with the EU legislation ([78]). The *Ufficio Parlamentare di Bilancio,* the Italian Parliamentary Budget Office (PBO), is mandated to endorse the macroeconomic assumptions associated with both the stability programme and the draft budget. It also assesses budgetary forecasts and compliance with EU and national fiscal rules.

The PBO played a significant role in the assessment of macroeconomic forecasts and in fiscal surveillance during and after the 2018 electoral period. The spring 2018 stability programme was submitted by a caretaker government on a no-policy change basis. In its assessment of the 2019 draft budgetary plan (DPB) presented by the newly-formed government in autumn 2018, the PBO warned against both too optimistic macroeconomic assumptions and non-compliance with fiscal rules; but this did not directly lead to the adoption of corrective measures. However, these warnings helped to increase the reputational costs for the government of announcing fiscal plans that were not compliant with EU fiscal rules. Following the PBO's assessment and intense dialogue with the European Commission, the DBP was adjusted to come closer to compliance with EU rules.

The PBO did not endorse the macroeconomic policy scenario underpinning the 2019 DBP ([79]).The PBO warned against non-compliance with EU and domestic fiscal rules. Italy's DBP for 2019 was the first to be rejected by the Commission on grounds of particularly serious non-compliance given the very large planned deviation from the recommended adjustment path and because it was based on an unrealistic macroeconomic scenario. The revised DBP presented by the Italian government on 13 November 2018 did not include any substantial change compared to the first submission.

Following the presentation of Italy's DBP for 2020, the PBO and the Commission assessed a risk of significant deviation from the required adjustment towards the medium-term budgetary objective for 2019 and 2020, and debt was projected to be non-compliant with the debt reduction benchmark in 2019 and 2020. In the end, the Commission invited the authorities to take the necessary measures within the national budgetary process to ensure compliance of the 2020 budget with the SGP and to use any windfall gains to accelerate the reduction of the government debt-to-GDP ratio.

Notwithstanding the PBO's assessment of serious non-compliance with EU and national fiscal rules in 2019, the Commission reached different conclusions at the end of 2019 by using the 'margin of discretion' in assessing compliance with the fiscal rules.

The budgetary dynamics were mainly driven by dialogue with the European Commission and tensions on the sovereign bond market. Both elements suggest a problem of ownership of the rules and a lack of awareness of the benefits deriving from sound fiscal policies; this undermines the role of the Fiscal Council.

Slovakia

Slovakia has two main national fiscal rules: a balanced budget rule ([80]) and a debt brake. The Council for Budget Responsibility (CBR) monitors *ex ante,* in-year and *ex post* compliance with the debt brake and, only *ex post*, compliance with the balanced budget rule ([81]). The CBR does not endorse macroeconomic assumptions ([82]) but

([78]) European Commission (2019b), p. 26.

([79]) As announced by the PBO Chairman in his hearing to the Parliamentary Budget Committees on 12 October 2018 and officially communicated to the Minister of Finance in the 'non-validation letter' of the macroeconomic policy scenario adopted in the 2019 draft budgetary plan.

([80]) The national balanced budget rule is based on concepts of the SGP (structural balance, expenditure benchmark, significant deviation, exceptional circumstances) applied with some modifications compared to the common European methodology. Since 2019, the government uses a different MTO in the national balanced budget rule (a structural deficit up to 0.5% of GDP) compared to the European-level SGP (a structural deficit up to 1.0% of GDP).

([81]) The assessment of compliance with the balanced budget rule for 2019 is expected to be available in July and December 2020.

([82]) Slovakia's draft budgetary plan is based on the macroeconomic forecast published by the Institute for Financial Policy (IFP) of the Ministry of Finance in September and endorsed by the Macroeconomic Forecasting Committee (MFC). According to the statutes, in its deliberations the MFC is independent and free from the government's influence. The MFC assesses whether the draft forecast submitted by the IFP is 'conservative', 'realistic' or 'optimistic' (https://ec.europa.eu/info/sites/info/files/

assesses budgetary forecasts and prepares reports on the long-term sustainability of public finances.

The case of Slovakia shows that there is a reliable alert system in place to warn against deviations from targets, but the policy reaction comes very late in the year (de facto addressing deviations only in the following year).

In November 2018, the CBR warned against risks of 0.6% of GDP to the government's target of a balanced budget for 2019 and 2020 presented in the proposed budget. This implied a need for additional measures to meet the objective. The CBR also warned about risks to debt levels between 2019 and 2021. After the approval of the 2019 budget in December 2018, the CBR confirmed the size and nature of the risks and concluded that additional consolidation measures were needed to achieve a balanced budget in 2019. In June 2019, the CBR again warned that, based on its assessment, a balanced budget could not be achieved, estimating the deviation at 0.9% of GDP in 2019 (equivalent to 0.8% of GDP in structural terms) without the adoption of additional measures. In September 2019, the government proposed savings measures amounting to 0.2% of GDP, yet the CBR assessed these measures to be insufficient and estimated a deviation of 1.2% of GDP from the target. On 6 November 2019 the Slovak authorities announced additional discretionary measures, but only for 2020 ([83]).

The CBR also noted that the transparency and credibility of the budget should be increased. It mentioned two means: strengthening the binding nature the tax forecasts approved by the independent Tax Revenue Forecasting Committee and using an independent assessment of the amount of non-tax revenues ([84]). The Council also pointed out the lack of transparency in the budget approval process, particularly due to missing information about the impact of some measures included in the 2019 budget and of approved amendments to the budget in the outer years (2020-2021), which were lastly clarified upon request by the CBR to the Ministry of Finance ([85]).

Slovenia

Domestic rules impose a balanced structural budget and an expenditure ceiling on the general government revenue. However, these rules are only applicable once the country has reached its MTO. Until then, compliance with the adjustment path is assessed against the requirements of the SGP ([86]). The Slovenian Fiscal Council has a very broad mandate ranging from the assessment of EU and domestic fiscal rules, to the *ex post* assessment of macroeconomic forecasts, produced by the Institute of Macroeconomic Analysis and Developments (IMAD) and the *ex post* assessment of budgetary forecasts ([87]). The timeline is dictated by the European Semester of EU surveillance.

The year 2019 is particularly interesting from an institutional point of view. The Fiscal Council issued many warnings about non-compliance with EU and national fiscal rules, which led to the negative assessment of the government's proposed revised state budget for 2019. Given that the fiscal rules are enshrined in the constitution, the Fiscal Council's negative assessment was used by the parliamentary opposition in an appeal to the constitutional court. The court has not yet reached a decision. Moreover, due to parliamentary elections, the 2019 DBP presented in October 2018 was prepared according to a no-policy change scenario.

In April 2018, the Fiscal Council pointed out non-compliance with both the structural balance rule and the expenditure rule over the period 2018-2021. It expected only the debt rule to be fulfilled, but not the domestic fiscal rule, because, according to the no-policy change scenario, the projected level of expenditure exceeded the legal ceiling. Hence, the Fiscal Council urged that measures specifically aimed at reducing expenditure growth, to achieve a neutral fiscal stance be adopted. In December 2018, the newly appointed government presented a revised 2019 DBP. The Fiscal Council confirmed its negative assessment of April

economy-finance/swd2019_928_en_autre_document_travail_service_part1_v4.pdf, p. 3). Moreover, the CBR assesses the tax revenue forecasts in its capacity as member of the Tax Revenue Forecasting Committee (the Committee consisting of experts from the Ministry of Finance, the central bank, academia, private banks, the CBR Secretariat). The assessment is published on the website of the Ministry of Finance and is also included in the budget documentation.

([83]) The budget deficit in 2019 reported by Eurostat for Slovakia ultimately amounted to 1.3% of GDP, which is the highest deviation from the target since 2010.

([84]) https://www.rozpoctovarada.sk/download2/eng_hodnotenierys_2019_2021_zhrnutie_final.pdf.

([85]) https://www.rozpoctovarada.sk/download2/hodnotenierys_2019_2021_addendum_eng.pdf.

([86]) https://ec.europa.eu/info/sites/info/files/economy-finance/24_si_sp_assessment_0.pdf, p. 20.

([87]) The IMAD prepares short-term and medium-term projections of macroeconomic variables.

2018 ([88]). At the beginning of 2019, the Slovenian authorities presented a proposal for a revised state budget resulting in an expansionary and pro-cyclical fiscal policy, according to the Fiscal Council. The Fiscal Council considered such a fiscal stance unsuitable, and the increase in general government expenditure compared to 2018 was deemed unlawful. Lastly, the Council pointed out that the amending process of the budget during a post electoral period had created inconsistencies in the medium-term budget planning ([89]). The Slovenian government replied that the main priority was lowering the general government debt, whose trend was envisaged to be in line with EU rules. In April 2019, the Fiscal Council assessed the stability programme as not fully compliant with the EU fiscal rules, although the MTO was estimated to be achieved from 2020 onwards without additional fiscal efforts. That was mostly due to the lowering of the MTO for the period 2020-2022.

Portugal

Portugal's national fiscal framework is very close to the EU framework. Until the MTO is achieved, two national numerical fiscal rules apply: (i) there must be an annual adjustment of the structural balance of least 0.5% of GDP (structural balance rule), and (ii) the nominal growth rate of net primary public expenditure may not exceed the potential GDP growth rate defined in the SGP (expenditure benchmark rule). In parallel, given that general government debt is above the reference value of 60% of GDP, Portugal's national fiscal framework requires the application of the EU debt rule ([90]). The Portuguese Public Finance Council (CFP) responsible for endorsing macroeconomic and budgetary forecasts twice a year before presentation of the stability programme and the DBP, respectively. According to its reply to the EFB questionnaire, the CFP also produces its own macroeconomic and budgetary forecasts beyond the official mandate; in addition to its own models, it uses the projections available at the macroeconomic level, namely those published by international institutions, the Ministry of Finance and the Bank of Portugal. It also assesses compliance with EU and domestic fiscal rules and issues opinions on the main documents prepared in accordance with the European Semester (stability programmes and draft budgetary plans).

The experience of fiscal surveillance in Portugal in 2019 shows that the IFI is able to exercise a strong role in addressing overly optimistic macroeconomic forecasts while keeping a focus on longer-term indicators. In 2019, the Portuguese Fiscal Council provided the only case of non-endorsement of macroeconomic forecasts. While the forecasts for 2019-2020 were endorsed, the Portuguese Fiscal Council did not endorse the forecasts for the outer years (2021-2023) because they did not represent a prudent or likely scenario, both in terms of GDP growth and its acceleration ([91]).

The Fiscal Council also stressed the importance of having reliable medium-term fiscal plans for the functioning of the national fiscal framework. In particular, it noted that expenditure ceilings set within a multiannual framework must be respected to effectively implement the policies underpinning the fiscal plans.

Spain

Spain's national fiscal rules are broadly aligned with the SGP in terms of the structural balance and debt. Similarly, the national fiscal rules include an expenditure benchmark, though with some differences compared to the SGP. The expenditure rule applies to both the central and subnational governments but not to social security funds. The mandate of the Spanish Fiscal Council, 'Autoridad Independiente de Responsabilidad Fiscal' (AIReF), is broad ([92]), allowing it to play a relevant role in Spain's budgetary processes. It includes issuing reports on the stability programme and the draft budgetary plan, assessing compliance of fiscal policy with the domestic numerical fiscal rules, including the regions' economic and financial plans, and giving advice on the activation of the correction mechanisms set out in Spain's Organic Law on Budgetary Stability and Financial Sustainability ([93]). It also endorses macroeconomic forecasts and assesses budgetary forecasts.

([88]) http://www.fs-rs.si/wp-content/uploads/2018/12/Assessment_-December_2018.pdf.
([89]) http://www.fs-rs.si/wp-content/uploads/2019/02/Assessment_Feb2019.pdf, p. 6.
([90]) https://ec.europa.eu/info/sites/info/files/economy-finance/22_pt_sp_assessment_0.pdf, p. 25.
([91]) https://www.cfp.pt/uploads/publicacoes_ficheiros/parecer-cfp-pe2019-conclusao-eng.pdf.
([92]) See European Fiscal Board (2019b), p. 39-42 for an in-depth analysis of the AIReF.
([93]) https://ec.europa.eu/info/sites/info/files/economy-finance/swd-2019-915_en_autre_document_travail_service_part1_v3.pdf, p. 3.

AIReF's main challenge in 2019 was to assess compliance with the fiscal rules in the presence of a caretaker government.

AIReF endorsed the macroeconomic scenario underpinning the DBP for 2019 and considered the budgetary forecasts as feasible ([94]). However, early 2019, AIReF changed this assessment due to the 2018 outturn and, most importantly, due to the non-approval of the 2019 budget and of the measures included in it. AIReF deemed the fulfilment of the general government deficit targets set in the spring 2019 stability programme as 'feasible' over 2019-2021, though the likelihood of compliance declined over time and became 'unlikely' in 2022. The debt projections included in the stability programme were deemed to be at the limit of what is feasible ([95]). In October 2019, AIReF warned against missing the expenditure benchmark and the annual structural adjustment, pointing to a risk of significant deviation. AIReF also considered the debt projection included in the DBP as unlikely for 2019.

AIReF also stressed the importance of medium-term budgetary planning in the national fiscal framework. In particular, it emphasised the importance of ensuring the consistency and credibility of medium-term budgetary planning and it provided recommendations in this respect ([96]).

Hungary

The only legal requirement for the Hungarian independent fiscal institution is to monitor compliance with national fiscal rules ([97]). The domestic fiscal rule for the deficit prescribes conformity with the 3 percent of GDP reference value. The Hungarian Fiscal Council, in its reply to the EFB questionnaire, indicated that it is also tasked with assessing compliance with the EU fiscal rules. The MTO was defined as a deficit of 1.5% of GDP in structural terms until 2019 ([98]).

([94]) https://www.airef.es/wp-content/uploads/2018/11/NOTICIAS/2018-11-20_InformeLneasFundam.PptosAAPP2019_EN.pdf.
([95]) https://www.airef.es/wp-content/uploads/2019/08/Informe_AIReF_APE2019-2022web_en-01082019-1.pdf, p. 9-10.
([96]) https://www.airef.es/wp-content/uploads/2018/10/Report-on-the-2018-2021-Stability-Programme-Update-of-the-Kingdom-of-Spain.pdf, p. 7.
([97]) Pursuant to Council Directive 2011/85/EU.
([98]) According to the convergence programme, the MTO is to become more demanding as of 2020, set as a structural deficit of 1.0% of GDP.

Since 2018, Hungary has been subject to a significant deviation procedure (SDP). However, the European Commission and the Council have found that Hungary had not taken effective action since then.

Compliance with the domestic fiscal rule based on the reference value of 3 percent of GDP could take place in presence of non-compliance with the EU fiscal rule of convergence towards the MTO. The Hungarian Fiscal Council deemed the 2019 budgetary targets in line with the 3 percent of GDP reference value, hence compliant with domestic fiscal rules. As for compliance with the required structural adjustment, the Fiscal Council acknowledged deviations for 2017 and 2018 while stressing broad convergence towards the MTO in 2019; but it deemed necessary to introduce measures to achieve the MTO ([99]).

In this case, the assessment of compliance with domestic and EU rules diverged, creating potential tensions between the views of the European Commission and the IFI. However, the IFI followed a balanced approach in advising the government to take measures and converge towards compliance with both the domestic and the EU fiscal rules.

In June 2019, the Fiscal Council advised the government to adopt measures to fight the black economy in order to safeguard the achievement of the fiscal targets included in the medium-term fiscal plans. In the end, such measures had been legislated by the government. According to the reply to the EFB questionnaire, the Fiscal Council attributes the adoption of these measures to the impact of its opinions. As for compliance with the structural budget balance rule, the Fiscal Council observed for 2019 a negative deviation of 0.4 percentage point of GDP from the 2019 budget due to an updated assessment of the cyclical components of the budget. The Fiscal Council also assessed compliance with the debt rule.

Romania

Romania's national numerical fiscal rule is a structural deficit rule, which requires convergence to the MTO of a structural deficit not exceeding

([99]) https://www.parlament.hu/documents/126660/4390325/Resolution+4+On+the+draft+budget+bill+of+2020.pdf/cb76557a-4c1c-71d9-178d-3b2d384a63b8?t=1581503328936 and https://www.parlament.hu/documents/126660/4390325/Resolution+6+On+the+execution+of+the+2019+budget+law.pdf/e12f5200-44c6-f9b0-5172-9cb074c1885b?t=1581503501971

1% of GDP. The national framework also contains several auxiliary rules on expenditure and revenue items.

The Romanian Fiscal Council is tasked with the *ex ante* and *in-year* assessment of compliance with the EU and national fiscal rules. It is also mandated to endorse the macroeconomic forecasts underpinning the budget and to assess budgetary forecasts.

The Romanian Fiscal Council played an important role in mitigating overly optimistic macroeconomic assumptions. The Fiscal Council deemed the economic growth scenario underpinning the 2019 budget as excessively optimistic.

However, its main challenge was to warn against non-compliance with fiscal rules. The Fiscal Council estimated the deficit at the end of 2019 to be close to 3 percent of GDP, with the risk of exceeding the reference value in the absence of corrective measures. As for compliance with the Council's recommendation to implement a structural adjustment of 1% of GDP in 2019 ([100]), the Fiscal Council acknowledged a significant deviation.

The Fiscal Council noted that fiscal rules laid down in the Fiscal Responsibility Law 'remained inoperable' with respect to the 2019 and 2020 budgetary laws, as the authorities continued derogating from them.

Requested to give an opinion on the approved 2019 budget in March 2019, the Fiscal Council ([101]) noted that for the first time since its establishment, the budget deficit target was increased after the submission of the draft budget to the country's national parliament, in direct contradiction with national law.

Following the upward revision of the deficit targets for 2019-2021, ([102]) the Fiscal Council stressed that the way in which the public finances had evolved showed a complete lack of commitment to the rules established by the Fiscal Responsibility Law and by the European Treaties.

([100]) With a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (Council Recommendation 14684/18 available at: http://data.consilium.europa.eu/doc/document/ST-14684-2018-INIT/en/pdf).

([101]) http://www.fiscalcouncil.ro/Fiscal%20Council%E2%80%99s%20Opinion%2011-march-2019.pdf, p. 3.

([102]) The upward revision implied the lack of any structural adjustment in the first 2 years covered by the national fiscal plans.

On the second draft budgetary revision proposed by the government in November 2019, the Fiscal Council envisaged an unprecedented major increase of the budget deficit, which was projected to reach 4.3 percent of GDP, far beyond the reference threshold of 3 percent ([103]). This substantial increase of the projected budget deficit was the result of a revenue shortfall that was only partially compensated by a decrease of public expenditure. The Fiscal Council considered that credible budgetary consolidation measures were needed, in view of both the deficit level and the medium-term perspective.

([103]) http://www.fiscalcouncil.ro/FC%20Opinion%20on%20the%20Draft%20of%20the%20Second%20Budget%20Revision%20for%202019.pdf, p. 3.

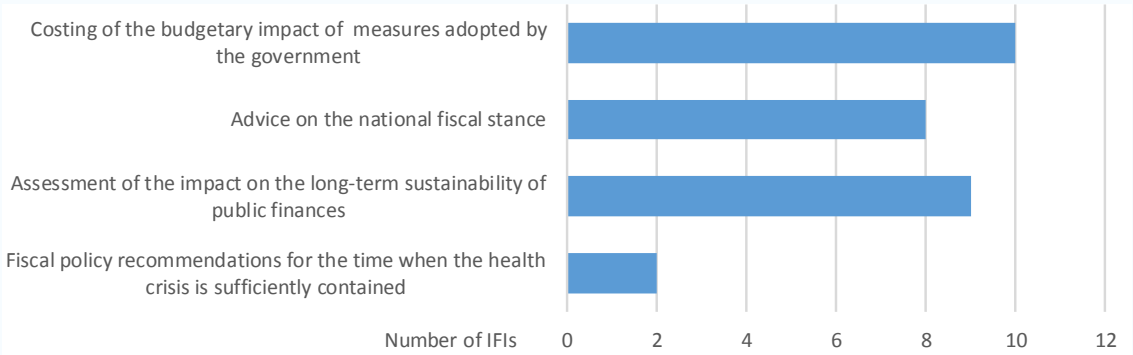
Box 3.2: **The IFIs' response to the Covid-19 crisis**

The uncertainty of economic and budgetary forecasts and the budget flexibility allowed to Member States by the activation of EU and national clauses ([1]) affect the role of IFIs. An exceptional degree of uncertainty makes the IFIs' endorsement of government macroeconomic forecasts less meaningful and effective compared to normal times. In 2020, the few IFIs producing official macroeconomic and budgetary forecasts used scenarios to account for the high level of uncertainty. The assessment of compliance with fiscal rules – the other mandate of EU IFIs – is also affected during the activation of EU and national escape clauses and the expansionary fiscal stance.

A dedicated questionnaire designed by the EFB was sent to 27 IFIs operating in 26 EU Member States and to the UK Office of Budget Responsibility to gather information on the activation of national escape clauses, activities undertaken by IFIs during the pandemic and the degree of cooperation with national governments. Similar initiatives had also been undertaken by other institutions such as the OECD Network of Parliamentary Budget Offices and Independent Fiscal Institutions ([2]) and by the network of EU IFIs ([3]). Results are broadly consistent across surveys.

The IFIs have swiftly reacted to the current crisis. They have at times been the first national budget institutions to shed light on the economic and budgetary impact of the pandemic. The EFB questionnaire enquired whether IFIs carried out at least one of the following activities: i) costing the budgetary impact of the measures adopted by the Government; ii) providing advice on the national fiscal stance; iii) assessing the impact on the long-term sustainability of public finances; and iv) issuing fiscal policy recommendations for the period when the health crisis is sufficiently contained. The large majority of the respondents carried out one or more of the tasks above. Only four out of the 28 IFIs did not indicate any activity during the first months of the pandemic crisis. Activities were evenly spread across countries, except for fiscal policy recommendations for the period when the health crisis is sufficiently contained. These were issued in only two cases as indicated in Graph 1. The majority of the IFIs carrying out sustainability analysis adhered to their formal mandate.

Graph 1: **IFIs' activities during the Covid-19 crisis**



Source: European Fiscal Board

IFIs also played an oversight role in the activation process of the escape clause at the national level. In 19 out of the 28 countries addressed by the questionnaire, a national escape clause was activated. In the large majority of cases, although not in all cases, IFIs were involved in assisting national parliaments in assessing the existence of circumstances before allowing their executives to use additional budgetary flexibility to respond to the economic crisis induced by the pandemic.

According to the OECD survey, IFIs were also faced with many challenges while undertaking these activities. The main challenges were capacity constraints, delays in budgetary processes due to the crisis, and difficulties obtaining data and information from government counterparts during the crisis. Respondents to the EFB questionnaire confirmed the challenging environment faced by IFIs especially with regard to cooperation with national governments. Only six IFIs reported having very good or closer cooperation than in normal times. The remaining respondents did not report any change in the established level of cooperation.

([1]) See Box 2 of European Fiscal Board (2020) for more details on the EU's general escape clause.
([2]) See OECD (2020).
([3]) See Network of EU IFIs (2020).

4. ASSESSMENT OF THE FISCAL STANCE IN 2019

Highlights

- In mid-2018, the guidance issued by the EFB, the Commission and the Council for the euro area fiscal stance in 2019 had common features: based on upbeat growth projections, the guidance noted that the prospective fiscal expansion was pro-cyclical and recommended reducing high debts and building fiscal buffers where needed, as required by the Stability and Growth Pact.

- However, the Commission and the EFB had different opinions on what countries with available fiscal space should do: the Commission invited Germany and the Netherlands to use some of their fiscal space for a domestic fiscal expansion, while the EFB did not give any specific guidance for these two countries.

- The EFB recommended a somewhat restrictive fiscal stance for the euro area, in line with what the aggregation of fiscal country-specific requirements for 2019 amounted to if the countries with available fiscal space made no use of it. The partial use of fiscal space recommended by the Commission implied a broadly neutral aggregate fiscal stance.

- The difference between the Commission's and EFB's guidance for the euro area was marginal in quantitative terms, but the EFB wanted to convey a qualitatively different message: its main concern was that good times would be underrated, and many countries would again miss an opportunity to improve public finances.

- In late 2018, when economic growth slowed somewhat, neither the Commission nor the Council issued any new guidance for the aggregate fiscal stance.

- Although growth turned out lower than expected at the height of a wave of earlier optimism, in hindsight 2019 was still a year of good times, especially compared to the much bleaker situation in 2020.

- Based on latest estimates, the fiscal stance in 2019 was expansionary on aggregate, with a fiscal loosening of 0.3% to 0.6% of GDP as measured by the change in the structural primary balance and net expenditure growth, respectively.

- The fiscal expansion observed in 2019 was larger than the one already projected for 2019 by the Commission in 2018; this was not warranted by prevailing economic conditions.

- The fiscal stance was expansionary in most euro area countries, including those with high debt; such a distribution across countries was not appropriate. It weighed on the capacity to implement fiscal stimuli in 2020.

- A retrospective analysis of the fiscal stance based on three different indicators shows that the change in the structural balance, primary or not, tends to underestimate the pro-cyclicality of fiscal policy compared to an indicator based on the expenditure benchmark.

- Much of the discrepancy is due to the fact that, unlike the expenditure benchmark, the structural balance tends to be affected by tax revenues reacting more to the economic cycle than assumed in the cyclical adjustment.

- Following the same pattern as in 2018, this was the case in 2019: the change in the structural primary balance signals a less expansionary stance than the expenditure benchmark, mainly because such revenue windfalls make the structural deterioration look more limited than it presumably was in many countries.

- Moreover, the expenditure benchmark is based on a moving average of potential growth, which makes it less prone to cyclical volatility.

- Differences between the various indicators are best assessed on a case-by-case basis.

This chapter provides a backward-looking assessment of the euro area fiscal stance. The first section summarises and compares the guidance for the fiscal stance in 2019 given by the Commission, the Council and the EFB, based on the information available in 2018 and early 2019. The second section uses the latest information to discuss whether the observed fiscal stance was in line with the guidance and what would have been appropriate.

4.1. GUIDANCE GIVEN IN 2018 AND EARLY 2019

While early guidance for 2019 rested on the consensus view of a strong economic outlook, subsequent guidance was based on somewhat weaker growth expectations. In the spring and summer of 2018, all main forecasters pointed to a steady expansion in 2019 (Graph 4.1). Accordingly, both the EFB in its June 2018 report and the Commission in its first guidance stressed that growth was likely to be solid (Box 4.1). The growth outlook started to soften only in the autumn of 2018. The Commission reflected these less optimistic prospects in its guidance of November 2018, noting that growth was expected to moderate, and flagged increasing risks. In January 2019, however, the Council presented a less negative assessment in the economic analysis underpinning its recommendation to the euro area. Compared to the Commission's draft, it stated that '[p]otential growth remain[ed] low compared to levels recorded in recent decades' rather than 'significantly below pre-crisis levels' and it added that 'labour supply [was] scarce in some Member States'.

The guidance agreed on the need to use the favourable economic environment to cut high public debt and build buffers. The message remained equally strong throughout the period and across the institutions: high-debt countries needed to consolidate in 2019, in line with the requirements of the Stability and Growth Pact (SGP). Similarly, the countries that had not yet achieved their medium-term budgetary objective (MTO) were asked to use good economic times to rebuild fiscal buffers and be ready to face future downturns.

The guidance also consistently noted that the projected aggregate fiscal expansion was not appropriate. The EFB, the Commission and the Council repeatedly made the point that the projected aggregate fiscal stance was overly expansionary in view of the positive economic situation. All three institutions also stressed that the planned fiscal effort in high-debt countries was too weak and in some cases even negative.

The main difference in guidance regarded large countries with fiscal space. In view of the projected ongoing expansion, the EFB did not provide any particular guidance for countries with fiscal space. The Board therefore made the agnostic assumption that these countries would have a neutral fiscal stance. By contrast, in July 2018 the Commission explicitly called for a fiscal expansion in Germany and the Netherlands (Table 4.1), and the Council asked them to use their fiscal space to prioritise investment.

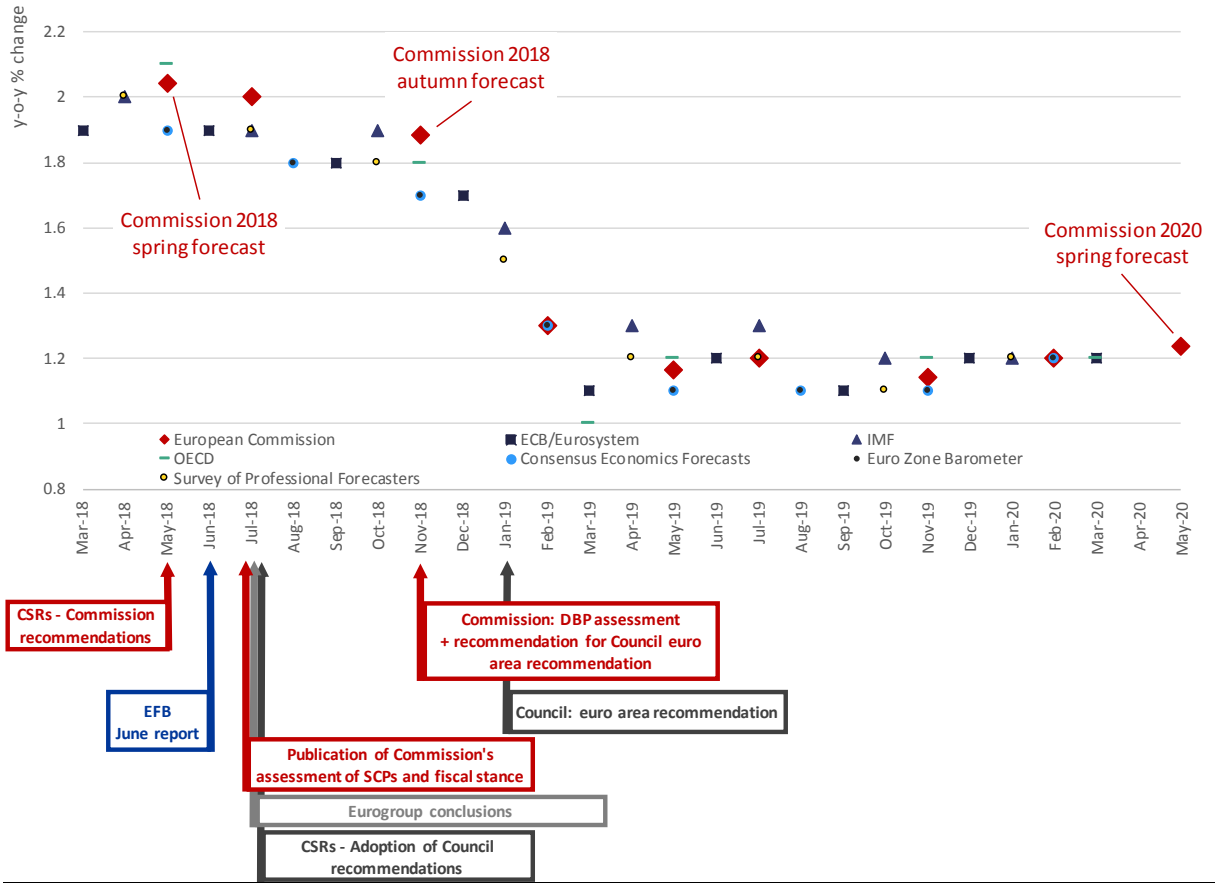
Table 4.1: **Scenarios underpinning Commission guidance in July 2018**

(Based on the Commission 2018 spring forecast)	Change in the structural balance (% of GDP)	Change in the structural primary balance (% of GDP)
Commission guidance: CSRs + partial use of fiscal space (1)	0.18	0.12
CSRs + no use of fiscal space	0.34	0.28
CSRs + full use of fiscal space	-0.16	-0.22
Projected aggregate fiscal stance	-0.31	-0.37
Projected fiscal stance in DE	-0.1	-0.2
Projected fiscal stance in NL	-0.2	-0.3

(1) The Commission called for a fiscal expansion of 0.5% of GDP in Germany and 0.4% of GDP in the Netherlands, as measured by the change in the structural balance.
Source: European Commission, own calculations

The Board called for a somewhat restrictive fiscal stance, while the Commission's early guidance was for a broadly neutral fiscal stance relying on some use of fiscal space. While not explicitly quantifying what would be appropriate, in June 2018 the Board noted that the aggregation of fiscal country-specific recommendations (CSRs) of May 2018 led to an improvement in the structural primary balance by an order of magnitude of a quarter of a percentage point of GDP and that this could be considered appropriate. By contrast, given the partial use of fiscal space in Germany and the Netherlands that the Commission called for in July 2018, the aggregate fiscal stance recommended by the Commission fell into the 'broadly neutral' category. The wording therefore differed, although the fiscal stance recommended by the Commission was in the same ballpark as the EFB (Table 4.1). Consistent with this, in its assessment of DBPs in November 2018, the Commission argued that a 'broadly neutral to mildly restrictive fiscal stance' would be appropriate. In its draft recommendation

Graph 4.1: **Real GDP growth projections and guidance on the fiscal stance for the euro area in 2019**



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

to the euro area, however, the Commission did not mention the aggregate fiscal stance. In January 2019, the Council too did not introduce any guidance for the aggregate fiscal stance in the final version of the euro area recommendation.

Overall, there was no major disagreement across institutions but a different, although important, nuance. There was a clear consensus on what countries not yet at their MTO should do, especially where public debt was high: in relatively favourable economic times, there was no reason to consolidate less than required by the EU fiscal rules. This is standard guidance; the Board, and presumably the Commission and the Council, would always call for appropriate consolidation in high-debt countries unless they have serious concerns about the economic outlook – and there were no such concerns for 2019. As regards large countries with fiscal space, there was also the view that they would benefit from using some of their fiscal space to boost potential growth, and that this may have positive spillover effects on the rest of the euro area. In what was perceived as a year of relatively strong growth, however, there was a risk that a fiscal expansion in Germany and the Netherlands could be pro-cyclical for these countries. The Board therefore chose not to give any specific guidance for these countries and left it up to them to decide whether, when and how to use their available fiscal space. Instead, the Board decided to focus on reminding policymakers that good economic times tend to be underestimated in real time, which was a real concern in view of the advanced stage of the economic recovery.

Box 4.1: Guidance issued by the Commission, the Council and the EFB

- **23 May 2018: Commission Communication on country-specific recommendations (excerpts):**

'As economic conditions steadily improve, it is the time to rebuild fiscal buffers in high-debt countries and use the fiscal space in surplus countries to make their economies more resilient and support growth. (...) The resultant mix of fiscal policies among Member States would make the aggregate fiscal stance for the euro area in 2019 broadly neutral, striking the right balance between attaining public finance sustainability and safeguarding the ongoing economic expansion and pick-up in employment.'

- **18 June 2018: EFB June 2018 report (excerpts):**

'The latest projections and indicators point to very favourable economic conditions in (...) 2019 which provide an important window of opportunity to create fiscal buffers, particularly in view of still high government debt levels. (...) In 2019, a somewhat restrictive fiscal stance is appropriate for the euro area. Since fiscal fine-tuning is ineffective, the Board does not want to set a specific quantitative target for 2019 but a general indication. For practical purposes, the difference between a 'neutral' and 'somewhat restrictive' fiscal stance may seem small. Still, for clarity, the Board believes that at the current juncture it is preferable to switch to 'restrictive' as opposed to 'broadly neutral'. (...) Implementing the adjustment required by the Pact in the countries that are not yet at their MTO would lead to a somewhat contractionary fiscal stance. In particular, the structural primary budget balance of the euro area would improve by an order of magnitude of a quarter of a percentage point of GDP. Such an outcome can be considered appropriate for the euro area as a whole.'

- **July 2018: Commission overview of the 2018 SCPs and assessment of the euro area fiscal stance for 2019 (excerpts):**

'The current economic expansion (...) calls for prioritising sustainability needs in a country specific approach. (...) [M]any euro area Member States should be rebuilding fiscal buffers to be able to allow the automatic fiscal stabilisers to fully play their role in an economic downturn (...) and to tackle possible increases in real interest rates. This notably concerns countries that still show sustainability challenges (...). The existing fiscal scope in some countries could be mobilised to invest in long-term growth (...) For instance, in Germany, (...) to achieve higher investment in particular on education, research and innovation (...). The Netherlands also appears to have some room for raising public investment in research, development and innovation to enhance potential growth and supporting euro area growth. This differentiated approach could lead to a broadly neutral fiscal stance at the euro area level, for 2019, assuming the use of fiscal scope in some Member States. (...) In order to illustrate the impact on the euro area fiscal stance, a scenario "SGP compliance and some use of fiscal space" (...) assumes that Member States not at the MTO in 2018 are fully compliant with SGP in 2019, while Germany and the Netherlands use part of their fiscal scope in 2019 (...). This scenario points to a broadly neutral stance for the euro area as a whole, that is, an improvement of less than 0.2% of GDP, while strict compliance with SGP without use of fiscal scope would result in a slightly contractionary stance of 0.3% for the euro area. This scenario is also broadly consistent with the outcome of [an] economic scenario based on the sustainability needs of Member States (...) [which] would result in a modest improvement in the structural balance of the euro area of around ¼% of GDP.'

- **12 July 2018: Eurogroup conclusions (excerpts):**

'The EFB (...) underlined that the current expansion offers a clear opportunity to create fiscal buffers and prepare public finances for the future. It concluded that, overall, the current outlook warrants a somewhat restrictive fiscal stance for the euro area in 2019. The Commission concurred with the EFB analysis on the need for fiscal consolidation in Member States with a high government debt-to-GDP ratio, while maintaining its assessment that a broadly neutral aggregate stance for 2019 is appropriate. (...) [G]iven the uncertainties and risks to the economic outlook (...), it is important for us to adopt credible policies that properly reflect each country's specific circumstances. Rebuilding fiscal buffers remains a priority for Member States with high debt levels. Member States having outperformed their medium term budgetary objectives could use their favourable budgetary situation to prioritise investments to boost potential growth while preserving the long-term sustainability of public finances.'

(Continued on the next page)

Box (continued)

- **21 November 2018: Commission overall assessment of the 2019 DBPs (excerpts):**

'All euro-area Member States are now either in "normal" or "good" economic times (...).Those Member States that face the highest sustainability challenges plan either a limited fiscal adjustment or, in the case of Italy, a fiscal expansion in 2019. The planned fiscal policies of these Member States take insufficient advantage of favourable macroeconomic conditions and accommodative monetary policy to rebuild fiscal buffers. (...) On the other hand, (...) Germany and the Netherlands plan to implement expansionary fiscal policies in 2019. However, those plans are only partly oriented towards public investment. An increase in public investment by these Member States would boost their potential growth and generate positive spill-overs to the rest of the euro area. (...) Overall, fiscal policies are insufficiently differentiated, resulting in an overly expansionary fiscal stance for the euro area as a whole. (...) [A] combination of some fiscal expansion, as planned by Member States with fiscal space, combined with compliance with the Stability and Growth Pact by Member States with consolidation needs would result in a broadly neutral to mildly restrictive fiscal stance for the euro area.'

- **21 November 2018: Commission recommendation for a Council Recommendation on the economic policy of the euro area (excerpts):**

Recitals: 'The euro area fiscal stance (...) is projected to become slightly expansionary in 2019 in spite of output being above potential. Rebuilding fiscal buffers is especially important in Member States with still high levels of public debt. (...) Increasing public investment, in particular in Member States with fiscal space, would support growth and rebalancing.'

Fiscal recommendation for 2019-2020: 'Rebuild fiscal buffers in euro area countries with high levels of public debt, support public and private investment and improve the quality and composition of public finances in all countries.'

- **21 November 2018: Accompanying Commission staff working document (excerpts):**

'[I]n view of the ongoing economic expansion, it is the time to rebuild fiscal buffers in Member States with still high level of public debt. (...) Member States with fiscal space could increase investment to sustain the expansion in a durable way. (...) According to both the Commission forecast and the Member States' budgetary plans, the aggregate fiscal stance of the euro area is projected to become slightly expansionary in 2019. Several Member States with high debt-to-GDP ratios are currently forecast to have sizeable and in one case increasing structural deficits in 2019, which in some cases, would not be consistent with requirements under the Stability and Growth Pact. (...) Based on the Commission forecast, Member States with sizeable budget surpluses are projected to use some of their fiscal space. An increase in public investment in these countries would be appropriate as it would also generate positive spillovers to the rest of the euro area.'

- **22 January 2019: Council Recommendation on the economic policy of the euro area adopted by the Ecofin Council (excerpt; additions compared to the Commission draft are highlighted in italics):**

'*While pursuing policies in full respect of the Stability and Growth Pact*, support public and private investment and improve the quality and composition of public finances. Rebuild fiscal buffers, *especially* in euro area countries with high levels of public debt.'

4.2. EX POST ASSESSMENT

The remainder of this chapter discusses whether, in hindsight, the guidance and the observed fiscal stance were appropriate.

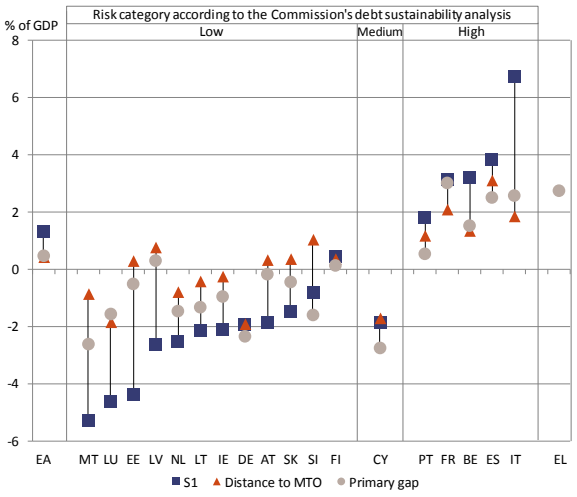
The EFB's assessment of the fiscal stance follows economic reasoning: it considers the need for discretionary fiscal stabilisation subject to sustainability constraints of public finances ([104]). Alternative fiscal stances, along with the fiscal requirements under the SGP, are reported in Graph 4.3 based on both the expectations of autumn 2018 (upper panel) and the outturn observed in spring 2020 (lower panel).

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

There is no single optimal path for how fast economic activity should return to its potential level. To account for differences across countries and over time, Graph 4.3 shows possible ranges for the fiscal stance. Starting with the stabilisation objective, a range of stylised policies is considered when the output gap has not closed yet, namely moderate to fast stabilisation — i.e. closing the output gap by 25% to 50% within the reference year ([105]) ([106]). Countries are ranked by the level of their output gap in 2018, as an indication of where they stood in the economic cycle. As the output gap was positive in nearly all countries, more stabilisation meant more fiscal contraction.

To ensure sustainability, 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 ([107]). To provide more background on whether sustainability is ensured or at risk in the various Member States, Graph 4.2 shows the assessment of risks according to four different indicators used by the Commission as measured in autumn 2018. These are (i) the S1 indicator, (ii) a debt sustainability analysis, (iii) the distance to the MTO and (iv) the primary gap, which is used as input for the debt rule ([108]). For high-debt countries, these standard indicators conveyed consistent signals of high risks to sustainability. The graph also reports the values for the euro area as a whole, although in the absence of a central fiscal capacity issuing common debt, the analysis of sustainability for the euro area as a whole remains a theoretical aggregation of national situations.

Graph 4.2: **Sustainability indicators in autumn 2018**



Notes: (1) This graph shows three quantitative indicators (S1, the distance to the MTO and the primary gap) plus the risk classification resulting from the Commission's debt sustainability analysis (DSA), except for the euro area as a whole for which the Commission does not publish a DSA. (2) The graph shows the euro area on the left, followed by Member States grouped by risk category according to the DSA and ranked by increasing levels of S1. (3) S1 measures the total cumulative adjustment, in terms of structural primary balance, needed in 2019-2023 to bring the debt-to-GDP ratio to 60% by 2033. (4) A negative distance to MTO means that the Member State is above its MTO. (5) The primary gap measures the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over 60% of GDP at an annual pace of 5%. (6) The Commission did not publish a DSA nor an S1 indicator for Greece in autumn 2018, and Greece did not have an MTO for 2019 (see Chapter 2). (7) S1 for the euro area is the average of national S1 indicators.
Source: European Commission, own calculations

To give a comprehensive overview of the fiscal situation, Graph 4.3 also shows the fiscal requirements under the Pact. The requirements incorporate the impact of granted flexibility. For the countries that had overachieved their MTO in 2018, the graph includes an additional point, corresponding to less demanding requirements: it shows their available fiscal space in 2019, i.e. the amount by which their structural position could deteriorate until it was at the MTO.

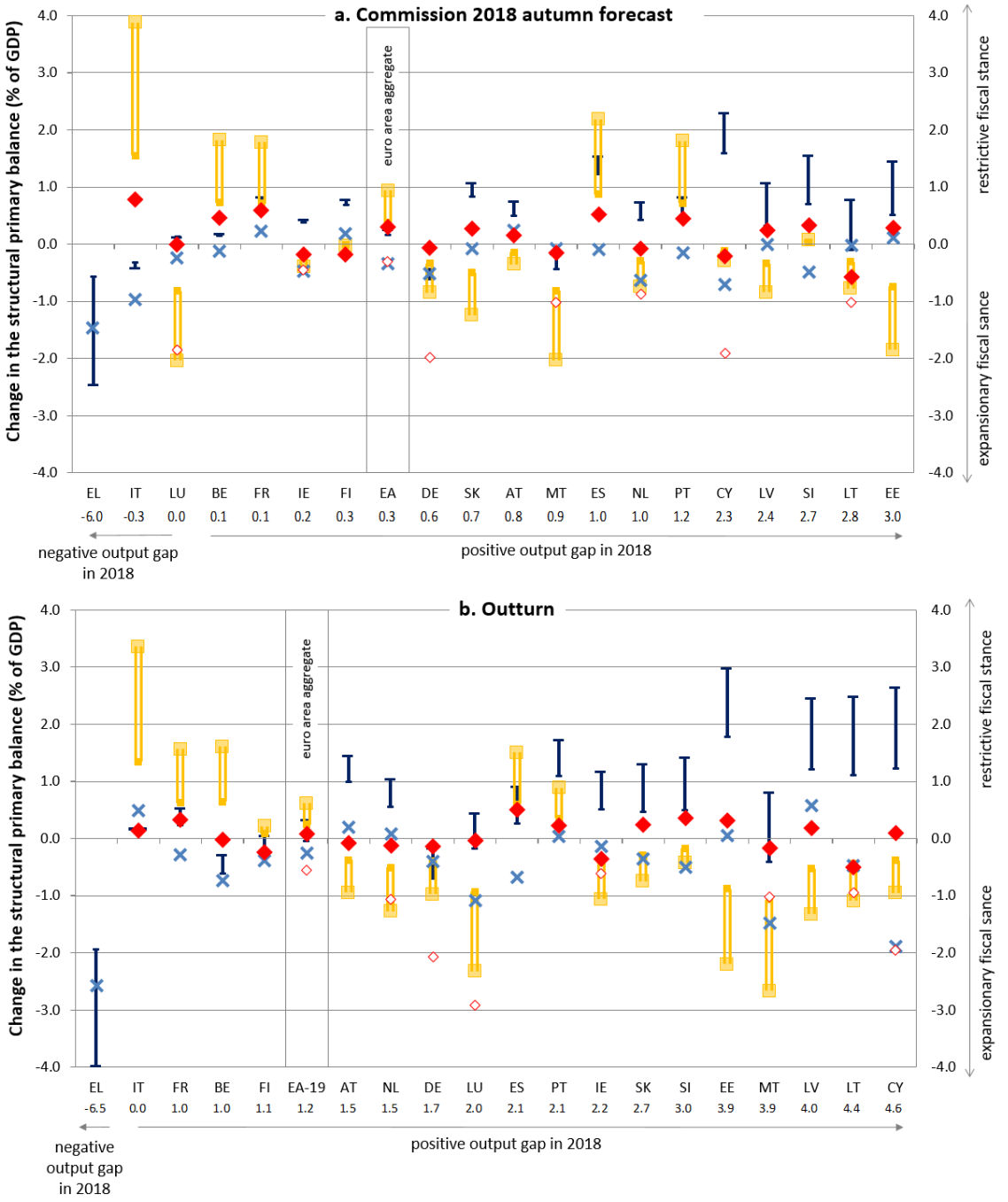
([105]) In this chapter, the fiscal stance needed to achieve a certain change in the output gap is calculated using a fiscal multiplier of 0.8. This is an average value that seems reasonable given the constraints on monetary policy and assuming a balanced composition between revenue and expenditure measures.

([106]) 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 signs, or when the stabilisation provided by automatic fiscal stabilisers is sufficient. For the sake of readability, this is not reported in the graph.

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

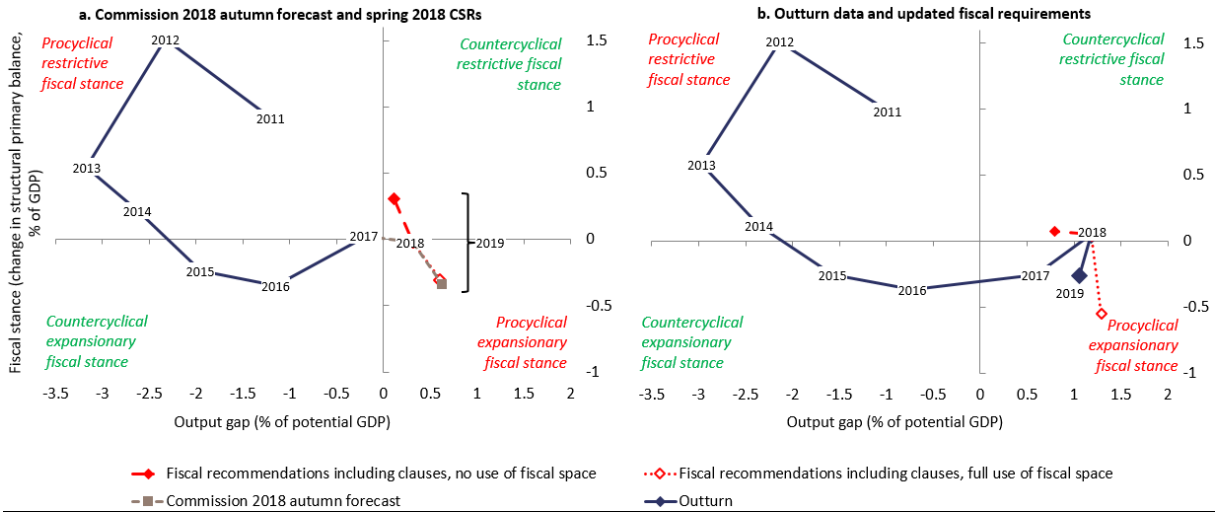
([108]) The primary gap measures the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over 60% of GDP at an annual rate of 5%.

Graph 4.3: **Analysis of the fiscal stance in 2019**



Notes: (1) The ranges for stabilisation are computed using a uniform fiscal multiplier of 0.8. (2) S1 measures the total cumulative adjustment needed in 2019-2023 to bring the debt-to-GDP ratio to 60% by 2033. Uniform implementation over five years means that one fifth of S1 is implemented in 2019. (3) For consistency, the fiscal requirements (diamonds) are recalculated in terms of the change in the structural primary balance, while in official documents they are formulated in terms of the change in the structural balance. (4) The countries benefiting from clauses are Latvia, Lithuania, Austria and Finland in the top graph, plus Belgium and Italy in the bottom graph. (5) EL was under enhanced surveillance and had a primary surplus target which was not translated into a structural balance target (see Chapter 2).
Source: European Commission, own calculations

Graph 4.4: **The fiscal stance in the euro area (2011-2019)**



Note: The impact of alternative implementations of the SGP in 2019 is computed assuming a uniform fiscal multiplier of 0.8.
Source: European Commission, own calculations

We can look at country-specific examples to understand how to read the overview graph. At the left end of the upper panel of Graph 4.3, the country with the second lowest output gap in 2018 in the Commission 2018 autumn forecast was Italy; the output gap of Greece was more negative but the country was not subject to the normal rules of the SGP (see Chapter 2). It would have taken some slight discretionary fiscal support for Italy's output gap to close by more than 25% (blue range). At the same time, significant fiscal consolidation was needed to bring Italy's high debt ratio closer to 60% of GDP, as shown by the yellow sustainability range above the horizontal axis. Under the preventive arm of the Pact, Italy was required to improve its structural balance by 0.6% of GDP in 2019; given the expected increase in interest payments, the requirement was slightly more than that in terms of the change in the structural primary balance (red diamond). The Commission forecast, however, was that Italy's structural primary deficit would widen substantially (blue cross). At the right end of the graph, Estonia was in a different situation: its output gap was significantly positive, and discretionary fiscal stabilisation would therefore have taken the form of fiscal retrenchment. With a debt ratio well below 60% of GDP, Estonia had some fiscal leeway; furthermore, its structural balance stood slightly below its MTO in 2018. According to the Commission 2018 autumn forecast, Estonia was expected to bring its structural balance slightly closer to its MTO in 2019.

In retrospect, what fiscal stance would have been appropriate?

Although lower than expected, growth in 2019 remained solid. It was positive in all quarters, albeit not as high as expected during the wave of optimism of spring 2018, when outturn data for 2017 gave the wrong impression that strong growth would continue in 2018, moderating only slightly in 2019 (Graph 4.1). As explained in Box 4.2, however, downward revisions to real GDP growth do not tell the whole story. The evolution of output gap estimates over time shows similarities with the run-up to the Great Recession and suggests that 2019, like 2008, was a turning point and a last year of normal to good economic times. What was previously considered a normal level of output before the Great Recession turned out to be well above potential, and 2008 was a year of positive output gap despite a series of downward revisions to growth. Similarly, in 2019 the economy experienced a slowdown compared to the one-off boom of 2017 but, relative to 2020, this still appears as a mild fluctuation. The nature of the shock that led to a crisis in 2020 is nevertheless very different from that of 2008-2009, and so far the major recession of 2020 has not led to revisions of the output gap for 2019 up to the high level of 2008 ([109]); this is also because most forecasts are pointing to a swift rebound in 2021.

([109]) This is largely explained by the fact that Member States agreed to ad hoc methodological changes to keep past potential output broadly unchanged, assuming that the fall in potential growth would only affect 2020.

A slightly restrictive fiscal stance would have been appropriate for 2019 on aggregate from a stabilisation perspective. A major issue when giving guidance on the fiscal stance is how to assess fiscal stabilisation subject to sustainability constraints. From a stabilisation perspective, except when anticipating major cyclical swings, it is not desirable to give quantified guidance given the normal uncertainty around forecasts. This applies to 2019: the Board was giving guidance for a non-crisis year, when the scope for discretionary demand management was fairly limited. Based on the latest estimates, the output gap turned positive in 2017 and was significantly positive in 2018. The Board confirms its view that letting automatic fiscal stabilisers operate as a first line of defence should have been sufficient to absorb a limited growth surprise such as the one observed in 2019. Our calculations suggest that even with the slight fiscal contraction envisaged in the Board's June 2018 report in view of SGP requirements and sustainability considerations, the output gap in 2019 still would have remained positive. The Board's recommendation to comply with fiscal requirements in 2019 therefore remains a sensible one.

Finally, the Board had not explicitly advised countries with available fiscal space to make use of it in 2019; this implied that they were free to keep it available for when it would be most needed, for which 2020 is a clear case. In 2020, the euro area countries with a more favourable structural budget position and a lower debt ratio have generally been able to deploy more fiscal firepower to face the Covid-19 crisis (see Table 4.2). We find a stable link between the initial fiscal position in 2019 and the size of the stimulus in 2020 across a variety of specifications, while controlling for a number of other variables such as the change in the output gap, the fall in industrial production, health care expenditure and the number of deaths per head.

The simple regression exercise reported in Table 4.2 is of a purely indicative nature. The results nevertheless underscore the important distinction between the short and the long term. If a country builds slightly more or slightly less fiscal buffers in one year, it may not make a big difference for its ability to absorb large shocks a year later. More generally, however, an accumulation of annual deviations from prudent policies results in high debt, and there is abundant evidence that a high level of debt weighs on a country's capacity to pursue other policy objectives, including stabilisation. The extensive literature on fiscal reaction functions shows how high debt and pressure from interest payments tend to go along with fiscal adjustment irrespective of cyclical conditions ([110]). In fact, the same literature actually shows that discretionary fiscal policies tend to be pro-cyclical or a-cyclical at best, contributing to an accumulation of debt, which then curtails fiscal space in the event of large shocks.

Table 4.2: **Initial fiscal position and size of fiscal stimulus in 2020**

Dependent variable: fiscal stimulus in 2020
(change in the structural primary deficit, i.e. increase = stimulus)

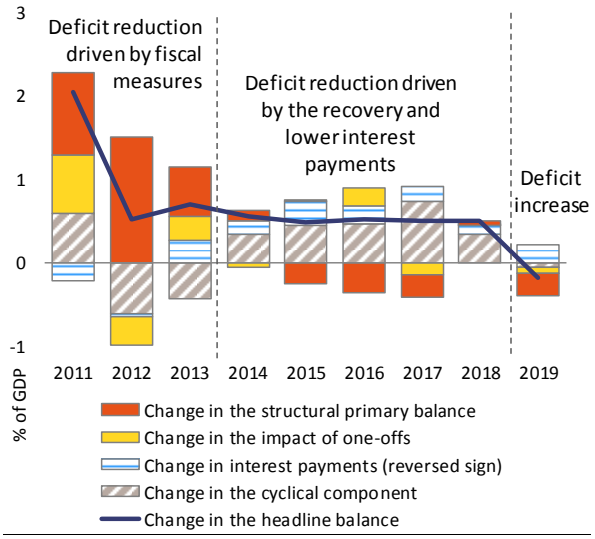
19 observations (euro area countries)

Initial fiscal position	Structural primary balance (2019)	0.479 (0.017)	0.462 (0.008)
	Government debt (2019)	-0.026 (0.016)	-0.023 (0.011)
Other determinants	Change in the output gap (2020)	0.453 (0.077)	
	Drop in industrial production (2019 average minus monthly minimum in 2020)		0.047 (0.006)
	Cumulated number of deaths per 1000 inhabitants (31 March 2020)	9.244 (0.093)	2.019 (0.649)
	Health expenditure per 100 000 inhabitants (2018, COFOG data)	-7.160 (0.017)	-3.203 (0.094)
	Constant	9.688 (0.002)	3.956 (0.000)

Notes: (1) In brackets: P-values. (2) The dependent variable, the structural primary balance, government debt and the change in the output gap are in percentage of GDP. Industrial production is measured by an index (2015 = 100). Health expenditure is in billion euro per 100 000 inhabitants.
Source: European Commission, Worldometer, own calculations

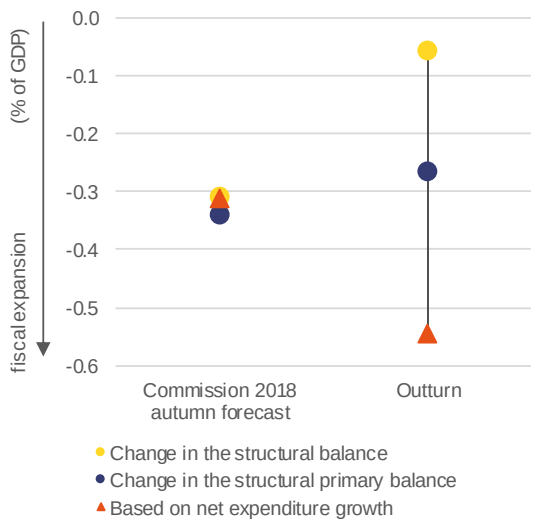
([110]) See for instance Bohn (1998), Ostry et al. (2010), Debrun and Kinda (2013), and Bénétrix and Lane (2015).

Graph 4.5: **Drivers of the change in the headline balance (euro area)**



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

Graph 4.6: **Fiscal stance in the euro area in 2019 according to three indicators, projections vs outturn**



Notes: (1) In this graph, the fiscal stance as measured by net expenditure growth is based on outturn data for the GDP deflator and medium-term potential growth. (2) The differences between the three fiscal stance indicators are due to interest payments, revenue windfalls, the use of annual or smoothed potential growth estimates, investment smoothing and a small technical residual.
Source: European Commission, own calculations

Was the aggregate fiscal stance appropriate?

Discretionary fiscal policy in 2019 led the headline budget deficit in the euro area as a whole to increase after eight years of decline. Despite a reduction in interest expenditure, the budget deficit increased by 0.2% of GDP, mainly due to expansionary discretionary fiscal measures (Graph 4.5).

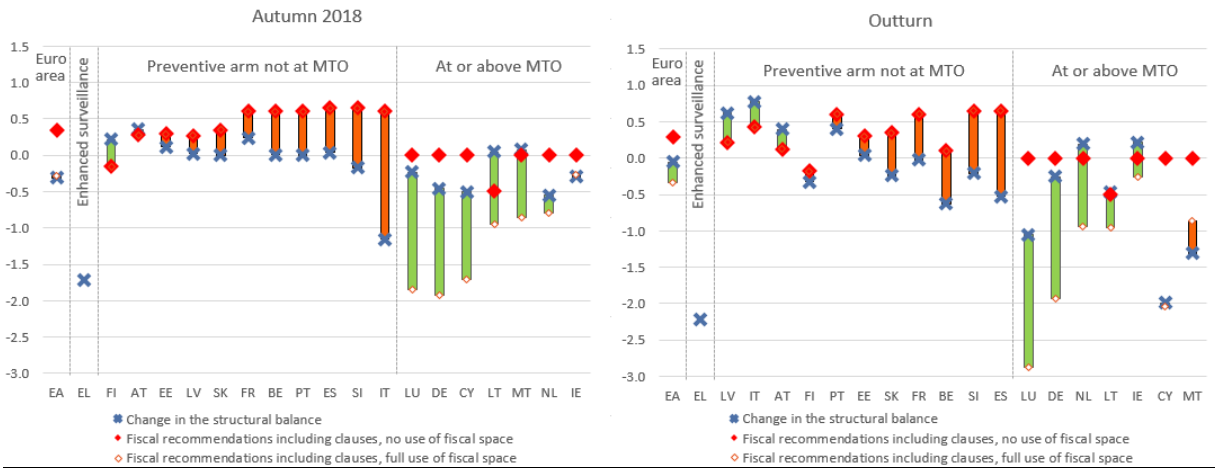
Three main indicators are available to measure the fiscal stance. Box 4.3 presents them more closely. Among them, the Board uses the change in the structural primary balance (SPB) as main reference and complements it with an indicator based on net expenditure growth as defined by the expenditure benchmark of the SGP. This is because, unlike the change in the structural balance, both indicators are corrected for interest expenditure, an item that does not directly reflect government decisions.

The euro area fiscal stance in 2019 was expansionary by up to 0.6% of GDP. Based on the Commission 2018 autumn forecast, all three indicators were clustered around a fiscal expansion of 0.3% of GDP (Graph 4.6). Using outturn data, the indicators still point in the direction of a fiscal expansion, although the magnitude differs between them ([111]). The change in the structural balance points to a quasi-neutral fiscal stance mainly because interest payments turned out lower than expected. Once corrected for this, there remains a measurable difference between the fiscal expansion as measured by the change in the SPB (-0.3% of GDP) and the expenditure-based indicator (-0.6% of GDP). Revenue windfalls explain two thirds of the discrepancy; that is, tax revenues were higher than the cyclical situation would normally imply. Unlike the change in the SPB, the expenditure-based indicator is not affected by such windfalls and therefore points to a larger fiscal expansion. Moreover, the point estimate for potential growth in 2019, used to calculate the change in the SPB, is somewhat higher than the 10-year moving average used for net expenditure growth; this also makes the expenditure-based indicator point to a slightly more expansionary stance.

Overall, the observed fiscal expansion did not follow the EU guidance and was somewhat overdone in the face of the mild economic slowdown. In spring 2018, the Board had signalled that the limited fiscal expansion projected for 2019 was not justified in good times, as this would have been pro-cyclical (Graph 4.4).

([111]) To make full use of the available information for our economic analysis, we use outturn data for the GDP deflator and medium-term potential growth for the expenditure-based indicator. By contrast, when the expenditure benchmark is calculated to assess compliance with the fiscal requirements, these two variables remain frozen at the levels expected in spring 2018.

Graph 4.7: **Change in the structural balance and fiscal requirements, projections vs outturn**



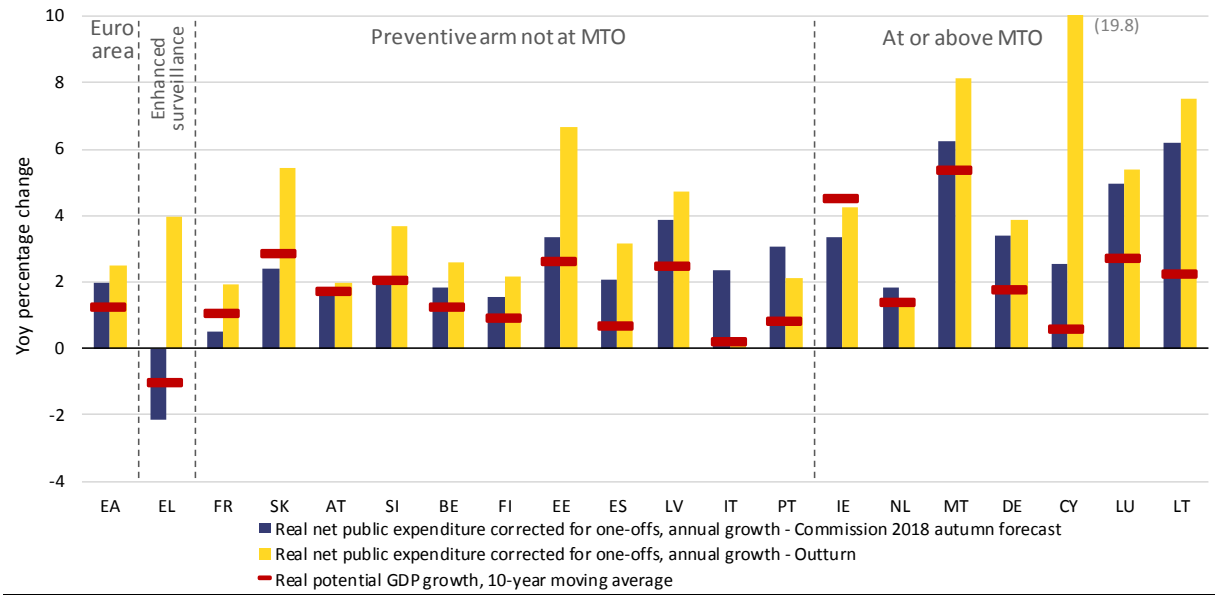
Notes: (1) Green bars indicate compliance with the required change in the structural balance (including with full use of available fiscal space). Orange bars indicate non-compliance. (2) Countries are sorted by status under the SGP in autumn 2018 then by decreasing compliance with requirements. (3) The countries benefiting from clauses are Latvia, Lithuania, Austria and Finland in the autumn 2018 graph, plus Belgium and Italy in the outturn graph. (4) EL was under enhanced surveillance and had a primary surplus target which was not translated into a structural balance target (see Chapter 2).
Source: European Commission, own calculations

Was the country composition appropriate?

In autumn 2018, most euro area countries were expected to have a neutral to expansionary fiscal stance in 2019. A majority of euro area countries were not at their MTO and the SGP required for them some fiscal adjustment (Graph 4.9). This was largely consistent with stabilisation considerations subject to sustainability concerns, especially in a year of positive output gap and for high-debt countries (Graph 4.3a). However, a vast majority of these countries were not expected to comply with the structural adjustment requirements (Graph 4.7, left-hand side); similarly, their net expenditure growth was expected to outpace medium-term potential output growth (Graph 4.8). Most of the countries that had achieved their MTO were also expected to conduct expansionary fiscal policies, by using some of their fiscal space.

Outturn data point to an exacerbated expansionary stance for most countries compared to forecasts. With some exceptions — in Italy, Latvia and Portugal — the structural primary balance in countries that were not at their MTO deteriorated more than projected and their net expenditure grew faster than projected (Graph 4.7, right-hand side, and Graph 4.8). Only a minority of countries delivered the required structural adjustment. In the countries that were above their MTO, the fiscal stance indicators also show a fiscal expansion, in some cases sizeable, with the notable exception of the Netherlands, which undertook some fiscal consolidation.

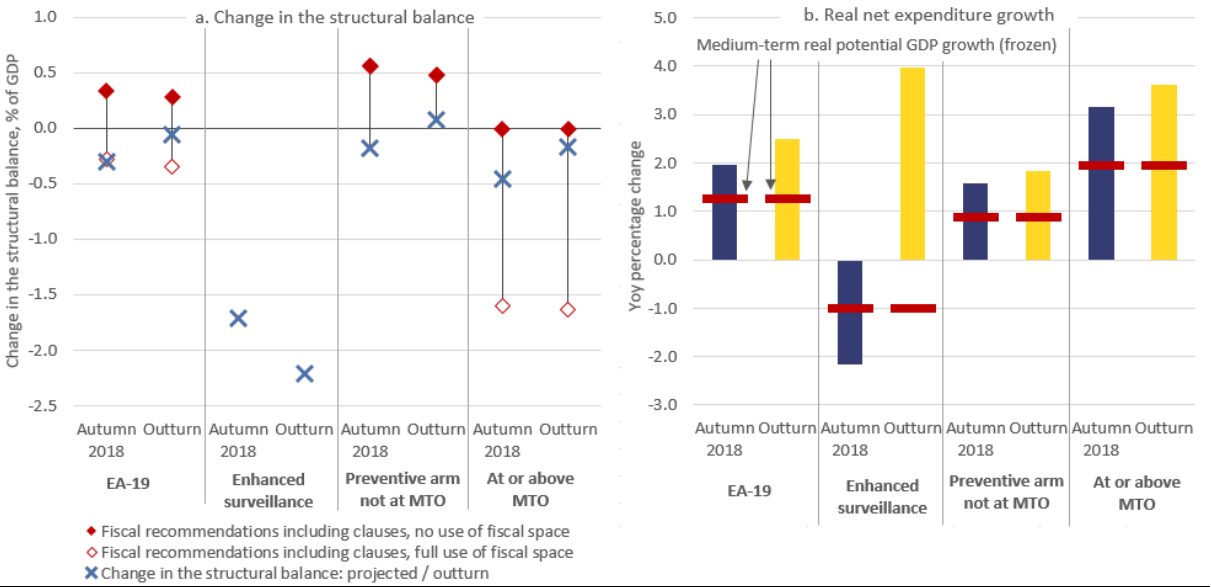
Graph 4.8: **Real net expenditure growth, projections vs. outturn**



Notes: Countries are sorted by status under the SGP and then by increasing difference between net expenditure growth and potential growth based on the Commission 2018 autumn forecast.
Source: European Commission, own calculations

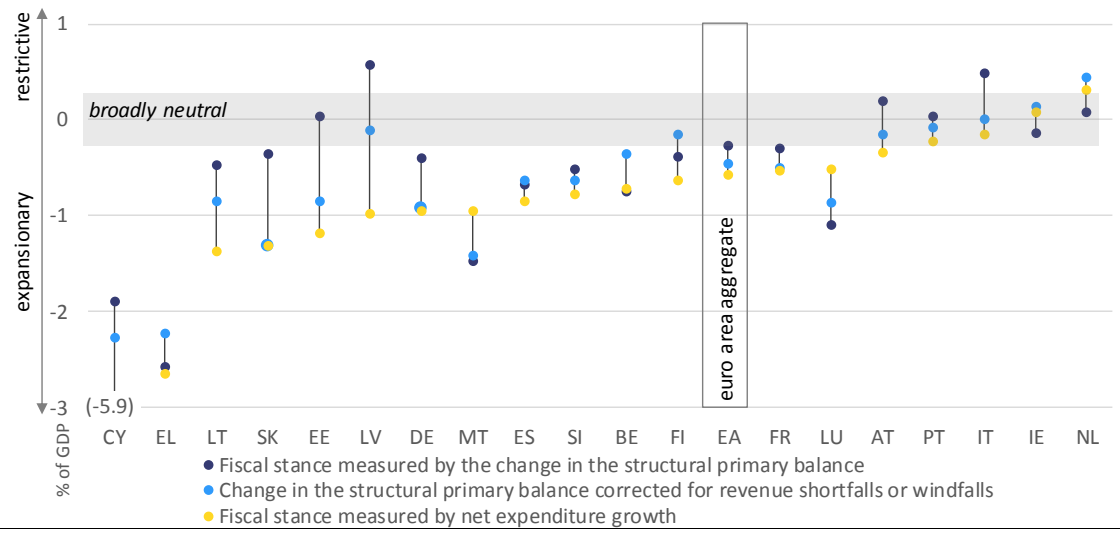
For most countries, the change in the SPB and net expenditure growth provide a consistent reading of the fiscal stance at least in qualitative terms. In most cases, these indicators point in the same direction (Graph 4.10). In many cases, however, net expenditure growth signals a larger expansion and much of the discrepancy is due to revenue windfalls. Germany provides a striking example with a large fiscal expansion estimated at 0.4% of GDP according to the change in the SPB and close to 1% of GDP based on net expenditure, the difference between the two exactly matching revenue windfalls. The indicators point in opposite directions for three countries (Italy, Latvia and Austria), where the expenditure-based indicator suggests an expansionary fiscal stance while the change in the SPB points to consolidation; for these countries too, much of the discrepancy is attributable to revenue windfalls. In the case of

Graph 4.9: **Change in the structural balance and real net expenditure growth in 2019 by group of countries**



Notes: (1) Countries are grouped according to their situation at the beginning of 2019. EL was under enhanced surveillance and had a primary surplus target which was not translated into a structural balance target (see Chapter 2). Countries in the preventive arm not at MTO: BE, EE, ES, FR, IT, LV, AT, PT, SI, SK and FI. At or above MTO: DE, IE, CY, LT, LU, MT and NL. (2) In line with practice for the expenditure benchmark, medium-term potential growth is frozen at its spring 2018 value and real net expenditure growth is corrected for one-offs.
Source: European Commission, own calculations

Graph 4.10: **Indicators of the fiscal stance in 2019, outturn**



Notes: (1) Countries are ranked by increasingly restrictive fiscal stance as measured by net expenditure growth. (2) In this graph, the fiscal stance as measured by net expenditure growth is based on outturn data for the GDP deflator and medium-term potential growth. (3) The differences between the two fiscal stance indicators are due to revenue windfalls or shortfalls, the use of annual or smoothed potential growth estimates, investment smoothing and a small technical residual.
Source: European Commission, own calculations

Italy, the improvement of the SPB by 0.5% of GDP vanishes completely if it is corrected for revenue windfalls, thus coming closer to the slight fiscal expansion of 0.2% of GDP signalled by net expenditure growth. This compares with a fiscal expansion of 1% of GDP initially expected in the Commission 2018 autumn forecast.

Overall, the country composition of the fiscal expansion was not optimal. The largest expansions generally took place in small countries, but three of the four largest euro area members (Germany, France and Spain) also ran fiscal expansions in a range of 0.5% to 1% of GDP irrespective of their fiscal situation; only Germany had the fiscal space available according to the SGP. Although avoiding a sizeable fiscal expansion such as the one initially expected, Italy did not implement the recommended adjustment.

Box 4.2: Output growth and output gap estimates over time: two complementary views

Assessing in real time whether an economy is in favourable or unfavourable cyclical conditions is crucial to make the right policy decisions and is not a straightforward exercise that can rely on a single indicator. This box argues that the analysis requires looking at different elements in conjunction, such as real GDP growth, the output gap and the evolution of forecasts and estimates of these two indicators over time. Moreover, identifying similarities and differences with the run-up to the Great Recession can help shed light on 2019. For both 2008 and 2019, the situation looked average as long as expectations for future growth were bright; but when the recession hit the economy, in hindsight it became clear that these years were good times.

The pace of output growth only makes full sense as a measure of the strength of an economy if it is put into perspective against potential growth. A point estimate of growth in a given year provides only a very partial view and a first step to broaden the picture is to look at the evolution of forecasts over time, as in Graph 4.1 of this chapter. As showed in the EFB's 2019 annual report, outturn data for 2018 gave the impression that growth in that year was disappointing because many observers had in mind the more sanguine projections of spring 2018. Taking a step back, growth simply turned out to match the forecasts made in 2017; the spring 2018 projections reflected a temporary surge of excessive optimism because they extrapolated to 2018 and 2019 the good news coming in about particularly strong growth in 2017. Putting things into a longer perspective, growth in 2018 was actually slightly above the average of the past 25 years, and growth in 2019 was not far below average. A crucial element to gauge growth is therefore to assess it against its trend. This is what underpins the concept of potential growth, which can be understood as the pace at which the economy can grow without feeding inflation or unemployment in the medium term. The output gap, which measures the distance between the level of real GDP and that of potential GDP, thus provides a useful analytical complement to the growth rate.

Potential output and the output gap are not observable, but they are linked to actual output. Potential output is calculated as a kind of moving average of real GDP over a period that goes beyond the current year and includes forecasts. As a result, potential output changes every year and incorporates both revisions to past data and new forecasts. This has clear implications: in particular, when growth forecasts are revised, potential output growth is also revised in the same direction but to a more limited extent; moreover, when output in a given year is revised, it affects potential output estimates for the years around it. Although real-time estimates of the level of the output gap are to be taken with a pinch of salt (as discussed in the box on 'Real-time assessment of the cycle as risk management' in our June 2018 report), the path of revisions of output gap estimates for a given year provides in itself relevant information.

We first look at successive vintages of euro area forecasts for 2006-2009, from the end of the boom to the Great Recession. The data show three different steps (Graph 1). First, in the course of 2006 and 2007, the economic outlook improved compared to initial forecasts, and real GDP growth forecasts for these two years were revised upwards by about 1 percentage point. Output gap estimates for 2006 and 2007 narrowed somewhat but remained in negative territory. This is because until late 2007, the outlook for both growth and potential growth until 2009 was nearly flat: the strong growth observed at the time was then perceived as normal and sustainable. Then, in the course of 2008, growth estimates for 2008 deteriorated markedly. Potential growth was again revised downwards and so was the estimated level of potential output, including for past years, which pushed output gap estimates for 2006 to 2008 to above zero, signalling normal to good times. Finally, in 2009 the situation and the outlook worsened further. This triggered further large negative revisions to potential output estimates for the whole period, both in level and in growth rates, and the output gap in 2006-2008 was re-estimated at high positive levels — that is, past years that initially looked average or below average 'suddenly' turned into boom years. Output gap estimates remained broadly unchanged in subsequent vintages. This is not only the case when using Commission numbers: output gap projections from the IMF's World Economic Outlook show the same pattern. Overall, in 2008, the year when the Great Recession started, growth collapsed in the last quarter but the year as a whole still turned out to be the last of positive growth and positive output gap after a period of boom.

A similar story applies to 2017-2020. First, positive news about 2017 stirred up optimism, and most forecasters believed that growth would remain strong in 2018 and beyond. Then forecasts started being adjusted downwards. At the time, the output gap estimates for 2018 and 2019 were still not particularly bright. Only once the outlook turned sour in 2020 did the recent past look better in relative terms and the output gaps for 2018 and 2019 became significantly positive. Overall, despite differences in magnitude so far, 2019 is bound to look like 2008: a last year of good times. More generally, we miss good times as they occur because we never have the courage or do not have the information to forecast downturns.

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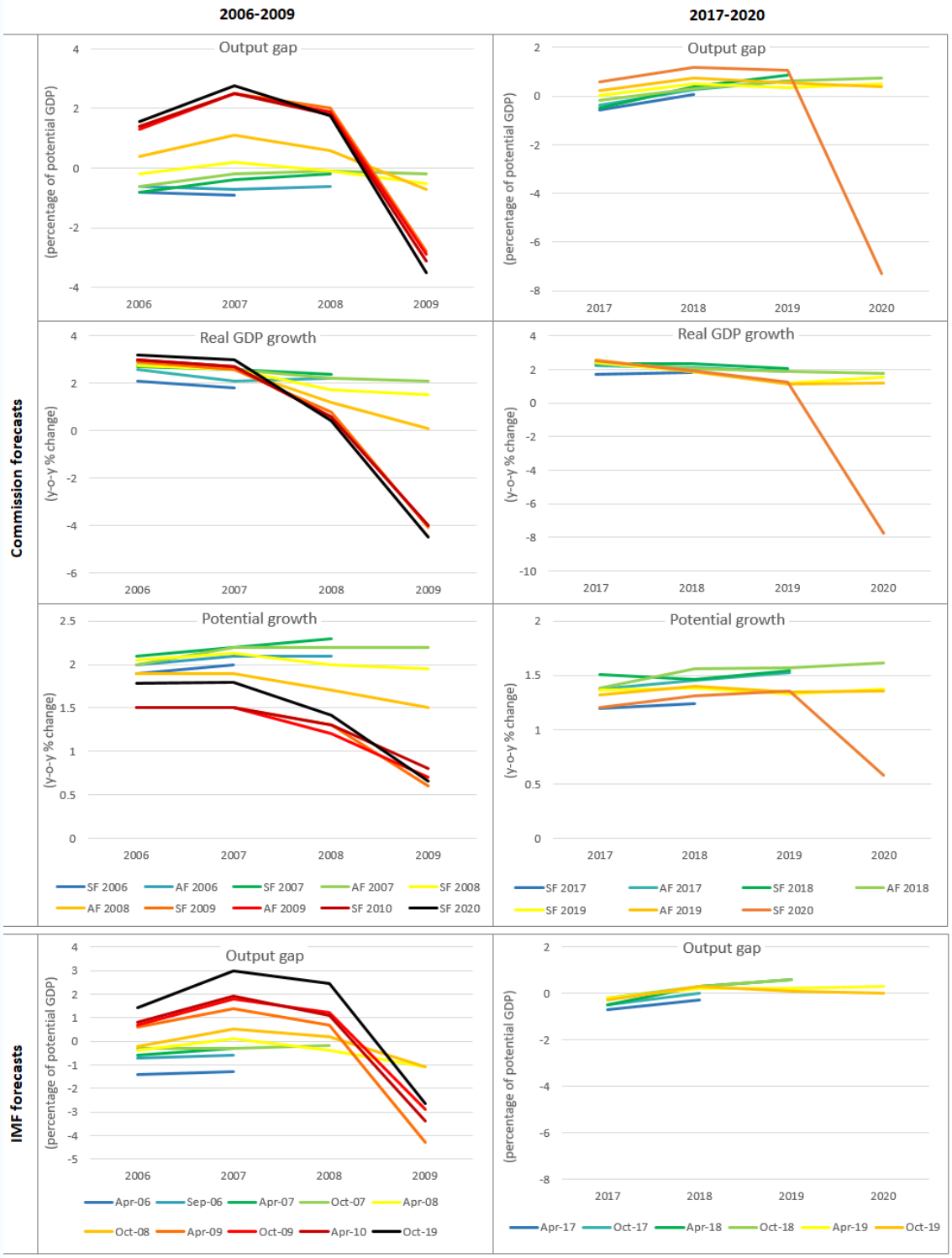
Box (continued)

Graph 1: **Forecast vintages from good times to recession, 2006-2009 and 2017-2020**



Notes: (1) 'SF' stands for 'spring forecast' and 'AF' for 'autumn forecast'. (2) The IMF did not publish output gap estimates in its April 2020 World Economic Outlook.
Source: IMF, European Commission

Box 4.3: Comparison of approaches to measure the fiscal stance

This box presents and compares different ways to measure the fiscal stance, based on a backward-looking analysis of the fiscal stance in the euro area. The focus is on the three most frequently used measures, namely the change in the structural balance, the change in the structural primary balance and net expenditure growth. Our analysis shows that while none of these approaches systematically points to a more expansionary or restrictive fiscal stance than the others, the change in the structural balance (primary or not) has a stronger cyclical pattern than the approach based on net expenditure growth: it tends to overrate changes in the underlying budgetary position across the cycle.

Several methods have been developed to measure the fiscal stance, that is, the extent to which the government's discretionary fiscal policy measures support or dampen aggregate demand. They are generally classified into two groups: bottom-up and top-down.

– The bottom-up group of measures estimates the budgetary impact of very individual policy measures, mostly based on expert judgement, and adds them up on both the revenue side and the expenditure side: the fiscal stance is considered to be expansionary when deficit-increasing measures exceed deficit-reducing measures.

– The top-down group of measures starts from the annual change in the headline budget balance and corrects it for a number of factors that are not considered to reflect discretionary government decisions. The adjustment can take different forms: the cyclically-adjusted balance (CAB) corrects the budget balance for the impact of the economic cycle, the structural balance (SB) corrects the CAB for one-off and other temporary measures, and the structural primary balance (SPB) corrects the SB for interest expenditure. The fiscal stance is considered to be expansionary when the change in the CAB, SB or SPB is negative.

Some measures combine bottom-up with top-down elements. They assume that in the absence of new policy measures, public expenditure should grow in line with potential output. Discretionary expenditure measures are then calculated on aggregate, following a top-down approach, as the difference between actual expenditure growth and potential output growth ([1]). On the revenue side, the bottom-up approach is followed. The discretionary fiscal effort (DFE) ([2]) and the expenditure benchmark (EB) of the Stability and Growth Pact are concrete examples of this mixed approach ([3]). According to this combined approach, the fiscal stance is expansionary if net expenditure – that is, expenditure net of discretionary revenue measures – grows faster than potential output.

Finally, within the category of top-down measures, for some approaches the separation into discretionary and non-discretionary components is done at a disaggregated level, i.e. the level of individual budgetary items. The European System of Central Banks (ESCB) has developed such a 'disaggregated approach' based on a panel regression analysis that measures how the various categories of structural government revenue and expenditure are affected by macroeconomic developments, discretionary fiscal policy measures and a residual that captures country-specific factors ([4]). On that basis, the ESCB estimates more precisely the cyclical component of each revenue and expenditure item and then aggregates the individual cyclical components to calculate the CAB. This approach relies on the national central banks' database of legislative changes, which includes expert judgement on their budgetary impact.

While all these approaches aim to isolate changes in the budget balance that originate in deliberate policy choices, they may provide different numerical signals. This is because they rely on different solutions to the trade-off between requiring detailed information on the amount and duration of each discretionary measure and having recourse to non-observables as a practical solution. While the bottom-up approach is well suited for the revenue side, it is more difficult to apply on the expenditure side because it would require a consensus on what to use as a counterfactual to quantify expenditure measures. Using a top-down approach on the expenditure side is a convenient solution as it simply estimates expenditure measures as deviations from a trend – usually a non-observable trend such as potential output growth. The full top-down approach is the solution that requires the least detailed

([1]) See Part III 'Measuring the fiscal effort' in European Commission (2013).
([2]) Carnot and de Castro (2015).
([3]) The methodological differences between the DFE and the EB are as follows: (i) investment is smoothed over four years in the EB; (ii) the EB nets out government expenditure programmes fully matched by revenues from EU funds; (iii) the EB uses a frozen value for the percentage change in the GDP deflator (the average of the forecasts for year t made by the Commission in spring and autumn of t-1), while the DFE uses the latest available value; and (iv) in its initial version, the EB was not corrected for one-offs.
([4]) See Kremer et al. (2006), and Agnello and Cimadomo (2012).

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Box (continued)

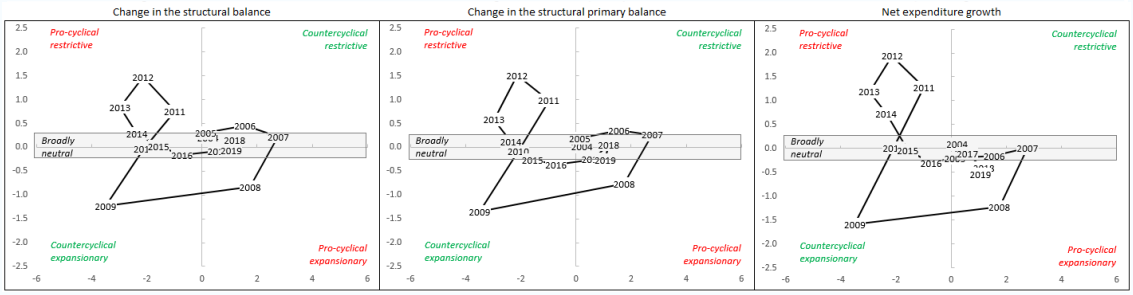
information about individual measures, but relies on the output gap and budgetary elasticities, for which outturns notoriously differ from the estimates available in real time.

Another reason why indicators may lead to different numbers is because they are designed for different uses. From an academic perspective, what matters the most is to distinguish between the part of the change in the headline balance that reflects cyclical fluctuations and the part that is due to policymakers' decisions; using a list of officially announced measures, despite known caveats on their accuracy, can be a good basis because it reflects the government's intentions. Correcting the budget balance for the impact of the economic cycle has also been on the agenda of policy analysists for half a century. However, the SB as specifically defined in the EU, i.e. correcting for the cycle according to a commonly agreed method and correcting also for one-offs and temporary measures, was adopted for a legal use within the highly codified framework of EU fiscal surveillance. Its main purpose is to be the official metric to assess compliance with quantified fiscal requirements, and the final assessment can lead to possible sanctions in case of deviation. As these considerations are not purely analytical, the numbers are carefully scrutinised and may be subject to government pressure. Finally, because it involves non-observables and frequent revisions, the SB is considered to be less intuitive, transparent and practical to policymakers who are interested in how much they can spend. An expenditure-based indicator such as the EB is more relevant in that case, and also more predictable as it explicitly defines a cap on expenditure growth.

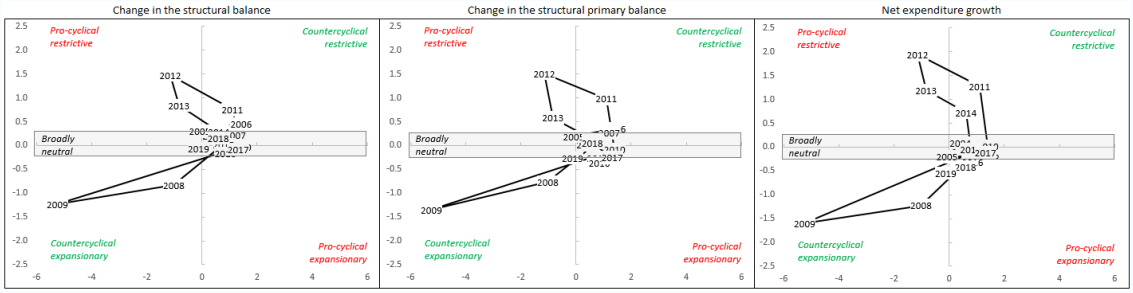
The remainder of this box focuses on the three main indicators currently in use in the EU: the change in the SB, the change in the SPB and net expenditure growth. In line with the definition currently in use for the EB, net expenditure is defined as government expenditure excluding some items (interest expenditure, expenditure on EU programmes fully matched by EU funds revenue, and the cyclical part of unemployment benefit expenditure), it smooths investment expenditure over four years and it is net of discretionary revenue measures and one-offs. Net expenditure growth is assessed against a 10-year moving average of potential growth.

Graph 1: **The fiscal stance in the euro area, 2004-2019**

a. Fiscal stance (% of GDP) vs output gap (% of potential GDP)



b. Fiscal stance (% of GDP) vs change in output gap (% of potential GDP)



Note: The column 'Net expenditure growth' shows medium-term potential growth minus net expenditure growth. To be expressed in terms of percentage of GDP, the difference in growth rates is multiplied by the share of the corrected expenditure aggregate in nominal GDP.
Source: European Commission, European Fiscal Board calculations.

As a first step, we construct the traditional snake graph showing the fiscal stance against cyclical conditions for all three indicators. The graphs go back to 2004, the first year when consistent data on the change in one-offs are available. As can be seen in Graph 1, the general picture is comparable across indicators, in particular as regards the

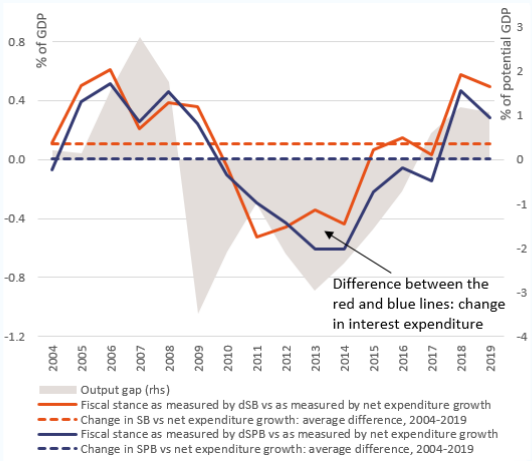
(Continued on the next page)

Box (continued)

periods of clear counter-cyclical fiscal expansion in 2009 and pro-cyclical fiscal consolidation in 2012-2013. More generally, all three indicators point in the same direction for most years, although the magnitude differs somewhat. For instance, 2006 is a borderline case that qualifies as counter-cyclically restrictive according to the change in the S(P)B but only as broadly neutral according to net expenditure growth. Conversely, 2014 is identified as broadly neutral using the change in the S(P)B but pro-cyclically restrictive according to net expenditure growth.

Looking more closely at the behaviour of all three indicators over the cycle, the difference between the fiscal stance as measured by the change in the S(P)B and by net expenditure growth shows a clear cyclical pattern (Graph 2). The average value of all three indicators over time is very similar, suggesting that none of them has a systematic bias towards signalling a more expansionary or restrictive fiscal policy than the others. However, the change in the SB or SPB indicates a more expansionary fiscal stance than net expenditure growth in bad times and a more restrictive stance in good times. Earlier Commission staff analysis comparing the change in the SB and the DFE between 2004 and 2013 found a similar cyclical pattern in the difference between the two indicators and explained it mainly by the existence of revenue windfalls and shortfalls, which are known to affect the S(P)B in a pro-cyclical manner ([5]) ([6]). This suggests that using the change in the S(P)B tends to underestimate the pro-cyclicality of the fiscal stance, which is problematic as it may encourage ill-timed fiscal decisions. Of note, in 2013-2019 interest expenditure steadily declined, and for that period the change in the SPB points to a more expansionary stance than the change in the SB. Compared to the change in the SB, this increases the gap between the change in the SPB and the expenditure-based approach in bad times (2013-2016) but reduces it in good times (2017-2019).

Graph 2: **Difference between the change in the structural (primary) balance and net expenditure growth over the economic cycle**



Note: The red (blue) line shows the difference between the fiscal stance as measured using the change in the structural (primary) balance and the fiscal stance as measured by net expenditure growth. When the line is above the horizontal axis, the change in the structural (primary) balance indicates a more restrictive fiscal stance than net expenditure growth.
Source: European Commission, European Fiscal Board calculations.

To understand the drivers of this cyclical pattern, we break down the difference between the indicators into five factors. All of them reflect methodological differences in the definitions of indicators. First, unlike the SB, net expenditure growth is corrected for interest expenditure; the impact is nearly identical to the difference between the change in the SB and the change in the SPB already shown in Graph 2. Graph 3 describes the impact of the four remaining factors. As discussed above, a known weakness of the S(P)B is that it fails to identify revenue shortfalls or windfalls, i.e. drops or increases in revenue that cannot be explained by the standard reaction of tax revenues to changes in cyclical conditions. This is because the cyclical adjustment is done in a way that assumes that the elasticities of revenue and expenditure to GDP are stable over time. Since revenue shortfalls and windfalls tend to be correlated with the cycle, they explain part of the cyclical pattern (top-left graph) ([7]). Moreover, the fact that the S(P)B uses annual rather than less volatile medium-term estimates of potential growth is also a major source of pro-cyclicality, because annual estimates of potential growth tend to be higher in good times and lower in bad times

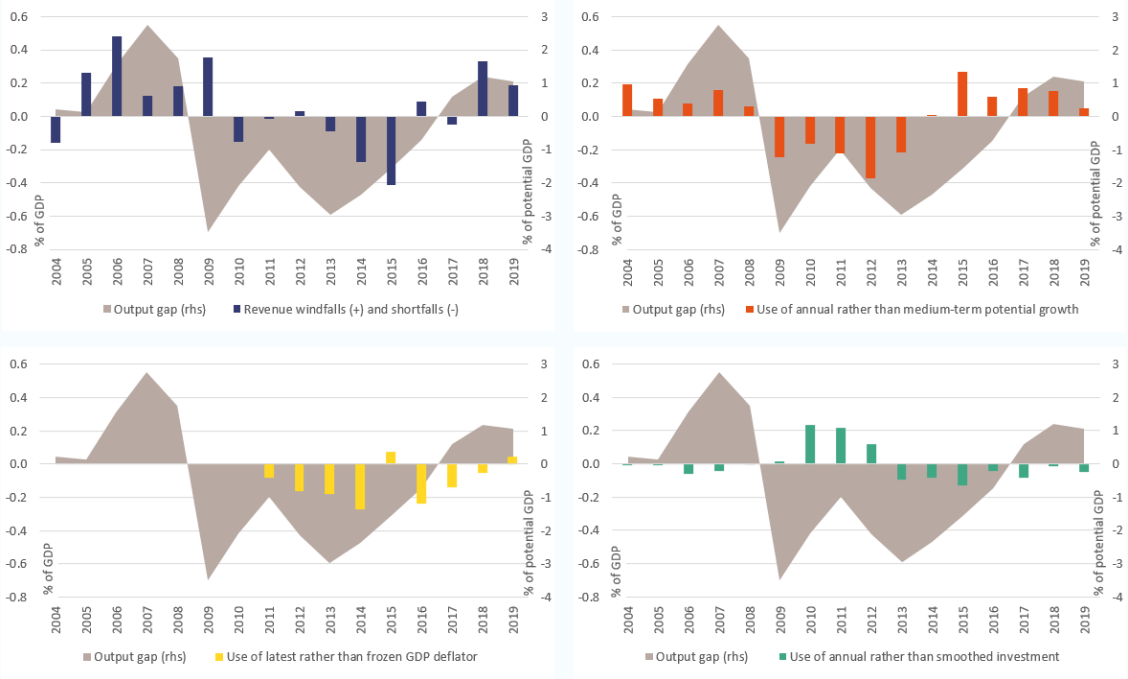
([5]) Carnot and de Castro (2015).
([6]) Morris et al. (2009).
([7]) In addition to changing over the cycle, revenue elasticities may also change over time for other reasons, e.g. they can increase over time if tax compliance improves.

(Continued on the next page)

Box (continued)

(top-right graph) ([8]). Using outturn rather than frozen values of the GDP deflator plays broadly in the same direction for the period after 2011 when inflation repeatedly surprised on the down side (bottom-left graph); however, this is not necessarily an indication that it always increases pro-cyclicality. Finally, investment smoothing plays a more limited role in most years for the euro area aggregate ([9]), and using annual investment data rather tends to dampen the pro-cyclical pattern (bottom-right graph).

Graph 3: **Drivers of the differences between fiscal stance indicators, 2004-2019**



Notes: (1) The graphs show the impact of using the structural balance (SB) approach as opposed to the approach based on net expenditure growth (NEG), broken down into specific factors. Compared to NEG, the SB (i) includes the impact of revenue windfalls and shortfalls, (ii) uses an estimate of potential growth for the year t under consideration rather than a 10-year moving average, (iii) uses the latest estimate of the percentage change of the GDP deflator rather than a frozen value from forecasts made in the year t-1, and (iv) incorporates the annual amount of gross fixed capital formation rather than a value smoothed over four years. Additional smaller factors are not shown on the graphs. (2) Ex post values of the GDP deflator were used to calculate the fiscal stance in terms of NEG prior to 2010, in line with the calculations of the SB; this explains why differences related to the vintage of GDP deflator only appear for 2011 to 2019. (3) Expenditure on EU programmes fully matched by EU funds revenue is assumed to have a flat profile over 2004-2009 due to missing annual data.
Source: European Commission, European Fiscal Board

Overall, this box confirms and extends earlier findings. The SB contributes to pro-cyclical fiscal policymaking: it signals stronger structural improvements in the budget during good times, and stronger deteriorations of the budget during bad times, mainly because it fails to identify revenue windfalls or shortfalls and because it uses annual estimates of potential growth that are correlated with the economic cycle. This suggests that net expenditure growth may generally be a more solid indicator from that perspective. Beyond this general indication, it remains useful to conduct a case-by-case analysis for each year and each country to assess more precisely the specific factors at play and determine which indicator provides the most relevant information in each case.

([8]) The importance of this factor is clearly shown in Part II 'Performance of spending rules at EU and national level – a quantitative assessment' of European Commission (2020b).
([9]) The impact can be much more significant in small countries.

5. FUTURE EVOLUTION OF THE EU FISCAL FRAMEWORK

Highlights

- Prior to the Covid-19 pandemic, the Commission had started a review of European economic governance, which is currently on hold as the EU focuses on responding to the new challenges.

- The crisis has underlined once more the need for further deepening of the Economic and Monetary Union (EMU). One crucial element would be a permanent and genuine central fiscal capacity.

- The central fiscal capacity (CFC) should ideally take the form of a larger EU budget financed by genuine own resources and with the capacity to borrow in the event of large shocks. Its size should be meaningful, and the spending should focus support on EU investment priorities.

- On the path towards the ideal CFC, alternatives can serve as intermediate steps. In addition, two new initiatives, Next Generation EU and SURE, if implemented successfully, can pave the way towards more permanent CFC.

- The European Fiscal Board reiterates the need to simplify the current fiscal framework around three core principles: i) a medium-term debt anchor; ii) a single operational rule that caps the growth rate of net primary expenditures for countries while protecting government investment; and iii) one general escape clause.

- The Covid-19 pandemic has had a dramatic impact on public finances in the EU Member States and beyond. In the coming years, strict compliance with the debt reduction benchmark would give rise to important challenges within the existing rules: in terms of generating burdensome fiscal adjustments and pressures for additional flexibilities under the Pact.

- Once the current general escape clause is deactivated, an explicit differentiation of the adjustment speed towards the debt anchor would provide a better and more credible distribution of fiscal efforts over time.

- Under current practice, differentiated adjustment speeds are de facto achieved with a flexible and not always transparent interpretation of the rules, by giving priority to the adjustment path to the MTO or by adding additional elements of discretion.

- A differentiation could be implemented with greater transparency in the simplified fiscal framework proposed by the European Fiscal Board.

- The modulation of the adjustment speed would be of particular interest for high-debt countries with low potential growth. The required adjustment would be slower than under the current rule, but still faster than observed in the recent past and involve substantial primary surpluses.

- More transparent fiscal rules and realistic adjustment speeds could make it easier for governments to credibly commit to debt targets. Compliance with fiscal rules could be improved by making it a precondition to access a future central fiscal capacity.

- Over the past decade, government investment has been on a declining trend throughout most of Europe, which could to be aggravated after the Covid-19 pandemic.

- The Board's proposals include a mechanism that offers governments the incentive to protect growth-enhancing government expenditure. The assessment of compliance would allow for increases in government investment compared to an appropriate benchmark.

5.1. REFORMING THE EU FISCAL FRAMEWORK: UPDATE OF THE DEBATE

At the beginning of February 2020, when the Commission adopted the Communication on the economic governance review ([112]), a majority of Member States had returned to sound budgetary positions, and with some exceptions (France and Italy), government debt ratios had been put on a firm downward path.

A few months on, the situation and outlook are totally different. The massive shock caused by the Covid-19 health crisis and the valiant attempt to mitigate its social and economic impact have led to an unprecedented increase in government deficits and debt levels in all Member States. For the euro area as a whole debt is expected to jump to above 100% of GDP in 2020, after having declined to 86% in the preceding years. Countries with already elevated debt levels prior to the pandemic who did not manage to take advantage of the last recovery to build buffers are even estimated to see their debt ratios rise by 15-20 percentage points, in some cases to levels above 150% of GDP. The current resurgence of infections in some Member States further fuels uncertainty over the fiscal outlook.

The Covid-19 health crisis has radically changed the perspective on the future of the EU fiscal framework. The public consultation launched by the Commission with the publication of its economic governance review was organised in a context where most if not all observers were critical of the way the EU fiscal rules had been implemented; but few saw a need for radical changes. The process very much looked like moving towards some gradual adjustments, most likely without legislative changes.

The sudden and significant deterioration of public finances in the wake of the Covid-19 pandemic raises more fundamental questions on the adequacy of the EU fiscal framework. The EFB had already noted in previous reports how rules had become unduly complex and ambiguous to the detriment of transparency and predictability; government investment had declined to very low levels; and in some countries the fiscal rules did not succeed in safeguarding the necessary leeway for fiscal stabilisation.

At the end of March 2020, in light of the expected substantial drop in output, the Council endorsed the Commission's assessment that an activation of the general escape clause of the Stability and Growth Pact (SGP) was warranted. The EFB seconded this decision ([113]). The policy debate had rightly shifted towards ways to safeguard the overall economic and financial stability of the Economic and Monetary Union (EMU) in the face of an unprecedented, truly exogenous common shock. Overall, it is clear that the legacy of the Covid-19 pandemic will have important implications for both how we apply the current system of rules and any possible initiative to improve the current system.

Firstly, the crisis has once more painfully exposed the costs of not having a central fiscal capacity, which puts much of the burden onto the shoulders of the ECB. The fiscal response to the crisis at the Member State level has been significant but largely uncoordinated, leaving countries with less fiscal space dangerously exposed and fuelling an already difficult and contentious discussion about the need and scope of risk sharing in EMU.

The EU has responded with a number of significant and bold proposals offering fiscal support, notably the Support to mitigate Unemployment Risks in an Emergency (SURE) and Next Generation EU (NGEU) (see Section 5.2 for more details). However, the implementation lags compared to the dynamics of the crisis, and the bulk of financial resources of the NGEU may be disbursed well into the recovery phase.

Secondly, with the activation of the SGP's general escape clause, the degree of discretion within the rules-based fiscal framework has significantly increased. The moment the escape clause is deactivated, we will be facing the important challenge of reconciling current rules with a completely new, much more difficult landscape of public finances in the EU. It is therefore opportune to relaunch the debate on the economic governance review as soon as possible, ideally at the end of 2020 or early 2021. Regardless of the actual solutions that will be found – be it within the current system of rules or as part of a possible legislative reform – commonly agreed and enforceable rules need to be at the centre of any credible fiscal framework in the EMU.

([112]) COM(2020) 55 final

([113]) https://ec.europa.eu/info/sites/info/files/2020_03_24_statement_of_efb_on_covid_19.pdf

Thirdly, and linked to the second point, addressing the very high post-crisis debt levels is likely to give rise to the usual political economy problem of the composition of the fiscal adjustment where government investment is usually the first and most prominent victim. The NGEU and SURE provide in this context an important respite. One key objective for the coming years must be to avert the mistakes of previous post-crisis periods and to favour ways and arrangements that protect and boost growth-enhancing government expenditures.

5.2. COMPLETING FISCAL GOVERNANCE IN THE EU: A CENTRAL FISCAL CAPACITY

Europe's Economic and Monetary Union (EMU) remains incomplete. A deepening of EMU would be helped by a central fiscal capacity, which could help cushion very large shocks, whether common or country-specific, in a timely manner. With the onset of the Covid-19 crisis, once again, an excessive burden has been put on the shoulders of the European Central Bank and of national governments; the potential for macroeconomic stabilisation through area-wide fiscal policies remains underexploited. The pandemic crisis, has given rise to proposals for new fiscal support instruments at EU level. They have prepared the ground for recovery, potentially forming an embryonic version of a central fiscal capacity. In this section, we (i) review the development of the idea of creating a central fiscal capacity up to today, with an emphasis on its purpose and its advantages and (ii) set out our view on the design and operationalisation of such a capacity.

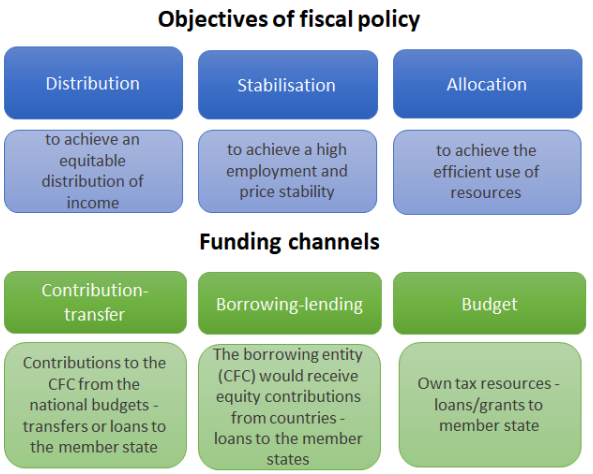
5.2.1. The evolution of the idea to create a central fiscal capacity

The idea of creating a central fiscal capacity is not new; it began to gain some prominence in the wake of the post-2007 economic and financial crisis, which had exposed important gaps in the EMU. Table 5.1 summarises selected proposals put forward by policy makers, international institutions and independent economists.

The proposals can be usefully framed in a space that distinguishes between different fiscal policy objectives on the one hand and funding channels on the other (see Graph 5.1). Objectives of budgetary policy identify allocation, distribution and stabilisation functions. These objectives are not exclusive, suggesting that one spending area (e.g. investment, unemployment, health care etc.) may advance different objectives at the same time.

In principle, a central fiscal capacity can address all objectives and their interactions. The funding channels depend on the type of resources and financing support. A central fiscal capacity can be financed by transfers from the Member States, own tax revenues (direct tax collections from entities within the country) and, in the case of borrowing, by capital contributions or guarantees from countries (e.g. as in the ESM set-up or the SURE instrument). The capacity could be embedded within the EU budget or it could be a separate entity. The financial support provided by the capacity may be provided as transfers or loans to Member States, transfers to individuals or loans and guarantees to private sector firms. Ideally, in a deeper Economic and Monetary Union, the central fiscal capacity would have a sufficiently large budget fully based on own resources and with the capacity to borrow. However, this would be the most challenging option in political terms.

Graph 5.1: **Objectives of fiscal policy and funding channels**



Source: European Fiscal Board

The proposals by policy makers, international institutions and independent economists have usually perceived the central fiscal capacity as an instrument to address common or country-specific shocks that are too large to be offset through the stabilising impact of monetary policy or the automatic stabilisers in national budgets. Most of the studies focus on the stabilisation function and suggest a contribution-transfer scheme. But some have already moved towards the multi-purpose perspective of public finance with a major role for

Table 5.1: **Proposals for central fiscal capacity**

Author/Instrument	Type	Purpose	Size	Trigger	Spending focus
Arnold et al. (2018)	contribution-transfer scheme	macroeconomic stabilization	annual gross contribution 0.35% of GDP (since 1990), in 2007 around 1.5% of GDP; higher/lower contribution rates, experience rating	unemployment rate above its 7-years moving average	no linking of transfers; if earmarking: large-multiplier items (public investment) or cyclical spending (unemployment benefirts)
Bara et al. (2017)	euro are budget	stabilisation (investment)	fix percentage of: VAT receipts (around 15% of VAT - around 1 percentage point of GDP) and corporate tax (around 40% - around 1 percentage point of GDP); account fot at least 2% of euro area GDP	in case of 'severe crisis' when euro area output gap falls below -1.5%	physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training)
Beblavý and Lenaerts (2017)	contribution-transfer scheme	stabilisation (income)	0.1% of GDP per year until 0.5% of EU GDP is accumulated; experience rating/claw-back	short-term unemplyment rate above its 10-years moving average, tresholds; 0.1/0.2 pps.	unemployment
Beetsma et al. (2020, forthcoming)	contribution-transfer scheme (intergovermental)	stabilisation (export-based)	changes in aggregate exports in each sector relative to other sectors; aimed at equalising income shifts as a fraction of exports; transfers add up to zero on an annual basis	changes in the world trade for each specific sector	Earmarked to improve the structural reforms or help in transforming the economy towards activities with a more prosperous future
Bénassy-Quéré et al. (2018)	the EU budget or borrowing-lending scheme	stabilisation	cyclical annual national contributions based on a rolling window; total volume of in the order of 0.1% of GDP	employment-based indicators: changes in the unemployment rate, employment, or the wage bill	relevant spending, such as active or passive policies related to unemployment or public investment
Carnot et al. (2017)	contribution-transfer scheme	macroeconomic stabilisation	average annual contribution of 0.1% of GDP, disbursment power of 0.5% of GDP per year; experience rating; the average size of (non-zero) payment and contributions is between 0.25-0.5% of national GDPs	double condition: y-o-y increase in unemployment rate and unemployment above its 15-years moving average	national governments are free to choose; alternatively: high stabilisaton power (a high multiplier) and/or high productive efficiency, or earmarking to a broader spectrum: unemployment benefit, labour-market and investment programmes
Dullien et al. (2018)	contribution-transfer scheme	stabilisation (income)	0.1 % of GDP up to 1% of country's GDP; experience rating/dynamic claw-back ; 80% into national compartment, 20% in common compartment (a "stormy day fund")	(i) payment from national compartment: unemplyment rate above its 5-years moving average, treshold: 0.2 pps (ii) additional payment from common compartment, treshold: 2 pps	unemployment
Dolls (2019)	contribution-transfer scheme	stabilisation (income)	from -0.1 to 0.1% of GDP per year	double condition: (i) y-o-y increase in unemployment rate and (ii) unemplyment is above its 7-year moving average	unemployment
Furceri and Zdzienicka (2015)	contribution-transfer scheme	stabilisation (income)	gross contribution of 1.5-2.5% of countries' GNP; in case of very severe crisis: gross (net) contribution about 4.5 (1.5)% of countries' GNP	country-specific GDP shocks	not specified
Lenarčič and Korhonen (2018)	contribution-transfer scheme	stabilisation	from 1% to 2.5% of euro area GDP	the "double condition" rule by Carnot et al. (2017)	no linking of transfers; if earmarking: national unemployment insurance systems or investment or the government decision
Zettelmeyer (2016)	euro are budget	stabilisation (investment)	cyclical revenue source: VAT or corporate tax in total about 2% of euro area GDP		(i) public investment (e.g. cross-boarder infrastructure); and (ii) a nominally fixed 'cheque' to national governments to use it in any way wanted
EFB proposals					
EFB (2017)	borrowing-lending scheme	stabilisation and allocation			investment protection
EFB (2018a)	contribution-transfer scheme	stabilisation and allocation	at least cummulative funds of 0.5% if euro area GDP	a combination of automaticity and independent assessment	investment protection in case of a large shock
EFB (2020)	euro area budget	allocation, stabilisation and disribution	geniune own taxes: cumulated assets of 1.5 to 2.5% of euro area/EU GDP	a combination of automaticity and independent assessment	growth-enhancing government expenditure and strategically align investments in key area such as climate, mitigation and digital transformation

Source: European Fiscal Board

an allocation function, by providing for the earmarking of government investments for a more efficient provision of European public goods with funds embedded in the budget (Graph 5.2).

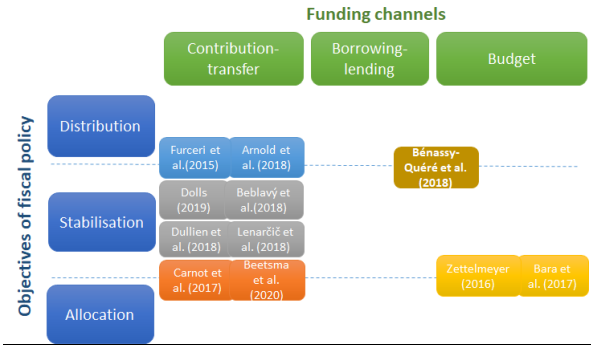
Evidence suggests that a common fiscal instrument has the potential for smoothing common shocks and large country-specific shocks and of raising potential growth. For example, Arnold et al. (2018) estimate that a central fiscal capacity can reduce the impact of a large shock by nearly three fifths when monetary policy is constrained. Bara et al. (2017) show that if an investment budget for the euro area had already existed during the last crisis, it would have permitted a fiscal expansion that would have mitigated recession as well as safeguarded potential growth from hysteresis effects. Despite an initial increase, the debt-to-GDP ratio would by 2018 have been the same as the observed outcome, but with a higher GDP.

Discussions at the EU level have developed in parallel with proposals by national policy makers, international institutions and independent economists. The Five Presidents' Report of 2015 launched the debate by proposing a number of far-reaching reforms including steps towards a fiscal union, aimed at establishing a macroeconomic stabilisation function for the euro area([114]). Its objective should be to 'improve the cushioning of large macroeconomic shocks and thereby make EMU overall more resilient'. 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 further announced the Commission's intention to make concrete proposals for the creation of a dedicated euro area budget line within the EU budget, providing among other things for a stabilisation function. The next step in this direction was included in the

([114]) https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf

Commission's Reflection Paper on the deepening of the EMU in which it suggested 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([115]). The idea of the common instrument was further developed in the Commission's Communication on new budgetary instruments for a stable euro area within the Union framework ([116]).

Graph 5.2: **Overview of analytical proposals with respect to the objectives and funding channels**



Source: European Fiscal Board

In spring 2018, the Commission tabled a first concrete legislative proposal: a European Investment Stabilisation Function (EISF) aimed at stabilising economies in the event of large asymmetric shocks and preventing the risk of negative spillovers ([117]). It was meant to operate under the new multiannual financial framework (2021-2027) with a very small allocation of €30 billion to be used as loans to Member States, coupled with a grant component to subsidise interest costs. The proposal did not obtain the necessary support from the Member States.

A period of lengthy and controversial discussions took place about the necessity and future of a euro area budget. A substantial group of Member States strongly opposed the idea of a stabilisation function. The countries in favour had been questioning whether it should be established within the EU budget or a completely new budget. New proposals ([118]) on the budgetary instrument had served as guidance for further discussion. The latter resulted in the proposal for a Budgetary Instrument for Convergence and Competitiveness (BICC). The BICC was meant to be anchored in the EU budget and to foster structural reforms and investment in order to increase the resilience against economic shocks in the euro area. With its limited size, these fiscal objectives would have been addressed only marginally.

Hence, the EMU entered the Covid-19 crisis without a central fiscal capacity. This crisis is a textbook example of a very large, exogenous and symmetric shock, though with substantial asymmetric effects. In the entrenched and difficult context of an incomplete EMU architecture, the task of safeguarding the overall stability of the single currency area largely fell once more into the lap of the European Central Bank (ECB). As a result, the monetary authority was pushed onto terrain where the demarcation between monetary and fiscal policy becomes increasingly fuzzy. By helping to prevent a deeper recession in the EMU, the ECB becomes de facto the central fiscal capacity. This is due to the fact that, unlike other monetary unions such as the United States and Switzerland, the EMU is not equipped with a sizeable federal budget that could be used to support fiscal stabilisation of the European economy when large shocks occur.

In the absence of such a capacity, Member States adopted unprecedented fiscal support packages. The distribution of fiscal efforts across countries, however, departed from the size of financial support that, under current rules, would have been undertaken for stabilisation purposes, taking into account national sustainability constraints. Furthermore, countries with limited fiscal space and hence constrained in their response to the crisis were also those hardest hit by the pandemic, and called for initiatives at the EU level. For these reasons, the pandemic re-fuelled the debate on policy instruments that could complement the efforts of the ECB, including different versions of a central fiscal capacity.

In response to the Covid-19 crisis, the Commission has (i) alongside other EU institutions, taken some

([115]) https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf
([116]) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017DC0822&from=EN
([117]) https://eur-lex.europa.eu/resource.html?uri=cellar:c9301291-64b1-11e8-ab9c-01aa75ed71a1.0001.03/DOC_1&format=PDF

([118]) On 19 June 2018 President Macron and Chancellor Merkel issued the Meseberg Declaration, in which they proposed to establish a euro area budget to promote competitiveness and convergence while stabilisation would be provided by the ESM or yet unestablished European unemployment stabilisation fund.

immediate support measures (for a detailed explanation see Box 1 in the EFB June report of 2020) and (ii) put forward two new proposals for fiscal support instruments at EU level. First, the Commission proposed the SURE instrument, which can provide financial support to national short-time work schemes and similar measures. SURE was adopted by the Council on 19 May and involves concessional loans of up to €100 billion. Second, the Commission proposed the NGEU ([119]), with the Recovery and Resilience Facility to support investment and reforms in the EU Member States at its core ([120]). Designed as a temporary measure, the Commission proposal amounted to overall financial support of €750 billion in 2021-2024, of which €500 billion to be allocated as grants and guarantees and the rest in loans.

At the European Council meeting of 17-21 July, Member States agreed to the overall size of the package proposed by the Commission, although with some noteworthy amendments were adopted. First, the grants and guarantee component was scaled down to €390 billion. Second, the allocation key of the grant components of the RRF was changed for the funds to be committed in 2023 ([121]). The 2015-2019 unemployment criterion was replaced by the loss in real GDP observed in 2020 and cumulatively over 2020-2021. Last, while the overall amount of funding was increased for the RRF, other instruments of the NGEU package were a reduced or removed. The reduction, in terms of grants, was especially pronounced for the Just Transition Fund, the European Agricultural Fund for Rural Development and Horizon Europe. In terms of guarantees, the amount decreased substantially for the InvestEU instrument while other proposed programmes were abolished ([122]). The European Council also agreed to an involvement of the EFC when assessing the release of funds and also allowed the possibility of bringing implementation issues to the attention of the European Council.

The NGEU has features of a genuine central fiscal capacity. Firstly, it enables the EU to borrow a meaningful amount on the financial markets at the central level. The NGEU is based on an exceptional and temporary increase of the own resources ceiling of 0.6% of EU gross national income (GNI), with each Member State's contribution determined pro rata. In line with the provisions of the Treaty, the NGEU will not entail a mutualisation of debt. Each Member State remains ultimately liable for transferring the amounts due by virtue of the application of the own resource decision.

The grants and guarantee component under the NGEU represent close to 0.7% of GDP per year. The EU's high credit rating secures low interest rates. Secondly, the proposed allocation key includes elements that partly reflect the impact of the Covid-19 crisis in the Member States.

From Graph 5.3 we can observe that the very modest political proposals prior to the Covid-19 pandemic aimed more at its distribution and stabilisation function: i.e. to support structural reforms in the weaker EU Member States in order to make them more resilient to shocks. In addition, the mechanism of support was through borrowing and lending on to those in need of support. These proposals only partly overlap with the pre-pandemic proposals mentioned above both in their objectives, stabilisation and allocation, and the way funds should be channelled. With the onset of the crisis, the proposals put increasing emphasis on allocation in addition to stabilisation and distribution, with a greater role for budget financing.

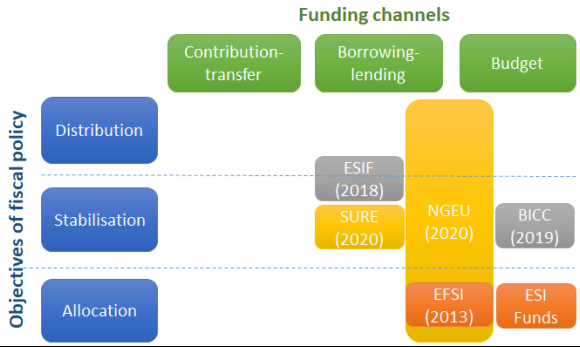
([119]) https://ec.europa.eu/info/sites/info/files/about_the_european_commission/eu_budget/com_2020_441_en_act_part1_v13.pdf

([120]) The Recovery and Resilience Facility builds on the earlier proposal for a much smaller Budgetary Instrument for Convergence and Competitiveness.

([121]) According to the Commission's original proposal RRF allocation criteria are: (i) the 2019 population, (ii) the inverse of 2019 GDP per capita and (iii) the 2015-2019 average unemployment rate, all relative to the EU-27 value. This allocation mechanism was confirmed by the European Council for 70% of RRF grants that will be committed in 2021-2022 and has introduced a change for the remaining 30% that will be committed in 2023 by replacing the average unemployment rate with the loss of real GDP.

([122]) Overall, the European Council decided to lower the amount of grants by €48.8 billion and guarantees by €61.2 billion in comparison with the Commission's original proposal.

Graph 5.3: **Overview of the Commission proposals with respect to objectives and funding channels**



Source: European Fiscal Board

SURE and the NGEU point in the right direction, but they are both meant to be temporary ([123]). SURE would end in 2022, with the possibility of extending it once by six months, and the NGEU in 2024. Nevertheless, the EFB hopes both instruments will prove to be stepping stones towards a permanent and genuine central fiscal capacity. Experience gained through the two instruments, if successful, would provide a blueprint for a central fiscal capacity that Member States are already familiar with and whose impact has been tested.

An effective and productive dialogue between the Commission and the Member States over the past few months has resulted in ratification of the SURE guarantee agreement by all EU Member States. By the end of August, the Commission presented proposals to the Council for decisions to grant financial support of €87.4 billion to 16 Member States. On 25 September 2020, the Council approved these proposals. The financial support will be provided to Member States to address sudden increases in public expenditure to preserve employment due to Covid-19.

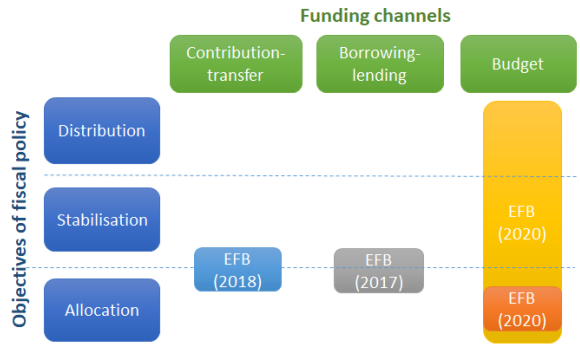
In little more than 10 years, the EU has been hit by three extreme crises, dangerously testing the limits of the current architecture. As in the previous two cases – the global financial crisis and the European sovereign debt crisis – the pandemic crisis has triggered a lively debate about the necessary common fiscal response by presenting ideas for instruments tailored to address primarily the current urgency. We present here the EFB perspective on a future genuine and permanent fiscal capacity, which we see as needed, in combination with other still outstanding elements, to achieve a deeper EMU.

([123]) Both instruments have their legal basis in Article 122 TFEU, which is suited for an ad hoc temporary emergency instrument, as the financial assistance is linked to a situation '*where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control*'.

5.2.2. A proposal for a central fiscal capacity

Building on earlier EFB proposals for a central fiscal capacity, we outline some specific dimensions of a permanent and genuine central fiscal capacity (see Graph 5.4). In our view, Europe needs a larger EU budget. While abiding by the principle of subsidiarity, a larger EU budget would help stabilise the euro area and the EU, foster economic convergence and efficiently supply EU public goods. To address all three policy objectives effectively a central fiscal capacity should entail the following characteristics: (1) it would be permanent, (2) ideally, the EU budget would be financed by genuine own tax resources and have the capacity to borrow to face large shocks, (3) its size should be meaningful, (4) the spending focus would support the EU investment priorities and (5) the criteria for disbursement should be governed by clear rules, based on indicators of economic activity combined with independent assessment.

Graph 5.4: **EFB proposals**



Source: European Fiscal Board

As our review of the recent history of EU debates on more timid and hesitant steps towards a CFC than those currently undertaken shows, one important source of disagreement between Member States has been whether any such steps should be taken with all EU countries as potential beneficiaries, or confined to those that have adopted the euro, i.e. in a special EMU-budget. With the integration of SURE and the NGEU in the next MFF, this issue has, in our view, rightly been resolved in the former way; widening the purposes beyond stabilisation has helped to achieve this. Strictly speaking, the new initiatives now belong under the heading of improved governance

of the entire EU; they are not 'just' a deepening of the EMU, though they should assist in that process as well.

Beyond the current pandemic crisis, steps toward creating a permanent fiscal capacity would obviate the need for ad hoc interventions during future crises while complementing the EMU architecture. The ECB recently made a similar point in its September 2020 Economic Bulletin ([124]). The main stepping stone towards a larger EU budget would be to transform temporary instruments into permanent ones. It would make sense to keep the instrument now being created 'alive', so that they could be activated based on a well-defined clause, in a timely manner in the event of a future crisis.

Another step in the direction of creating a genuine and permanent fiscal capacity with allocation as its major objective could include establishing a dedicated fund separate or as a part of the EU budget. The fund would provide constant support for growth-enhancing government expenditure irrespective of cyclical conditions. Each member's fixed contribution ([125]) to the fund would be spent in the same Member State, so that the fund remains neutral in terms of its intertemporal budgetary impact, hence minimising the political controversy that inevitably surrounds net national contributions. Furthermore, the dedicated expenditure would receive favourable treatment in the assessment of fiscal compliance. Two potential options for achieving this are: (i) building on existing flexibilities to provide fiscal leeway to Member States under the current Stability and Growth Pact and (ii) reforming the Stability and Growth Pact in such a way that contributions to this fund ([126]) are explicitly excluded from fiscal compliance metrics (for detailed explanation see the EFB June 2020 report).

The ideal central fiscal capacity would be embedded within the EU budget. There are different ways to finance such a capacity. Member States could contribute a share of their gross national product or empower the EU to collect designated revenues (such as those mentioned in the context of the Commission proposal of the NGEU) ([127]). Over time, own revenues would come to dominate, which would also increase transparency and reduce uncertainty related to the EU budgetary negotiations every seven years.

The most efficient set-up endows the central fiscal capacity with the ability to borrow a meaningful amount on the markets to fund disbursements in the event of large shocks. The ability to borrow would secure that the central fiscal capacity could provide further financial transfers when its own assets become exhausted. Issuing debt would also be necessary should a large common shock occur before sufficient resources have been accumulated in the capacity. This also helps to ensure that the euro area aggregate fiscal stance is adequately countercyclical. European debt issuance would also provide an additional safe asset to the financial market.

The newly created facility should address large shocks only, when automatic fiscal stabilisers at the national level and standard monetary policy reach their limits. As discussed earlier, over the last 10 years, Europe has experienced three very large shocks, namely the global financial crisis, the sovereign debt crisis and the pandemic crisis. Recent experience has unequivocally shown the risks associated with large area-wide shocks. While the shocks may have a common source and a broadly similar impact throughout the EU, asymmetries between challenges facing Member States may soon appear. During the current pandemic crisis, some countries have been hit harder and the lockdown has lasted longer, leading to higher current public expenditures as a fraction of GDP. Moreover, if a country is already fiscally constrained, financing current expenditures leaves little or no room to address more growth-enhancing spending. Immediate disbursement from the fund to the Member State in need would prevent pro-cyclical tightening and protect potential growth, while at the same time producing positive cross-country spillover effects.

The size of the central fiscal capacity needs to be meaningful in order to address all fiscal policy objectives. If funds are collected through annual contributions, a central instrument would, to become effective for stabilisation purposes require about 0.2% of the euro area/EU GDP, assuming that a major shock hits once every one or two decades. Following Zettelmeyer (2016), Carnot et al. (2017) and Bara et al. (2017) and taking into

([124]) See ECB (2020).
([125]) Minimum contributions could be set at a fixed share of GDP.
([126]) Annual contributions (fixed at a percentage of GDP frozen over the investment period/multiannual financial framework) would be deducted from deficits and the required fiscal effort.
([127]) The Commission also announced future proposals for new own resources such as the carbon border adjustment mechanism, a tax on non-recycled plastics, a common corporate tax or a digital tax, or a revenue share of an expanded EU emissions trading scheme.

account current Commission estimates of EU investment needs, we suggest that a genuine and permanent fiscal capacity with cumulated assets of 1.5 to 2.5% of euro area/EU GDP would be required to supplement national countercyclical policies while also supporting a minimal allocation as well as distribution objectives and to stabilisation.

The funds raised jointly would be made available to Member States through the EU budget in the forms of grants and loans. The financing mix eases the constraints on fiscal space at the national level, while leaving wider scope for EU influence on how the funds are spent. They should only be used to provide temporary financial support against shock, even in the case of a shock with permanent effects. Thus, a central fiscal capacity is meant to be a risk-sharing instrument to face a crisis and not an instrument to provide continuing support to countries with little fiscal space. Therefore, the instrument will have to be designed to avoid permanent one-way transfers among Member States, which would undermine the scheme's political viability. Transfers should primarily address structural spending, mostly in areas where national government investment would bring value added for the whole EU.

There is little doubt, from the perspective of the EFB, that a joint instrument to support government investment in the euro area would be desirable. Throughout most of Europe, government investment has been on a declining trend for about one decade. In fact, the EU as a whole has seen virtually no net investment for years, with some countries experiencing a shrinking capital stock. The economic and fiscal repercussions of the Covid-19 lockdown threatens to worsen the investment outlook further. At the same time, the Commission estimates a public and private investment gap of at least €1.5 trillion for the coming two years. Moreover, making good on the Green Deal and succeeding in making digitalisation of the European economy a reality will require vast and continued investment over the next decades. Many of these investments have a clear European dimension and will entail significant cross-border spillovers. A central fiscal capacity could respond to these challenges, serving a double purpose of strengthening the underlying growth potential and stabilising the economies in response to a major shock. Achieving this double benefit will require that the targeted investments can be activated without long time lags after the shock has hit.

In case of continuous disbursement of investment funds, the central fiscal capacity would effectively provide a stable flow of investments throughout the cycle. It would exert a stabilisation function while channelling funds to support growth-enhancing government expenditure in line with the main European investment priorities. As the central fiscal capacity would be managed at EU level, it would indeed be well placed to provide the needed impetus to revitalise growth-enhancing government expenditure and strategically align investments in key areas such as climate, mitigation and digital transformation. The central fiscal capacity would be an effective tool to foster in particular, transnational investment projects, especially in the area of physical infrastructure such as cross-border energy or transport.

The mechanism to disburse the funds would be based on a combination of automaticity and independent assessment. Automaticity may be simple but might not be effective. There are essentially two ways to design a trigger: automatically by relying on predefined statistical benchmarks, or by using economic judgement. In the ongoing debate, automaticity is often preferred, in order to avoid partisan interference and assure a timely deployment of funds. However, automaticity comes with a serious downside: it does not take into account the type of the shock. A dedicated analysis is crucial to avoid both moral hazard and the ineffective use of resources. Therefore, independent assessment and advice should be applied at the central level in relation to a central stabilisation function or more generally to a central fiscal capacity. This could be carried out by an independent assessor at the EU level. The ultimate decision must be taken at the political level; but independent assessment and advice would improve the quality and transparency of the decisions taken.

Activation of the central fiscal capacity would be targeted. In order to ensure that the funds jointly raised are responsibly used for eligible expenditure, earmarking funds for given investment objectives or sectors should apply. At the same time, support spending from the central fiscal capacity for public investment should not substitute existing national investment spending. Furthermore, both *ex-ante* and *ex-post* monitoring should be enshrined in the respective legislation and carried out by the national fiscal institutions as well as the

Commission. One caveat to this solution may arise for the central fiscal capacity to fulfil its stabilisation mandate if eligible investment project cannot be developed in time to provide the needed stimulus.

Full access to the central fiscal capacity should be conditional on compliance with the SGP. Compliance with the latter would in turn be improved by the existence of a central fiscal capacity to smooth government expenditure and alleviate budgetary pressures during a downturn when the risk of non-compliance is most acute. Thus, making access to the central fiscal capacity conditional upon compliance with the EU fiscal rules should be viewed as an effective positive incentive for some national governments to improve fiscal policymaking.

5.3. RETHINKING THE EU FISCAL RULES

Before the Covid-19 pandemic wreaked havoc on public finances in the EU Member States, the EU fiscal rules were considered to be only partially effective. The Commission's economic governance review of 5 February 2020 had launched a debate on how to improve the SGP. With the aggregate euro area and EU deficit now expected to surge from just 0.6% of GDP in 2019 to around 8½% in 2020 and debt ratios at historic highs, the Commission's review and consultation have been catapulted into a completely new context with far-reaching implications.

The activation of the SGP's general escape clause was fully justified by the exceptional circumstances of the crisis. However, once exceptional circumstances are behind us (see the EFB's 2020 assessment of the fiscal stance report), the SGP will most likely have to be adapted in terms of implementation or legislation or both to reflect new circumstances. However, it must remain one of the pillars of economic policy making at EU level.

In its current form and in practice, the SGP create more general pressure points when implemented in the post Covid-19 context. Compliance with the debt reduction benchmark, as made operational with the 2011 reform of the Pact, is especially going to become a growing challenge for a sizeable group of countries, creating stronger tensions within the current system of rules. Deviations from the debt benchmark and a *de facto* differentiation of the speed of debt reduction are already being implemented under the current rules by way of new interpretations and by extending elements of discretion and judgement. Unless current rules are given an even wider interpretation, to the detriment of transparency and disregarding drastic solutions to reduce very high debt levels in some Member States through debt restructuring ([128]), a one-size-fits-all prescription for debt reduction may no longer be tenable.

Building on the EFB's original proposal for a reform of the EU fiscal rules ([129]), the next section will introduce country-specific elements in a otherwise simplified fiscal framework. While getting rid of the over-specification that characterises the current fiscal architecture – due to the co-existence of competing objectives and multiple metrics – the proposal would ensure a more credible and hopefully also a more transparent decision on the appropriate adjustment towards the debt target, taking into account country-specific conditions.

A simplified Stability and Growth Pact should also – despite the complications of the rules implied – include a mechanism encouraging governments to protect government investment without jeopardising debt sustainability ([130]).

5.3.1. Differentiation of debt targets

Back in 2018, the EFB proposed a simplification of the EU fiscal framework, which is even more relevant in the aftermath of the Covid-19 crisis.

The proposal was built around three key elements: (i) a single fiscal anchor (i.e. a debt ratio objective and a declining path towards it); (ii) a single operational rule (i.e. a ceiling on the growth rate of net primary expenditures for countries with debt in excess of the objective); and (iii) one general escape

([128]) Pâris and Wyplosz (2014) have outlined a proposal for a politically acceptable debt restructuring in the Eurozone (PADRE). It envisages that a share of existing public debt of each Member State be acquired by an agency (e.g. the ECB) and swapped into zero-interest perpetuities. Over the indefinite future, the agency's losses pass on to governments in proportion to each country's share of the ECB capital. In turn, the proposal amounts to a transfer of the debt burden from current to future generations within each country, without any transfer from one country to another or from current debt holders. A similar proposal for a more acceptable debt restructuring has been presented in Corsetti et al. (2015).

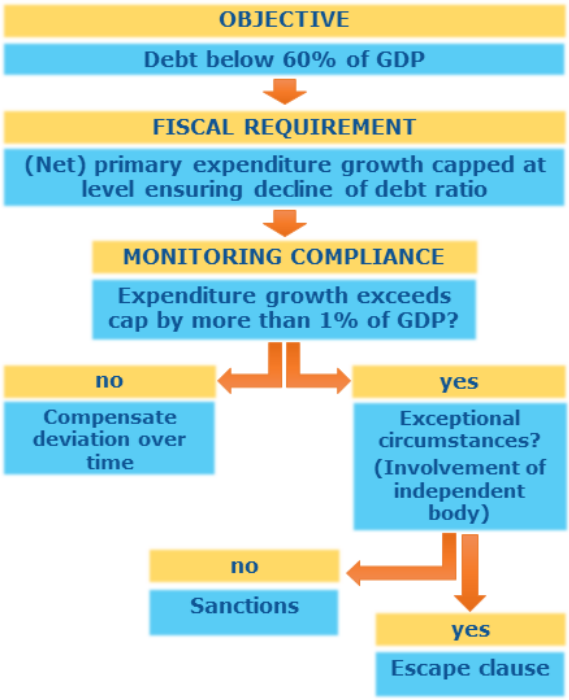
([129]) European Fiscal Board (2018b).

([130]) See European Fiscal Board (2020), pp. 17-32.

clause, triggered on the basis of independent economic analysis (see Graph 5.5) ([131]).

Building on its original proposal, in 2019 the EFB also envisaged the possibility of going beyond uniform reference values or benchmarks within the rules ([132]). The idea was to preserve in a simplified fiscal framework some country-specific elements by differentiating debt targets across countries or the speed of adjustment towards a given reference value, or both.

Graph 5.5: **EFB proposal for a simplification of the EU fiscal framework**



Source: European Fiscal Board

The EFB noted that while the 60% of GDP reference value 'is arbitrary but justifiable […] it risks lapsing into irrelevance', directly for those who are below it and, indirectly, for very high-debt Member States, for which the current debt rule looks unattainable even over a longer time span ([133]). The proliferation of new interpretations and ways to avert procedural steps under the corrective arm of the SGP testifies to this predicament.

Based on the standard debt accumulation equation (i.e. abstracting from possible stock-flow adjustments), the primary balance (pb) required to achieve a targeted level for gross government (d^*) in n years can be written as:

$$pb_t^* = \left(\frac{i_t - y_t}{1 + y_t}\right) d_{t-1} + \frac{1}{n}(d_{t-1} - d^*)$$

where d_{t-1}, i_t and y_t label the debt-to-GDP ratio at the end of year t-1, the average interest rate that governments pay on their debt and the nominal growth rate of the economy, respectively. The term $1/n$ can also be interpreted as the speed of adjustment towards the debt target d^*. It should be noted that in this simplified set-up, $1/n$ and d^* are the only parameters that are under direct control of the governing institutions.

As the formula suggests, both a change in the debt target or in the speed of adjustment can produce a similar impact on fiscal requirements over the medium-term (see Table 5.2).

Table 5.2: **Primary budget balances supporting alternative debt-reduction strategies**

1/n	*i-y*	*d 0*		
		90	120	150
0.05	0.5	1.6	2.9	4.2
	0.0	1.2	2.4	3.6
	-0.5	0.8	1.9	2.9
	d 10	*83*	*108*	*132*
0.03	0.5	1.3	2.2	3.2
	0.0	0.9	1.7	2.6
	-0.5	0.4	1.2	1.9
	d 10	*86*	*112*	*137*
0.02	0.5	1.0	1.7	2.3
	0.0	0.5	1.1	1.6
	-0.5	0.1	0.5	1.0
	d 10	*87*	*115*	*142*

Notes: (1) The table shows the average primary surpluses over the first 10 years of adjustment and the debt ratios at the end of this 10 year period of adjustment (d10). (2) Simulations assume d* = 60% of GDP and y = 0.03. (3) Interest-growth differentials are expressed in base points (i.e. (i-y)*100).
Source: European Fiscal Board

As an example, consider a country with an initial government debt at 150% of GDP, an average interest rate of 2.5%, and a nominal rate of GDP growth of 3%. In order to reduce its debt towards a target of 60% of GDP at an adjustment speed of 0.05, i.e. the 1/20th as per current SGP, the country would need a primary budget surpluses of 2.9% of GDP on average in the first 10 years of adjustment ([134]). As a comparison, the average

([131]) European Fiscal Board (2018b).
([132]) European Fiscal Board (2019a), Section 6.5.
([133]) European Fiscal Board (2019a), Section 6.5, p. 92.

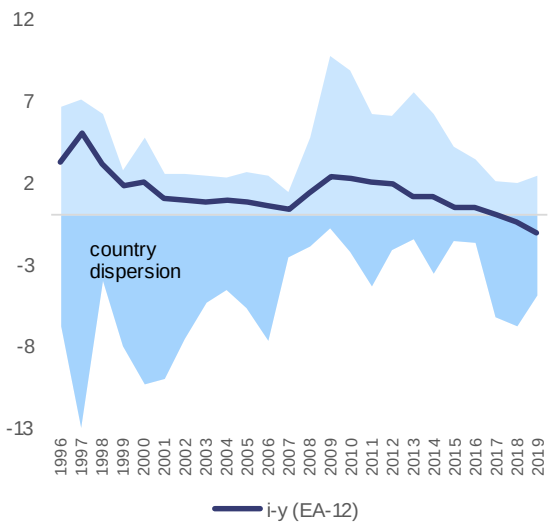
([134]) As for the SGP debt rule, debt ratios are allowed to decline asymptotically to the target level. According to this approach, after 20 years, the debt ratio would still be above 90% of GDP.

primary surplus over 1995-2019 (excluding the crisis years of 2008-2012) was below 1% for both euro area and EU Member States.

If the speed of adjustment were reduced, to say 1/30th per year, the average primary surplus required over the same period would fall significantly to 1.9% of GDP. The same result can be achieved by raising the debt target to 85% of GDP, while keeping the speed of adjustment unchanged to 1/20th.

In addition, the required fiscal targets are very sensitive to variations in the interest-growth differential, i.e. the difference between the average interest rate that governments pay on their debt and the nominal growth rate of the economy ([135]). If the interest rate-growth differential $(i - y)$ is positive, a higher primary fiscal surplus is needed to reduce the debt-to-GDP ratio. While the recent debate fuelled by Olivier Blanchard's 2019 American Economic Association (AEA) Presidential address, has focused on the role of fiscal policy with a negative interest rate-growth differential $(y > i)$ ([136]),long periods of positive interest rate-growth differential were not uncommon in the past (see Graph 5.6) ([137]).

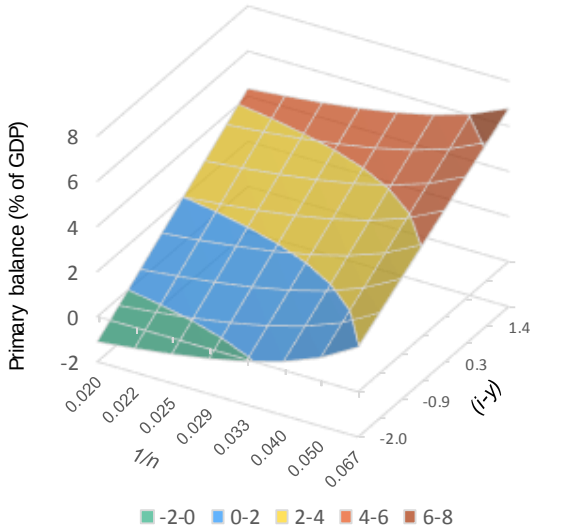
Graph 5.6: **Interest rate-growth differential (Euro area 12)**



Notes: (1) The graph shows the difference between the implicit interest rate paid on government debt (Interest(t)/debt(t-1)*100) and the nominal potential GDP.
Source: European Commission, own calculations

Graph 5.7 shows the average primary balance ratio a country would have to secure over the first 10 years of adjustment in order to reduce an initial debt ratio of 150% of GDP towards the 60% of GDP Treaty reference value under different interest rate-growth differentials (i.e. between 2 and -2 percentage points) and considering different speeds of adjustment (i.e. from $n = 15$ to $n = 50$). A combination of very high initial debt ratios, positive interest-growth differentials and a relatively fast speed of adjustment imply very demanding primary balance ratios, which would be difficult to sustain for extended periods of time ([138]), even in light of what has been observed in the past ([139]).

Graph 5.7: **Primary balance required to reduce a 150% debt-to-GDP to 60% under different interest growth differentials and adjustment speeds**



Notes: (1) Coloured areas correspond to different bands of primary balance ratios, which ensure, on average over the first 10 years, a debt reduction in line with the trajectory path defined by a given interest-growth differential (i-y) and a given adjustment speed (1/n). (2) Simulations assume y = 0.03. (3) Interest-growth differentials are expressed in base points (i.e. (i-y)*100).
Source: European Fiscal Board

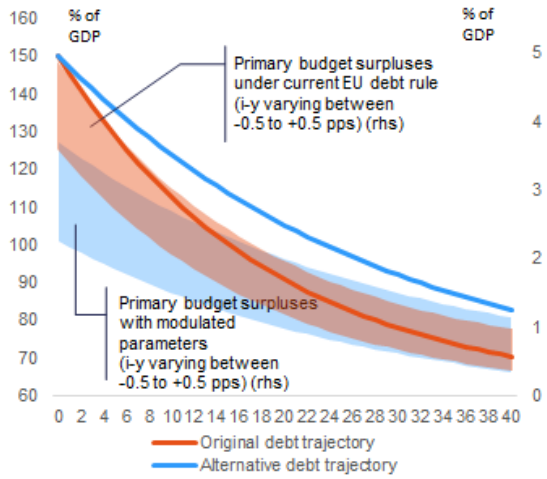
Under the current circumstances, the two parameters selected for (1) where to cast the government debt anchor, and (2) how fast to adjust towards the debt target, need to take centre stage.

Once the current general escape clause is deactivated, considering a modulation of the pace of debt adjustment could provide a better distribution of fiscal efforts across the years.

([135]) Hauptmeier and Kamps (2020).
([136]) 'Public Debt and Low Interest Rates', 2019 AEA Presidential Address by Olivier Blanchard (Atlanta, 5 January 2019).
([137]) ECB Economic Bulletin, Issue 2/2019.
([138]) See, for example, Ghosh et al. (2013).
([139]) Eichengreen and Panizza (2014) used a sample of 54 emerging and advanced economies between 1974 and2013, studying what type of economic and political variables are associated with large and persistent primary surpluses. They found that primary surpluses as large as 4% of GDP that last for at least a decade have been extremely rare.

Graph 5.8 shows the debt trajectories for a country with an initial government debt of 150% of GDP under two alternative debt-reduction strategies, the one embedded in the current EU fiscal framework (i.e. the red line) and an alternative one, entailing a slower speed of adjustment and/or a different debt target (i.e. the blue line). A modulation of the debt-rule parameters smoothens the required primary surplus over the adjustment period, making the fiscal targets more easily attainable under different $i - y$ scenarios (i.e. the light blue band as opposed to the red one).

Graph 5.8: **Smoothing fiscal requirements over the adjustment path under alternative debt rules**



Notes: (1) The red (light blue) band shows, on the right-hand side, the primary budget surplus required under the current (alternative) EU debt-reduction rule assuming different interest rate-growth differentials. (2) The alternative debt-reduction strategy assumes a slower adjustment speed (i.e. 0.03), compared to the original one. A similar trajectory could be achieved considering a higher debt target. (3) Simulations assume y = 0.03.
Source: European Fiscal Board

A differentiation of the debt target, or a differentiation of the adjustment path towards the debt target, can, in principle, be more easily implemented in a simplified EU fiscal framework, like the one outlined by the EFB in 2018 ([140]). However, while a differentiation of the adjustment speed can be introduced in the EU framework by amending secondary legislation, an explicit differentiation of the debt target requires a change of the Treaty or of relevant Protocols of the Treaty as a minimum ([141]). Giving priority to a swift adaptation of the existing fiscal rules, the present section focuses on possible ways to operationalise a differentiation of adjustment speeds in a simplified fiscal framework.

The more far-reaching proposal of a differentiation of the debt target would clearly have an impact also for countries with not-very-high debt levels, depending on the agreed medium-term debt target (i.e. a country with an initial debt-to-GDP ratio of 80% might not necessarily be required to reduce it). However, the proposal would entail a higher degree of legal and institutional complications compared to the one developed in this section ([142]).

In the EFB's original proposal of 2018, the adjustment path towards the single fiscal anchor, i.e. a medium-term debt target, was operationalised and monitored through a single operational rule: a ceiling on the growth rate of primary expenditures, net of discretionary revenue measures. Specifically, the growth rate of the expenditure ceiling would be capped by the trend rate of potential output growth, with a correction calibrated to bring the debt ratio within the range of its long-run objective in a given maximum number of years (e.g. 15 years, as in our original proposal).

The expenditure ceiling was computed to ensure that if net expenditure had grown consistently at this pace, the gross debt-to-GDP ratio would have reached the 60% reference value after 15 years, provided that the economy would have grown at its potential rate and inflation was at 2%. The net expenditure ceiling was recomputed every three years; at the same time, the 15-year horizon to bring the debt ratio to 60% was extended by three years. The target was therefore reached asymptotically, as under the existing SGP debt rule ([143]).

The expenditure ceiling has several advantages. First, it is under the direct control of the government and builds on largely observable variables ([144]). Second, the benchmark is based on the trend growth rate of potential output. Being

([140]) European Fiscal Board (2018b).
([141]) While the reference value for the debt ratio (i.e. 60% of GDP) is set in Protocol No. 12 to the Treaty, the definition of when a debt ratio is 'sufficiently diminishing and approaching the reference value at a satisfactory pace' has been left to secondary legislation (Regulation (EC) 1467/97).
([142]) Similar complications hold for another more innovative proposal presented in our assessment report (EFB, 2019a), which envisaged a fully symmetric adjustment to the country-specific debt target. In this case, once the debt target is achieved, the country commits to keep net primary expenditure growing in line with potential output. For countries with debt ratios below the target, the symmetry is achieved by a commitment to increase net expenditure growth above potential output.
([143]) For more details, see European Fiscal Board (2018b), Box 6.3.
([144]) It is important to recall that debt servicing costs and unemployment benefit payments are excluded from the calculation of expenditure growth, which is also adjusted for the impact of discretionary changes in government revenues (i.e. direct and indirect tax rates).

measures of the longer period, and because by using growth rates systematic mismeasurement in levels is removed, this measure is subject to smaller revisions than, for example, the output gap. Lastly, the net primary expenditure ceiling has a built-in automatic stabilising property. Abstracting from the debt correction factor, when actual output grows more slowly than the trend rate of potential output, net primary expenditure growth will exceed the former, while a rising expenditure-to-GDP ratio will help to stabilise the economy; vice versa, when actual GDP grows faster than the trend, net expenditures will shrink as a share of GDP.

In this respect, the expenditure rule leads also to more countercyclical fiscal stances (e.g. Member States are not required to compensate revenue shortfalls when the economy is below its potential) and should accumulate windfalls when the economy is above potential. In addition, in order to provide a medium-term orientation to fiscal policy and avoid relying on variations of annual data, we proposed to set the expenditure ceiling for a period of three years and recalculate it after that.

There are two basic options for integrating a country-differentiation of debt-reduction strategies into the single operational rule, as outlined in our simplified EU fiscal framework. In the first option, different speeds of adjustment could be set *ex ante*, based on a set of values predetermined according to key macroeconomic variables (as an example, see Table 5.3).

Table 5.3: **Set of adjustment speeds towards the debt anchor**

		initial debt level		
	$1/n$	$60<d_{t-1}<100$	$100<d_{t-1}<150$	$d_{t-1}>150$
interest rate-growth differential	i-y<0	0.06	0.05	0.04
	0<i-y<1	0.05	0.03	0.03
	i-y>1	0.04	0.03	0.02

Note: The table shows possible speed of debt-reduction adjustment (i.e. 1/n) for different initial debt levels (i.e. dt-1) and interest-growth differentials (i.e. i-y).
Source: European Fiscal Board

This fixed set of adjustment speeds aims at ensuring that under unchanged circumstances, countries do not have to face excessively demanding fiscal corrections in the first years of the adjustment (e.g. primary surpluses higher than 3% on average over the first 10 years). This is especially true for countries starting from very high debt levels and/or confronted with positive and large interest rate-growth differentials.

The modulation of the adjustment speed could take into consideration several other dimensions, such as the projected increase in health and pension expenditure due to an ageing population or the costs related to the transition towards a greener economy.

Once the macro-based adjustment speed is set, an expenditure ceiling can be computed from a consistent macroeconomic scenario, including assumptions about real GDP growth, inflation, interest rates, as well as the size of the existing stock of gross government debt ([145]).

In the second option, the differentiation of the adjustment speed – and the definition of the expenditure ceiling – could be set on a case-by-case basis, taking into account a comprehensive independent economic judgement. The assessment would take into account, among other factors, the initial level of debt and its composition (external versus domestic holders), the economic growth and inflation perspectives, the projected costs of ageing and environmental challenges, internal and external imbalances and, primarily, whether the implied fiscal adjustment (e.g. the required primary budget surplus) is realistic. This ultimately entails an assessment of the country's capacity to raise taxes to finance the desired net expenditure growth that is compatible with the required speed of debt reduction.

Each option raises in turn fundamental questions about the governance of the fiscal surveillance framework. Under the first option, the underlying macroeconomic scenario, which includes assumptions about real GDP growth, inflation, interest rates, as well as the size of the existing stock of gross government triggers, mostly automatically, both the speed at which government debt should converge towards the target of 60% of GDP and the ceiling on net expenditure growth. In other words, the focal point is who prepares and decides the assumptions underlying the relevant macroeconomic scenario.

([145]) For more details on the computation of the expenditure ceiling, see Box 6.3 of the EFB 2018 Annual report.

The standard division of labour provided by the EU fiscal framework could still be appropriate in this case. This entails:

1. national governments presenting their medium-term budgetary plans and the underlying macroeconomic scenario;

2. the national IFIs assessing the plausibility of their government's macroeconomic projections;

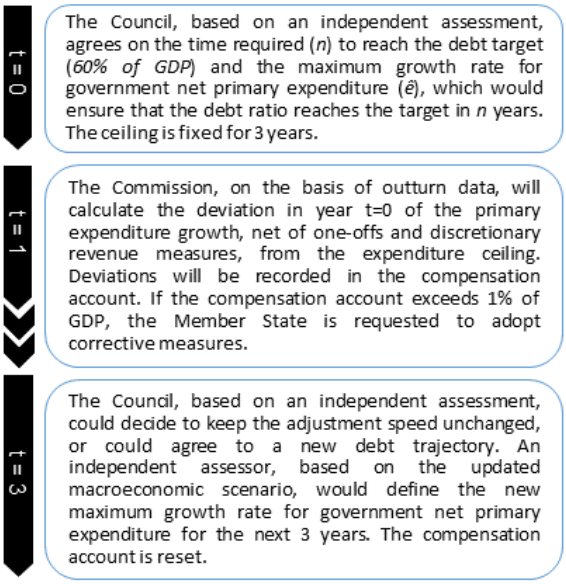
3. the Commission, based on governments' plans as endorsed by the national IFIs, preparing forecasts and proposing fiscal recommendations to the Council; and

4. the Council issuing fiscal recommendations to the countries.

Conversely, under the second option, the crucial point is who exercises the economic judgement and makes the final verdict on the more appropriate debt trajectory. While the ultimate decision remains a prerogative of the Council, the technical analysis preparing the Council's decision (based on an economic judgement) would require a stronger independence of the assessor from political considerations and, possibly, more interaction between the central independent assessor (e.g. the Commission) and the national watchdogs (i.e. the IFIs). Based on such independent economic judgement, the Council decides whether to agree with the proposed speed of adjustment towards the debt target, or to choose a different parameter. In this latter case, the 'comply-or-explain' principle should apply.

Based on the underlying macroeconomic scenario, the same independent assessor would set the maximum growth rate for the government net primary expenditure, which would ensure that the debt ratio reaches the debt target at the agreed horizon. As in our original proposal, the ceiling on net expenditure growth would be fixed for a three-year period. The ceiling is then recalculated in year t+3. Following the new assessment, a new ceiling will be set on the basis of the realised stock of debt and an updated macroeconomic scenario, so as to ensure that the 60% debt-to-GDP ratio is reached again in the same initial years' time or according to the revised target year as agreed by the Council. Graph 5.9 offers a simplified diagrammatical layout on how the reformed EU fiscal framework would work in practice.

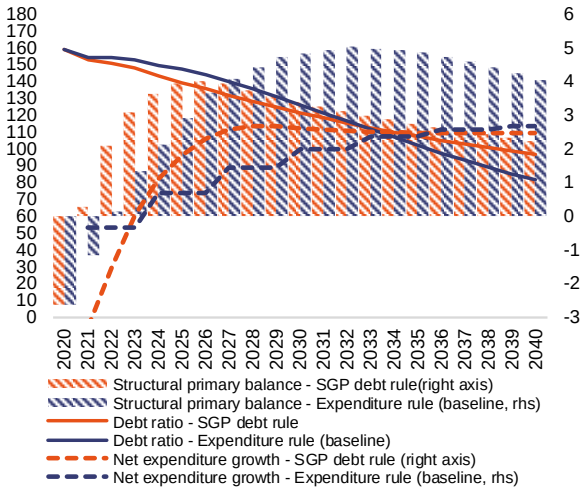
Graph 5.9: **A simplified fiscal framework with differentiated debt-reduction strategies**



Source: European Fiscal Board

Graph 5.10 provides a simulation of how the expenditure rule would operate in one of the EU Member States most affected by the Covid-19 health crisis, namely Italy.

Graph 5.10: **Debt trajectory under the expenditure rule versus the SGP's debt rule, the case of Italy**



Notes: (1) The adjustment path under the baseline expenditure rule is computed assuming that the economy is growing at its potential rate, inflation is at 2% and the debt-to-GDP ratio converges to 60% in 15 years. The adjustment path under the debt rule is computed based on actual projections for GDP and inflation. (2) Implicit interest rates are computed assuming that long-term nominal rates converge to 3.1%, i.e. the observed 10-years average, and interest expenditures increase in line with the expected rollover schedule of debt. (3) Net expenditure growth refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits.
Source: European Fiscal Board

With a debt-to-GDP ratio expected at around 160% in 2020, ensuring a downward trajectory

would be essential for the credibility of the EU fiscal framework and for the country's debt sustainability. The baseline expenditure rule (i.e. the dark blue line) considers a speed of adjustment of 0.07 (i.e. 1/15).

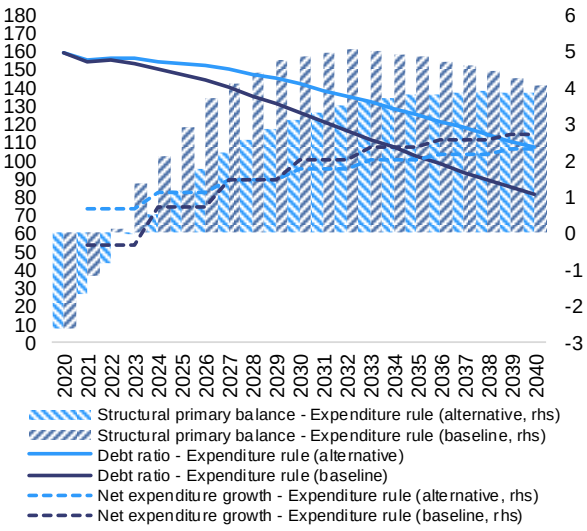
The reduction in the debt ratio implied by this baseline expenditure rule is equivalent to – or even slightly faster than – the one implied by the existing debt rule in the SGP (i.e. the red line). In the short term, however, the expenditure rule is less demanding for Member States facing adverse economic circumstances. Specifically, over 2021-2024 the expenditure rule would require a structural consolidation, which is 1.5 percentage points lower than what is necessary under today's debt rule. This is because the expenditure rule is based on potential growth, while the current debt rule only caters for a limited cyclical correction ([146]).

In turn, the expenditure rule may allow for a short-term debt increase during adverse economic circumstances – as long as this is offset by a faster debt reduction in the subsequent years – while the current debt rule imposes a reduction in the debt ratio already in the short-term.

Nonetheless, the fiscal adjustment implied by the expenditure benchmark rule (baseline) shows a sharp steepening of the required fiscal adjustments as soon as the cyclical conditions improve (i.e. when the estimated output gap closes) ([147]). The debt trajectory under the expenditure rule (i.e. the dark blue line) implies primary surpluses of close to 5% for more than one decade. Graph 5.11 shows that adopting a slower adjustment speed of 0.05 (i.e. 1/20) would provide a smoother debt trajectory (i.e. the light blue line), with required fiscal adjustments that remaining below 4% over the entire adjustment path.

Over the medium-term, the required primary surplus is mainly affected by the assumptions on the interest rate-growth dynamics. In fact, the simulation assumes that starting from 2028, $i - y$ becomes increasingly positive. Under these circumstances, the Council could, on a proposal or assessment of an independent assessor, decide to revise the debt trajectory, for example by adopting a slower speed of adjustment.

Graph 5.11: **A slower pace of adjustment under the expenditure rule, the case of Italy**



Notes: (1) The baseline scenario assumes debt-to-GDP converging to 60% in 15 years; the alternative scenario in 20 years. (2) The adjustment path is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. (3) Implicit interest rates are computed assuming that long-term nominal rates converge to 3.1%, i.e. the observed 10 year average, and interest expenditures increase in line with the expected rollover schedule of debt. (4) Net expenditure growth refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits.
Source: European Fiscal Board

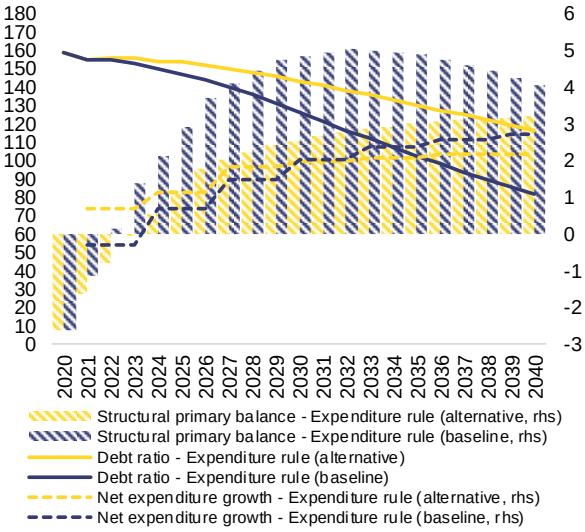
Graph 5.12 shows an alternative debt trajectory (i.e. the yellow line), which, compared to the baseline, starts in 2021 with a speed of adjustment of 0.05 and in 2027, at the second revision, a slower adjustment speed of 0.04 (i.e. 1/25) is adopted.

While the debt ratio remains on a steady downward trajectory, the required primary surplus profile appears more evenly distributed along the adjustment path. In turn, a modulated debt trajectory appears economically more sensible and, at the end, more acceptable.

It should be noted that the simulations above do not consider the possibility that the interest rate declines with the debt ratio, because market confidence in the country's policies improves, which would imply a faster debt reduction, other things remaining equal.

([146]) The debt rule allows only a backward-looking cyclical correction. Furthermore, the rule does not correct for the possibility that inflation may be below target. See European Commission (2018c).
([147]) This lower initial effort is compensated by higher primary surpluses in the medium term, so that the overall debt reduction achieved in 15 years is equivalent to that of the debt rule in the SGP.

Graph 5.12: **Revising adjustment speeds under the expenditure rule, the case of Italy**



Notes: (1) The alternative scenario assumes debt-to-GDP converging to 60% in 20 years and, starting from 2027, in 25 years. (2) The adjustment path is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. (3) Implicit interest rates are computed assuming that long-term nominal rates converge to 3.1%, i.e. the observed 10 year average, and interest expenditures increase in line with the expected rollover schedule of debt. (4) Net expenditure growth refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits.
Source: European Fiscal Board

5.3.2. Protecting and boosting growth-enhancing government expenditure

A simplified Stability and Growth Pact could be designed to help to address another economic challenge the euro area is facing: low government investment.

Gross government investment has been in decline throughout most of Europe ([148]). In fact, euro area government investment shrank from a pre-financial crisis average of 3.2% to 2.8% of GDP in 2019. Nearly all of it constitutes replacement investment, so that net government investment is negligible. Moreover, governments have shown the tendency to cut, in particular, investment expenditure in response to an economic downturn and consolidation pressure, while not using windfalls to increase investment in upturns. The currently low investment rate is bound to affect the long-term growth potential of the euro area and thus have a negative effect on long-term debt sustainability as well.

([148]) Comparing the average government investment rate of 2015-2019 with the pre-crisis average (2005-2009), 20 out of 27 Member States saw their rate decline, for some by as much as 50%.

The current Stability and Growth Pact focuses on short-term, mostly annual, budgetary targets and remains largely silent about the composition of government expenditure. On paper, the current fiscal framework contains provisions, such as the investment clause or elements of discretion, which are meant to encourage government investment. However, the flexibility available via the investment clause has rarely been invoked, primarily due to its restrictive eligibility criteria (negative growth forecast or an output gap below 1.5% of potential GDP). Moreover, deviations from the recommended adjustment mostly originated in current expenditure.

In its previous EFB reports ([149]), the Board has outlined how a reformed Stability and Growth Pact could in fact achieve a double objective: simplify the fiscal rules and introduce a mechanism that would allow governments to increase investment. The simplified fiscal rules rely on a single indicator of fiscal performance, namely a ceiling on the growth rate of net primary expenditures, net of discretionary revenue measures. This growth rate is capped at the trend growth rate of potential GDP and adjusted so that the debt target is reached within a given timeframe.

To encourage governments to invest more, government investment would be taken into account when assessing compliance with the expenditure ceiling. Thus, expenditure growth in excess of the ceiling may still be compatible with the rule if driven by government investment expenditure. To avoid mere investment substitution, the favourable treatment should be limited to 'additional' government investment ([150]).

However, special treatment of government investment under the revised rules poses some conceptual challenges. If higher investment leads to a breach of the expenditure growth ceiling, it will, everything else equal, result in a deviation from the agreed adjustment path of the debt-to-GDP ratio ([151]). Ideally, additional investment should eventually give rise to higher GDP growth and therefore enhance the prospect of a declining

([149]) See European Fiscal Board (2018b), European Fiscal Board (2019a), European Fiscal Board (2019b) and European Fiscal Board (2020)

([150]) This could be determined by the change of the government investment level relative to the backward-looking, country-specific average.

([151]) This may not necessarily be the case if there is a sufficiently large buffer to the ceiling on expenditure growth. It will also depend on the (immediate) return on the investment.

debt ratio. However, a reformed EU fiscal framework would also have to include provisions on how to deal with a less benign scenario, namely one in which the debt ratio continues to increase. Making subsequent adjustment paths more demanding is one option also contemplated in the past. However, it needs to be weighed against the well-established practice that if major difficulties arise, the multilateral system of surveillance tends to find exceptions rather than tighten the rules.

A more far-reaching approach to treat investment preferentially would be to split the government accounts into a capital account that captures government investment and a current account that contains all the other expenditures (see Blanchard et al., 2019) ([152]). This separation of government accounts would enable fiscal rules to apply differently to each account. However, such a profound overhaul requires further detailed deliberations and extensive analysis in the context of the European fiscal framework ([153]).

In any case, all approaches require a clear delineation of eligible expenditure that is assumed to have particular growth-enhancing characteristics. Some government expenditure that does not fall under 'investment' could nonetheless be included if it also raises the growth potential of the economy – for example education expenditure. However, to avoid reclassification and creative accounting, it may be prudent to rely on the already established investment category in the system of national accounts (ESA). Alternatively, the exempted investment expenditures could be more narrowly defined as co-financing commitments of Member States for projects linked to the EU budget.

Modulating the rule system for investment would require a high level of transparency and close monitoring. National independent fiscal institutions should be involved, provided they have the necessary resources and the institutional safeguards. The effect of eligible expenditure on growth over time would have to be carefully monitored. This would apply in particular to countries that have repeatedly breached the ceiling on expenditures due to increased investment and that already exhibit level of high debt, sustainability concerns must be given much attention.

5.3.3. Governance and enforceability of fiscal rules

The ambition of formalising a differentiated speed of debt reduction – coupled with a government investment protection mechanism –, as described in the two previous sections, is twofold: (i) when assessing compliance with the debt rule, make the definition of the adjustment path more transparent compared to the current approach, which is largely based on a continuous re-interpretation of the EU fiscal rules and an extensive use of discretion on a case-by-case basis; (ii) formulate more realistic, country specific, fiscal targets, which are expected to lead to more ownership and better compliance with the rules.

These two objectives are certainly valid and should be pursued. At the same time, they need to be carefully assessed against the lessons learned so far. First, the expected or postulated nexus between more economic rationale and country specific elements on the one hand and ownership and commitment on the other is not a given. Since 2005, all successive reforms of the SGP added economic rationale and country specific elements, but the outcomes in terms of compliance have been mixed. As evidenced in EFB (2019), the SGP continued to work reasonably well for a specific group of countries, but less for other groups. Since 1998, compliance with the different rules of the SGP has exhibited a discernible and unsurprising cyclical pattern – improving in upturns and deteriorating in downturns – but there is no underlying trend towards better compliance overall. As a result, one cannot assume that more realistic and country-specific rules will necessarily or automatically lead to better compliance. Some further considerations about incentives and time consistency are warranted.

Second, the multilateral nature of EU fiscal surveillance has important implications where the Council is involved both as legislator and together with the Commission when implementing the rules on its members, including the decision to impose fines. There are numerous cases where there were no major institutional consequences when the Council decided not to proceed with certain procedural steps provided for in the rules. Although formally possible, no interested party contests the decisions of the Council as regards the

([152]) In their proposal,. the capital account is to be financed by returns on investment and transfers from the current account. These transfers would cover capital depreciation and the gap between the market returns and financial return in order to repay debt over time.

([153]) Such reforms enter into the wider discussion on the use of public sector balance sheets to provide a comprehensive overview of public assets and liabilities (see e.g. IMF 2019).

SGP ([154]). The notable exception was the SGP crisis in 2003 when the Commission referred the Council to the Court of Justice of the European Union after the Council had not adopted the Commission recommendation that would have opened the door to the adoption of measures, including the imposition of fines, for Germany and France and adopted its own conclusions.

Similarly, the reverse qualified majority voting (RQMV) introduced with the six and two-pack reforms was meant to address the political negotiations within the Council by making it more difficult or costly to form coalitions against the adoption of a Commission proposal. However, as argued in EFB (2019) this innovation has not produced the desired effect. Rather, it has put more the pressure on the Commission as the Guardian of the Treaty to anticipate the political concerns within the Council. The cases of Spain and Portugal in 2016 were a clear case in point ([155]).

Therefore, the reform proposal of the EU fiscal framework, as outlined by the EFB in its recent reports, includes innovations that could help to make the EU fiscal rules more effective.

First, on top of fiscal requirements that *a priori* should be more realistic, fiscal rules should rely on operational targets for budgetary aggregates that are under the direct control of the government. The choice of setting a single medium-term debt anchor for all countries to be reached by (i) following one operational rule, and (ii) with a careful differentiation of the adjustment speed or the debt target, represents an improvement compared to the existing rules. The focus of national authorities and the public, in general, would be on a directly controllable, transparent and easy-to-grasp quantitative target, rather than on a multiplicity of competing and intricate requirements.

Second, the incentive for governments to breach fiscal rules is arguably reduced in a fiscal framework that keeps track of past 'errors'. The simplified fiscal framework, as proposed by the EFB, is meant to preserve a better memory of past deviations. Under current rules, deviations from the adjustment towards the MTO are assessed over one year and, more rarely, on average over two years, often with a high degree of discretion. Furthermore, compliance with the preventive arm is used as a 'relevant factor' to mitigate the observed non-compliance with the debt rule, which, so far, has been condoned by putting all past errors behind.

Conversely, under the simplified fiscal framework outlined above, memory is kept by both the compensation account, where deviations from the net expenditure ceiling are recorded and are tracked for all the years between two reviews of the expenditure ceiling ([156]), and at regular intervals (e.g. 3 years) at the time of reviewing the adjustment path. In particular, past deviations from the expenditure ceiling translate into a higher debt level and therefore into a more demanding fiscal adjustment in the subsequent years before the new review. Naturally, the effectiveness of this innovation stands and falls with the determination to overcome the issue of 'time inconsistency' observed in the past, namely the tendency in the Council to soften the implementation of the rules should unpopular decisions have to be taken.

Lastly, enforcing fiscal rules also requires a transparent and credible system of disincentive for non-compliance. However, recent experience has shown that tighter monitoring and the prospect of sanctions do not necessarily improve compliance. Furthermore, in the present crisis context, following the unprecedented economic shock resulting from the Covid-19 pandemic, financial sanctions would be very difficult to justify let alone enforce. For that reason, already in 2018 the EFB proposed to substitute financial sanctions in the SGP with an incentive to maintain or obtain access to joint facilities. This can be achieved by strengthening – and extending beyond the European Structural and Investment (ESI) Funds – the macroeconomic conditionality in the EU budget, which links disbursements to compliance with EU fiscal rules. Similarly, compliance can be improved by making the access to a future central

([154]) This is provided for by Articles 263 and 265 of the TFEU. Ifa European institution (e.g. the European Parliament, the European Council, the Council, the Commission or the European Central Bank) adopts an act that infringes the Treaties or any rule of law relating to their application or fails to act, a Member State and the other institutions of the Union can bring an action before the Court of Justice of the European Union to review the legality of the adopted act or to have the infringement established in case of failure to act.

([155]) The introduction of the RQMV might also have contributed to the politicisation of the Commission and the bilateralisation of fiscal surveillance at the expense of multilateral peer review.

([156]) In line with the original EFB proposal of 2018, when net expenditure is above the ceiling in a given year, the difference will be credited into the account; when it is below the ceiling, the shortfall will be debited in the account and will compensate for past excesses.

stabilisation mechanism, such as the one proposed in Section 5.2.2, conditional on compliance with fiscal rules. In particular, in our proposed fiscal framework, access to funds could be denied when, in one of the previous years, the Member State was in breach of the expenditure rule beyond what is allowed by the compensation account and did not provide for sufficient corrective measures.

In this respect, we noted that the agreement reached by the EU leaders on the 17-21 July on the future multiannual financial framework (MFF) and on the recovery plan under Next Generation EU (NGEU) does not include specific economic conditionality for the disbursement of grants or loans. This is fully understandable, given the emergency and the need to support those economies and sectors most affected by the Covid-19 crisis. However, if these arrangements become the blueprint for a future central fiscal capacity, access could be made conditional on compliance with the fiscal framework.

GLOSSARY

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

Budget semi-elasticity: The change in the *budget balance-to-GDP ratio* to a cyclical change in GDP. The estimates of budget semi-elasticity used for EU fiscal surveillance purposes are derived from an agreed methodology developed by the OECD. The average semi-elasticity for the EU as a whole is 0.5.

Constrained judgement: A two-step approach that allows the Commission, under specific circumstances, to depart from the *output gap* estimates of the commonly agreed method in its assessment of the cyclical position of a Member State. The plausibility of the commonly agreed method is first checked against the indications of an alternative tool. If the difference between the two exceeds a given threshold, the Commission may apply a constrained degree of discretion in choosing the appropriate output gap estimate for surveillance purposes.

Corrective arm of the Stability and Growth Pact: The part of the *Stability and Growth Pact* that deals with preventing the risk of and/or correcting an excessive budgetary imbalance. Under the SGP an excessive budgetary imbalance is (i) a government deficit exceeding 3% of GDP and (ii) government debt in excess of 60% of GDP that is not approaching 60% at a satisfactory pace (see also *debt reduction benchmark*).

Country-specific recommendations (CSRs): Policy guidance tailored to each EU Member State based on the provisions of the SGP and the MIP. The recommendations are put forward by the European Commission in May of each year, then discussed among Member States in the Council, endorsed by EU leaders at a summit in June, and formally adopted by the finance ministers in July.

Debt reduction benchmark: The reduction of a country's government debt above 60% of GDP by 1/20th per year on average. This is the criterion used to assess whether excessive government debt is sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The pace of reduction is assessed over both the past 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.

Economic partnership programme: since the two-pack reform of 2013, euro-area Member States entering an excessive deficit procedure (or receiving a new deadline for correction) must present such programmes, which contain detailed fiscal and structural reforms (for example, on pension systems, taxation or public healthcare) that will correct Member States' deficits in a lasting way.

Enhanced surveillance: tighter surveillance introduced by the two-pack reform for countries experiencing financial difficulties or under precautionary assistance programmes from the European Stability Mechanism. Under the enhanced surveillance, they are subject to regular review visits by the Commission and must provide additional data, for example on their financial sectors.

European economic recovery plan: a large coordinated stimulus package initiated by the European Commission and the euro-area Member States to tackle the negative effects of the 2008

global financial crisis. It aimed to boost demand and stimulate confidence. The plan called for a fiscal stimulus of €200 billion, equivalent to 1.5% of EU GDP. €170 billion would come from Member States' budgets, while the rest would take the form of EU funding.

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

Excessive deficit procedure (EDP): A procedure under the corrective arm of the SGP to correct an excessive deficit, i.e. a deficit that lastingly exceeds the 3% of GDP Treaty threshold by a margin, or a debt ratio that is not diminishing sufficiently.

Expenditure benchmark: One of the two pillars used to assess compliance with the *preventive arm of the Stability and Growth Pact*, along with the change in the *structural balance*. It specifies a maximum growth rate for public expenditure that (i) is corrected for certain non-discretionary items, such as interest expenditure, (ii) includes a smoothed measure of public investment, and (iii) is 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*), which is 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 Czechia, the United Kingdom and Croatia (which did not join the EU until 2013). However, Croatia and Czechia recently became signatories to the TSCG, but they are currently exercising their right of exemption from the Fiscal Compact provisions of the Treaty until Eurozone accession. Of the 25 contracting parties to the TSCG, 22 (the 19 euro-area Member States plus Bulgaria, Denmark and Romania) are formally bound by the Fiscal Compact. 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 measured by two indicators: (i) the annual change in the *structural primary balance* – when the change is positive, the fiscal stance is said to be restrictive, and when it is negative, the fiscal stance is said to be expansionary; and (ii) *net expenditure growth* – when it exceeds medium-term *potential GDP* growth, this signals an expansionary *fiscal stance*.

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 sets out a roadmap towards the completion of the Economic and Monetary Union.

Flexibility clauses: Provisions under the preventive arm of the SGP allowing for a temporary and limited deviation from the *MTO*, or the adjustment path towards it. Flexibility clauses can be granted, subject to pre-defined eligibility conditions, to accommodate the budgetary impact of major structural reforms or government investment.

Maastricht Treaty (TFEU): The Treaty on European Union was signed in Maastricht in the Netherlands on 7 February 1992. The Treaty founded the European Union and also laid the foundations of 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 States, the euro area or the EU as a whole. It was introduced in 2011 after the financial crisis showed that macroeconomic imbalances in one country, such as a large current account deficit or a real estate bubble, can affect others.

Margin of broad compliance: The margin of error the Commission applies in the assessment of compliance with the preventive arm of the SGP. A Member State is considered to be broadly compliant if the observed deviation from its MTO, or from the recommended adjustment towards it, does not exceed 0.5% of GDP in a single year, or

cumulatively over two consecutive years. The margin of broad compliance is motivated by the measurement uncertainty surrounding real time estimates of the *structural budget balance*.

Margin of discretion: A new element of discretion the Commission intends to use in the 2018 surveillance cycle when assessing compliance with the preventive arm of the SGP. Allowing for a margin of discretion means that a Member State may be found compliant even if the established indicators — the change in the structural budget balance and the expenditure benchmark — point to a significant deviation from the MTO or the adjustment path towards it.

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

Medium-term budgetary objective (MTO): the *Stability and Growth Pact* requires EU Member States to specify a medium-term objective for their budgetary position in the *stability and convergence programmes*. The MTO is country-specific, in order to take account of the diversity of economic and budgetary developments and the diversity of fiscal risks to the sustainability of public finances. It is defined in structural terms (see *structural balance*).

Minimum benchmark: The lowest value of the structural balance that provides a sufficient margin against the risk of breaching the Treaty deficit threshold of 3% of GDP during normal cyclical fluctuations. For each Member State, the Commission provides an annual update of the *minimum benchmark*, by taking into account past output volatility and the budgetary responses to output fluctuations. A Member State with a greater output volatility and a larger budgetary semi-elasticity will need a more demanding structural balance in order to ensure compliance with the threshold of 3% of GDP.

Net expenditure growth: The growth rate of primary public expenditure corrected for certain items and net of discretionary revenue measures, in line with the *expenditure benchmark* definition. When net expenditure growth exceeds medium-term *potential GDP* growth, this signals an expansionary *fiscal stance*.

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) which indicator would provide a more accurate assessment in the given context if the two indicators do not support the same conclusions.

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*.

Revenue windfalls and shortfalls: Changes in government revenue that are not explained by the standard elasticity of revenue to the economic cycle. Unusually buoyant revenue leads to revenue windfalls while unusually weak revenue leads to revenue shortfalls.

Reverse qualified majority voting: an EU decision system according to which a Commission proposal is deemed to be approved by the EU Council of Ministers unless a qualified majority of Member States overturns it. Since the six-pack reform of 2011, decisions on most sanctions under the excessive deficit procedure are taken by reverse qualified majority voting (RQMV).

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.

Safety margin: The difference between the 3%-of-GDP deficit threshold and the *minimum benchmark*.

Significant deviation procedure (SDP): A procedure under the preventive arm of the SGP to correct a significant deviation from the MTO or the adjustment path towards it.

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

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

Stability and convergence programmes (SCPs): Every year in April, EU Member States are required to set out their fiscal plans for the next 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 (budget) balance: The actual budget balance corrected for the impact of the economic cycle and net of one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance and of the overall orientation of fiscal policy (see also *fiscal stance*).

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

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

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

Unusual event clause: A provision under the preventive arm of the SGP allowing for a temporary deviation from the MTO or the adjustment towards it, in the case of an unusual event outside government control with a major impact on the financial position of the general government. To be granted, the deviation must not endanger fiscal sustainability in the medium term.

Zero lower bound (ZLB): When the short-term nominal interest rate is at or near zero, the central bank is limited in its capacity to stimulate economic growth by further lowering policy rates. To overcome the constraint imposed by the ZLB, alternative methods of stimulating demand, such as asset purchase programmes, are generally considered. 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.

ANNEX A: OVERVIEW TABLES

Table A1: **Application of EU fiscal rules in the 2019 surveillance cycle: The preventive arm of the SGP (see Box A1 on how to read the table)**

	Spring 2018			Autumn 2018	2019	Spring 2020					
		Country-specific recommendation (CSRs) for 2019				Final Commission assessment					
	Distance to MTO in 2018 % of GDP	Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Flexibility clauses (granted *ex ante*) % of GDP	Commission assessment of draft budgetary plan (DBP)	In-year assessment	Flexibility and unusual event clauses (granted *ex post*) % of GDP	Observed deviation from the required structural adjustment (or MTO) % of GDP red = significant deviation if < -0.5% (1-y) or < -0.25% (2-y)				Conclusion of the overall assessment and procedural steps after the reference period
							2019		2018-19		
							ΔSB	EB	ΔSB	EB	
BE	-1.4	(1.8 ; 0.6)	-	Risk of non-compliance	Risk of non-compliance	Structural reform clause (-0.5)	-0.7	-0.7	-0.6	-0.7	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
BG	1.5	-	-	-	Compliant	-	2.1	2.1	2.5	2.3	-
							Compliant				
CZ	1.9	-	-	-	Compliant	-	1.3	0.6	1.4	0.4	-
							Compliant				
DK	0.8	-	-	-	Compliant	-	4.1	2.2	2.7	2.2	-
							Compliant				
DE	1.7	Use of fiscal space	-	Compliant	Compliant	-	1.7	1.0	1.9	1.0	-
							Compliant				
EE	-0.8	(4.1 ; 0.6)	-	Broadly compliant	Broadly compliant	-	-0.3	-1.7	-0.3	-1.2	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
IE	-0.1	Achieve the MTO	-	Compliant	Compliant	-	0.5	0.3	-0.2	-0.1	-
							Compliant				

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Table (continued)

	Spring 2018			Autumn 2018	2019	Spring 2020					
		Country-specific recommendation (CSRs) for 2019				Final Commission assessment					
	Distance to MTO in 2018 % of GDP	Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Flexibility clauses (granted *ex ante*) % of GDP	Commission assessment of draft budgetary plan (DBP)	In-year assessment	Flexibility and unusual event clauses (granted *ex post*) % of GDP	Observed deviation from the required structural adjustment (or MTO) % of GDP red = significant deviation if < -0.5% (1-y) or < -0.25% (2-y)				Conclusion of the overall assessment and procedural steps after the reference period
							2019		2018-19		
							ΔSB	EB	ΔSB	EB	
EL*	-	no CSR issued	-	Compliant	Compliant	-	3.3	2.9			-
							Compliant				
ES	-3.3	(0.6 ; 0.65)	-	Risk of non-compliance	Risk of non-compliance	-	-1.2	-1.6			No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
FR	-1.7	(1.4 ; 0.6)	-	Risk of non-compliance	Risk of non-compliance	-	-0.6	-1.0	-0.5	-0.7	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
HR	1.4	-	-	-	Compliant	-	1.1	0.1	1.2	0.4	-
							Compliant				
IT	-1.7	(0.1 ; 0.6)	-	Risk of non-compliance	Risk of non-compliance	Unusual event clause (-0.18)	0.4	-0.4	0.0	-0.5	The Commission was of the view that there were not robust evidence to conclude on the existence of a significant deviation in 2019 and over 2018 and 2019 together.
							No conclusion				
CY	0.8	-	-	Compliant	Compliant	-	0.1	-3.9	1.0	-0.5	-
							Compliant				
LV	-0.9	Achieve the MTO	(-0.23)	Broadly compliant	Broadly compliant	-	0.4	-1.0	0.0	-1.2	Latvia was assessed to have come closer to its MTO in 2019 once the granted flexibilty is taken into account
							Compliant				
LT	0.3	-	(-0.5)	Compliant	Broadly compliant	-	0.5	-0.71	0.6	-0.6	Lithuania was assessed to have come closer to its MTO in 2019 once the granted flexibility is taken into account
							Compliant				
LU	1.3	-	-	Compliant	Compliant	-	1.8	1.6	2.2	1.4	-
							Compliant				

(*) Since Greece was exempted from submitting stability programmes under the macroeconomic adjustment programme, the Greek authorities did not establish an MTO for 2018 and 2019. For the same reason, the Council issued no fiscal-related CSR in 2019 for Greece.

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Table (continued)

	Spring 2018			Autumn 2018	2019	Spring 2020					
	Distance to MTO in 2018 % of GDP	Country-specific recommendation (CSRs) for 2019		Commission assessment of draft budgetary plan (DBP)	In-year assessment	Final Commission assessment					Conclusion of the overall assessment and procedural steps after the reference period
		Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Flexibility clauses (granted *ex ante*) % of GDP			Flexibility and unusual event clauses (granted *ex post*) % of GDP	Observed deviation from the required structural adjustment (or MTO) % of GDP red = significant deviation if < -0.5% (1-y) or < -0.25% (2-y)				
							2019		2018-19		
							ΔSB	EB	ΔSB	EB	
HU	-2.1	(3.9 ; 0.75)	-	-	Subjecto to a significant deviation procedure (SDP) since June 2018 Dec. 2018: Council reccomendation with additional requirement (0.25) for 2019 Jun. 2019: Concil reccomendation to correct deviation (no add. requirement) Nov. 2019: no effective action taken	-	-1.2	-2.3	-1.3	-1.8	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
MT	0.6	-	-	Compliant	Compliant	-	-0.5	-0.1	0.5	0.0	Deviation not significant because within the margin of broad compliance of -0.5 % of GDP.
							Broadly compliant				
NL	0.4	Use of fiscal space	-	Compliant	Compliant	-	1.1	0.9	1.2	0.5	-
							Compliant				
AT	-0.3	Achieve the MTO	(-0.03)	Compliant	Compliant	-	0.3	-0.2	0.3	-0.4	-
							Compliant				
PL	-1.2	(4.2 ; 0.6)	-	-	Risk of non-compliance	-	-1.4	-2.0	-0.7	-1.0	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
PT	-1.3	(0.7 ; 0.6)	-	Risk of non-compliance	Risk of non-compliance	-	-0.2	-1.0	0.0	-1.3	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
RO	-2.8	(5.1 ; 0.8)	-	-	Subjecto to a significant deviation procedure (SDP) since June 2017 Dec. 2018: Council reccomendation with additional requirement (0.2) for 2019 Jun. 2019: Concil reccomendation to correct deviation (no add. requirement) Nov. 2019: no effective action taken	-	-2.4	-2.5	-1.6	-2.4	-
							April 2020: the Council opened an EDP for the expected breach of the 3% of GDP deficit reference value in 2019				

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Table (continued)

	Spring 2018			Autumn 2018	2019	Spring 2020					
		Country-specific recommendation (CSRs) for 2019				Final Commission assessment					
	Distance to MTO in 2018 % of GDP	Required adjustment: limit on spending growth under exp. benchmark, (EB); recomm. change in the structural balance (ΔSB) (y-o-y % ch. ; % of GDP)	Flexibility clauses (granted *ex ante*) % of GDP	Commission assessment of draft budgetary plan (DBP)	In-year assessment	Flexibility and unusual event clauses (granted *ex post*) % of GDP	Observed deviation from the required structural adjustment (or MTO) % of GDP red = significant deviation if < -0.5% (1-y) or < -0.25% (2-y)				Conclusion of the overall assessment and procedural steps after the reference period
							2019		2018-19		
							ΔSB	EB	ΔSB	EB	
SI	-1.3	(3.1 ; 0.65)	-	Risk of non-compliance	Risk of non-compliance		-0.9	-1.3	-0.8	-1.2	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
SK	-0.7	(4.1 ; 0.5)	-	Broadly compliant	Risk of non-compliance	-	-0.6	-1.3	-0.7	-1.2	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							Non-compliant				
FI	-0.3	Achieve the MTO	(-0.5)	Compliant	Broadly compliant	-	-0.1	-0.5	0.0	-0.3	Deviation not significant because within the margin of broad compliance of -0.5 % of GDP.
							Broadly compliant				
SE	1.7	-	-	-	Compliant	-	1.9	2.1	1.8	1.8	-
							Compliant				
UK**	-1.6	(1.6; 0.6)	-	-	Risk of non-compliance	-	0.0	-1.1	0.2	-0.7	No procedural step taken, in light of the exceptional economic impact of Covid-19 pandemic
							At risk of non compliance				

(**) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period, lasting until 31 December 2020. During this period, Union law — including that related to the European Semester — continues to apply to and within the United Kingdom. The Commission's overall assessment confirmed a risk of significant deviation from the recommended adjustment path towards the MTO in 2019-2020 and over 2018-2019 and 2019-2020 taken together. The UK government's own financial year, which runs from April 1 to the following March 31, does not coincide with the calendar year. Outturn data for 2019-2020 will be available in autumn 2020.

Source: European Commission

Table A2: **Application of EU fiscal rules in the 2019 surveillance cycle: The corrective arm of the SGP: Countries not in EDP (see Box A1 on how to read the table)**

	Autumn 2018		2019	Spring 2020		
	Commission assessment of draft budgetary plan (DBP)			Final assessment		
	Deficit Rule	Debt Rule (DR) / Transitional Arrangement (MLSA)	Procedural steps during the reference period	Deficit Rule	Debt Rule (DR) / Transitional Arrangement (MLSA)	Procedural steps after the reference period
BE	Compliant	At risk of non-compliance with the debt rule	**05/06/2019 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Belgium had not made sufficient progress towards compliance with the debt reduction benchmark in 2018. The Commission's assessment of relevant factors stressed (i) the macroeconomic conditions were no longer considered a factor in explaining Belgium's gap to the debt reduction benchmark; (ii) the implementation of growth-enhancing structural reforms in recent years, several of which were considered substantial and projected to help improve debt sustainability; and (iii) the fact that there was insufficiently robust evidence for a conclusion on the existence of a significant deviation from Belgium's adjustment path towards the MTO in 2018 and over 2017 and 2018 taken together. **The report concluded that the current analysis is not fully conclusive as to whether the debt criterion was or was not complied with as defined in the Treaty and in Regulation (EC) No 1467/1997.** **20/11/2019** - The Commission published its Opinion on the DBP of Belgium. The Commission concluded that Belgium was at risk of non-compliance with the provisions of the SGP in 2019: the expenditure benchmark and the structural balance pointed to a risk of a significant deviation from the required adjustment path towards the MTO and Belgium was not projected to comply with the debt reduction benchmark in 2019.	Compliant	Non-compliant	**20/05/2020 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Belgium had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the implementation of growth-enhancing structural reforms in the past; and (iii) the significant deviation from the recommended adjustment path towards the medium term budgetary objective. **The report concluded that the debt criterion should be considered as not complied with. Due to activation of the general escape clause, the EDP for Belgium was not be triggered.**
FR	Compliant	At risk of non-compliance with the debt rule	**05/06/2019 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that France had not made sufficient progress towards compliance with the debt reduction benchmark in 2018. Moreover, the Commission forecast did not expect France to comply with the debt reduction benchmark in 2019 and 2020 either. The planned deficit for 2019 also provided evidence of the *prima facie* existence of an excessive deficit. The Commission's assessment of relevant factors stressed that (i) France was broadly compliant with the recommended adjustment path towards the MTO in 2018; (ii) short-term sustainability risks were low; (iii) the breach of the 3% of GDP value in 2019 was marginal, temporary and solely due to a one-off effect; and (iv) the implementation of growth-enhancing structural reforms in recent years, several of which were considered substantial and projected to help improve debt sustainability. **The report concluded that deficit and debt criteria should be considered as being complied with at present.** **20/11/2019** - The Commission published its Opinion on the DBP of France. The Commission concluded that France was at risk of non-compliance with the provisions of the SGP in 2019: the expenditure benchmark and the structural balance pointed to a risk of a significant deviation from the required adjustment path towards the MTO and France was not projected to comply with the debt reduction benchmark in 2019.	Compliant	Non-compliant	**20/05/2020 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that France had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the implementation of growth-enhancing structural reforms in the past; and (iii) the significant deviation from the recommended adjustment path towards the medium term budgetary objective. **The report concluded that the debt criterion should be considered as not complied with. Due to activation of the general escape clause, no further procedure for France was triggered.**

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Table (continued)

IT	Compliant	At risk of non-compliance with the debt rule	**05/06/2019 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Italy had not made sufficient progress towards compliance with the debt reduction benchmark in 2018. The Commission's assessment of relevant factors stressed (i) the non-compliance with the recommended adjustment path towards the MTO in 2018; (ii) the macroeconomic slowdown recorded in Italy from the second half of 2018, which could only partly explain Italy's large gaps to compliance with the debt reduction benchmark; and (iii) the limited progress on the 2018 CSRs, including backtracking on past growth-enhancing reforms. **The report concluded that the debt criterion should be considered not complied with, and that a debt-based EDP was warranted.** **14/06/2019 - EFC Opinion under Article 126(4):** the Committee supported the Commission assessment put forward in the Article 126(3) report, and the debt criterion was considered not to be fulfilled. The Committee invited the Italian authorities to take necessary measures to restore compliance with the SGP and to continue a dialogue with the Commission. **02/07/2019-** The Italian authorities sent a letter with revised fiscal measures for 2019 and a commitment for 2020 to achieve broad compliance with the SGP. **03/07/2019 -** The Commission published its Communication to the Council. The Commission assessed that a new package of measures ensured a fiscal correction broadly compliant with the required effort under the preventive arm of the SGP in 2019, and also partially compensating the deterioration in the structural balance recorded in 2018. Taking account also of the commitment for 2020, the Commission concluded that this package was material enough to rule out a proposal to open an EDP for Italy. **04/07/2019 -** The Commission sent a letter to the Italian authorities informing them about the final decision not to open the EDP. **20/11/2019** - The Commission published its Opinion on the DBP of Italy. The Commission concluded that Italy was at risk of non-compliance with the provisions of the SGP in 2019: the expenditure benchmark and the structural balance pointed to a risk of a significant deviation from the required adjustment path towards the MTO and Italy was not projected to comply with the debt reduction benchmark in 2019.	Compliant	Non-compliant	**20/05/2020 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Italy had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors stressed (i) the observed macroeconomic conditions, whereby the slowdown recorded since 2018 can be argued to partly explain Italy's large gaps to compliance with the debt reduction benchmark; (ii) some progress with the implementation of growth enhancing structural reforms in past years; and (iii) the fact that there is no robust evidence of a significant deviation from the preventive arm in 2019 and over 2018 and 2019 taken together. **The report concluded that the debt criterion should be considered as not complied with. Due to activation of the general escape clause, the EDP for Italy was not be triggered.**
CY	Non-compliant	Compliant	**05/06/2019 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Cyprus had not made sufficient progress towards compliance with the deficit criterion in 2018. The report found that in 2018 the breach of the deficit criterion was only temporary due to the one-off impact of the banking support measures. At the same time, Cyprus was expected to comply with all the requirements of the SGP in 2019 and 2020. **The report concluded that no further steps leading to a decision on the existence of an excessive deficit should be taken.**	Compliant	Non-compliant	**20/05/2020 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Cyprus had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the limited progress with the implementation of growth enhancing structural reforms in past years; and (iii) the compliance with the medium term budgetary objective. **The report concluded that the debt criterion should be considered as complied with.**
GR				Compliant	Non-compliant	**20/05/2020 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Greece had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) some progress with the implementation of growth enhancing structural reforms in past years; and (iii) the compliance with Greece's fiscal targets in the context of the enhanced surveillance. **The report concluded that the debt criterion should be considered as complied with.**

Source: European Commission

Table A3: **Application of the EU fiscal rules in the 2019 surveillance cycle: The corrective arm of the SGP: Countries in EDP (see Box A1 on how to read the table)**

	Spring 2018	Autumn 2018			2019	Winter/Spring 2020		
	EDP status (deadline)	Requirements % of GDP		Commission Assessment of draft budgetary plan (DBP)	Procedural steps during the reference period	Final assessment % of GDP		Procedural steps after the reference period
		Headline budget balance	Structural adjustment			Headline budget balance	Change in the structural budget balance	
ES	in abeyance (2018)	-2.2	0.65	At risk of non-compliance **19/10/2018 –** The Commission sent a letter to the Spanish authorities following the submission of the DBP for 2019, seeking clarifications on the compliance of Spain's planned fiscal effort and expenditure developments in 2019 with the requirements of the preventive arm of the SGP and highlighting a risk of some deviation. In addition, the Commission noted that there were differences between the DBP and the draft 2019 Budget Act submitted to the Spanish Parliament and called on Spain to submit a new DBP. The letter also questioned Spanish's compliance with the transitional debt rule laid down by Article 2(1a) of Regulation 1467/97. **19/10/2018** – The Spanish authorities replied with a letter. **21/11/2018** - The Commission published its Opinion on the DBP of Spain. The Commission's assessment indicated that neither the intermediate headline deficit target nor the recommended fiscal effort would be achieved. Moreover, the Commission also pointed to a risk of significant deviation from the required adjustment towards the MTO in 2019. Based on the DBP and its own Commission 2019 autumn forecast, Spain was not projected to comply with the debt reduction benchmark in 2019. The Commission invited Spain to submit an updated Draft Budgetary Plan for 2019.	**05/06/2019** – The Commission issued a Recommendation under Article 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. **09/07/2019** – The Council adopted the Decision abrogating the Decision on the existence of an excessive deficit in Spain.	-2.8	-0.5	**20/05/2020 –** The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2019 spring forecast suggested that Spain had not made sufficient progress towards compliance with the debt reduction benchmark in 2019. The Commission's assessment of relevant factors examined (i) the observed macroeconomic conditions; (ii) the implementation of growth-enhancing structural reforms in the past; and (iii) the significant deviation from the recommended adjustment path towards the MTO. **The report concluded that the debt criterion should be considered as not complied with. Due to activation of the general escape clause, no further procedure for Spain was triggered.**
RO						-4.0	-1.0	**14/02/2020 –** The Commission prepared a report under Article 126(3) TFEU after Romania had taken no effective action in response to the Council recommendations. On 10 December 2019 the government adopted and sent to the Parliament its Fiscal Strategy for 2020-22, with an accrual deficit target of 3.8% of GDP in 2019. The Commission's assessment of relevant factors, based on the Commission 2020 winter forecast, stressed that (i) the planned excess over the reference value was considered to be neither exceptional nor temporary (ii) the general government gross debt remained well below the 60% of GDP reference value, and (iii) relevant factors did not provide mitigating elements. **The report concluded that after the assessment of all the relevant factors the deficit criterion should be considered as not complied with, and that an EDP was warranted.** **04/03/2020 –** the Commission issued a Recommendation for a Council Recommendation to end the excessive deficit situation. The Commission concluded that Romania should put an end to the present excessive deficit situation by 2022 at the latest with an annual structural adjustment of 0.5% of GDP in 2020, 0.8% of GDP in 2021 and 0.8% of GDP in 2022 **08/04/2020** – The Council adopted a report under Article 126(7) TFEU. The conclusions of the Recommendation coincided with those of the Commission's Recommendation.

Source: European Commission

Box A1: Reading the overview tables A1, A2 and A3

The overview tables in Annex A aim to provide a comprehensive view of the status of the EU Member States in the various steps under the Stability and Growth Pact for the reference period 2019. All overview tables are organised by columns that follow the annual cycle of fiscal surveillance.

Table A.1. Application of EU fiscal rules in the 2019 surveillance cycle: The preventive arm

Distance to MTO: the difference between the country-specific medium-term budgetary objective (MTO) and the structural balance in 2018 on the basis of the spring 2018 Commission forecasts underpinning the July 2018 country-specific recommendations by the Council.

Required adjustment: the annual adjustment requirement is expressed in terms of the two quantitative indicators under the preventive arm of the SGP. These are the expenditure benchmark (EB) and the change in the structural budget balance (ΔSB). The EB limits the year-on-year increase of government spending unless funded by new revenue measures. It is expressed by the annual growth rate of an expenditure aggregate, net of interest payments, spending on EU programmes paid for by EU funds and the cyclical component of unemployment benefits, while nationally financed government investment is smoothed over four years. The ΔSB is defined on the basis of the country's cyclical conditions, while taking into account the sustainability needs of its public finances ([1]). The required structural adjustment is net of any flexibility clauses granted *ex ante* – see column 3.

Flexibility clauses granted *ex ante*: an allowance for a reduction in the structural adjustment the country is required to deliver, granted for 2019 in the context of the assessment of the Stability and Convergence Programmes in spring 2018, or granted in previous years and carried over for three years. Allowed deviations apply to either the change or level of the structural balance, whichever leads to the least stringent requirement. A deviation in terms of change affects the adjustment path towards the MTO and applies to countries that are still relatively far from their MTO. By contrast, when the structural balance stands in the vicinity of the MTO, the deviation is in level and refers directly to the distance from the MTO. In 2019, all the flexibility granted *ex ante* pertains to this last case. A Member State can be granted flexibility for structural reforms, including the specific case of pension reform, for investments, or for the impact of adverse economic events outside its control, such as natural disasters or the refugee crisis. For a comprehensive presentation of how flexibility is taken into account, see the Vade Mecum (2019 edition), Sections 1.3.3, 1.3.4, 1.3.5.

Commission overall assessment of the 2019 draft budgetary plan (DBP): In line with Regulation (EU) 473/2013, every year, all euro area countries submit their DBPs by 15 October except when under a macroeconomic adjustment programme (in our reference period, Greece). They are assessed for (*ex ante*) compliance with the provisions of the SGP. The overall conclusion of the Commission can be compliant, risk of (some) deviation ([2]) or risk of significant deviation. In case of risk of some deviation, the DBP is considered to be 'broadly compliant', while in case of risk of significant deviation, the DBP is considered as non-compliant. For a comprehensive presentation of the assessment of compliance with the preventive arm of the SGP, see the Vade Mecum, Section 1.3.7.

In-year assessment: Commission's assessment of compliance with the preventive arm of the SGP between autumn 2018 and spring 2020. For non-euro area countries, the column reports the assessment of the spring 2019 Convergence Programmes.

Flexibility and unusual event clauses granted *ex post*: includes any flexibility clauses that are granted for 2019 in the context of the final assessment.

Deviation from the required structural adjustment (or MTO): presents the deviation from the fiscal requirement according to both compliance indicators: (i) the ΔSB and (ii) the EB. It includes the deviation in one year and on average over two consecutive years (i.e. 2018 and 2019). Colours: green, yellow and red, corresponding respectively to the indicator pointing to compliance, some deviation or a significant deviation to the MTO or the required path towards it. The deviation is considered significant if it exceeds 0.5% of GDP in a single year, or 0.25% of GDP on average over two consecutive years. The assessment is done by comparing the actual change in the structural balance to the required adjustment path as a reference, including an assessment of compliance with the expenditure benchmark. If both indicators confirm the required adjustment, the overall conclusion is of compliance with the preventive arm. In all other cases, the conclusion will depend on an 'overall assessment', which includes an in-depth analysis of both indicators; see the *Vade Mecum,* Section 1.3.7.

Conclusion of the overall assessment and procedural steps after the reference period: records procedural or other steps taken following the spring 2020 assessment. For those cases where the country seems not to have delivered the requirements but no procedural steps to have been taken, an explanation is provided.

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

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

(Continued on the next page)

Box (continued)

Table A.2. Application of EU fiscal rules in the 2019 surveillance cycle - The corrective arm: Countries not in EDP

Deficit Rule: the Commission's assessment of the Member State's 2019 Draft Budgetary Plans' ([3]) compliance with the 3% of GDP deficit criterion in autumn 2018.

Debt Rule (DR) / Transitional Arrangement (MLSA): Commission's assessment of the country's compliance with the debt criterion. A Member State is considered 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.

Procedural steps taken during the reference period: records procedural or other steps under the corrective arm of the SGP taken between autumn 2018 and spring 2020. For 2018, 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.

Deficit Rule: see above.

Debt Rule (DR) / Transitional Arrangement (MLSA): see above.

Procedural steps after the reference period: see Table A.1.

Table A.3. Application of EU fiscal rules in the 2019 surveillance cycle - The corrective arm: Countries in EDP

EDP status (deadline): presents the country's status in the EDP procedure in July 2018; in brackets, the deadline set by the Council for the correction of the excessive deficit.

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 2019.

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

Commission assessment of 2018 Draft Budgetary Plans: see Table A.2 – column 4.

Procedural steps taken during the reference period: covers all steps taken under the corrective arm of the SGP in the period between autumn 2018 and spring 2020. All articles referred to in this column are of the Treaty on the Functioning of the European Union.

Headline budget balance: presents the headline budget balance outturn in 2019 or the information that the excessive deficit has been corrected.

Structural adjustment: the estimated structural adjustment delivered in 2019 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 the *Vade Mecum* (2019 edition), Sections 2.3.2.1.

Procedural steps after the reference period: see Table A.2.

([3]) https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2019_en

ANNEX B: STATISTICAL ANNEX

Table B1: **Gross domestic product at 2015 reference levels (annual percentage change, 2002-2021)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	1.7	1.0	3.6	2.3	2.6	3.7	0.4	-2.0	2.9	1.7	0.7	0.5	1.6	2.0	1.5	2.0	1.5	1.4	-7.2	6.7
BG	6.0	5.2	6.4	7.2	6.8	6.6	6.1	-3.4	0.6	2.4	0.4	0.3	1.9	4.0	3.8	3.5	3.1	3.4	-7.2	6.0
CZ	1.7	3.6	4.9	6.5	6.9	5.6	2.7	-4.8	2.3	1.8	-0.8	-0.5	2.7	5.3	2.5	4.4	2.8	2.6	-6.2	5.0
DK	0.5	0.4	2.7	2.3	3.9	0.9	-0.5	-4.9	1.9	1.3	0.2	0.9	1.6	2.3	3.2	2.0	2.4	2.4	-5.9	5.1
DE	-0.2	-0.7	1.2	0.7	3.8	3.0	1.0	-5.7	4.2	3.9	0.4	0.4	2.2	1.7	2.2	2.5	1.5	0.6	-6.5	5.9
EE	6.8	7.6	6.8	9.5	9.7	7.6	-5.1	-14.4	2.7	7.4	3.1	1.3	3.0	1.8	2.6	5.7	4.8	4.3	-6.9	5.9
IE	5.9	3.0	6.7	5.7	5.1	5.3	-4.5	-5.1	1.8	0.3	0.2	1.4	8.6	25.2	3.7	8.1	8.2	5.5	-7.9	6.1
EL	3.9	5.8	5.1	0.6	5.7	3.3	-0.3	-4.3	-5.5	-9.1	-7.3	-3.2	0.7	-0.4	-0.2	1.5	1.9	1.9	-9.7	7.9
ES	2.7	3.0	3.1	3.7	4.1	3.6	0.9	-3.8	0.2	-0.8	-3.0	-1.4	1.4	3.8	3.0	2.9	2.4	2.0	-9.4	7.0
FR	1.1	0.8	2.8	1.7	2.4	2.4	0.3	-2.9	1.9	2.2	0.3	0.6	1.0	1.1	1.1	2.3	1.7	1.3	-8.2	7.4
HR	5.1	5.6	4.2	4.3	5.0	5.3	1.8	-7.4	-1.5	-0.3	-2.2	-0.5	-0.1	2.4	3.5	3.1	2.7	2.9	-9.1	7.5
IT	0.3	0.1	1.4	0.8	1.8	1.5	-1.0	-5.3	1.7	0.7	-3.0	-1.8	0.0	0.8	1.3	1.7	0.8	0.3	-9.5	6.5
CY	3.7	2.6	5.0	4.9	4.7	5.1	3.6	-2.0	2.0	0.4	-3.4	-6.6	-1.9	3.4	6.7	4.4	4.1	3.2	-7.4	6.1
LV	7.1	8.4	8.3	10.7	11.9	10.0	-3.3	-14.2	-4.5	6.3	4.1	2.3	1.9	3.3	1.8	3.8	4.3	2.2	-7.0	6.4
LT	6.8	10.5	6.6	7.7	7.4	11.1	2.6	-14.8	1.5	6.0	3.8	3.6	3.5	2.0	2.6	4.2	3.6	3.9	-7.9	7.4
LU	3.8	1.6	3.6	3.2	5.2	8.4	-1.3	-4.4	4.9	2.5	-0.4	3.7	4.3	4.3	4.6	1.8	3.1	2.3	-5.4	5.7
HU	4.7	4.1	4.8	4.2	4.0	0.2	1.1	-6.7	0.7	1.8	-1.5	2.0	4.2	3.8	2.2	4.3	5.1	4.9	-7.0	6.0
MT	3.0	2.5	0.4	3.8	1.8	4.0	3.3	-2.5	3.5	1.4	2.8	4.8	8.8	10.9	5.8	6.5	7.3	4.4	-5.8	6.0
NL	0.2	0.2	2.0	2.1	3.5	3.8	2.2	-3.7	1.3	1.6	-1.0	-0.1	1.4	2.0	2.2	2.9	2.6	1.8	-6.8	5.0
AT	1.7	0.9	2.7	2.2	3.5	3.7	1.5	-3.8	1.8	2.9	0.7	0.0	0.7	1.0	2.1	2.5	2.4	1.6	-5.5	5.0
PL	2.0	3.6	5.1	3.5	6.2	7.0	4.2	2.8	3.6	5.0	1.6	1.4	3.3	3.8	3.1	4.9	5.3	4.1	-4.3	4.1
PT	0.8	-0.9	1.8	0.8	1.6	2.5	0.3	-3.1	1.7	-1.7	-4.1	-0.9	0.8	1.8	2.0	3.5	2.6	2.2	-6.8	5.8
RO	5.7	2.3	10.4	4.7	8.0	7.2	9.3	-5.5	-3.9	2.0	2.1	3.5	3.4	3.9	4.8	7.1	4.4	4.1	-6.0	4.2
SI	3.5	3.0	4.4	3.8	5.7	7.0	3.5	-7.5	1.3	0.9	-2.6	-1.0	2.8	2.2	3.1	4.8	4.1	2.4	-7.0	6.7
SK	4.5	5.5	5.3	6.6	8.5	10.8	5.6	-5.5	5.7	2.9	1.9	0.7	2.8	4.8	2.1	3.0	4.0	2.3	-6.7	6.6
FI	1.7	2.0	4.0	2.8	4.0	5.3	0.8	-8.1	3.2	2.5	-1.4	-0.9	-0.4	0.5	2.7	3.1	1.6	1.0	-6.3	3.7
SE	2.2	2.2	4.3	2.9	4.6	3.4	-0.2	-4.2	6.2	3.1	-0.6	1.1	2.7	4.4	2.4	2.4	2.2	1.2	-6.1	4.3
UK	2.3	3.3	2.4	3.2	2.8	2.4	-0.3	-4.2	1.9	1.5	1.5	2.1	2.6	2.4	1.9	1.9	1.3	1.4	-8.3	6.0
EA-19	0.9	0.6	2.3	1.7	3.2	3.0	0.4	-4.5	2.1	1.7	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-7.7	6.3
EU-28	1.3	1.3	2.5	2.1	3.3	3.0	0.5	-4.3	2.2	1.8	-0.4	0.3	1.7	2.3	2.0	2.6	2.0	1.5	-7.6	6.1

Notes: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) EA and EU aggregated figures are weighted in common currency.
Source: Commission spring 2020 forecast.

Table B2: **Harmonised index of consumer prices (percentage change on preceding year, 2002-2021)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	1.5	1.5	1.9	2.5	2.3	1.8	4.5	0.0	2.3	3.4	2.6	1.2	0.5	0.6	1.8	2.2	2.3	1.2	0.2	1.3
BG	5.8	2.3	6.1	6.0	7.4	7.6	12.0	2.5	3.0	3.4	2.4	0.4	-1.6	-1.1	-1.3	1.2	2.6	2.5	1.1	1.1
CZ	1.4	-0.1	2.6	1.6	2.1	2.9	6.3	0.6	1.2	2.2	3.5	1.4	0.4	0.3	0.6	2.4	2.0	2.6	2.3	1.9
DK	2.4	2.0	0.9	1.7	1.8	1.7	3.6	1.0	2.2	2.7	2.4	0.5	0.4	0.2	0.0	1.1	0.7	0.7	0.3	1.3
DE	1.3	1.1	1.8	1.9	1.8	2.3	2.8	0.2	1.1	2.5	2.2	1.6	0.8	0.7	0.4	1.7	1.9	1.4	0.3	1.4
EE	3.6	1.4	3.0	4.1	4.4	6.7	10.6	0.2	2.7	5.1	4.2	3.2	0.5	0.1	0.8	3.7	3.4	2.3	0.7	1.7
IE	4.7	4.0	2.3	2.2	2.7	2.9	3.1	-1.7	-1.6	1.2	1.9	0.5	0.3	0.0	-0.2	0.3	0.7	0.9	-0.3	0.9
EL	3.9	3.4	3.0	3.5	3.3	3.0	4.2	1.3	4.7	3.1	1.0	-0.9	-1.4	-1.1	0.0	1.1	0.8	0.5	-0.6	0.5
ES	3.6	3.1	3.1	3.4	3.6	2.8	4.1	-0.2	2.0	3.0	2.4	1.5	-0.2	-0.6	-0.3	2.0	1.7	0.8	0.0	1.0
FR	1.9	2.2	2.3	1.9	1.9	1.6	3.2	0.1	1.7	2.3	2.2	1.0	0.6	0.1	0.3	1.2	2.1	1.3	0.4	0.9
HR	2.5	2.4	2.1	3.0	3.3	2.7	5.8	2.2	1.1	2.2	3.4	2.3	0.2	-0.3	-0.6	1.3	1.6	0.8	0.4	0.9
IT	2.6	2.8	2.3	2.2	2.2	2.0	3.5	0.8	1.6	2.9	3.3	1.2	0.2	0.1	-0.1	1.3	1.2	0.6	-0.3	0.7
CY	2.8	4.0	1.9	2.0	2.2	2.2	4.4	0.2	2.6	3.5	3.1	0.4	-0.3	-1.5	-1.2	0.7	0.8	0.5	-0.2	1.0
LV	2.0	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2	2.3	0.0	0.7	0.2	0.1	2.9	2.6	2.7	0.2	1.9
LT	0.3	-1.1	1.2	2.7	3.8	5.8	11.1	4.2	1.2	4.1	3.2	1.2	0.2	-0.7	0.7	3.7	2.5	2.2	0.8	1.5
LU	2.1	2.5	3.2	3.8	3.0	2.7	4.1	0.0	2.8	3.7	2.9	1.7	0.7	0.1	0.0	2.1	2.0	1.6	0.7	1.6
HU	5.2	4.7	6.8	3.5	4.0	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.0	0.1	0.4	2.4	2.9	3.4	3.0	2.7
MT	2.6	1.9	2.7	2.5	2.6	0.7	4.7	1.8	2.0	2.5	3.2	1.0	0.8	1.2	0.9	1.3	1.7	1.5	0.7	1.1
NL	3.9	2.2	1.4	1.5	1.6	1.6	2.2	1.0	0.9	2.5	2.8	2.6	0.3	0.2	0.1	1.3	1.6	2.7	0.8	1.3
AT	1.7	1.3	2.0	2.1	1.7	2.2	3.2	0.4	1.7	3.6	2.6	2.1	1.5	0.8	1.0	2.2	2.1	1.5	1.1	1.5
PL	1.9	0.7	3.6	2.2	1.3	2.6	4.2	4.0	2.6	3.9	3.7	0.8	0.1	-0.7	-0.2	1.6	1.2	2.1	2.5	2.8
PT	3.7	3.2	2.5	2.1	3.0	2.4	2.7	-0.9	1.4	3.6	2.8	0.4	-0.2	0.5	0.6	1.6	1.2	0.3	-0.2	1.2
RO	22.5	15.3	11.9	9.1	6.6	4.9	7.9	5.6	6.1	5.8	3.4	3.2	1.4	-0.4	-1.1	1.1	4.1	3.9	2.5	3.1
SI	7.5	5.6	3.7	2.4	2.5	3.8	5.5	0.8	2.1	2.1	2.8	1.9	0.4	-0.8	-0.2	1.6	1.9	1.7	0.5	1.2
SK	3.5	8.4	7.5	2.8	4.3	1.9	3.9	0.9	0.7	4.1	3.7	1.5	-0.1	-0.3	-0.5	1.4	2.5	2.8	1.9	1.1
FI	2.0	1.3	0.1	0.8	1.3	1.6	3.9	1.6	1.7	3.3	3.2	2.2	1.2	-0.2	0.4	0.8	1.2	1.1	0.5	1.4
SE	1.9	2.3	1.0	0.8	1.5	1.7	3.3	1.9	1.9	1.4	0.9	0.4	0.2	0.7	1.1	1.9	2.0	1.7	0.4	1.1
UK	1.3	1.4	1.3	2.1	2.3	2.3	3.6	2.2	3.3	4.5	2.8	2.6	1.5	0.0	0.7	2.7	2.5	1.8	1.2	2.1
EA-19	2.3	2.1	2.2	2.2	2.2	2.2	3.3	0.3	1.6	2.7	2.5	1.3	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
EU-28	2.5	2.1	2.3	2.3	2.3	2.4	3.7	1.0	2.1	3.1	2.6	1.5	0.6	0.1	0.2	1.7	1.9	1.5	0.7	1.4

Notes: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) National index if not available.
Source: Commission 2020 spring forecast.

Table B3: **Net lending (+) or net borrowing (-), general government (as a percentage of GDP, 2002-2021)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	0.0	-1.9	-0.2	-2.7	0.2	0.1	-1.1	-5.4	-4.1	-4.3	-4.3	-3.1	-3.1	-2.4	-2.4	-0.7	-0.8	-1.9	-8.9	-4.2
BG	-1.2	-0.4	1.8	1.0	1.8	1.1	1.6	-4.0	-3.1	-2.0	-0.3	-0.4	-5.4	-1.7	0.1	1.1	2.0	2.1	-2.8	-1.8
CZ	-6.4	-6.9	-2.4	-3.0	-2.2	-0.7	-2.0	-5.5	-4.2	-2.7	-3.9	-1.2	-2.1	-0.6	0.7	1.5	0.9	0.3	-6.7	-4.0
DK	0.0	-0.1	2.1	5.0	5.0	5.0	3.2	-2.8	-2.7	-2.1	-3.5	-1.2	1.1	-1.3	0.1	1.8	0.7	3.7	-7.2	-2.3
DE	-3.9	-3.7	-3.3	-3.3	-1.7	0.3	-0.1	-3.2	-4.4	-0.9	0.0	0.0	0.6	0.9	1.2	1.2	1.9	1.4	-7.0	-1.5
EE	0.4	1.8	2.4	1.1	2.9	2.7	-2.6	-2.2	0.2	1.1	-0.3	0.2	0.7	0.1	-0.5	-0.8	-0.6	-0.3	-8.3	-3.4
IE	-0.5	0.3	1.3	1.6	2.8	0.3	-7.0	-13.8	-32.1	-12.8	-8.1	-6.2	-3.6	-2.0	-0.7	-0.3	0.1	0.4	-5.6	-2.9
EL	-6.0	-7.8	-8.8	-6.2	-5.9	-6.7	-10.2	-15.1	-11.2	-10.3	-8.9	-13.2	-3.6	-5.6	0.5	0.7	1.0	1.5	-6.4	-2.1
ES	-0.3	-0.4	-0.1	1.2	2.1	1.9	-4.6	-11.3	-9.5	-9.7	-10.7	-7.0	-5.9	-5.2	-4.3	-3.0	-2.5	-2.8	-10.1	-6.7
FR	-3.2	-4.0	-3.6	-3.4	-2.4	-2.6	-3.3	-7.2	-6.9	-5.2	-5.0	-4.1	-3.9	-3.6	-3.6	-2.9	-2.3	-3.0	-9.9	-4.0
HR	-3.3	-4.5	-5.0	-3.7	-3.1	-2.2	-2.8	-6.0	-6.5	-7.9	-5.4	-5.3	-5.3	-3.3	-1.0	0.8	0.2	0.4	-7.1	-2.2
IT	-2.9	-3.2	-3.5	-4.1	-3.6	-1.3	-2.6	-5.1	-4.2	-3.6	-2.9	-2.9	-3.0	-2.6	-2.4	-2.4	-2.2	-1.6	-11.1	-5.6
CY	-4.1	-5.9	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.8	-8.7	-1.0	0.3	2.0	-3.7	1.7	-7.0	-1.8
LV	-2.3	-1.6	-1.2	-0.5	-0.5	-0.6	-4.3	-9.6	-8.7	-4.3	-1.4	-1.2	-1.6	-1.4	0.2	-0.8	-0.8	-0.2	-7.3	-4.5
LT	-1.9	-1.3	-1.4	-0.3	-0.3	-0.8	-3.1	-9.1	-6.9	-9.0	-3.1	-2.6	-0.6	-0.3	0.2	0.5	0.6	0.3	-6.9	-2.7
LU	2.0	0.3	-1.4	-0.2	1.9	4.4	3.5	-0.2	-0.4	0.6	0.5	0.8	1.3	1.3	1.8	1.3	3.1	2.2	-4.8	0.1
HU	-8.8	-7.2	-6.6	-7.8	-9.3	-5.1	-3.8	-4.8	-4.5	-5.2	-2.3	-2.6	-2.8	-2.0	-1.8	-2.5	-2.1	-2.0	-5.2	-4.0
MT	-5.4	-9.0	-4.3	-2.6	-2.5	-2.1	-4.2	-3.2	-2.4	-2.4	-3.5	-2.4	-1.7	-1.0	1.0	3.3	1.9	0.5	-6.7	-2.5
NL	-2.1	-3.1	-1.8	-0.4	0.1	-0.1	0.2	-5.1	-5.2	-4.4	-3.9	-2.9	-2.2	-2.0	0.0	1.3	1.4	1.7	-6.3	-3.5
AT	-1.4	-1.8	-4.8	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4	-2.6	-2.2	-2.0	-2.7	-1.0	-1.5	-0.8	0.2	0.7	-6.1	-1.9
PL	-4.8	-6.1	-5.0	-4.0	-3.6	-1.9	-3.6	-7.3	-7.4	-4.9	-3.7	-4.2	-3.6	-2.6	-2.4	-1.5	-0.2	-0.7	-9.5	-3.8
PT	-3.3	-5.7	-6.2	-6.1	-4.2	-2.9	-3.7	-9.9	-11.4	-7.7	-6.2	-5.1	-7.4	-4.4	-1.9	-3.0	-0.4	0.2	-6.5	-1.8
RO	-1.9	-1.4	-1.1	-0.8	-2.1	-2.7	-5.4	-9.1	-6.9	-5.4	-3.7	-2.1	-1.2	-0.6	-2.6	-2.6	-2.9	-4.3	-9.2	-11.4
SI	-2.4	-2.6	-1.9	-1.3	-1.2	0.0	-1.4	-5.8	-5.6	-6.6	-4.0	-14.6	-5.5	-2.8	-1.9	0.0	0.7	0.5	-7.2	-2.1
SK	-8.2	-3.1	-2.3	-2.9	-3.6	-2.1	-2.5	-8.1	-7.5	-4.5	-4.4	-2.9	-3.1	-2.7	-2.5	-1.0	-1.0	-1.3	-8.5	-4.2
FI	4.1	2.4	2.2	2.7	4.0	5.1	4.2	-2.5	-2.5	-1.0	-2.2	-2.5	-3.0	-2.4	-1.7	-0.7	-0.9	-1.1	-7.4	-3.4
SE	-1.4	-1.2	0.4	1.8	2.2	3.4	1.9	-0.7	0.0	-0.2	-1.0	-1.4	-1.5	0.0	1.0	1.4	0.8	0.5	-5.6	-2.2
UK	-1.9	-3.1	-3.1	-3.1	-2.8	-2.7	-5.1	-10.1	-9.3	-7.5	-8.2	-5.5	-5.6	-4.6	-3.3	-2.5	-2.2	-2.1	-10.5	-6.7
EA-19	-2.7	-3.1	-2.9	-2.6	-1.5	-0.6	-2.2	-6.2	-6.3	-4.2	-3.7	-3.0	-2.5	-2.0	-1.5	-1.0	-0.5	-0.6	-8.5	-3.5
EU-28	-2.6	-3.1	-2.8	-2.5	-1.6	-0.9	-2.5	-6.6	-6.4	-4.6	-4.3	-3.3	-2.9	-2.4	-1.7	-1.1	-0.7	-0.8	-8.6	-4.1

Note: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) National index if not available.
Source: Commission 2020 spring forecast.

Table B4: **Interest expenditure, general government (as a percentage of GDP, 2002-2021)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	5.8	5.4	4.9	4.4	4.1	4.0	4.0	3.9	3.6	3.5	3.5	3.3	3.2	2.9	2.7	2.3	2.1	2.0	2.0	1.9
BG	2.2	2.2	1.8	1.6	1.3	1.1	0.8	0.7	0.7	0.7	0.8	0.7	0.9	0.9	0.9	0.8	0.7	0.6	0.6	0.7
CZ	1.1	1.0	1.1	1.1	1.0	1.1	1.0	1.2	1.3	1.3	1.4	1.3	1.3	1.1	0.9	0.7	0.8	0.7	0.9	0.9
DK	3.1	2.8	2.5	2.1	1.8	1.6	1.4	1.9	1.9	2.0	1.8	1.7	1.5	1.6	1.1	0.8	0.8	0.7	0.8	0.8
DE	3.0	2.9	2.8	2.8	2.7	2.7	2.7	2.6	2.5	2.5	2.3	1.8	1.6	1.4	1.2	1.1	0.9	0.8	0.7	0.7
EE	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
IE	1.3	1.2	1.1	1.0	1.0	1.0	1.3	2.0	2.8	3.4	4.2	4.3	3.9	2.6	2.3	2.0	1.6	1.3	1.2	1.1
EL	5.6	4.9	4.8	4.7	4.4	4.5	4.8	5.0	6.0	7.5	5.3	4.1	4.0	3.5	3.2	3.1	3.3	2.9	3.0	2.7
ES	2.6	2.3	2.0	1.7	1.6	1.6	1.6	1.7	1.9	2.5	3.0	3.5	3.4	3.0	2.8	2.5	2.4	2.3	2.4	2.3
FR	3.0	2.8	2.8	2.7	2.6	2.7	2.9	2.5	2.5	2.7	2.6	2.3	2.2	2.0	1.8	1.7	1.7	1.4	1.4	1.3
HR	1.7	1.7	1.8	1.8	1.6	1.7	1.8	2.2	2.4	2.7	3.1	3.1	3.4	3.4	3.1	2.7	2.3	2.2	2.3	2.3
IT	5.4	5.0	4.6	4.5	4.4	4.7	4.9	4.4	4.3	4.6	5.2	4.8	4.6	4.1	3.9	3.8	3.7	3.4	3.7	3.6
CY	3.0	3.2	3.0	3.2	3.0	2.8	2.6	2.3	2.0	2.1	3.1	3.4	3.2	3.2	2.7	2.5	2.4	2.5	2.4	2.1
LV	0.7	0.8	0.7	0.5	0.5	0.4	0.6	1.6	1.8	1.8	1.7	1.5	1.5	1.3	1.0	0.9	0.7	0.7	0.8	0.7
LT	1.3	1.2	0.9	0.8	0.7	0.7	0.7	1.2	1.8	1.8	2.0	1.8	1.6	1.5	1.3	1.1	0.9	0.9	0.6	0.6
LU	0.3	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.5	0.5	0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2
HU	4.0	4.0	4.3	4.1	3.8	4.0	4.1	4.5	4.1	4.2	4.6	4.5	4.0	3.5	3.1	2.7	2.4	2.3	2.5	2.4
MT	3.9	3.5	3.7	3.8	3.7	3.5	3.3	3.3	3.1	3.2	3.0	2.9	2.7	2.4	2.1	1.8	1.5	1.4	1.5	1.5
NL	2.6	2.4	2.3	2.2	2.0	2.0	2.0	2.0	1.8	1.8	1.7	1.6	1.5	1.3	1.2	1.0	0.9	0.8	0.8	0.8
AT	3.4	3.2	3.0	3.2	3.1	3.1	2.9	3.1	2.9	2.8	2.7	2.6	2.4	2.3	2.1	1.8	1.6	1.4	1.5	1.3
PL	2.9	3.0	2.7	2.5	2.4	2.2	2.1	2.5	2.5	2.5	2.7	2.5	2.0	1.8	1.7	1.6	1.4	1.4	1.4	1.4
PT	2.8	2.7	2.6	2.6	2.8	3.0	3.1	3.0	2.9	4.3	4.9	4.8	4.9	4.6	4.1	3.8	3.4	3.0	3.4	3.4
RO	2.5	1.6	1.5	1.2	0.8	0.7	0.7	1.4	1.5	1.6	1.8	1.8	1.7	1.6	1.5	1.3	1.1	1.2	1.5	1.7
SI	2.2	1.9	1.7	1.5	1.4	1.2	1.1	1.3	1.6	1.9	2.0	2.5	3.2	3.2	3.0	2.5	2.0	1.7	1.8	1.7
SK	3.6	2.5	2.2	1.7	1.5	1.4	1.3	1.5	1.3	1.5	1.8	1.9	1.9	1.8	1.7	1.4	1.3	1.2	1.3	1.3
FI	2.0	1.8	1.7	1.6	1.5	1.4	1.4	1.3	1.3	1.4	1.4	1.3	1.2	1.2	1.1	1.0	0.9	0.9	0.8	0.7
SE	3.0	2.1	1.7	1.8	1.7	1.7	1.6	1.2	1.1	1.2	0.9	0.8	0.7	0.6	0.5	0.5	0.5	0.4	0.3	0.3
UK	1.8	1.8	1.8	1.9	1.9	2.1	2.2	1.8	2.8	3.1	2.8	2.8	2.6	2.3	2.4	2.7	2.4	2.2	2.1	2.0
EA-19	3.5	3.2	3.0	2.9	2.8	2.9	3.0	2.8	2.8	3.0	3.0	2.8	2.6	2.3	2.1	1.9	1.8	1.6	1.7	1.6
EU-28		2.9	2.8	2.7	2.6	2.6	2.7	2.6	2.7	2.9	2.9	2.7	2.5	2.2	2.1	2.0	1.8	1.6	1.7	1.6

Note: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) National index if not available.
Source: Commission 2020 spring forecast.

Table B5: **Structural budget balance, general government (as a percentage of GDP, 2011-2021)**

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	-4.0	-3.6	-3.1	-3.1	-2.7	-2.6	-1.8	-2.0	-2.6	-4.7	-2.9
BG	-2.0	-0.1	0.1	-1.6	-1.4	-0.1	0.7	1.3	1.1	-1.3	-1.6
CZ	-2.6	-1.5	0.1	-0.9	-0.7	0.7	0.8	0.1	-0.5	-4.6	-2.9
DK	-0.9	-0.4	-1.1	-0.6	-1.8	0.3	2.0	0.8	3.6	-1.9	0.6
DE	-1.2	-0.1	0.4	0.9	1.0	0.9	0.7	1.2	0.9	-3.8	-0.5
EE	-0.4	-0.2	-0.1	0.1	0.2	-0.6	-2.0	-2.4	-2.4	-5.8	-1.9
IE	-8.1	-7.1	-5.3	-4.8	-3.2	-2.2	-1.7	-0.9	-0.7	-1.5	-0.5
EL	-4.9	1.5	3.6	3.5	3.3	5.5	5.0	5.0	2.8	-0.1	0.8
ES	-6.5	-3.4	-1.9	-1.7	-2.9	-3.8	-3.5	-3.5	-4.0	-5.6	-5.2
FR	-4.9	-4.2	-3.2	-2.9	-2.8	-2.9	-2.9	-2.8	-2.8	-4.7	-2.5
HR	-7.1	-4.1	-3.8	-4.2	-2.6	-1.1	0.2	-0.9	-1.2	-4.4	-1.9
IT	-3.5	-1.4	-0.6	-1.0	-0.5	-1.5	-2.1	-2.3	-1.5	-6.3	-3.7
CY	-4.8	-3.6	-0.8	4.6	2.5	0.3	0.7	2.0	0.1	-5.2	-2.1
LV	-1.9	-0.5	-0.9	-1.1	-1.8	-0.4	-1.7	-2.4	-1.7	-5.2	-3.8
LT	-3.3	-2.2	-1.8	-1.2	-0.6	-0.5	-1.0	-1.1	-1.6	-4.4	-1.6
LU	1.8	2.9	2.8	2.6	1.6	1.4	1.0	2.2	1.2	-2.6	0.7
HU	-4.2	-1.5	-1.6	-2.5	-2.3	-2.0	-3.6	-3.6	-3.8	-2.6	-3.1
MT	-1.6	-2.3	-1.4	-2.3	-2.8	-0.1	2.3	0.0	-1.3	-4.2	-1.3
NL	-3.8	-2.5	-1.7	-0.8	-1.1	0.2	0.5	0.4	0.6	-2.4	-1.6
AT	-2.5	-1.7	-1.0	-0.5	0.1	-1.1	-1.0	-0.7	-0.3	-3.4	-1.1
PL	-5.6	-3.6	-3.3	-2.6	-2.1	-2.1	-2.1	-1.9	-2.7	-8.5	-3.1
PT	-7.0	-4.1	-3.4	-2.0	-2.3	-2.0	-1.6	-0.9	-0.5	-3.2	-1.2
RO	-3.2	-3.2	-1.5	-0.8	-0.4	-1.9	-3.0	-2.9	-4.3	-6.7	-9.2
SI	-4.7	-1.7	-1.2	-2.0	-1.2	-1.0	-0.6	-0.6	-0.8	-4.4	-1.2
SK	-4.2	-3.6	-1.6	-2.4	-2.5	-2.3	-1.3	-2.1	-2.3	-6.6	-4.0
FI	-1.0	-1.1	-0.9	-1.2	-0.7	-0.9	-1.1	-1.4	-1.7	-4.2	-1.6
SE	-0.3	0.1	0.0	-0.6	-0.3	0.5	0.8	0.0	0.1	-2.1	-0.2
UK	-5.7	-6.7	-4.7	-5.2	-4.8	-3.7	-3.0	-2.8	-2.7	-6.1	-4.7
EA-19	-3.6	-2.1	-1.3	-1.0	-0.9	-1.1	-1.2	-1.0	-1.1	-4.4	-2.1
EU-28	-3.8	-2.8	-1.8	-1.7	-1.7	-1.5	-1.4	-1.3	-1.3	-4.7	-2.5

Note: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) National index if not available.
Source: Commission 2020 spring forecast.

Table B6: **Gross debt, general government (as a percentage of GDP, 2002-2021)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
BE	105.4	101.7	97.2	95.1	91.5	87.3	93.2	100.2	100.3	103.5	104.8	105.5	107.0	105.2	104.9	101.7	99.8	98.6	113.8	110.0
BG	51.0	43.4	35.7	26.6	20.9	16.3	13.0	13.7	15.4	15.2	16.7	17.1	27.1	26.0	29.3	25.3	22.3	20.4	25.5	25.4
CZ	25.9	28.3	28.5	27.9	27.7	27.5	28.3	33.6	37.4	39.8	44.5	44.9	42.2	40.0	36.8	34.7	32.6	30.8	38.7	39.9
DK	49.1	46.2	44.2	37.4	31.5	27.3	33.3	40.2	42.6	46.1	44.9	44.0	44.3	39.8	37.2	35.8	33.9	33.2	44.7	44.6
DE	59.7	63.3	65.0	67.3	66.7	64.0	65.5	73.0	82.4	79.8	81.1	78.7	75.7	72.1	69.2	65.3	61.9	59.8	75.6	71.8
EE	5.7	5.6	5.1	4.7	4.6	3.8	4.5	7.2	6.6	6.1	9.8	10.2	10.6	10.0	10.2	9.3	8.4	8.4	20.7	22.6
IE	30.6	29.9	28.2	26.1	23.6	23.9	42.4	61.5	86.0	111.1	119.9	119.9	104.4	76.7	73.8	67.7	63.5	58.8	66.4	66.7
EL	104.9	101.5	102.9	107.4	103.6	103.1	109.4	126.7	146.2	172.1	159.6	177.4	178.9	175.9	178.5	176.2	181.2	176.6	196.4	182.6
ES	51.2	47.7	45.4	42.4	39.1	35.8	39.7	53.3	60.5	69.9	86.3	95.8	100.7	99.3	99.2	98.6	97.6	95.5	115.6	113.7
FR	60.3	64.4	65.9	67.4	64.6	64.5	68.8	83.0	85.3	87.8	90.6	93.4	94.9	95.6	98.0	98.3	98.1	98.1	116.5	111.9
HR	36.8	38.2	40.3	41.3	38.7	37.4	39.3	48.7	57.8	64.4	70.1	81.2	84.7	84.3	80.8	77.8	74.7	73.2	88.6	83.4
IT	106.4	105.5	105.1	106.6	106.7	103.9	106.2	116.6	119.2	119.7	126.5	132.5	135.4	135.3	134.8	134.1	134.8	134.8	158.9	153.6
CY	60.5	63.8	64.8	63.4	59.3	54.0	45.5	54.3	56.4	65.9	80.3	104.0	109.2	107.5	103.4	93.9	100.6	95.5	115.7	105.0
LV	13.0	14.1	14.7	11.9	10.1	8.5	18.6	36.9	48.1	43.9	42.4	40.3	41.6	37.3	40.9	39.3	37.2	36.9	43.1	43.7
LT	22.1	20.4	18.7	17.6	17.2	15.9	14.6	28.0	36.3	37.2	39.8	38.7	40.6	42.6	39.7	39.1	33.8	36.3	48.5	48.4
LU	7.4	7.5	7.9	8.0	8.3	8.2	15.4	16.1	20.2	19.0	22.0	23.7	22.7	22.0	20.1	22.3	21.0	22.1	26.4	25.7
HU	55.6	58.1	58.9	60.6	64.5	65.7	71.8	78.2	80.6	80.8	78.6	77.4	76.8	76.2	75.5	72.9	70.2	66.3	75.0	73.5
MT	63.2	69.0	71.9	70.0	64.5	62.3	62.6	67.6	67.5	70.2	67.8	68.4	63.4	58.0	55.5	50.3	45.6	43.1	50.7	50.8
NL	48.8	50.0	50.3	49.8	45.2	43.0	54.7	56.8	59.2	61.7	66.2	67.7	67.8	64.6	61.9	56.9	52.4	48.6	62.1	57.6
AT	66.7	65.9	65.2	68.6	67.3	65.0	68.7	79.9	82.7	82.4	81.9	81.3	84.0	84.9	82.9	78.3	74.0	70.4	78.8	75.8
PL	41.8	46.6	45.1	46.6	47.3	44.5	46.7	49.8	53.5	54.5	54.1	56.0	50.8	51.3	54.3	50.6	48.8	46.0	58.5	58.3
PT	60.0	63.9	67.1	72.2	73.7	72.7	75.6	87.8	100.2	114.4	129.0	131.4	132.9	131.2	131.5	126.1	122.0	117.7	131.6	124.4
RO	24.8	22.1	18.9	15.9	12.4	11.9	12.3	21.8	29.6	34.0	37.0	37.6	39.2	37.8	37.3	35.1	34.7	35.2	46.2	54.7
SI	27.4	26.8	26.9	26.4	26.1	22.8	21.8	34.5	38.3	46.5	53.6	70.0	80.3	82.6	78.7	74.1	70.4	66.1	83.7	79.9
SK	45.3	43.2	41.7	34.7	31.4	30.3	28.6	36.4	41.0	43.5	51.8	54.7	53.5	51.9	52.0	51.3	49.4	48.0	59.5	59.9
FI	40.2	42.7	42.6	39.9	38.1	33.9	32.6	41.5	46.9	48.3	53.6	56.2	59.8	63.6	63.2	61.3	59.6	59.4	69.4	69.6
SE	50.1	49.6	48.8	49.0	43.9	39.2	37.7	40.9	38.1	37.3	37.6	40.4	45.1	43.9	42.2	40.8	38.8	35.1	42.6	42.5
UK	34.2	35.4	38.4	39.6	40.5	41.5	49.4	63.3	74.6	80.1	83.2	84.2	86.2	86.9	86.8	86.2	85.7	85.4	102.1	101.5
EA-19	68.0	69.3	69.6	70.3	68.3	65.9	69.6	80.2	86.0	88.4	92.7	94.9	95.1	93.0	92.2	89.8	87.8	86.0	102.7	98.8
EU-28	59.5	61.1	61.7	62.2	60.7	58.1	61.3	74.0	79.7	82.5	85.8	88.0	88.7	86.5	85.3	83.6	81.8	80.7	96.2	93.4

Notes: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) National index if not available. (2) For EA-19, non-consolidated for intergovernmental loans (bn EUR): 0.9 in 2009, 21.2 in 2010, 69.3 in 2011, 193.4 in 2012, 231.0 in 2013, 240.5 in 2014, 231.0 in 2015, 231.0 in 2016. For EU-28, non-consolidated for intergovernmental loans (bn EUR): 0.9 in 2009, 21.2 in 2010, 69.8 in 2011, 196.4 in 2012, 235.9 in 2013, 245.7 in 2014, 236.4 in 2015, 235.7 in 2016.
Source: Commission 2020 spring forecast.

Table B7: **Debt dynamic components (as a percentage of GDP)**

	Primary balance						Snow-ball effect (1)						Stock-flow adjustment (2)					
	average 2011-2016	2017	2018	2019	2020	2021	average 2011-2016	2017	2018	2019	2020	2021	average 2011-2016	2017	2018	2019	2020	2021
BE	-0.1	1.6	1.3	0.1	-6.8	-2.4	0.3	-1.5	-0.9	-0.9	8.1	-6.9	0.4	-0.1	0.3	-0.2	0.2	0.7
BG	-0.8	1.9	2.6	2.6	-2.2	-1.2	0.0	-1.3	-1.0	-1.1	2.1	-1.4	1.5	-0.8	0.6	1.9	0.9	0.0
CZ	-0.4	2.3	1.7	1.0	-5.8	-3.1	0.0	-1.3	-1.0	-1.2	2.5	-1.5	-0.5	1.4	0.6	0.3	-0.3	-0.3
DK	0.5	2.6	1.5	4.4	-6.4	-1.5	0.5	-0.4	-0.3	-0.4	2.7	-2.1	-1.0	1.6	0.0	4.0	2.4	0.6
DE	2.1	2.3	2.8	2.3	-6.3	-0.8	-0.8	-1.3	-1.0	-0.8	3.5	-4.6	0.7	-0.3	0.4	1.0	6.1	0.0
EE	0.3	-0.7	-0.5	-0.3	-8.3	-3.3	-0.4	-0.9	-0.8	-0.6	0.5	-1.5	1.3	-0.8	-0.7	0.3	3.5	0.0
IE	-2.1	1.7	1.8	1.7	-4.4	-1.8	-4.2	-4.3	-4.0	-3.0	5.5	-3.4	0.1	-0.1	1.5	-0.1	-2.2	1.9
EL	-2.2	3.8	4.3	4.4	-3.4	0.6	11.5	-0.6	-1.0	0.3	22.4	-12.7	-8.3	2.1	10.3	-0.5	-5.9	-0.6
ES	-4.1	-0.5	-0.1	-0.5	-7.7	-4.4	2.2	-1.6	-0.9	-1.1	12.1	-6.4	0.1	0.5	-0.2	-1.6	0.4	0.0
FR	-2.0	-1.2	-0.6	-1.6	-8.4	-2.7	0.6	-1.0	-0.9	-1.2	8.9	-7.8	-0.4	0.1	0.1	-0.3	1.1	0.4
HR	-1.6	3.5	2.5	2.6	-4.8	0.1	2.3	-0.7	-1.0	-1.0	9.1	-4.7	0.0	1.1	0.5	2.1	1.5	-0.5
IT	1.7	1.3	1.5	1.7	-7.4	-2.1	3.4	0.6	1.4	1.8	16.6	-7.6	0.8	0.1	0.7	0.0	0.1	0.3
CY	-1.4	4.5	-1.3	4.2	-4.6	0.3	3.2	-3.5	-2.5	-1.2	9.5	-5.5	3.2	-1.5	7.9	0.4	6.1	-4.9
LV	-0.2	0.2	-0.1	0.5	-6.6	-3.8	-0.9	-1.7	-2.3	-1.0	3.0	-2.7	-0.5	0.2	0.2	1.2	-3.3	-0.5
LT	-0.9	1.6	1.5	1.1	-6.4	-2.2	-0.4	-2.1	-1.7	-1.3	3.0	-4.0	0.0	3.0	-2.1	4.8	2.9	1.7
LU	1.5	1.7	3.4	2.4	-4.5	0.3	-0.7	-0.4	-0.9	-0.9	1.4	-1.9	2.2	4.3	3.0	4.4	-1.7	1.5
HU	1.2	0.2	0.2	0.2	-2.6	-1.6	0.5	-3.0	-4.1	-3.9	4.7	-3.9	-0.2	0.7	1.7	0.3	1.4	0.8
MT	1.0	5.2	3.5	1.9	-5.2	-1.1	-2.0	-2.8	-2.9	-1.5	3.3	-2.0	1.0	2.8	1.6	0.9	-1.0	1.0
NL	-1.1	2.3	2.3	2.5	-5.5	-2.7	0.4	-1.5	-1.7	-1.7	3.8	-3.0	-1.0	-1.2	-0.5	0.4	4.2	-4.2
AT	0.5	1.0	1.8	2.2	-4.7	-0.5	-0.1	-1.1	-1.5	-1.0	4.7	-3.2	0.6	-2.5	-1.0	-0.5	-0.9	-0.3
PL	-1.4	0.1	1.2	0.6	-8.1	-2.4	0.0	-1.9	-1.7	-1.9	2.3	-2.3	-1.3	-1.6	1.1	-0.3	2.1	-0.3
PT	-0.8	0.8	2.9	3.2	-3.1	1.6	3.6	-2.6	-1.8	-1.6	10.4	-5.5	0.8	-2.0	0.6	0.5	0.3	0.0
RO	-1.0	-1.4	-1.8	-3.1	-7.8	-9.6	-0.5	-2.8	-2.3	-2.3	2.8	-1.2	0.8	-0.8	0.1	-0.2	0.3	0.1
SI	-3.3	2.5	2.7	2.3	-5.3	-0.3	1.4	-2.3	-2.5	-1.6	5.3	-4.2	2.1	0.2	1.5	-0.5	7.0	0.0
SK	-1.6	0.5	0.3	-0.1	-7.1	-2.9	0.4	-0.7	-1.6	-1.1	3.7	-3.1	-0.1	0.5	0.0	-0.4	0.6	0.7
FI	-0.9	0.3	0.1	-0.3	-6.6	-2.8	0.0	-1.3	-1.1	-0.7	3.7	-3.0	1.9	-0.2	-0.5	0.2	-0.2	0.4
SE	0.3	1.9	1.3	0.9	-5.3	-1.8	-0.7	-1.4	-1.3	-1.1	2.2	-1.9	1.6	1.8	0.6	-1.7	0.0	0.0
UK	-3.1	0.2	0.2	0.1	-8.4	-4.6	-0.3	-0.5	-0.5	-0.6	8.3	-5.2	-0.8	0.2	0.2	0.3	0.0	0.0
EA-19	-0.2	1.0	1.4	1.0	-6.8	-2.0	0.7	-1.2	-1.0	-0.9	7.6	-5.8	0.1	-0.1	0.4	0.1	2.2	-0.1
EU-28	-0.6	0.9	1.2	0.8	-7.0	-2.5	0.4	-0.4	-0.8	-1.0	7.2	-5.1	-0.1	-0.4	0.2	0.8	1.2	-0.1

Notes: (1) Following the withdrawal by the United Kingdom from the EU on 31 January 2020 and the entry into force of the Withdrawal Agreement, the United Kingdom entered a transition period lasting until 31 December 2020. During this period, Union law - including that related to the European Semester - continues to apply to and within the United Kingdom. (2) 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); (3) The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.
Source: Commission 2020 spring forecast.

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