

**European Fiscal Board**

# Assessment of EU fiscal rules

with a focus on the six and two-pack legislation

August 2019

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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
EA-12	Euro area, 12 Member States

#### Other

AIReF	Independent authority of fiscal responsibility
AWG	Ageing Working Group
CAB	Cyclically-adjusted budget balance
CAPB	Cyclically-adjusted primary balance
CP	Convergence programme
CSR	Country-specific recommendation
DBP	Draft budgetary plan
DG ECFIN	Directorate-General for Economic and Financial Affairs
DSA	Debt sustainability analysis
ECA	European Court of Auditors
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
EIP	Excessive imbalance procedure
EMU	Economic and Monetary Union

EPC	Economic Policy Committee
EPP	Economic partnership programme
ESM	European Stability Mechanism
GDP	Gross domestic product
GFCF	Gross fixed capital formation
HICP	Harmonised index of consumer prices
IFIs	International financial institutions
IMF	International Monetary Fund
JRC	Joint Research Centre
MIP	Macroeconomic imbalance procedure
MLSA	Minimum linear structural adjustment
MTBF	Medium-term budgetary framework
MTO	Medium-term budgetary objective
NAWRU	Non-accelerating wage rate of unemployment
NPLs	Non-performing loans
NRP	National reform programme
OECD	Organisation of Economic Co-operation and Development
OGWG	Output Gap Working Group
PBO	Parliamentary Budget Office
PISA	Programme for international student assessment
PPS	Purchasing power standard
QPF	Quality of public finances
RQMV	Reverse qualified majority voting
SB	Structural balance
SDP	Significant deviation procedure
SGP	Stability and Growth Pact
SP	Stability programme
SCPs	Stability and convergence programmes

SPB	Structural primary balance
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
UMTS	Universal mobile telecommunications systems

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## FOREWORD



**Prof. Niels Thygesen**

Chair of the European Fiscal Board

By a letter of 28 January 2019, the President of the European Commission asked the European Fiscal Board (EFB) to ‘carry out an assessment of the current EU fiscal rules’. The President’s letter and the broad terms of reference are attached as Annex A to this report.

The EFB welcomes this challenging and wide-ranging assignment. The mandate also provides guidance by listing three main criteria on which to base our assessment of the effectiveness the fiscal rules, viz. have they (1) ensured the long-term sustainability of public finances; (2) stabilised economic activity in a counter-cyclical fashion; and (3) improved the quality of public finances. We have structured most of our report around these general themes, while keeping in mind the President’s wish to have our suggestions for simplifying a set of fiscal rules and procedures that has become increasingly complex and difficult to communicate.

The six and two-pack – the major reforms of EU fiscal rules and governance launched in 2011-13 in the unique post-crisis environment – are emphasised in our mandate as the main point of reference. Undertaking an analysis of a nearly decade-long experience, comprising a double-dip recession and a prolonged, but for long hesitant, recovery has imposed two changes to the analytical approach the EFB had adopted in its annual reports for 2017 and 2018.

First, rather than providing a snap-shot photo of the practice of implementation and recording national experience in some granular detail, a more evolutionary and broad-brush approach has seemed appropriate for the present report. Evidence on what would have happened, if the EU had continued to rely on the pre-crisis rule book is

not available, so conclusions are necessarily tentative. Yet we believe, that – underpinned by the major analytical efforts undertaken, in particular, by our Secretariat – the six and two-pack reforms have moderately advanced sustainability. However, the reforms have been unable to significantly reduce pro-cyclical elements in national fiscal policies and to improve the quality of public finances. In particular, the reforms have not protected investment against bearing the brunt of the cutbacks in public expenditures since the crisis.

Second, the EFB has found it useful to supplement the rich documentary evidence available by collecting well-informed, often divergent, views through a series of conversations with policy officials who have been involved in designing and in implementing the EU fiscal rules, including some of the ‘architects’ of the six and two-pack reforms; a list of those with whom we have conducted conversations can be found as Annex B. We are grateful for the additional insights into a long experience – of which we have ourselves mainly observed the more recent part and not at first hand – which these conversations provided. They have been helpful in understanding the past and in developing our own perspectives on desirable features of the future of a rules-based system. We have not attributed views to any individual official and assume sole responsibility for the way in which we have interpreted them.

While the simplification of the rules we have been asked to propose may seem analytically feasible, the EFB is under no illusion that political agreement on how to advance could be easily achieved; the agenda may at the same time be too narrow and too divisive. As to the former and the more analytical aspects, the EFB sees itself as part of an emerging consensus in understanding simplification as focussing on one anchor – the longer-term evolution of the ratio of public debt to GDP – and one main instrument – the expenditure benchmark – while replacing some of the piecemeal elements of flexibility which have been introduced, mostly through negotiations between the Commission and individual Member States since 2015, by a general escape clause. The use of such a clause should be embedded into a clearer demarcation than in current practice between economic analysis and the political arguments that

will occasionally have to override it. We already presented some of these ideas in our Annual Report 2018.

Simplification along the lines suggested would, in the view of the EFB, be desirable, even when viewed in isolation. But it is easy to anticipate the resistance to it and to understand why the current Commission – which has sought our advice – envisages a revision of the rules after 2020. Member States, which have relied on delaying fiscal adjustments, want to retain well-known, but opaque procedures, while other Member States fear that the latter could risk becoming (even) more flexible. Both groups seem to share the view that the current practices have not been sufficiently destabilising to make a revision a high priority.

Given this stalemate, a narrow agenda may become a constraint – as it was when the six and two-pack reforms were adopted. At that time, agreement on a major clarification of the fiscal rules and on tighter monitoring of them was facilitated by its coincidence with an agreement on a safety net, later the European Stability Mechanism (ESM), to provide conditional financing, if things were to go badly wrong, despite efforts to observe the rules.

Circumstances in 2019 are, fortunately, less ominous than nearly a decade ago, mainly because much of a banking union and a wider safety net have come into existence. Yet some of the original flaws persist: despite a substantial recovery over the past couple of years, a number of high-debt Member States have not used the good times to build fiscal buffers, making their public finances vulnerable once more to even a modest slow-down of activity; at the same time, monetary policy has limited scope for further accommodation. We have reviewed the challenges of such a shorter-term scenario in our report of June 2019 on the appropriate fiscal stance in the euro area. Looking beyond the next one or two years, a simplification of the fiscal rules with carefully targeted scrutiny of a general escape clause could be easier to implement if accompanied by some allowance for a stabilisation capacity at the joint level of the euro area, as we argued already in the EFB Annual Report 2017.

In general, in the absence of a movement towards either a central fiscal capacity or other features of a deeper Economic and Monetary Union (EMU) and coordination of national policies, a burden will continue to be put on the fiscal rules as a partial

substitute. We have tried to outline a major simplification of the rules and a revision of the governance framework within which they operate. They would, in our view, help in reconciling the objectives of sustainability of public finances and of economic stabilisation.

But we have felt the need to go beyond pure simplification by trying to accommodate, through a variant of a Golden Rule, stronger incentives for public investment into the rules than have been provided so far. More attention to stimulating growth-enhancing spending is warranted by the likely persistence of a low interest rate environment as well as by the increasingly specific nature of EU investment initiatives. We finally look at how EMU deepening might reconcile the heterogeneity of the euro area with the need to give more meaning to its aggregate economic performance, as represented by the notions of the euro area fiscal stance and the macroeconomic imbalance procedure (MIP). This would involve recognition of diversity by collective negotiation of country-specific debt targets for the longer run.

These latter subjects go well beyond our immediate mandate and require much further reflection. We hope to return to them in future work, as well as to addressing links from fiscal rules to financial integration and to the strength of crisis mechanisms in the euro area to lessen the risks for public finances.

# 1. EXECUTIVE SUMMARY

**This report assesses the EU fiscal rules with a focus on the six and two-pack legislation.** The assessment has been carried out by the European Fiscal Board (EFB) following a request by the President of the European Commission, Jean-Claude Juncker. The EFB has closely followed the mandate it has received for this ad hoc request (see Annex A). It entailed three criteria against which the EU fiscal rules have been assessed: (1) ensuring the long-term sustainability of public finances; (2) stabilising of economic activity in a counter-cyclical fashion; and (3) improving the quality of public finances. To fulfil its mandate, the EFB also held various conversations with some of the ‘architects’ of the six and two-pack reforms and with some current and past EU officials to form a comprehensive view of their rationale and objectives. The concluding chapter of this report takes a forward-looking perspective and makes recommendations aimed at a simplification and improvement of the EU fiscal framework.

**The Maastricht Treaty aimed at fostering fiscal discipline to reduce the risk of negative spillovers for the euro area.** This was to be achieved by banning excessive deficits, monetary financing and financial repression as well as by introducing a no-bailout clause. This would ensure monetary dominance, avoid fiscal ‘free-riding’ and strengthen market discipline. However, instruments for crisis management and resolution were missing, as was a central fiscal capacity.

**The original Maastricht compromise neglected the importance of macroeconomic imbalances as a source of fiscal risks.** Large capital inflows create public sector solvency risks if expanding private sector indebtedness coincides with rising contingent liabilities. Sudden stops can then turn into a source of liquidity risks for Member States with large current account deficits. Macroeconomic risks will also become a challenge for fiscal surveillance to the extent that the existing metrics of the fiscal effort do not sufficiently capture an overheating or a deterioration of the economy.

**In the run-up to the global financial crisis of 2008, a loose implementation of fiscal rules led Member States to avoid building-up adequate**

**fiscal buffers.** Public debt ratios in a number of high-debt Member States were not adequately reduced during good economic times. Financial markets failed to discriminate between the differing sovereign risks and thus fuelled the build-up of explicit and implicit fiscal imbalances. Moreover, the crisis fiscal stimulus package – the European economic recovery plan – neglected initial fiscal positions and worsened the situation of some already fragile Member States. The lack of adequate differentiation contributed to the ensuing pro-cyclical contraction.

**The Greek sovereign debt crisis highlighted the importance of effective institutions.** For example, Eurostat – the statistical office of the EU – was given the power to monitor and verify upstream public finance data from EU Member States. The sovereign debt crisis highlighted also other weaknesses in the design features of the Economic and Monetary Union (EMU). First, it revealed that the no-bailout clause lacked credibility. Second, it showed that the Maastricht architecture was incomplete. Finally, it laid bare the EMU’s vulnerability to contagion effects.

**The sovereign-bank nexus gave rise to detrimental consequences for public finances.** In the economic and financial governance framework at the time, undisciplined fiscal policies became a particularly important source of bank distress and impaired the functioning of the EMU. The European sovereign debt crisis demonstrated the need for governments to maintain sound public finances enabling them to avoid adverse feedback loops between fiscal and banking risks.

**The six and two-pack legislation have both strengthened fiscal rules and added elements of flexibility and discretion.** Four key developments are noteworthy: (i) a reorientation of the fiscal rules towards a greater focus on debt developments and expenditure control; (ii) strengthening enforcement through sanctions; (iii) expanding economic governance to the monitoring of macroeconomic imbalances; and (iv) the creation of independent fiscal institutions at the national level.

**The six-pack legislation aimed at strengthening both the preventive and corrective arm of the Stability and Growth Pact.** This was to be achieved via a graduated system of financial sanctions, enhanced reporting requirements and the possibility to open a debt-based excessive deficit procedure. The six-pack reform, which introduced the expenditure benchmark as an additional indicator first in the preventive and later in the corrective arm, might have only added to the existing complexity even though the underlying rationale to rely on variables under the direct control of policy-makers seems sensible. Moreover, it might not have eliminated the incentives under the corrective arm of the SGP to pursue a so-called ‘nominal strategy’ during economic recoveries.

**Compliance rates differ markedly depending on the fiscal rule and the periods of comparison.** An empirical analysis of numerical fiscal rules at the EU level shows that, following the six and two-pack reforms, compliance has generally increased even though it is difficult to establish a clear causality. Compared to the pre-crisis period, average compliance across all EU numerical rules has marginally improved from 57% to 63%. However, the compliance rates of individual rules differ widely when comparing the periods 1998-2007 to 2011-2018. Compliance with the structural balance rule increased from 44% to 63%, while compliance with the debt rule declined from 83% to 59%. In practice, compliance with the debt rule has been waived by referring to other relevant factors (i.e. compliance with the preventive arm and structural reforms) in the assessment. In high-debt countries that made use of flexibility within the SGP, the medium-term sustainability of public finances has weakened.

**On the back of the economic recovery, progress has been made in correcting fiscal imbalances since the six and two-pack legislation.** However, it is difficult to disentangle any causal effects of the six and two-pack reforms in the absence of a counterfactual. For the first time since 2003, no EU Member State is under the excessive deficit procedure, and the aggregate deficit for the EU is the lowest since 2000. The number of EU Member States that have attained their medium-term budgetary objectives (MTOs) under the preventive arm of the SGP has steadily increased after the reforms. Today, over 40% of Member States are estimated to be at their MTO – the highest share ever recorded. Prior to the six

and two-pack reforms, some EU Member States displayed excessive net expenditure growth compared to medium-term potential output. One consequence of the reforms is that there are now instruments in place to better monitor excessive expenditure growth. A stronger focus on expenditure developments in the pre-crisis period would have resulted in larger fiscal buffers and thus an enhanced capacity to absorb economic shocks.

**Debt trajectories differ significantly across countries.** EU Member States can be clustered into three groups: low debt, high debt and very high debt. Low-debt Member States with solid fiscal positions have returned to their pre-crisis debt levels at around 40% of GDP. Another group of Member States with pre-crisis debt levels around the 60% of GDP reference value increased their debt levels substantially during the crisis years but managed to put them on a downward path subsequently. A third group of eight Member States that entered the crisis already with high debt levels (above 60% of GDP) ended up with even higher debt levels and have thus far not achieved sufficient debt reduction. Diverging economic growth dynamics account only in part for the observed heterogeneity.

**Certain rules exhibit a clear pro-cyclical bias in their compliance rate and give rise to ‘cherry-picking’.** There is a pro-cyclical bias in particular for compliance with the 3% of GDP reference value, as Member States under the corrective arm of the SGP have continued to pursue a so-called ‘nominal strategy’, relying on temporary budgetary windfalls for the correction of their excessive deficits. Compliance with the expenditure benchmark is less dependent on the economic cycle. This poses a challenge to the proper enforcement of the fiscal rules. Overlapping fiscal requirements often lead to ‘cherry-picking’, whereby Member States choose to comply with the less demanding fiscal target and are absolved from compliance with the other rules.

**Medium-term fiscal planning has not improved while fiscal surveillance has become increasingly bilateral.** A number of Member States have repeatedly postponed the achievement of the targets presented in their stability and convergence programmes (SCPs) or moved them to the outer years. This calls into question the reliability of medium-term fiscal plans. Poor execution of budgetary plans can be a cause of non-compliance with the fiscal rules. In addition,

the assessment of the SCPs has become less important as political attention has shifted to the draft budgetary plans (DBPs) in October. Thus far, in any given year, between 30-45% of the DBPs were deemed to be at risk of non-compliance with the fiscal rules. Two Member States (Portugal and Italy) have submitted a DBP for which the first Commission assessment was always at least ‘at risk of non-compliance’ while they were subject to the preventive arm of the SGP. At the same time, fiscal surveillance has become increasingly bilateral involving only the Commission and the Member State concerned. This increasing bilateralism came at the expense of carrying out a comprehensive multilateral peer review.

**The average size of fiscal slippages has almost halved.** Without necessarily establishing any causality, since the six and two-pack reforms the average slippage from the required annual structural adjustment has almost halved from 1.1% to 0.6% per year. These slippages seem to cluster around 0.5% of GDP, which coincides with the margin of tolerance in the preventive arm of the SGP. This suggests that the margin of tolerance exerts a ‘magnet effect’ similar to the one observed for the 3% deficit threshold. Member States seem to deliberately plan to locate their structural target at the border of the allowed deviation.

**Member States not yet at their medium-term objective have lost momentum in pursuing the required adjustment path.** This comes on top of a repeated use of flexibility since 2015 in combination with reliance on the allowed margin of broad compliance in the preventive arm. Given that compliance with the debt criterion is closely intertwined with compliance under the preventive arm, a lack of progress towards the MTO in high-debt countries has in turn caused an insufficient rate of debt reduction. While the speed of adjustment towards the MTO increased after the six-pack reform compared to the pre-crisis period, this temporary acceleration was largely driven by the EDP requirements and intense market pressures rather than by the SGP itself.

**Independent fiscal institutions function as useful complements to the existing national fiscal frameworks.** They currently exert soft influence on the budgetary process by producing independent macro forecasts or by assessing the governmental forecasts, hence fostering local ownership of the fiscal rules. In particular, there are some key characteristics associated with higher

independent fiscal institution (IFI) effectiveness such as a sufficient degree of independence and resources. However, EU IFIs still exhibit a marked degree of heterogeneity.

**During the first five years of the macroeconomic imbalance procedure, the number of EU countries experiencing macroeconomic imbalances gradually rose from 12 to 19.** While the MIP may have succeeded in raising awareness about the need to implement certain corrective measures, thus far, the Commission has not launched any excessive imbalance procedure (EIP). One reason may be that the criteria for opening an EIP are less well defined than in the case of the SGP.

**Fiscal stabilisation did not feature prominently in the initial version of the Stability and Growth Pact, but has gained in importance since.** The original SGP entailed some pro-cyclical bias in fiscal policies as it focused on nominal variables. The six-pack reform and subsequent changes to the EU fiscal rules allowed to reduce the pro-cyclicality of fiscal policy. Adjusting fiscal requirements to cyclical conditions and acknowledging the costs of certain unusual events and growth-enhancing measures were key in this regard. After the six-pack reform entered into force, the revamped adjustment requirements under the preventive arm of the SGP have attempted to take into account the trade-off between stabilisation and sustainability needs. Countries with stabilisation needs gained fiscal leeway, whereas the adjustment requirements for high-debt countries became more stringent.

**In 1999-2018 only one major counter-cyclical fiscal expansion is recorded in 2009.** This was due to the European economic recovery plan (EERP) – a coordinated fiscal stimulus in response to the global economic and financial crisis. During the same period, a pro-cyclical fiscal expansion followed the euro adoption in 2000 and a sizeable pro-cyclical fiscal consolidation took place in 2011-2013. Most notably, such pro- and counter-cyclical episodes have generally been more pronounced in countries with debt exceeding 90% of GDP.

**The fiscal stance in the euro area has remained within a broadly neutral range most of the time since 1999.** This means that the change in the cyclically-adjusted or structural primary balance has not exceeded  $\pm 0.25\%$  of GDP. There has not been any case of aggregate counter-cyclical fiscal

contraction in good economic times. In particular, the years 2003-2007 and 2017 constituted missed opportunities due to the failure to build fiscal buffers in good economic times.

**Overall, the six-pack legislation and following changes have not reduced the pro-cyclicality of fiscal policy.** In the euro area as a whole in 2011-2018 discretionary fiscal policy turned out to be pro-cyclical 63% of the time as opposed to 17% of the time in 1999-2010. In very high-debt countries discretionary fiscal policy offset automatic fiscal stabilisers even 75% of the time during the period 2011-2018. Pro-cyclical fiscal consolidation took place in the euro area during the sovereign debt crisis. Fiscal policy has subsequently returned to its status quo ante (before the six-pack reform), which was characterised by broadly neutral fiscal stances even during periods of strong economic growth when counter-cyclical consolidation was warranted. In 2012-2014, Member States lacked sufficient fiscal leeway to address the double-dip recession, because of overwhelming sustainability concerns. Conversely, the increased flexibility since 2015 came in late, when the recovery was already well advanced. Econometric analysis confirms the persistence of pro-cyclical fiscal policy.

**The six and two-pack legislation have paid some attention to the quality of public finance dimension but not to the extent needed.** The two-pack reform has introduced additional monitoring requirements with a clear quality of public finance (QPF) dimension such as public investment, education and taxation. Euro area Member States subject to an EDP have to submit an economic partnership programme (EPP). Building on the existing country-specific recommendations (CSRs), the EPP is supposed to encompass detailed structural measures deemed essential to correct the excessive deficit in a long-lasting manner. Thus, the EPP contributes towards strengthening the link between the corrective arm of the SGP and QPF. However, it has largely turned into a procedural agenda item. The implementation of CSRs on key QPF dimensions remains at an unsatisfactorily low level.

**During an excessive deficit procedure Member States tend to reduce public investment as a share of total government expenditure and of GDP.** In particular, the initial level of public investment determines the space for further cuts. Member States with low initial levels of public investment as a share of current primary

expenditure maintain the status quo or reduce public investment only marginally. On the other hand, Member States with high initial levels of public investment as a share of current primary expenditure have often reduced it by the final year under the excessive deficit procedure (EDP). This highlights the need to incentivise Member States under an EDP to protect public investment rather than cutting it with the aim to exit the EDP as soon as possible.

**In general, in some Member States public investment as a share of government expenditure has declined on average for the period 2011-2018 compared to the period 1998-2007.** In particular, this was the case for Greece, Portugal, Cyprus, Ireland, Spain, Belgium, France, and Italy. This development is disappointing, because the long-term benefits of productive public expenditure in education, R&D, transport and infrastructure should be harnessed to the fullest extent possible. In combination with more efficient revenue systems, this will not only foster compliance with EU fiscal rules but also enhance the sustainability of public finances.

**The six and two-pack legislation might have helped to build more sustainable public finances but major vulnerabilities remain.** The EFB sees it as a remarkable achievement that no Member State is currently in an excessive deficit procedure. However, national fiscal policies have proven to remain pro-cyclical and, as a result, debt ratios have not been reduced sufficiently during good economic times. While the EU fiscal rules have attempted to encourage structural reforms and public investment by operationalising the flexibility provisions, they have not prevented severe cutbacks in public investment over the past decade in some Member States.

**The EU fiscal rules should focus on sustainability and, in particular, on achieving a reduction of very high-debt levels.** At the same time, they should encourage more counter-cyclical policies and contribute in a more constructive manner towards improving the quality of public finances. The EFB stresses that there is still an urgent need to simplify the EU fiscal rules. A simplification would also generate positive feedback effects for EMU governance as a whole.

**The EFB identified multiple sources of unnecessary complexity in the current framework.** First, there is an excessive reliance on

unobservable indicators and real-time data – both often subject to major revisions ex-post. Second, with the benefit of hindsight, flexibility was often badly timed, also due to political considerations thus facilitating pro-cyclicality, while at the same time it failed to protect public investment. Third, there is a tendency to rely on annual rather than longer-term plans. Member States continue to postpone adjustments to the outer years in their stability and convergence programmes.

**The proposal of the EFB would have several advantages resulting in a simplification.** In its annual report 2018 the EFB has made a proposal that relies on a simple medium-term debt ceiling and one operational target, namely, a ceiling on the growth rate of primary expenditure net of discretionary revenue measures, and an escape clause triggered on the basis of independent economic judgement. This proposal would focus more clearly on underpinning sustainability, improve observability, simplify the rules and reduce pro-cyclicality. Net primary expenditure growth is linked to potential growth and thus would have an implicit stabilising effect on the economy. The EFB proposal encourages a focus on the medium run by fixing the net primary expenditure growth ceiling for a period of three years ahead. Furthermore, the use of flexibility to reconcile stabilisation better with sustainability, while improving the quality of public finances, remains an appropriate objective. The EFB proposes that any flexibility should be based on independent economic judgement. Finally, the EFB concludes that the ‘matrix approach’, which determines the speed of adjustment towards to the medium-term objective, has not worked and could be abandoned.

**Further efforts need to be undertaken to improve the quality of public finances.** The EFB’s proposes the introduction of a limited Golden rule to protect public investment, while avoiding overburdening the EU fiscal rules with too many conflicting objectives. Our variant of the Golden rule would exclude some specific growth-enhancing expenditure from the net primary expenditure growth ceiling. The selection of relevant expenditure would take into account projects already identified by the EU budget. The EFB proposes that Member States could voluntarily top-up expenditures on projects beyond their co-financing commitments. These could then be deducted from the calculation of the net primary expenditures. National independent fiscal

institutions could monitor the classification of growth-enhancing expenditure. This would further reduce the risk that governments unduly classify certain expenditure items as public investment.

**There are certain governance issues that need to be addressed.** First, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission should play a more independent role, to be defined in secondary legislation, in carrying out economic analysis and providing advice to the College of Commissioners. Second, after the introduction of the reverse qualified majority voting (RQMV) the Commission appears to have become more reluctant in following through with the enforcement of the fiscal rules. RQMV might also have contributed to the politicisation of the Commission and the bilateralisation of fiscal surveillance at the expense of multilateral peer review. The RQMV should be abolished. Third, the EFB is convinced that the functioning of the Eurogroup could be improved if it was chaired by a full-time president, who is neither a national Finance Minister nor a member of the Commission. Considering the relatively high turnover of Finance Ministers in the Eurogroup this would improve continuity and the governance of the euro area as a whole.

**Financial sanctions in case of non-compliance with the EU fiscal rules framework have been politically difficult to enforce.** The EFB has been a strong advocate of introducing a common fiscal capacity at the European level. One of the eligibility criteria to access funds could be compliance with the EU fiscal rules. Incentivising compliance in this way might be more effective than financial sanctions.

**Going beyond uniform rules, one could imagine closer coordination of fiscal policies across Member States.** Based on a mutual agreement between Member States over a seven-year cycle, staggered against the multiannual financial framework of the EU, medium-term debt targets could be made country-specific. High-debt countries would commit to reduce their debt, and symmetrically low-debt countries would commit to increase growth-enhancing government expenditure, in particular those that have positive cross-border spillovers. The proposed agreement would effectively implement a euro area aggregate fiscal stance. Finally, the creation of links between net expenditure growth and the MIP could be explored.

## 2. BACKGROUND TO THE REFORMS

### KEY FINDINGS

- Fiscal discipline has always been considered a necessary prerequisite for the orderly functioning of a monetary union geared towards price stability.
- The original architecture for economic governance in Europe's Economic and Monetary Union (EMU), established with the Maastricht Treaty of 1992, included a series of provisions aimed at fostering fiscal discipline: the prohibition of excessive deficits, the prohibition of monetary financing, the no-bailout clause and the prohibition of privileged access to financial institutions.
- The original EMU architecture, however, neglected the importance of macroeconomic imbalances, which can be a source of fiscal risks for national governments.
- Furthermore, in the run-up to the global financial crisis of 2008, a loose implementation of fiscal rules failed to encourage Member States to build up sufficient fiscal buffers. Public debt ratios in a number of high-debt Member States were not adequately reduced under these relatively favourable economic circumstances.
- The Greek sovereign debt crisis highlighted the important role of national institutions in ensuring an effective and transparent enforcement of fiscal rules.
- The emergence of the sovereign-bank nexus in the euro area made clear that banking crises can have detrimental consequences for public finances and, conversely, that undisciplined fiscal policies can be a source of bank distress and impair the functioning of EMU.
- Based on the lessons learned during the crisis, the six and two-pack reforms aimed at strengthening the EU economic governance framework in five ways, by:
  - (i) reorienting fiscal rules towards a greater focus on debt developments and expenditure control;
  - (ii) strengthening enforcement through sanctions;
  - (iii) expanding economic governance to the monitoring of macroeconomic imbalances;
  - (iv) establishing independent fiscal institutions at the national level;
  - (v) completing the EMU architecture, most notably by introducing crisis-resolution mechanisms and establishing a banking union.
- Since the six and two-pack reforms, EU fiscal rules remained subject to continued refinements and interpretative innovations, which added to the complexity of an already elaborated system.
- Greater complexity and judgement in the implementation of the Stability and Growth Pact (SGP) heightened frictions between different institutional players over who ultimately exercises discretion.
- While flexibility is desirable, the growing complexity of the functioning of the SGP has become problematic, raising questions about transparency, equal treatment among countries, and communicability to the public.

## 2.1. THE MAASTRICHT ARCHITECTURE

Member States signed the Maastricht Treaty in 1992, establishing a new framework for the economic governance of the EU, consisting of a single monetary policy and decentralised fiscal policies. Such a framework reflected the only political compromise available at the time, as Member States were unwilling to relinquish their fiscal sovereignty. The framework was based on the guiding principles of price stability and fiscal discipline. On the one hand, the fiscal discipline was considered a necessary precondition to ensure price stability. On the other hand, the ‘Maastricht compromise’ traded off the gains from early monetary unification, in terms of lower interest rates and inflation, for the adoption of prudent fiscal policies and structural reforms that would make participating economies competitive and enable them to absorb adverse shocks.

### The role of fiscal discipline in a monetary union

Under the Maastricht Treaty, the primary objective of the European Central Bank (ECB) is to maintain price stability<sup>(1)</sup>. However, this may not be possible in the absence of disciplined fiscal policies. A continuous increase in public indebtedness may force the central bank to use monetary policy to finance the government’s budget deficit. This results in a situation of fiscal dominance, where the central bank is no longer able to take decisions autonomously and has to conform itself to the fiscal position of the government, thus abandoning price stability<sup>(2)</sup>.

An additional problem that arises in a monetary union with decentralised fiscal policies stems from the opportunity for fiscal free-riding. Since a higher government deficit usually leads to higher inflation, a central bank will tend to offset the expansionary impact of fiscal policy by tightening the monetary stance. In the euro area, however, each Member State has a relatively small impact on the overall inflation rate, so that the offsetting role of monetary policy vis-à-vis national deficits is limited.

<sup>(1)</sup> See Article 127(1) TFEU.

<sup>(2)</sup> A long literature explores the interaction between fiscal and monetary policy. Phelps (1973) already noted that, from a public finance perspective, inflation can be viewed as a tax on the holders of nominal assets. Sargent and Wallace (1981) discuss how monetary policy and fiscal policy need to be coordinated, in view of the former’s impact on the latter. Anand and van Wijnbergen (1988) develop a framework to assess the consistency between fiscal deficits and the inflation rate, centred around the government budget constraint.

Furthermore, while each Member State can fully appropriate the benefits of higher borrowing, the costs in terms of higher real interest rates are dispersed throughout the monetary union. This creates further incentives for expansionary fiscal policies.

The orderly functioning of a monetary union therefore requires provisions aimed at fostering fiscal discipline, to avoid fiscal dominance and fiscal free-riding. The Maastricht Treaty included a series of such provisions to impose discipline in two ways: first, by directly constraining government policies with fiscal rules; and second, by enabling a regime of market pressure. However, tools for crisis resolution were missing, and this proved to be a major shortcoming in the context of the Greek sovereign debt crisis. The possibility of private sector involvement in debt restructuring sparked a financial contagion, which could be addressed only by introducing new governance tools.

### Budgetary discipline via fiscal rules

There were two main inspirations for the design of the Treaty fiscal rules: (i) the emerging practice of monetary policy targets pursued by independent central banks; and (ii) the architecture adopted in large federal countries to ensure the fiscal responsibility of sub-federal governments. However, both inspirations offered inadequate guidance. The role of the Commission as the guardian of the treaties could not match that of independent central banks. At the same time, while in federal countries the central government is responsible for economic stabilisation, in the EU this remains the responsibility of national governments. Therefore, a trade-off between the two main functions of fiscal policy – cyclical stabilisation and assurance of longer-term sustainability – was much harder to avoid in the EU in the presence of strict rules and the no bailout clause. It was nevertheless left aside, since the reputation of fiscal policy as a counter-cyclical stabiliser had reached a low point around 1990, due to the negative experience of often pro-cyclical policies in the 1970s and 1980s. The current view of the economics profession, however, is less negative than some thirty years ago.

In the Maastricht Treaty, Member States adopted reference values for budget deficits and debt levels, at 3% and 60% of GDP respectively. A deviation from these values can constitute a ‘gross error’,

triggering the excessive deficit procedure (EDP) <sup>(3)</sup>. The Treaty also established a system of multilateral economic surveillance to strengthen the coordination of Member States' policies. Under this system, the Council issues 'broad guidelines' for the economic policies of Member States, and monitors the consistency of national policies with such guidelines, issuing a warning to deviating Member States <sup>(4)</sup>.

The Stability and Growth Pact (SGP) was introduced in 1997. Council Regulation (EC) 1467/97 of 7 July 1997 operationalised the corrective arm of the SGP: it defined a detailed list of procedural steps, including sanctions, aimed at correcting an excessive deficit. Council Regulation (EC) 1466/97 of 7 July 1997 established the preventive arm of the SGP: with its adoption, Member States committed to maintaining a budgetary position of 'close to balance or surplus' over the medium-term. They further committed to regularly submit stability and convergence programmes, detailing all information necessary to carry out multilateral fiscal surveillance.

A first reform of the fiscal rules occurred in 2005 to enhance their economic rationale. In a phase of low economic growth following the burst of the dot-com bubble, with some Member States even in recession, adhering to a nominal deficit target caused pro-cyclical tightening. This led the ECOFIN Council to take the controversial decision of putting in abeyance the excessive deficit procedures of France and Germany in 2003, a decision later overturned by the European Court of Justice.

To enhance the economic rationale of the rules, the 2005 reform introduced five main innovations. (i) It moved the focus towards assessments based on fiscal efforts rather than fiscal outcomes, to account for the impact of the economic cycle on revenues and expenditures. (ii) The reform linked the medium-term budgetary objectives to public debt and long-term ageing costs, thus making them country-specific. (iii) It introduced the possibility to take into account the implementation of major structural reforms when defining the adjustment path to the medium-term budgetary objectives. (iv) The reform codified the role of the 'other relevant factors' which may be relevant when assessing the existence of an excessive deficit. (v) It established that the deadline to correct excessive deficits under

the EDP could be postponed following the materialisation of 'unexpected adverse economic events with major unfavourable consequences for government finances', provided that the Member State took effective action.

### Budgetary discipline via market pressure

Beyond fiscal rules, the Maastricht Treaty established a set of provisions to maintain market pressure on national fiscal policies. The most prominent of such provisions is the no-bailout clause <sup>(5)</sup>. Since fiscal policy remained under the domain of national governments, the Treaty established that each Member State would be responsible for repaying its own debts to prevent moral hazard. The clause implied that lenders would face the costs of a possible default, and therefore it aimed at strengthening market discipline by leading investors to discriminate among borrowers based on their creditworthiness.

A second provision for market discipline, conceptually linked to the no-bailout clause, consists in prohibiting monetary financing <sup>(6)</sup>. While this provision aims primarily at protecting central bank independence, it also has direct fiscal implications, because it prohibits the ECB from using monetary policy to provide a more favourable financing environment for national governments. By forbidding 'monetary bailouts', the prohibition of monetary financing implies that governments face the full costs of their sovereign risks, as they are determined by the market.

A final provision for market discipline comes from the prohibition of privileged access to financial institutions <sup>(7)</sup>. This aims at preventing Member States from resorting to explicit forms of financial repression. Council Regulation (EC) 3604/93 of 13 December 1993, which specifies the application of this provision, establishes that Member States cannot oblige financial institutions to hold their public debt, and cannot confer fiscal or other advantages to financial institutions that decide to do so.

In sum, while the practical conduct of fiscal policy remains under the responsibility of Member States, the economic governance envisaged in the Maastricht architecture has significant fiscal implications. On the one hand, fiscal rules aim at

<sup>(3)</sup> See Article 126 TFEU.

<sup>(4)</sup> See Article 121 TFEU.

<sup>(5)</sup> See Article 125 TFEU.

<sup>(6)</sup> See Article 123 TFEU.

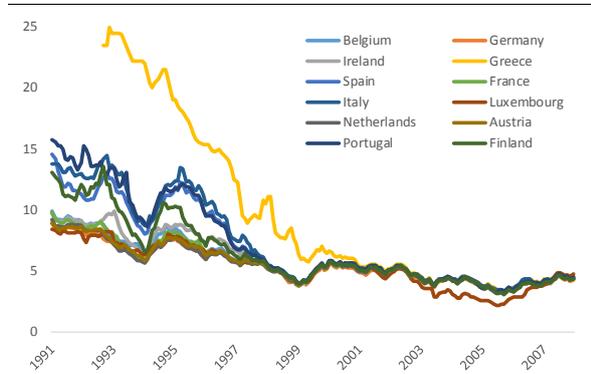
<sup>(7)</sup> See Article 124 TFEU.

directly reducing political discretion in order to mitigate the deficit bias of national governments. On the other hand, the Treaty prohibits all the strategies that governments may use to evade their budget constraint: debt bailouts, inflation and financial repression. All these provisions were aimed at fostering fiscal discipline, as a crisis-prevention mechanism, with a view to allow an orderly functioning of the euro area. Tools for crisis resolution were, however, missing.

## 2.2. MACROECONOMIC IMBALANCES

The new economic governance framework that emerged from the Maastricht Treaty offered the promise of uniform macroeconomic stability across the EU, and altered market expectations about the future direction of Member States' policies. The expectation that 'higher-risk' Member States would pursue stability-oriented policies, and that they would experience better growth prospects due to convergence, triggered large capital flows from 'lower-risk' Member States. This led to a progressive convergence of nominal interest rates between the two groups of countries, which reflected a perceived convergence of risks (Graph 2.1).

Graph 2.1: Interest rates on 10-year government bonds (% , year-on-year)



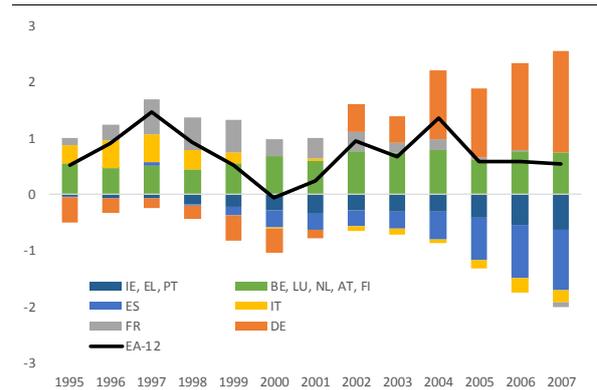
Source: European Commission.

This increase in net cross-border capital flows led to the formation of large external imbalances between euro area Member States. While the overall current account surplus of the euro area remained broadly unchanged until the global financial crisis of 2007/2008, large deficits and surpluses began to appear in individual Member States (Graph 2.2).

The economic impact of these imbalances was equivalent to that of a positive credit supply shock

in Member States with current account deficits. The reduced cost of borrowing triggered by capital inflows led to a credit-fueled growth, which manifested itself in the accumulation of large private sector leverage, asset overvaluations, wage and costs inflation. These domestic developments caused a loss of cost-competitiveness, which in turn led to a decline in export market shares and to a further widening of current account deficits.

Graph 2.2: Current account balance in the euro area 12, and countries' contribution (% of EA-12 GDP)



(1) Euro area 12 Member States are: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Source: European Commission, own calculations.

### 2.2.1. The fiscal risks stemming from macroeconomic imbalances

The external and internal imbalances mentioned above led to a steady accumulation of fiscal risks, which went largely unnoticed in the years before the crisis. There are traditionally three fundamental drivers of sovereign risks: solvency risks, liquidity risks and overall macroeconomic risks. All these were steadily increasing in Member States, but markets did not price these risks into sovereign spreads, which largely vanished during the pre-crisis period.

#### Solvency risks

Large capital inflows in trade-deficit countries led to lower borrowing costs, which resulted in substantial leverage build-up in the private sector. Excess private borrowing increases solvency risks for the government, due to an accrual of contingent liabilities. Unlike public debt, contingent liabilities arise only if a specific event occurs in the future. These liabilities can be explicit if they are set in laws or contracts: such is the case for loan guarantees, state guarantees of public-private-partnerships or public insurance schemes (e.g. bank deposit insurance). Other types of

contingent liabilities are implicit, because they stem from political rather than legal obligations. This is the case, for instance, of private sector defaults on bank credit, which may force the government to intervene to preserve the viability of banks. To the extent that private sector indebtedness expands contingent liabilities, it is therefore a source of fiscal risks for the government. This problem is particularly acute in the context of financial crises, because the risks that give rise to such liabilities (e.g. bank defaults) are usually correlated.

By focusing on gross public debt ratios, the SGP did not consider the fiscal risks arising from private sector indebtedness. Indeed, by looking solely at public debt developments, several crisis-hit Member States displayed a remarkably solid fiscal position until 2007. The global financial crisis triggered a sharp correction in the value of financial and non-financial assets in trade-deficit countries, leaving borrowers exposed and banks saddled with large volumes of non-performing assets. With the unravelling of macroeconomic imbalances, euro area governments intervened to support domestic banks: this led to the transfer of substantial volumes of private debts onto public balance sheets. Between 2008 and 2014, the direct fiscal impact of financial sector support led to sizeable debt increases in several Member States, most notably Ireland (+31.1% of GDP), Greece (+22.1%), Cyprus (+18.8%), Slovenia (+18.1%), Portugal (+11.3%) and Germany (+8%)<sup>(8)</sup>.

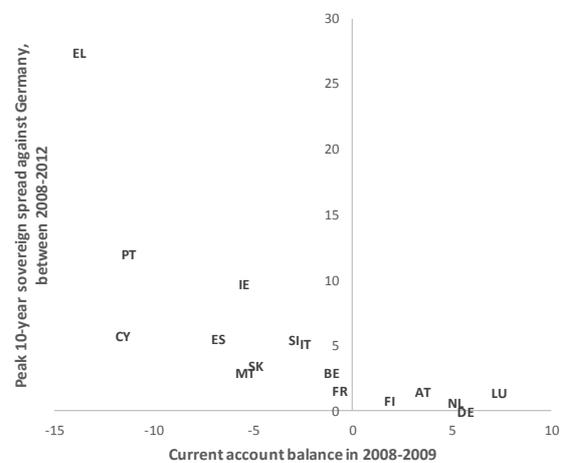
### Liquidity risks

Liquidity risks – for both public and private borrowers – increased during the pre-crisis years due to the emergence of large current account deficits. The rapid economic growth observed in trade-deficit Member States was largely financed with foreign borrowing. The same holds true for their budget deficits. A sharp dependence on foreign capital exposed trade-deficit countries to the risk of a reversal of capital flows, which promptly materialised during the euro crisis. This source of risk was also neglected at the time.

Following the unravelling of external imbalances, euro area Member States that had sizeable current account deficits faced a sudden stop to capital flows. One of the main drivers of capital outflows was the emergence of a redenomination risk following the Greek sovereign crisis, and the

possibility of private sector involvement in a debt restructuring. This sudden reversal of capital flows created direct pressure on public finances, as governments struggled to refinance their debts. A dramatic widening of sovereign spreads hit Member States that were relying on foreign investors to absorb domestic debt (Graph 2.3). By contrast, Member States with current account surpluses were largely untouched by the euro crisis, irrespective of the level of their public debt (between 2010 and 2012, for instance, the debt ratio of Belgium was above the euro area average, whereas Spain's debt ratio was below).

Graph 2.3: 10-year sovereign spreads against German government bonds (percentage points) vs. current account balance (% of GDP)



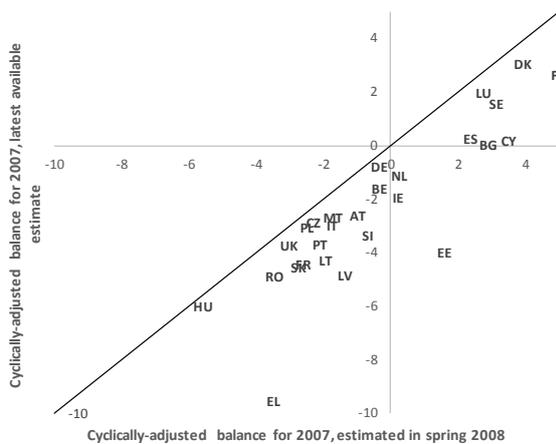
Source: European Commission, own calculations.

### Macroeconomic risks

Macroeconomic risks were also significant, as the credit-fuelled growth observed in trade-deficit countries was not sustainable and exposed these economies to the risks of a correction. The remarkable debt reduction achieved in several Member States before the crisis partly rested on cyclical revenue windfalls and on unsustainable GDP levels. This particular source of risks also had direct implications for fiscal surveillance, because conventional metrics of fiscal effort – such as the structural balance – hinge on estimates of the output gap, which largely failed to capture the overheating of the economy in the run-up to the global financial crisis. Estimates of the cyclically-adjusted budget balance available at the time did indeed provide an overoptimistic picture of the underlying budgetary position of EU Member States (Graph 2.4).

<sup>(8)</sup> See European Central Bank (2015).

Graph 2.4: Revisions in the estimate of the 2007 cyclically adjusted budget balances across time (% of GDP)



Source: European Commission.

### 2.3. FISCAL POLICIES IN THE RUN-UP TO THE CRISIS

Unless there are sustainability concerns, the stance of fiscal policy should be counter-cyclical. Building up fiscal buffers during phases of economic expansion is necessary in order to provide fiscal support to the economy during downturns without jeopardising the long-term sustainability of public finances. In pre-crisis years, not all Member States took advantage of the good economic times to improve their fiscal positions. Moreover, financial markets failed to exert the envisaged pressure and, on the contrary, rewarded Member States that maintained large budget deficits with low interest rates. When the crisis hit in 2008, the EU reacted with the European economic recovery plan (EERP). Towards the end of 2009, however, the sovereign debt crisis in Greece brought to the fore weaknesses in national governance, which were not addressed by the original Maastricht architecture.

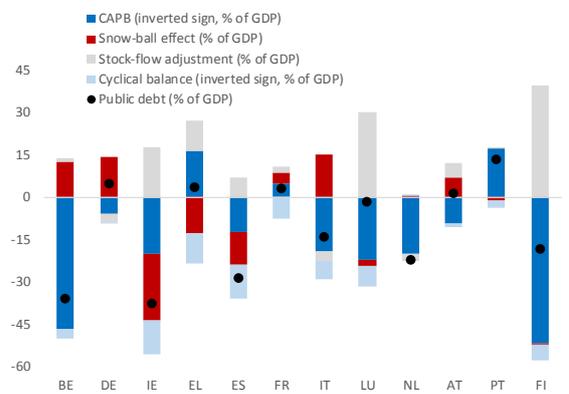
#### Fiscal policies during the pre-crisis years

Between the adoption of the SGP in 1997 and the post-2007 financial crisis, several euro area Member States did not take full advantage of the good economic times to reduce their public debt levels. Greece increased its public debt, despite having already a debt ratio of 99% in 1997. Portugal also noticeably increased its indebtedness, from 55% to 68% of GDP. Smaller debt increases also occurred in Germany, France and Austria. Italy, with a debt ratio of 114% of GDP in 1997, reduced its indebtedness largely thanks to cyclical

surpluses and lower debt servicing costs. Other Member States, conversely, achieved a substantial debt reduction: Belgium did so thanks to sizeable structural surpluses, as did Spain and Ireland thanks to an exceptional growth performance (Graph 2.5).

Contrary to expectations, financial markets failed to ensure budgetary discipline, despite all the related provisions in the Maastricht Treaty. In the run-up to the post-2007 financial crisis, market pricing of sovereign risk was mostly homogeneous across euro area countries despite large fiscal and macroeconomic divergences. By failing to discriminate between borrowers based on their creditworthiness, credit markets led to the build-up of fiscal imbalances.

Graph 2.5: Cumulative public debt developments between 1997 and 2007 in EA-12



(1) CAPB is the cyclically-adjusted primary balance. (2) The snowball effect is the debt impact of the differential between the interest rate and GDP growth. (3) Stock-flow adjustments are changes in gross debt which are unrelated to changes in the budget deficit.

Source: European Commission, own calculations.

#### The European economic recovery plan

The EU reacted to the economic and financial crisis with a joint monetary and fiscal stimulus. The latter took the form of the EERP, which was proposed by the Commission in November 2008<sup>(9)</sup> and endorsed by the European Council in December of that year. The plan called for a fiscal stimulus of EUR 200 billion, equivalent to 1.5% of EU GDP: EUR 170 billion would come from Member States' budgets, while the rest would take the form of EU funding. The stimulus would take into account the fiscal position of each Member State: those who built sufficient fiscal buffers before the crisis would have more room for manoeuvre, while Member States that faced

<sup>(9)</sup> See COM(2008) 800 final.

significant imbalances were called to use budgetary policy to correct such imbalances.

The fiscal support effectively deployed by Member States in 2009 did not, however, reflect adequately their individual fiscal challenges. This was a natural consequence of the failure to spot the underlying weaknesses in the public finances of several economies where revenues had been inflated by extraordinary booms in non-traded activity, mainly construction. The legacy of the effort to stimulate the economy regardless of its initial position was a major contributor to the subsequent pro-cyclical contraction.

Under the plan, Member States deploying counter-cyclical measures were required to submit an updated stability or convergence programme, specifying the measures that would be taken to reverse the stimulus and resume convergence towards medium-term budgetary objectives. For Member States under the EDP, the plan stressed that ‘corrective action would have to be taken in time-frames consistent with the recovery of the economy’.

The ECOFIN Council of January 2009 further stressed the temporary nature of fiscal support, reinforcing its commitment to sustainable public finances against a short-term increase in budget deficits. The ECOFIN committed to resume fiscal consolidation towards medium-term budgetary targets as soon as possible, noting that ‘[t]he coordinated fiscal stimulus will thus be followed by a coordinated budget consolidation’<sup>(10)</sup>. 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. [...] In view of the challenges, the planned pace of the fiscal consolidation should be ambitious, and will have to go well beyond the benchmark of 0.5% of GDP per annum in structural terms in most Member States’<sup>(11)</sup>.

### The Greek sovereign debt crisis

The unfolding of the Greek sovereign debt crisis, starting towards the end of 2009, highlighted failures in national governance. On 2 and 21 October 2009, the Greek authorities sent two different sets of EDP notification tables to

Eurostat. In the second notification, deficit figures for 2008 were revised upward from 5% to 7.7% of GDP. The planned deficit for 2009 was also substantially revised upward. In its October 2009 fiscal notification, Eurostat expressed a reservation on the data reported by Greece<sup>(12)</sup>. The ECOFIN Council in November invited the Commission to produce a report on Greek public finance statistics, and to propose appropriate measures to address the situation<sup>(13)</sup>.

The Commission published its report in January 2010<sup>(14)</sup>, after Eurostat conducted a first EDP methodological visit to Greece. In the report, the Commission highlighted the presence of ‘[s]evere irregularities in the EDP notifications of April and October 2009, including submission of incorrect data, and non-respect of accounting rules and of the timing of the notification’. The report further noted that ‘the current set-up does not guarantee the independence, integrity and accountability of the national statistical authorities’.

Following a series of visits to the country, Eurostat lifted its reservations on Greek public finance statistics in the November 2010 notification<sup>(15)</sup>. Under the November 2010 EDP notification, the budget deficit and debt ratios of Greece in 2009 were estimated at 15.4% and 126.8% of GDP respectively, whereas the January 2009 update of the stability programme planned a deficit and debt ratios of 3.7% and 96.3% of GDP respectively.

The news that Greek public finance statistics were misreported triggered a sharp market reaction. Between September 2009 and May 2010, when the first EU/IMF joint financial assistance programme was approved, 10-year borrowing costs increased by 340 basis points. By March 2012, when privately held Greek public debt was restructured with a 53.5% write-down, the yield of 10-year Greek bonds peaked at 33%.

The Greek sovereign debt crisis revealed three major shortcomings in the original economic governance framework provided for in the Maastricht Treaty. First, it became clear that the no-bailout clause lacked credibility, due to the sovereign-bank nexus (see following section). Second, the Maastricht architecture was limited to provisions aimed at fostering budgetary discipline,

<sup>(12)</sup> See News Release 149/2009.

<sup>(13)</sup> See ECOFIN 15572/09 (Presse 319).

<sup>(14)</sup> See COM(2010) 1 final.

<sup>(15)</sup> See News Release 170/2010.

<sup>(10)</sup> See 5543/09 ECOFIN 38 UEM 14 EF 11.

<sup>(11)</sup> See Council conclusions on fiscal exit strategies, 20 October 2009.

### Box 2.1: The sovereign-bank nexus.

Sovereign risks are highly correlated with domestic banks' risks and this link, which is particularly acute in countries with fragile banking sectors and weak fiscal positions, prominently emerged during the euro crisis. The first predominant cause of this nexus between banks and sovereigns is that banks are creditors of their own governments. This implies that a decline in sovereign credit-worthiness leads to a decline in the value of banks' claims on the government. Fiscal risks are therefore an important source of bank risks. Banks may hold government bonds for entirely benign reasons, most notably for their use as collateral in liquidity management operations. However, banks frequently display a home bias in their portfolio holdings, which increases exposure to sovereign risks beyond what would be desirable under an optimal portfolio allocation. Following the euro crisis, the home bias of sovereign holdings rose substantially, as banks increased their aversion to cross-border lending. For instance, while in 2007 domestic government bonds represented around half of all the euro area sovereign bonds held by euro area banks, this increased to three-quarters by 2012.

A second important source of the sovereign-bank nexus is that governments provide a financial safety net to banks: this fiscal backstop can be direct, for instance in the case of bank bailouts, or indirect, such as in the case of deposit guarantees. Bank distress can therefore be a source of fiscal risks whenever fiscal policy is asked to intervene as a backstop. Conversely, fiscal risks can be a source of bank distress whenever the ability of the government to fulfil its guarantees is put into question <sup>(1)</sup>.

The existence of the sovereign-bank nexus implies that fiscal discipline is also a precondition for financial stability. Governments should therefore maintain a strong balance sheet position to mitigate the risks of adverse feedback loops between fiscal risks and banking risks. At the same time, the absence of a complete banking union may lead to more volatile public finances during crisis periods, when governments may need to intervene to stabilise domestic banks. Completing the banking union, including a common deposit insurance, will therefore contribute to mitigating fiscal stress originating from the banking sector.

A further implication of the sovereign-bank nexus is that the no-bailout clause cannot be credibly enforced, because any debt default would trigger a severe banking crisis, which cannot be resolved without resorting to some form of monetary financing. The no bailout clause was, however, the main instrument foreseen by the Maastricht Treaty to provide *ex ante* market discipline to Member States. The non-enforceability of the clause may therefore carry the risk that financial markets will again supply funding to governments without adequately considering their creditworthiness, as happened before the global financial crisis.

<sup>(1)</sup> Moral suasion on the part of the sovereign may have contributed to the domestic bias in the wake of the crisis (Dell'Ariccia et al., 2018).

while tools for crisis resolution were missing. Third, these disciplining instruments envisaged only a role for EU institutions and financial markets, while ignoring the crucial importance of national institutions. As a first remedial action, Council Regulation (EU) 679/2010 of 26 July 2010 granted Eurostat audit-like powers to monitor and verify upstream public finance data from Member States.

Finally, the Greek sovereign debt crisis highlighted the importance of contagion effects in a monetary union. Contagion typically refers to a situation of excess spillovers, which go beyond what can be justified based solely on economic fundamentals. A crisis in one country can trigger a crisis elsewhere simply because of a shift in markets' risk appetite, without changes in the underlying

fundamentals <sup>(16)</sup>. Starting from mid-2010, financial contagion began to spread from Greece to other trade-deficit countries, which relied on foreign borrowing to finance their budget deficits. Concerns about redenomination risk and possible private sector involvement in debt restructuring triggered generalised capital outflows, and resulted into a progressive widening of sovereign spreads that ultimately led other Member States to request financial assistance.

#### 2.4. THE SIX AND TWO-PACK REFORMS

The six and two-pack reforms introduced substantial changes to the EU economic governance framework. The reforms occurred in a context of crisis, when the orderly functioning of

<sup>(16)</sup> For instance, the Asian financial crisis of 1997 rapidly spread to other emerging economies such as Latin America, despite substantial differences between these regions.

the euro area was in jeopardy. One of the main objectives of the rules was to restore market confidence in the fiscal sustainability of crisis-hit Member States. To this end, the reforms initially aimed at achieving a substantial strengthening the rules. This also reflected a compromise between Member States, where stronger rules would be the necessary prerequisite for the introduction of new crisis-resolution mechanisms such as the ESM. Afterwards, when distress in sovereign credit markets subsided, new layers of flexibility were introduced in the SGP to mitigate what was perceived as an unbalanced trade-off between debt sustainability and economic stabilisation. This led however to a further increase in the complexity of the overall framework.

### The six-pack reform of 2011

It is in this historical context that the reform of the fiscal rules took place. The six-pack reform overhauled EU economic and fiscal surveillance, as set out under Articles 121 and 126 TFEU, and led to the creation of a reinforced SGP. The reform added both elements aimed at strengthening the rules, and elements that added flexibility and room for more discretion (see Table 2.1).

The six-pack reform included five regulations and one directive. Regulation (EU) 1175/2011 amended the preventive arm of the SGP in several ways. The expenditure benchmark was introduced alongside the structural balance as an indicator to assess compliance with the adjustment path towards the MTO. The Regulation also introduced the significant deviation procedure, establishing a corrective mechanism already under the preventive arm, with sanctions in the form of interest-bearing deposits. Finally, the Regulation codified and introduced in secondary legislation the European Semester, which was established by the European Council in 2010, based on a Commission proposal. The Semester streamlined the calendar of economic surveillance for EU Member States.

Regulation (EU) 1177/2011 amended the corrective arm of the SGP. It operationalised for the first time the debt requirement of the Treaty, by establishing the debt-reduction benchmark and by putting on an equal footing violations of the deficit and debt criterion. The Regulation, moreover, introduced a ‘comply-or-explain’ principle for the Council vis-à-vis Commission recommendations and proposals under the corrective arm. In light of the experiences of the

Great Recession, the Regulation also introduced an escape clause in case of ‘severe economic downturn in the euro area or the Union as a whole’, which is implemented on a country-by-country basis.

Regulation (EU) 1173/2011 established a graduated system of sanctions for euro area Member States that are found to be non-compliant with the rules. Most notably, the Regulation established that sanctions can be applied already under the preventive arm of the SGP and were rendered semi-automatic via the reverse qualified majority voting principle. According to this principle, Commission proposals for sanctions are deemed to be automatically adopted unless a qualified majority in the Council votes against.

Council Directive 2011/85/EU established minimum requirements for national budgetary frameworks. In particular, these requirements cover the quality of accounting and statistics, the prudence of macroeconomic and fiscal forecasts – which ought to be based on the ‘most likely scenario’ or a ‘more prudent’ one. The Directive also covers the introduction of numerical fiscal rules and medium-term budgetary frameworks. Finally, the Directive contains references to the involvement of national independent institutions in three separate tasks: (i) auditing public accounting systems, which need to cover comprehensively all areas of income and expenditure; (ii) ensuring the quality of the macroeconomic and budgetary forecasts underpinning fiscal plans; (iii) monitoring compliance with domestic fiscal frameworks. By referring to a direct involvement in fiscal surveillance, the role of independent fiscal institutions (IFIs) in the context of this Directive is therefore similar to the one envisaged by the fiscal compact (Box 2.3).

Finally, Regulation (EU) 1176/2011 and Regulation (EU) 1174/2011 established the macroeconomic imbalance procedure (MIP). The Regulations introduced and defined the concept of macroeconomic imbalances, starting from an assessment of a scoreboard of indicators. They further established an annual monitoring cycle and a corrective arm: the excessive imbalance procedure (EIP).

### The two-pack reform of 2013

Unlike the six-pack reform, the two-pack only applies to euro area Member States. Furthermore,

the reform does not introduce new fiscal rules. Rather it focuses on policy coordination within the euro area to address the risk of negative spillover effects in a monetary union. The two Regulations complement the six-pack reform by adding a new surveillance process, to monitor compliance with the requirements of the reinforced SGP. Their legal basis is Article 136 TFEU (see Table 2.1).

Regulation (EU) 472/2013 introduces a regime of enhanced surveillance for Member States facing severe difficulties with their financial stability, those receiving financial assistance, and those exiting a financial assistance programme. For these Member States, the Regulation sets out a separate surveillance calendar and additional reporting requirements.

Regulation (EU) 473/2013 requires euro area countries to submit to the Commission and the Council draft budgetary plans (DBPs) in autumn of each year. The Regulation gives the Commission the authority to issue a negative opinion on a DBP, and to request a revised DBP. It also requires Member States under the EDP to prepare economic partnership programmes (EPPs), describing the policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit, and allows the Commission to issue autonomous recommendations to Member States at risk of non-compliance with their EDP requirements. Finally, the Regulation envisages an involvement of IFIs in producing or endorsing budgetary forecasts underpinning national medium-term fiscal plans and draft budgets. It also envisages that IFIs should monitor compliance with numerical fiscal rules, assessing the occurrence of circumstances warranting the activation of the national correction mechanisms, or events warranting a deviation from fiscal requirements.

## 2.5. TODAY'S SYSTEM OF EU FISCAL RULES

Since the six and two-pack reforms, the EU fiscal framework, and its practical implementation, has been subject to further refinements and interpretative add-ons, with the aim of providing stronger economic underpinnings while adapting the rules to a wider set of new codified circumstances. The most notable example was the Commission Communication of January 2015 laying out in detail the criteria for the use of

flexibility within the EU fiscal framework <sup>(17)</sup>. However, such new features added incrementally to the existing rules, creating additional complexity and further reducing transparency <sup>(18)</sup> (see Table 2.1).

The increasing complexity of the SGP has given rise to growing calls to simplify EU fiscal rules and procedures and to make their implementation more transparent. The Five Presidents' Report on *Completing Europe's Economic and Monetary Union* of June 2015 set the tone. It included the objective of improving the clarity, transparency, compliance and legitimacy of the EU fiscal rulebook. In November 2015, the Eurogroup called on the Commission to make the implementation of the SGP more transparent and predictable <sup>(19)</sup>. Along similar lines, during its rotating EU Presidency in the first half of 2016, the Netherlands expressed the intent to improve the working of the SGP and to support steps towards a simpler and more transparent EU fiscal framework.

In recent years, amid concerns of excessive complexity and lack of transparency, the Commission and the Council agreed on some innovations to the implementation of the SGP <sup>(20)</sup>. However, these initiatives did not achieve their stated objectives of simplifying the rules, because: (i) they added new elements without resolving potential conflicts with existing provisions; and (ii) they were coupled with initiatives going in the opposite direction. As a result, complexity and opacity increased.

A clear example of this evolution is the introduction in 2017 of the margin of discretion in assessing compliance with the preventive arm of the GDP <sup>(21)</sup>. In 2017, the Commission, without the formal agreement of the Council, prepared the ground for a new margin of discretion to be used in 2018. The initiative consisted in extending the

<sup>(17)</sup> COM(2015)12 final.

<sup>(18)</sup> See Section 5.1.8 of the 2017 EFB annual report for a detailed analysis of complexity of the EU fiscal framework.

<sup>(19)</sup> <http://www.consilium.europa.eu/en/press/press-releases/2015/11/23/eurogroup-budgetary-plans/pdf>

<sup>(20)</sup> They mainly refer to two sets of initiatives: (i) an agreement between the Commission and the Council to give a more prominent role to the expenditure benchmark when assessing compliance in the preventive arm of the SGP; (ii) an agreement to incorporate the expenditure benchmark into the corrective arm of the SGP (see Section 2.2.1 of 2018 EFB annual report).

<sup>(21)</sup> 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.

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

Greater flexibility and discretion also produced two interlinked developments: (i) a growing competition between EU institutions over who exercises the discretion emanating from the many elements of flexibility and judgement; and (ii) a stronger bilateral dimension in a framework intended to ensure multilateral surveillance.

The rules and provisions governing the implementation of the SGP have reached a degree of complexity and opacity where the costs outweigh the expected benefits. While flexibility is desirable, the growing complexity of the functioning of the SGP make it difficult to communicate to the public.

Table 2.1: Main innovations of the six and two-pack reforms

Achieving sustainable fiscal positions			
New rules and procedures			
Reform	Innovation	Description	Purpose
Six-pack	Expenditure benchmark	The expenditure benchmark imposes a cap on the growth rate of primary expenditures net of discretionary revenue measures. It was introduced alongside the structural balance to define and assess adjustment requirements.	To complement the surveillance tool-kit with an indicator considered to be a more stable reference for governments in preparing and implementing their budgets, compared to the structural balance.
	Debt reduction benchmark	When the debt ratio is above 60% of GDP, the excess over 60% must be reduced at an average annual rate of 1/20th. The average speed of debt reduction is assessed in a backward-looking and in a forward-looking manner, also taking into account the impact of the economic cycle.	To provide an operational benchmark for the appropriate pace of debt reduction mentioned in the Treaty.
	The Macroeconomic Imbalance Procedure	A new surveillance and enforcement mechanism to monitor, prevent and correct macroeconomic imbalances. Imbalances are identified by means of a scoreboard of indicators, and an in-depth analysis.	To monitor, prevent and correct macroeconomic developments which, if left unchecked, may jeopardise the functioning of the EMU.
Stronger enforcement			
Reform	Innovation	Description	Purpose
Six-pack	Significant deviation procedure	The procedure is triggered when a Member State deviates significantly (by more than 0.5% of GDP in a single year or cumulatively over two consecutive years) from the required adjustment, with the possibility to apply sanctions in case the deviation is not rectified.	To ensure that Member States return to the adjustment path towards their MTOs. The significant deviation procedure is also a useful early warning to prevent the Member State from slipping into an excessive deficit.
	Financial sanctions	An early and gradual system of financial sanctions in both the corrective and preventive arm of the Pact. It starts with an interest-bearing deposit in case a significant deviation under the preventive arm of the Pact, turns into a non-interest bearing deposit when an EDP is launched and can become a fine if no effective action is taken.	To dissuade Member States from flouting the fiscal rules.
	Reverse qualified majority voting	For euro area countries, in most of the decisions leading up to sanctions, decisions in the Council are taken by a reversed qualified majority vote (RQMV). Commission proposals are deemed to be approved by the Council unless a qualified majority of Member States overturns them.	To make the stepping-up of procedure and the application of sanctions more automatic, by making it more difficult for Member States to form a blocking majority in the Council.
Stronger coordination			
Reform	Innovation	Description	Purpose
Two-pack	Draft budgetary plans	Euro-area countries are obliged to present their draft budgetary plans (DBPs) for the following year by 15 October. Before the plans are adopted by the national parliaments, the Commission issues an opinion on these plans. In case of a <i>particular serious non compliance</i> with requirements, the Commission may request a revision of the draft budgetary plan.	To assess whether the forthcoming budget complies with the EU fiscal rules and to inform the national budgetary debate. The examination of DBPs comes on top of the joint Commission and Council assessment of the stability and convergence programmes (SCPs) that EU Member States present each April.
	Economic partnership programmes	A closer monitoring for countries under EDP. It includes a roadmap for the fiscal structural reforms that Member States under an EDP consider necessary to ensure an efficient and lasting correction of their excessive deficit.	To create a stricter and more credible link between fiscal and structural commitments with the aim of ensuring a lasting correction of an excessive deficit.
	Commission autonomous recommendation	A Commission recommendation to a euro area country at risk of missing its deadline for the correction of the excessive deficit. The recommendation does not require adoption by the Council.	To warn the Member State concerned of the implicit risks of missing the deadline, which can still be met if actions are taken on time.
	Enhanced surveillance	A closer monitoring of euro-area Member States experiencing or threatened with serious difficulties with respect to their financial stability. Countries under enhanced surveillance must adopt measures to address their weaknesses, in cooperation with the Commission (and ECB).	To ensure a swift return of the country to a normal situation and to protect the other euro area Member States against potential adverse spillover effect.
Stronger EU governance			
Reform	Innovation	Description	Purpose
Six-pack	European Semester	The European Semester represents a comprehensive annual cycle of coordination and surveillance of the EU's economic policies, with clear timelines and procedures.	To synchronise the assessment of fiscal policies with the assessment of macroeconomic and structural policies in one integrated framework.
Six-pack & two-pack	National fiscal frameworks	Minimum legal requirements for national fiscal frameworks covering five different areas: i) numerical fiscal rules; ii) medium-term budgetary framework; iii) forecasts; iv) statistics and transparency; v) coordination mechanisms. The two-pack reform also gave national independent fiscal institutions a key role in preparing and monitoring macroeconomic forecasts and budgetary decisions and in supervising the operation of national fiscal rules.	To strengthen the national ownership and establishing uniform requirements as regards rules and procedures forming the budgetary procedure of the Member States.

(Continued on the next page)

Table (continued)

Introducing elements of flexibility/economic judgement			
Allowing for country-specific elements and prevailing economic situations			
Reform	Innovation	Description	Purpose
Six-pack & 2016 Commonly agreed position on flexibility	Modulation of adjustment requirements	The required structural adjustment is modulated around a benchmark of 0.5% of GDP per year: a higher adjustment effort is required in economic good times, whereas the effort might be more limited in economic bad times. A matrix of requirements, defined in 2015 for countries subject to the preventive arm of the Pact, has refined the modulation around the benchmark of an annual improvement of the structural balance of 0.5% of GDP, by a required effort ranging from 0 to 1% of GDP, depending on the cyclical position, the debt level and the risks to public finance sustainability.	To find a better balance between stabilising economic activity and maintaining sustainable public finances.
Six-pack	General escape clause	In the case of a severe economic downturn in the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards their MTOs, or from the adjustment required to correct an excessive deficit, provided that this does not endanger fiscal sustainability in the medium term.	To avoid a pro-cyclical contraction in difficult economic conditions.
Six-pack	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. The deviation must not endanger fiscal sustainability in the medium term.	To enable governments to respond to shocks outside their control, without flouting the rules.
Six-pack	Other relevant factors	A list of factors, in addition to the deficit, the Commission can take into account when assessing the existence of an excessive deficit or debt (or compliance with the required adjustment) under the corrective arm of the SGP. The six-pack reform extended and further clarified the list introduced by the 2005 reform. Under current legislation and practice, the Commission considers three key aspects: i) the implementation of structural reforms; ii) the presence of unfavourable macroeconomic conditions which may hamper the reduction of the debt ratio; iii) adherence to the MTO or the adjustment path towards it.	To provide the framework with a certain degree of leeway to deal with factors not directly reflected by the nominal/numerical indicators.
Dealing with uncertainty			
Reform	Innovation	Description	Purpose
Six-pack	Overall assessment	The six-pack reform introduced the expenditure benchmark as a second indicator alongside the change in the structural budget balance. Since, in practice, the two indicators can lead to conflicting messages in the final assessment of compliance, an overall assessment was introduced in the preventive arm of the Pact. This overall assessment effectively amounted to applying judgement in relation to which indicator is deemed to provide a more reliable assessment of the budgetary adjustment.	To apply economic judgement when interpreting numerical indicators of fiscal adjustment.
Six-pack and 2016 Code of conduct of the SGP	Careful analysis	A refinement (and codification) of an existing methodology to assess whether a Member State under the corrective arm has complied with the EDP requirements. The careful analysis is warranted when the Member State concerned fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, or both. The methodology is based on a 'top down' approach, which aims to correct differential growth and revenue outturns relative to expectations at the time of recommendations, and a 'bottom-up' approach, which aims to estimate the budgetary impact of (new) measures. Since 2017, an expenditure benchmark will replace the top-down and bottom-up approaches for future EDPs.	To apply economic judgement when interpreting numerical indicators of fiscal adjustment.
Six-pack	Margin of broad compliance	An asymmetric margin of error the Commission applies in the assessment of compliance with the preventive arm of the SGP. A Member State is considered to be broadly compliant if the observed deviation from its MTO, or from the recommended adjustment towards it, does not exceed 0.5 % of GDP in a single year, or cumulatively over 2 consecutive years.	To allow for measurement uncertainty surrounding estimates of the structural budget balance at the time of assessing compliance with the SGP.
Six-pack & Vademecum	Margin of discretion	An element of discretion the Commission used in the 2018 surveillance cycle to assess compliance with the preventive arm of the SGP. If a country is considered to experience a fragile economic recovery, the Commission can decide to reduce the required fiscal adjustment, unless there are risks to fiscal sustainability in the short term.	To ensure a better balance between stabilising economic activity and ensuring sustainable public finances.

(Continued on the next page)

Table (continued)

Six-pack & October 2016 EFC agreement	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.	To address the uncertainty surrounding the estimation of the output gap in real time.
Six-pack & 2016 Commonly agreed position on flexibility	Unfreezing principle	An arrangement that allows for an asymmetric adjustment of the initial adjustment requirements set under the preventive arm of the SGP. The requirement can be unfrozen and lowered only in two specific situations in order to avoid an overachievement of the MTO or a fiscal tightening in a particularly unfavourable economic conditions. The requirement cannot be more demanding.	To address the uncertainty surrounding the estimation of the output gap in real time.

#### Innovations aimed at extending flexibility to foster growth-enhancing policies

Reform	Innovation	Description	Purpose
Six-pack & 2016 Commonly agreed position on flexibility	Structural reform and investment clauses	The six-pack reform confirmed provisions introduced in 2005 on how to treat the implementation of major structural reforms. These provisions formed the basis of the January 2015 Commission Communication on 'Making the best use of the flexibility within the existing rules of the Stability and Growth Pact', which extended the interpretation of when deviations from the MTO, or the adjustment towards it, are allowed in countries implementing structural reforms. According to the Communication some investments are deemed to be equivalent to major structural reforms.	To foster growth-enhancing policies by relaxing fiscal requirements in case of structural reforms and government investment.

Source: European Commission

## Box 2.2: Timeline of the reforms

### The six-pack reform of 2011

In May 2010, the Commission laid the groundwork of the reform process in its Communication 'Reinforcing economic policy coordination' <sup>(1)</sup>, by outlining its proposals to broaden and deepen economic surveillance. In its follow-up Communication of June 2010, 'Enhancing economic policy coordination for stability, growth and jobs' <sup>(2)</sup>, the Commission advanced a more detailed set of proposals, including: (i) addressing macroeconomic imbalances through stronger surveillance, including alert and sanction mechanisms. (ii) Strengthening national fiscal frameworks by specifying minimum requirements, and moving to a more multi-annual budgetary dimension. (iii) Strengthening the Stability and Growth Pact, in particular by focusing on the issue of debt dynamic as well as deficits. (iv) Setting out effective enforcement mechanisms, including sanctions to be applied already under the preventive arm. (v) Establishing a European semester for policy co-ordination.

On 25-26 March 2010, the European Council established a Task Force on economic governance to present its reform proposals. The task force included representatives of the Member States, the Commission and the European Central Bank. In its report on October 2010, the Task Force highlighted recommendations across five main directions: (i) strengthening budgetary discipline, most notably by giving a greater focus to debt developments and strengthening sanctions, including fines. (ii) Broadening macroeconomic surveillance with an annual assessment of the risks of macroeconomic imbalances. (iii) Strengthening coordination via the European Semester, to be launched in January 2011. (iv) Establishing a robust framework for crisis management. (v) Strengthening the institutional setup at both the EU and national level, including with the creation of IFIs <sup>(3)</sup>.

The European Central Bank presented its reform proposals in June 2010. On the fiscal side, these proposals involved: (i) Enhancing the euro area dimension of fiscal policy by strengthening *ex ante* discussions in the Eurogroup. (ii) A stronger enforcement via quasi-automatic EDP steps and sanctions. (iii) A more effective surveillance, by differentiating Member States' monitoring based on their fiscal performance, by strengthening the role of the Commission and by enhancing the quality of statistics. (iv) Strengthening the sanction framework, by applying it already in the preventive arm and broadening its scope to excessive debts. (v) Introducing a wider spectrum of sanctions: financial, non-financial (e.g. suspension of voting rights), procedural (e.g. more stringent reporting requirements, missions, etc.). (vi) Strengthening the independence of fiscal surveillance, by creating an independent fiscal agency, preferably within the Commission, to assess euro area Member States' policies, without prejudice to Commission's prerogatives <sup>(4)</sup>.

The Commission adopted the initial drafts of the six-pack reform on 29 September of 2010. The European Parliament played an important role during the legislative phase, in particular by insisting on greater automaticity of sanctions already at an early phase of violation, by means of reverse qualified majority voting in the Council. The Parliament also strengthened the transparency and accountability of the proposals with the introduction of the economic dialogues. Finally, in the context of economic surveillance, the Parliament introduced greater symmetry in the treatment of macroeconomic imbalances, requiring that surveillance covers both countries with current account deficit and surpluses <sup>(5)</sup>. On 13 December 2011, the reinforced Stability and Growth Pact (SGP) enters into force.

### The two-pack reform of 2013

The Commission launched the legislative work behind the two-pack in November 2011, while Member States were working on the intergovernmental Treaty on Stability, Coordination and Governance (the Fiscal Compact). With the two-pack reform, the Commission aimed at strengthening budgetary surveillance and coordination in the euro area. The reform also incorporated some of the elements of the Fiscal Compact into EU law, such as the requirement for Member States under EDP to prepare economic partnership programmes, and the requirement that Member States report their debt issuance plans to the Commission and the Eurogroup for *ex ante* coordination.

<sup>(1)</sup> See COM(2010) 250 final.

<sup>(2)</sup> See COM(2010) 367/2.

<sup>(3)</sup> See 'Report of the Task Force to the European Council', 21 October 2010.

<sup>(4)</sup> European Central Bank (2010). 'Reinforcing economic governance in the euro area'.

<https://www.ecb.europa.eu/pub/pdf/other/reinforcingeconomicgovernanceintheeuroareaen.pdf>

<sup>(5)</sup> European Parliament (2011). FAQ on the economic governance "six pack".

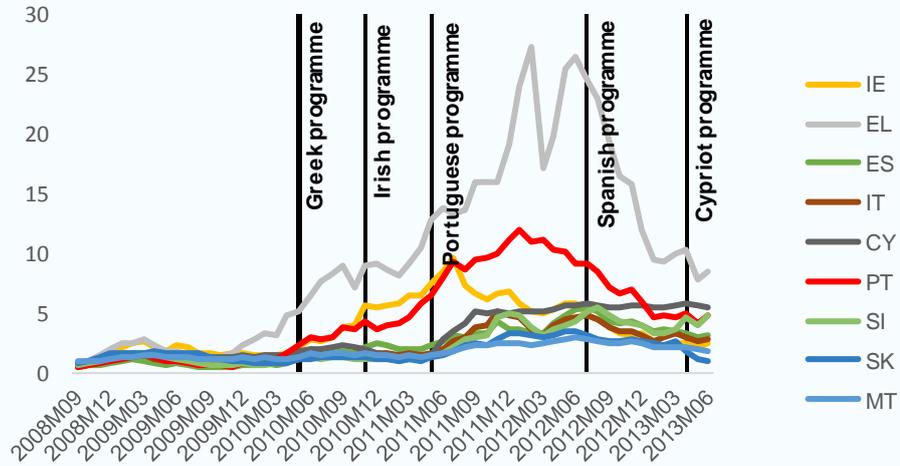
<http://www.europarl.europa.eu/sides/getDoc.do?type=IM-PRESS&reference=20110920BKG27073&language=MT>

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Box (continued)

The reforms took place in a context of significant economic turbulence, as several Member States were subject to intense market pressure, and as a consequence requested assistance programmes (Graph 1).

Graph 1: 10-year sovereign spreads vs. German bonds (percentage points)



Source: European Commission, ESM.

### Box 2.3: The Treaty on Stability, Coordination and Governance.

The reform of EU economic governance also includes an inter-governmental treaty, which complements the EU legal framework while not being part of it: the Treaty on Stability, Coordination and Governance (TSCG). To stave off the market pressure experienced by crisis-hit Member States, the TSCG was part of a broader political agreement where stronger fiscal commitments would enable the provision of further financial assistance. In particular, recital 5 of the ESM Treaty stresses that ‘[the ESM] Treaty and the TSCG are complementary in fostering fiscal responsibility and solidarity within the economic and monetary union’ and that ‘the granting of financial assistance in the framework of new programmes under the ESM will be conditional, as of 1 March 2013, on the ratification of the TSCG’. While the ‘fiscal compact’ was initially envisaged as a reform of the Treaty on the Functioning of the European Union, the European Council failed to agree on such an amendment in December 2011, opening the door to an inter-governmental treaty.

The TSCG was concluded on 2 March 2012, and entered into force on 1 January 2013. The treaty was signed by 25 Member States and is formally binding for 22 of them (all euro area Member States plus Bulgaria, Denmark and Romania). Title III of the treaty, known as the ‘fiscal compact’, requires the contracting parties to transpose the essential elements of the preventive arm of the SGP into their national legislation, through provisions of binding force and permanent character, preferably constitutional. Specifically, the signatories are required to be at their medium-term budgetary objectives, as defined in the SGP, with a maximum structural deficit of 0.5% of GDP. Member States with a debt ratio significantly below 60% of GDP and with low sustainability risks can maintain a maximum structural deficit of 1% of GDP. In line with the requirements of the SGP, progress towards the MTO is determined with an overall assessment, based on the structural balance and including an analysis of net expenditures growth. Finally, the fiscal compact envisages the introduction of an automatic correction mechanism, which is triggered in the event of a significant deviation from requirements, and it also envisages the establishment of independent fiscal institutions to monitor compliance with the rules at national level.

The Commission established a series of common principles for the design of national correction mechanisms, including principles on the role and design of national fiscal councils <sup>(1)</sup>. In particular, national fiscal councils ought to assess the need to activate the correction mechanism and the progress of the correction. They should also assess the opportunity of triggering escape clauses for exceptional events. In terms of design requirements, the common principles establish that national fiscal councils should be endowed with a high degree of functional autonomy, including (i) a statutory regime grounded in law; (ii) freedom from interference and an adequate capacity to communicate publicly; (iii) appointments based on experience and competence; (iv) adequate resources and access to information. Finally, governments should abide by a ‘comply or explain’ principle vis-à-vis the national fiscal councils.

The treaty also includes provisions aimed at strengthening monitoring and policy coordination. In particular, Member States under the corrective arm of the SGP must present budgetary and economic partnership programmes, including a description of the structural reforms that must be put in place to ensure a durable correction of excessive deficits. Furthermore, the signatories are required to report *ex ante* on their debt issuance plans to the Council and the Commission.

Two important safeguards are envisaged to ensure coherence between the TSCG and the EU economic governance framework. First, the TSCG must be interpreted in conformity with EU treaties and laws, and is applicable only insofar as it is compatible with them. Second, the treaty includes an incorporation clause, which requires a transposition of the main elements of the TSCG into the EU legal framework by 1 January 2018. While on 6 December 2017 the Commission put forward a legislative proposal for incorporating the main elements of the TSCG into EU law <sup>(2)</sup>, this incorporation has not yet taken place.

<sup>(1)</sup> See COM(2012) 342 final

<sup>(2)</sup> See COM(2017) 824 final.

### 3. SUSTAINABILITY OF PUBLIC FINANCES

#### KEY FINDINGS

- Progress on fiscal sustainability in the EU remains mixed. Some indicators suggest that substantial progress has been made in correcting fiscal imbalances since the introduction of the six and two-pack reforms and on the back of a protracted economic recovery:
  - For the first time since 2003, no EU Member States is under the excessive deficit procedure (EDP), and the aggregate EU deficit is the lowest since 2000.
  - The number of Member States estimated to be at their medium-term objective (MTO) has steadily increased since 2011.
  - Before the reforms a number of Member States displayed excessive net expenditure growth compared to potential output growth. Expenditure control has improved since the reforms even if in some cases net expenditure growth still exceeds medium-term economic growth.
- An analysis of compliance with EU fiscal rules also shows that, since the six and two-pack reforms, compliance has increased, although a causal relationship is difficult to establish. Some findings are relevant:
- Large differences across individual rules exist: while compliance with the required structural adjustment has substantially increased, compliance with the debt rule has declined.
  - Compliance with some rules has a clear pro-cyclical pattern. This is the case in particular for the 3% of GDP deficit rule, while compliance with other rules, such as the expenditure benchmark, is less subject to the economic cycle.
  - The average size of fiscal slippages from the required structural adjustment towards the MTO has almost halved since the reforms, from 1.1% to 0.6% of GDP.
  - However, the narrowing of such slippages appears to have halted at around 0.5% of GDP, as Member States are exploiting the agreed margin of tolerance in the preventive arm of the SGP.
  - A number of challenges remain, which primarily stem from the interaction of different provisions in the EU fiscal rules:
  - A number of high-debt Member States is struggling to reverse the large increase in government debt as a percentage of GDP following the post 2007 crises, and compliance with the debt rule under the corrective arm has been waived by referring to other relevant factors.
  - For Member States that have not yet reached their MTO, there has been a substantial loss of momentum in the adjustment path towards it. This follows a repeated use of flexibility since 2015, together with the allowed margin of broad compliance in the preventive arm.
  - While in an EDP, Member States continued to pursue a ‘nominal strategy’, relying on budgetary windfalls rather than structural adjustment to bring the deficit below the 3% of GDP.
  - Existing provisions of sanctions in the SGP turned out to be ineffective, confirming the original doubts about the practicability of penalising sovereign countries.
  - Since compliance with the debt criterion has been linked to compliance with the preventive arm, lack of progress in adjusting towards the MTO in high-debt countries has resulted in an insufficient rate of debt reduction.
  - The medium-term orientation of fiscal policy leaves ample room for improvement: Member States have repeatedly postponed the achievement of their MTOs, casting doubts on the reliability of medium-term fiscal plans.

### 3.1. INTRODUCTION

#### The sustainability of public finances

The main goal of EU fiscal rules is to ensure sustainable public finances, which is a necessary precondition for the orderly functioning of the monetary union. The government faces a budget constraint: any increase in public expenditures must be eventually financed either by raising additional revenues or by borrowing extra funds. In the latter case, the government's access to borrowing hinges on a credible commitment to honour in full all existing financial obligations. To respect its budget constraint, a government must ensure that the present value of all future primary balances is sufficient to cover its existing financial obligations. When this is not the case – for instance when the debt ratio takes on an explosive trajectory – the budget constraint implies that the government at some point will face some adverse event: a default, a debt restructuring or excess inflation.

Assessing the sustainability of public finances is an inherently difficult exercise because the government is infinitely lived, and may therefore indefinitely postpone the necessary fiscal adjustments. An increasing debt dynamics in a finite time horizon is therefore not per se incompatible with the budget constraint, provided that the government can credibly commit to a sufficiently strong fiscal adjustment in the future. There is, however, a limit to the size of primary surpluses that a government can politically sustain. This implies the existence of a threshold, or a debt limit, beyond which a government may no longer be able to control its debt dynamics. The IMF<sup>(22)</sup> defines sustainability as ‘a situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditures’. The sustainability of public finances therefore hinges on the credibility of the fiscal adjustment necessary to ensure the observance of the government budget constraint.

<sup>(22)</sup> International Monetary Fund (2002).  
<https://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf>

#### The Stability and Growth Pact

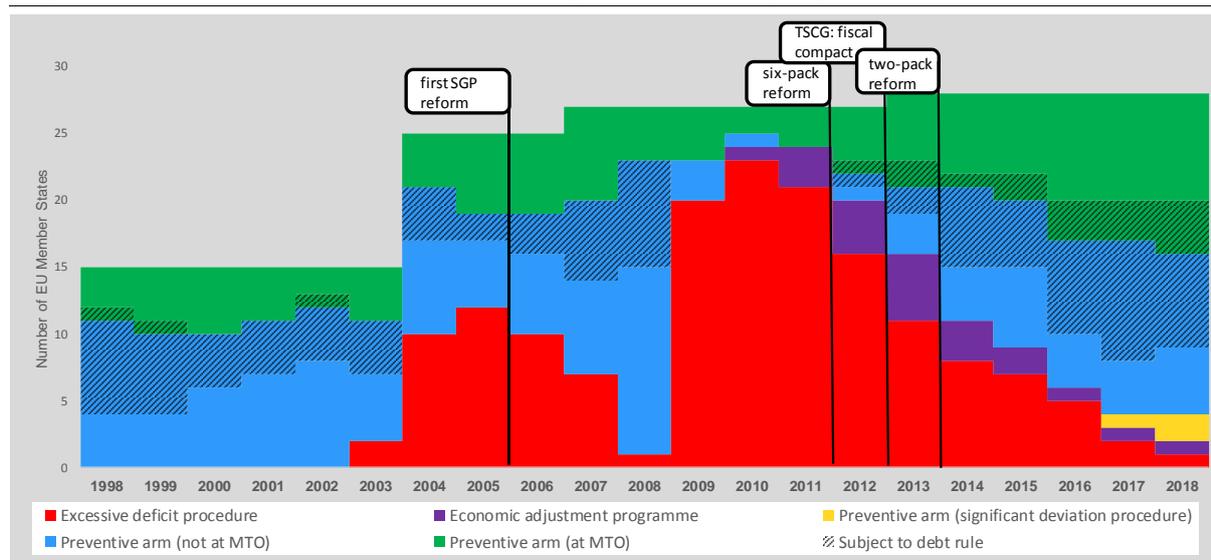
The Stability and Growth Pact (SGP) aims to ensure the sustainability of public finances by imposing a constraint on the dynamics of public debts and budget deficits. Since an explosive debt dynamics is not compatible with sustainable public finances over the long-term, a pragmatic approach for policymakers is therefore to ensure that the public debt-to-GDP ratio remains stable around a steady state. The SGP ensures this by establishing a reference value for Member States' debts at 60% of GDP.

As outlined earlier, however, a key requirement for debt sustainability is the credibility of government's fiscal adjustments. The SGP ensures this by introducing a medium-term orientation in Member States' policies. National governments are required to reach a medium-term budgetary objective (MTO), and must present each year an updated multi-year fiscal plan, which details all the necessary measures that the government intends to take to converge towards its objective. At the same time, fiscal adjustments in the SGP are modulated on the basis of cyclical conditions, and therefore cannot be postponed indefinitely: a back-loading of fiscal consolidation should happen only during bad economic times, whereas fiscal consolidation would accelerate in good times.

When the SGP was introduced in 1997, Member States were pursuing a sizeable fiscal adjustment for the introduction of the euro. Adherence to fiscal requirements was therefore very high during the first few years of operation of the SGP. The cyclically-adjusted deficit of euro-area Member States that adopted the single currency in 1993 declined from 6.7% to 1.6% of GDP between 1995 and 2000.

Starting in 2003, and on the back of a cyclical slowdown, Member States' commitment to the SGP began to weaken. Numerous excessive deficit procedures (EDPs) were opened, and approximately half of EU Member States were under the corrective arm in 2005. At the same time, progress towards the MTO was stalling. The SGP was only loosely enforced in these first years of operation, and therefore Member States failed to take advantage of the good economic times before the crisis to build-up sufficient fiscal buffers. While the position of Member States vis-à-vis the SGP improved between the 2005 reform of the SGP and 2008, better fiscal outcomes in these years were mostly the result of a strong cyclical upswing

Graph 3.1: EU Member States' status under the Stability and Growth Pact (SGP)



Notes: (1) The position with respect to the MTO is assessed using final data (Commission 2019 spring forecast), considering the country-specific MTOs since 2006 and a balanced budget in structural terms for all countries between 1998 and 2005. (2) Until 2003, the structural improvement is measured by the change in the cyclically-adjusted balance. It is corrected for the proceeds of the sales from mobile phone licences in 2000-2001 but not for other possible one-offs. (3) Only the excessive deficit procedures launched after the introduction of the Pact in 1997 are considered.

Source: European Commission, own calculations.

in the European economy. Following the global financial crisis of 2008, Member States' fiscal positions deteriorated significantly, and most countries ended up in the corrective arm of the SGP. From 2011 onward, significant market pressure during the euro area sovereign debt crisis prompted a dramatic pro-cyclical fiscal consolidation in some Member States (Graph 3.1).

### The six and two-pack reforms

Since an inadequate enforcement of fiscal rules during good economic times was seen as one of the major causes of the post 2007 deterioration of public finances, the six and two-pack reforms of 2011 and 2013 aimed to establish a reinforced SGP, which would be more conducive to sustainable public finances.

Today, the EU fiscal framework encompasses a plurality of rules. To assess whether the overall framework ensures sustainability, it is therefore important to evaluate the interaction of different rules. To the extent that different rules cater to separate operational objectives, there may be inconsistencies between the guidance provided by the various rules for instance, rules more oriented towards sustainability may imply stricter fiscal requirements than rules that are more geared towards stabilisation. There may also be inconsistencies in the way compliance is assessed,

for instance due to the presence of different escape clauses in different rules.

It is thus necessary to assess how possible conflicts between different parts of the framework are resolved, and what kind of balance is struck.

### 3.2. COMPLIANCE WITH EU NUMERICAL FISCAL RULES

In this section we investigate compliance with numerical fiscal rules at the EU level. Compliance is a means to an end: EU fiscal rules are ultimately meant to ensure the long-term sustainability of public finances and some stabilisation of aggregate demand over the cycle. Weak compliance could signal shortcomings in the design of the rules. Most of the recent reforms to the EU fiscal framework have been motivated by the will to improve the effectiveness of EU fiscal rules. Assessing whether the reforms contributed to an increase in compliance is therefore crucial. Such an assessment is, however, challenging for numerous reasons: the lack of counterfactuals, the shortness of time series combined with measurement errors are only examples of possible challenges.

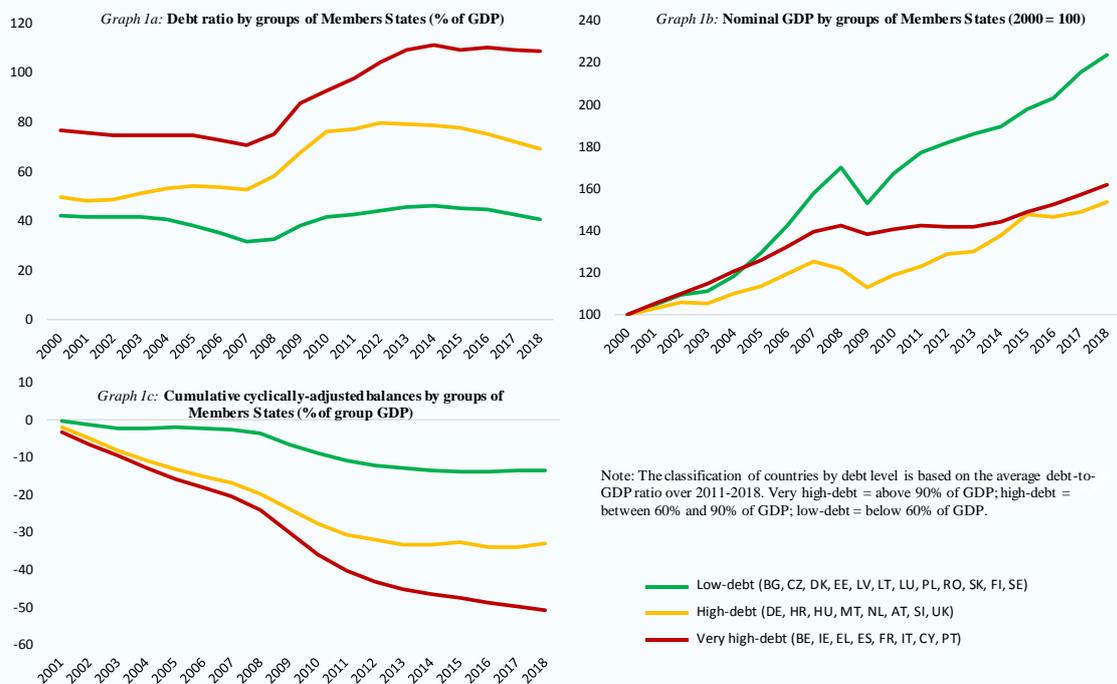
### Box 3.1: Public debt developments across Member States.

The fiscal costs of the protracted economic downturn that began with the global and economic financial crisis of 2008 remain significant. Between 2000 and 2008, the average debt-to-GDP ratio of EU Member States remained broadly stable around its reference value of 60% of GDP. It increased substantially in the aftermath of the economic crisis, reaching a peak of 88% of GDP in 2014, and began to decline only in 2015. The euro area displayed a similar dynamic throughout these years, although with a somewhat higher level of indebtedness: the average debt-to-GDP ratio of euro area Member States increased from 69% in 2008 to 94% in 2014, gradually declining after that.

Aggregate debt developments mask, however, substantial differences between Member States (Graph 1.a). In particular, three separate groups of EU countries emerge with a distinct fiscal trajectory. At one end, low-debt Member States with a solid fiscal position in the years before the crisis managed to maintain their debt ratios below 60% of GDP also throughout the crisis. Overall, these countries maintained a stable debt-to-GDP ratio at around 40% of GDP since 2000. A second group of Member States, which on average maintained public debt below the 60% reference value before the crisis, ended up with relatively high-debt levels during the crisis years. These countries, however, succeeded in setting their debt dynamics on a downward trajectory from 2015 onward. Finally, a third group of Member States entered the crisis with debt ratios already above the 60% of GDP reference value, and ended up with very high-debt levels during the crisis years. Until then, this third group of Member States had only a limited success in correcting their fiscal imbalances.

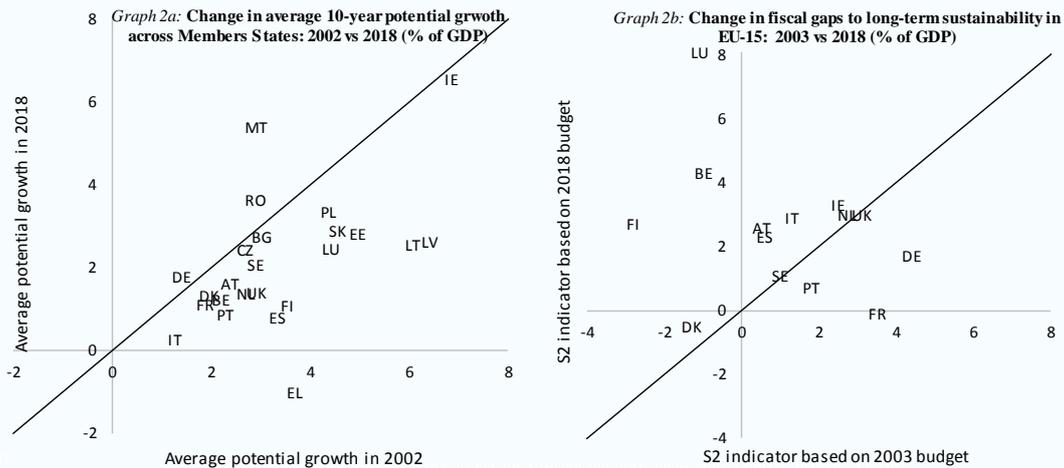
Divergent growth dynamics are partly responsible for this large difference in debt developments (Graph 1.b). Low-debt Member States displayed a remarkable growth performance both before and after the global financial crisis, which helped them to maintain sustainable fiscal positions throughout the years. These countries are small and open economies, and many are catching-up economies that are benefiting from a rapid convergence towards the average EU per capita income level. Meanwhile, between 2000 and 2018, Member States that ended up with relatively high levels of debt after the crisis (between 60% and 90% of GDP) had a similar growth performance to Member States that had very high-debt levels in the post-crisis years (over 90% of GDP). The increasing gap in indebtedness between these two groups of Member States therefore cannot be fully explained by divergent growth dynamics.

Differences in fiscal discipline are a key determinant of the large difference in debt developments across Member States (Graph 1.c). The three groups of Member States outlined above display a noticeable difference in fiscal policy stance since 2000: low-debt Member States also maintained very low cyclically-adjusted deficits throughout the years, while Member States with very high debts maintained the largest budget deficits. A more expansionary fiscal stance is partly justified by a worse economic performance after the global financial crisis of 2008. But Member States with very high debts also maintained a more relaxed fiscal stance than high-debt Member States during the



(Continued on the next page)

Box (continued)



Notes: (Graph 4) Data unavailable for Hungary, Slovenia, Cyprus and Croatia. (Graph 5) The fiscal gap to long-term sustainability is calculated with the S2 indicator, which measures the immediate and permanent fiscal adjustment ensuring that the intertemporal budget constraint of the government is satisfied.

pre-crisis years, despite having a better growth outlook: this further indicates a more pronounced deficit bias in the former group of countries.

### Medium-term fiscal challenges

Going forward, declining growth prospects present a major challenge to fiscal sustainability in the EU. With few exceptions, most Member States have seen a decline in their outlook for medium-term potential growth (Graph 2.a), which will adversely affect debt sustainability in two ways. First, since indebtedness is usually measured relative to the size of the economy (i.e. the debt-to-GDP ratio), an increase in nominal GDP is one of the ways in which governments can address existing fiscal imbalances, and therefore a decline in growth prospect implies a reduced ability to control debt dynamics. Additionally, expenditure control may prove difficult because the growth slowdown is partly caused by demographic factors: a decline in fertility rates coupled with an increase in life expectancy. These factors will also lead to an increase in age-related expenditures, on healthcare and pensions, so that public finances will face increasing strain from both the revenue and the expenditure side.

The legacy of the crisis is also evident in conventional sustainability measures, which indicate a deterioration in the long-term fiscal outlook of many Member States. The fiscal gaps required to ensure the long-term solvency of public finances have generally increased, despite the fact that Member States' budgetary positions have substantially improved in the last few years. For instance, when looking at EU-15 Member States in 2018, most have seen an increase in their fiscal gaps to long-term sustainability compared to 2003 (Graph 2.b), but the overall structural deficit of EU-15 Member States is about 2 percentage points lower than in 2003. Nevertheless, the size of outstanding fiscal gaps remain contained for most Member States, indicating that the adjustment required to ensure long-term sustainability can be realistically achieved.

In this section, the focus is on economic as opposed to legal compliance. Most of the literature examining compliance with the EU fiscal rules is based on an empirical assessment that compares budgetary outcomes against a set of predefined numerical fiscal rules. Therefore, such an analysis generally relies on dataset that differs from the one available at the time of the formal Commission assessment. A deviation from a numerical rule in the EU fiscal framework does not necessarily lead to formal non-compliance, because of the considerable margins of deviations allowed in the

rules themselves, and because of the discretion in their interpretation from a legal point of view.

### 3.2.1. Recent literature on compliance with fiscal rules

Although successive reforms of the EU fiscal framework were also aimed at enhancing compliance, the track record appears weak. The recent literature shows that compliance with national and supranational fiscal rules in advanced and emerging economies has been mixed at best

(<sup>23</sup>). In particular, in the EU, noncompliance has been the rule rather than the exception (<sup>24</sup>). According to some authors, compliance with EU fiscal rules has been poor since the introduction of the euro, while the preventive arm has failed to encourage the build-up of sufficient buffers in good times (<sup>25</sup>). Eyraud, Gaspar and Poghosyan (2017) argue that the various reforms of the SGP over 2005-2013 have not had any evident impact on compliance. Reuter (2019) finds that average compliance with all rules (national and supranational) and across all the sampled countries was around 50% between 1995 and 2014 and slightly higher for the EU rules (around 58%). The author finds that the probability of compliance increases with stronger independent monitoring and enforcement bodies, while non-compliance is more likely with more fragmented governments, in decentralised countries and in election years.

Few studies have also explored the link between compliance and effectiveness of the fiscal rules (<sup>26</sup>). Available analyses share the view that, although non-compliance seems to prevail, fiscal rules have nonetheless changed the behaviour of fiscal authorities. The most notable example is the well-documented ‘magnet effect’ exerted by the 3% of GDP reference value for the deficit (<sup>27</sup>), also referred by other authors as ‘threshold-reversion effect’ (<sup>28</sup>). These studies find evidence of attractive forces that pull budget balances towards the threshold value set by the rules while reducing the occurrence of large government deficits and surpluses (<sup>29</sup>). However, these findings do not appear sufficiently robust to counterweigh the perceived lack of compliance with the EU fiscal rules and the associated risks to the sustainability of public finances. In particular, the EU rules have failed to impose sufficient fiscal discipline in high debt countries to generate a convergence of public debt to safer levels. Some authors have emphasised that the secular decline of output growth has

loosened the link between the deficit and debt Treaty reference values (<sup>30</sup>), advocating a recalibration of fiscal parameters (<sup>31</sup>). However, the prolonged low-interest environment in recent years eased sustainability constraints, as shown by the contribution of the snowball effect in debt developments.

### 3.2.2. Numerical compliance in retrospect: an empirical exercise

In this section, we follow an empirical approach similar to the one used in Eyraud and Wu (2015), Eyraud, Gaspar and Poghosyan (2017) and Reuter (2017). The analysis considers four main numerical fiscal rules defined as closely as possible to those of the current SGP framework:

1. Deficit rule: a country is non-compliant if its headline budget balance falls below – 3% of GDP for at least two consecutive years (i.e. the rule disregards temporary deviations);
2. Debt rule: a country is non-compliant if its debt-to-GDP ratio is above 60% and not falling at a sufficient pace (i.e. 1/20 of the distance to the Treaty reference value on average over the past three years);
3. Structural balance rule: a country is non-compliant if it is not at the medium-term objective (MTO) and its structural fiscal effort is less than the benchmark requirement of 0.5% of GDP or less, depending on the initial distance from the MTO;
4. Expenditure benchmark rule: a country is non-compliant if the annual rate of growth of primary expenditure, net of discretionary revenue measures and one-offs, is above the 10-year average real potential output growth rate, plus the convergence margin (<sup>32</sup>) and the estimated GDP deflator (<sup>33</sup>).

(<sup>23</sup>) Caselli et al. (2018), pp.42-59.

(<sup>24</sup>) Gaspar and Amaglobeli (2019).

(<sup>25</sup>) The authors consider compliance with four simplified fiscal rules: the 3% of GDP deficit and the 60% of GDP debt Treaty reference values, the ‘close to balance position’ and the minimum annual fiscal effort of 0.5% of GDP.

(<sup>26</sup>) The perceived link is based on two main presumptions: first, deviations from the rule, especially large ones, if not corrected, may lead to unsustainable fiscal positions; second, noncompliance may erode the credibility of the rule (Lledó and Reuter, 2018).

(<sup>27</sup>) Caselli and Wingender (2018).

(<sup>28</sup>) Caselli et al. (2018), pp.42-59.

(<sup>29</sup>) Furthermore, the attraction seems to be stronger for negative deviations (i.e. underachievement) than for positive deviations (i.e. overachievement). For negative deviations, the authors also find that countries with rules have a faster reversion to the threshold/target than countries without rules.

(<sup>30</sup>) Eyraud and Wu (2015). According to the authors, the downward revisions to potential growth, currently estimated to be about 3% in nominal terms in many euro-area countries, would imply a debt converging towards 100% of GDP.

(<sup>31</sup>) Gaspar and Amaglobeli (2019).

(<sup>32</sup>) The convergence margin allows the structural balance to adjust towards the MTO. In case an adjustment is required, the convergence margin reduces the maximum allowed growth of expenditure compared to the medium-term potential GDP growth. The size of the convergence margin depends on the required adjustment and to the share of government primary expenditure in GDP. Although the SGP does not require any specific adjustment for countries above the MTO, in the present analysis the expenditure benchmark rule also applies to such

By comparing in retrospect fiscal outturns with this set of targets and ceilings, the analysis provides an indication of economic compliance towards achieving the ultimate objective of the fiscal rules, which is to ensure the sustainability of public finances. Compared to existing works, the present exercise provides for a more granular definition of fiscal rules, with a degree of detail closer to the ones currently used under the SGP, over an extended period (1998-2018).

**Table 3.1: Average compliance with EU fiscal rules (1998-2018)**

	1998-2018	1998-2007	2008-2010	2011-2018
<b>EU-28</b>	Deficit rule	64%	67%	71%
	Debt rule	72%	83%	59%
	Structural balance rule	49%	44%	63%
	Expenditure benchmark rule	42%	32%	60%
	<b>Overall compliance</b>	<b>57%</b>	<b>57%</b>	<b>63%</b>
<b>EA-19</b>	Deficit rule	64%	71%	69%
	Debt rule	64%	77%	50%
	Structural balance rule	46%	41%	61%
	Expenditure benchmark rule	40%	32%	57%
	<b>Overall compliance</b>	<b>54%</b>	<b>55%</b>	<b>59%</b>
<b>EA-12 (old)</b>	Deficit rule	63%	72%	65%
	Debt rule	52%	71%	33%
	Structural balance rule	48%	46%	61%
	Expenditure benchmark rule	41%	32%	58%
	<b>Overall compliance</b>	<b>51%</b>	<b>55%</b>	<b>54%</b>

Note: (1) The overall compliance rate is the frequency of compliant cases across all rules, years and countries. (2) The EA-12 (old) refers to the EA countries subject to the SGP since its entry into force. It excludes Estonia, Cyprus, Latvia, Lithuania, Malta, Slovenia and Slovakia.

Source: European Commission, own calculations.

As indicated above, this kind of numerical exercise should not be taken as a formal assessment of compliance with the provisions of the SGP. Firstly, the analysis uses the latest available data and estimates, and not those available in real time. Secondly, it assesses compliance with rules even for years when they are not in force (e.g. compliance with the expenditure benchmark before 2011). Finally, the assessment does not consider the activation of escape clauses, the use of flexibility, or the margin of broad compliance<sup>(34)</sup>.

Overall, our results are in line with the existing literature (Table 3.1). Since the entry into force of the SGP, the average compliance rate, across all

cases. When a country is above its MTO, the convergence margin, based on the (positive) distance between the structural balance and the MTO, increases the allowed expenditure growth compared to the medium-term potential GDP growth rate.

<sup>(33)</sup> Discretionary revenue measures are available only since 2009. This expenditure benchmark, as the one used by the Commission to assess compliance with the preventive arm of the SGP, also smooths public investment by taking the average of expenditure in gross fixed capital formation over the previous four years.

<sup>(34)</sup> For an analysis of the different type of flexibility in the Stability and Growth Pact, see Chapter 5 of the 2018 EFB annual report.

countries and rules, is around 57%. With the exception of the debt rule, compliance improved after 2011 compared to the pre-crisis period. However, this trend is less evident for the euro area and, in particular, among the 12 original euro area countries. For them, compliance with the debt rule appears remarkably low in 2011-2018. This reflects the significant accumulation of public debt in 2011-2013, combined with low economic growth and inflation. Even when countries were reducing their deficits or adjusting to their MTO, debt continued to rise.

Table 3.2 shows cases of numerical compliance with fiscal rules<sup>(35)</sup> for countries under the preventive and the corrective arm of the SGP, respectively. In order to have a comparable number of episodes, it considers the two sub-periods (i.e. 2003-2007 and 2012-2016) with approximately as many Member States in the preventive arm as in the corrective arm of the SGP.

**Table 3.2: Average compliance: preventive vs corrective arm of the Stability and Growth Pact (SGP)**

	preventive arm		corrective arm	
	2003-2007	2012-2016	2003-2007	2012-2016
Debt rule	92%	75%	50%	25%
Structural balance rule	42%	62%	43%	65%
Expenditure benchmark rule	32%	49%	21%	66%
<b>Overall compliance</b>	<b>55%</b>	<b>62%</b>	<b>38%</b>	<b>52%</b>

Note: (1) The overall compliance is the frequency of compliant cases across all countries, years and rules (except for the deficit rule). (2) Countries subject to the corrective arm of the SGP also include those under economic adjustment programmes.

Source: European Commission, own calculations.

This numerical exercise does not indicate any clear difference in compliance between the two arms of the SGP. Except for the debt rule, compliance rates vis-à-vis the structural balance and expenditure benchmark rules present a rather similar pattern, increasing in the second sub-period, especially for countries in EDP. However, compliance rates among countries under the corrective arm of the SGP drop by 10 percentage points when countries under macroeconomic adjustment programmes are excluded<sup>(36)</sup>.

<sup>(35)</sup> Except for the deficit rule, because it triggers the EDP and therefore defines if a country is in the preventive or the corrective arm of the SGP. Noncompliance with the debt rule can also trigger an EDP. However, so far, it has never happened.

<sup>(36)</sup> Macroeconomic adjustment programmes are applied to Member States which no longer have access to financial markets and require external financial assistance. These programmes include

Higher compliance rates are associated with lower debt levels, smaller country sizes and a longer tradition of national independent fiscal institutions (see Table 3.3).

Table 3.3: Compliance with fiscal rules across several dimensions

Countries grouped by:	1998-2018	1998-2007	2008-2010	2011-2018
Very high-debt countries (1)	43%	47%	20%	47%
High-debt countries (2)	50%	47%	28%	61%
Low-debt countries (3)	72%	71%	59%	78%
Large countries (4)	44%	49%	18%	47%
Medium and small countries (5)	63%	65%	46%	65%
Long-established institution (6)	70%	72%	55%	73%
Recently-established institution (7)	51%	50%	32%	59%

Notes: Compliance rates refer to the frequency of compliant cases across all rules, years, and groups of countries. The analysis used the following groups of countries. The classification of countries by debt level is based on the average debt-to-GDP ratio over 2011-2018: (1) Very high-debt countries = above 90% of GDP (i.e. BE, EL, ES, FR, IT, CY, PT); (2) High-debt countries = between 60% and 90% of GDP (i.e. DE, HR, HU, MT, NL, AT, SI, UK); (3) Low-debt countries = below 60% (i.e. BG, CZ, DK, EE, LV, LT, LU, PL, RO, SK, FI, SE). The classification of countries by size is based on GDP levels: (4) DE, FR, UK, IT, ES, NL; (5) SE, BE, EL, PT, AT, DK, FI, IE, LU; it excludes the smallest countries. The classification of countries by independent fiscal bodies is based on their tenure: (6) NL, SE, AT, BE, DK, EE, LT, LU; (7) IT, IE, SK, DE, EL, ES, FI, FR, HR, HU, LV, PT, RO, UK, MT, SI, CZ, CY, BG.

Source: European Commission, own calculations.

These findings are in line with the existing literature. For instance, the relation between compliance and country size has already been explored<sup>(37)</sup>. Several explanations for disparities between large and small economies have been provided, including the different perception regarding the threat of sanctions. Among economic arguments, it has been emphasised that large countries may have higher fiscal multipliers, making fiscal stabilisation more effective and fiscal adjustment costlier compared to smaller and more open economies. Better compliance with fiscal rules in countries with a longer tradition of independent fiscal institutions is also in line with the finding that strengthened national fiscal frameworks contribute to budgetary discipline<sup>(38)</sup>.

A glance at the development of compliance scores over the economic cycle (Graph 3.2) raises two main considerations. First, compliance with the deficit rule shows a clear pro-cyclical pattern, while this is less the case for the other rules. Headline budget balances improve during upturns, fostering the correction of excessive deficits, and worsen in

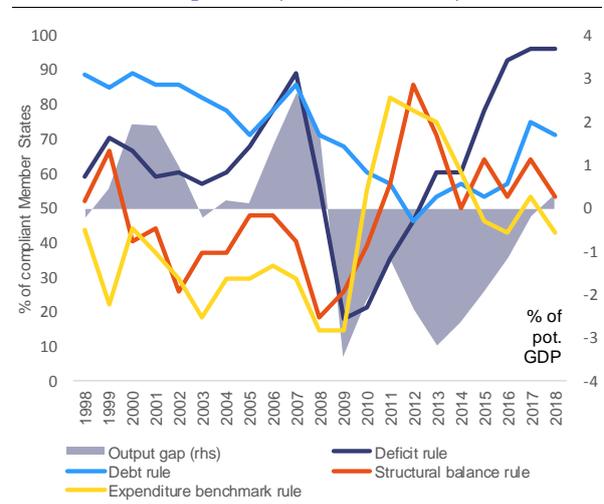
measures aimed at consolidating public finances and reducing macroeconomic imbalances, with the final goal of recovering financial solvency and, at the same time, promoting economic growth and job creation. Ireland, Greece, Spain, Cyprus and Portugal have undergone adjustment programmes in the period.

<sup>(37)</sup> Buti and Pench (2004); De Haan, Berger and Jansen (2004).

<sup>(38)</sup> European Commission (2018b).

downturns. The only period where compliance with the deficit rule improved despite a worsening of economic conditions was in 2011-2013 when most of the EU Member States were in EDP or under an economic adjustment programme. The second main consideration is that there are substantial differences in compliance between different rules at various points of the cycle. This could reduce the effectiveness of the SGP in case of overlapping fiscal requirements. Indeed, it is now well known that, in recent years, Member States under the corrective arm have been cherry-picking the most favourable fiscal target, which during the recovery happened to be the nominal deficit. This behaviour has been referred to as 'nominal strategy' (see Section 3.5).

Graph 3.2: Compliance with fiscal rules and output gap developments (EU-28, 1998-2018)



Source: European Commission, own calculations.

Compliance with the structural balance and the expenditure benchmark was relatively low before 2008, although good economic times prevailed. These findings reinforce a widespread belief that the years before the crisis were a missed opportunity to reduce debt and build up fiscal buffers<sup>(39)</sup>. In this regard, the six-pack reform of 2011, enriching the surveillance tool with the introduction of the expenditure benchmark, provided a desirable innovation. However, it is worrisome that numerical compliance with both the structural balance and the expenditure benchmark seems to have weakened again in recent years. It may signal a fiscal fatigue after the remarkable consolidation of 2011-2013, or it could

<sup>(39)</sup> It should be noted that there is no data for government's discretionary revenue measures before 2010, which may partially affect compliance with the expenditure benchmark as measured here.

be the result of an excessive use of the flexibility provisions embedded in the SGP.

Focusing on the expenditure benchmark, the analysis shows that EU Member States that today have the lowest debt ratio are also the countries that had consistently higher compliance with the expenditure benchmark before the crisis, compared to the high and very-high-debt countries.

**Graph 3.3: Deviations from the expenditure benchmark by level of government debt**



Notes: 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. 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, 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).

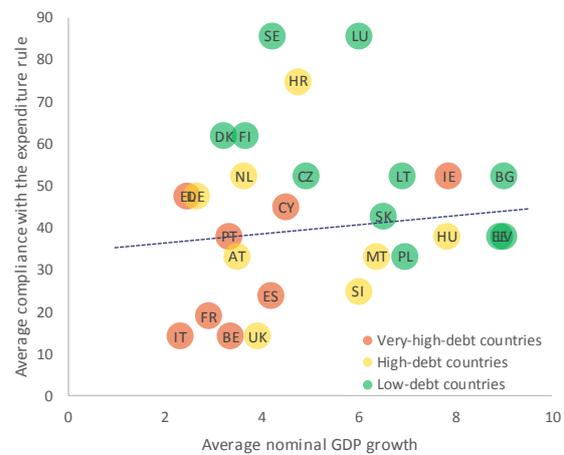
Source: European Commission, own calculations.

Looking at the size of deviations from the expenditure benchmark rule (see Graph 3.3) reinforces the finding. In the period before the crisis, low-debt countries (i.e. the green line) largely met the expenditure benchmark (i.e. net primary expenditure grew at a slower pace than medium-term potential output), while high and very high-debt countries deviated significantly from the benchmark. During the recovery phase (2013-2016), with most of the EU Member States in EDP or under economic adjustment programmes, countries with debt higher than 90% of GDP (i.e. the red line) kept their spending increases well below benchmarks, somewhat converging to the other two groups. A stronger focus on expenditure developments would have created a larger fiscal cushion to absorb economic shocks in the years preceding the crisis.

While in the most recent years deviations from the rules have in general narrowed, a closer look at the

amount of deviations from the numerical fiscal rules reveals a convergence of negative deviations towards 0.5% of GDP, for both the structural budget balance and the expenditure benchmark rule (see Graphs 3.5). In other words, it seems the margin of broad compliance (i.e. the margin of tolerance introduced by the six-pack reform in the assessment of compliance with the preventive arm of the SGP) has worked as a ‘magnet’, similarly to the effect exerted by the 3% of GDP deficit reference value.

**Graph 3.4: Compliance with the expenditure benchmark and nominal GDP growth (1998-2018)**

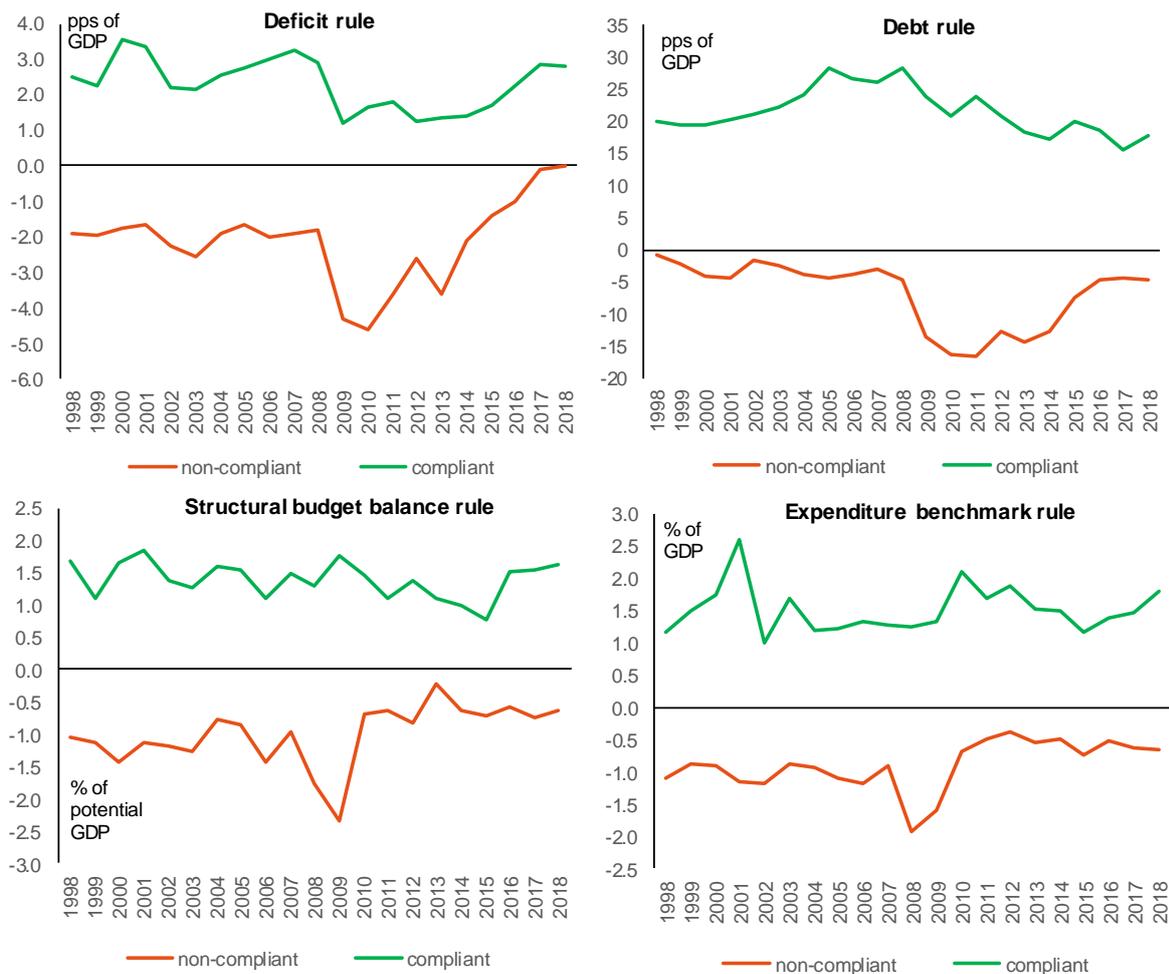


Notes: (1) The average compliance rate is the average percentage of compliance of a country with the expenditure benchmark rules over 1998-2018. (2) The classification of countries by debt level is based on the average debt-to-GDP ratio over 2011-2018. Very high-debt countries = above 90% of GDP (i.e. BE, EI, 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). (3) RO, an outlier in terms of average annual nominal GDP growth (close to 20%), is not included.

Source: European Commission, own calculations.

Compliance with the expenditure benchmark also appears to be less affected by, or associated with, nominal GDP growth (see Graph 3.4). This result is not unexpected. First, the expenditure benchmark is independent of cyclical conditions (by netting out the cyclical drivers of unemployment benefit expenditure). Second, the expenditure benchmark is built around the medium-term growth rate of potential GDP, estimated as the 10-year average of potential GDP. The medium-term growth rate of potential GDP is much more stable than the potential output growth of a single year used for the estimation of the structural balance. Graph 3.4 compares the compliance rate with the expenditure benchmark rule with the average nominal GDP growth over 1998-2018 for all EU Member States grouped by debt-to-GDP ratios. Unlike compliance with the other fiscal rules (especially the deficit and the

Graph 3.5: Deviations from the numerical fiscal rules (compliant vs non-compliant cases)



Notes: (1) The charts show the average amount of deviation from the four numerical fiscal rules. The charts distinguish the average deviation for country-year compliance cases (i.e. the green line) from the average deviation among non-compliant country-year cases (i.e. the red line). (2) Deviations from the deficit rule (i.e. 3% of GDP) are expressed in percentage points of GDP. (3) For countries with debt-to-GDP above 60%, deviations from the debt benchmark are the difference between the actual debt-to-GDP ratio and the one required by the debt reduction rule. For countries with debt-to-GDP below 60%, the graph shows the average distance to the 60% of GDP Treaty reference value. (4) Deviations from the structural budget balance rule are expressed in % of potential GDP. For countries at or above the MTO, requirements consider the use of fiscal space (i.e. countries are allowed to deteriorate their underlying fiscal position). Therefore, a positive deviation from the requirement does not necessarily indicate a fiscal expansion. (5) Deviations from the expenditure benchmark rule (i.e. the excess of the growth in expenditure over the reference rate) are given in percent of GDP. For countries at or above the MTO the same considerations as for the structural balance rule apply.

Source: European Commission, own calculations.

structural budget rules), no clear link exists between the average annual nominal GDP growth and compliance with the expenditure benchmark.

### 3.3. THE INSTITUTIONAL PROCESS OF BUDGETARY SURVEILLANCE

#### 3.3.1. The European Semester

As recalled in Chapter 2, the European Semester is one of the main innovations introduced in the EU economic governance framework after the crisis. It was first proposed and introduced in 2010 as a way to deepen and broaden economic surveillance and strengthen policy coordination among Member

States<sup>(40)</sup>. When the six-pack reform entered into force, the European Semester was further codified and introduced in secondary legislation by Regulation (EU) 1175/2011, which amended Regulation (EC) 1466/97 on the preventive arm of the SGP. Since 2015, the Juncker Commission has introduced a series of additional innovations to streamline the Semester and increase national ownership through a greater involvement of national parliaments and social partners.

The first objective of the European Semester is to introduce an integrated cycle for economic surveillance. The crisis highlighted the important

<sup>(40)</sup> COM(2010)250 and COM(2010)367.

connection that exists between fiscal sustainability and macroeconomic imbalances, and the need to establish an integrated surveillance cycle covering both aspects. This is achieved by synchronising the assessment of fiscal policies under the SGP with the assessment of macroeconomic and structural policies, in the context of the broad economic policy guidelines, which are formulated by the Council under Article 121 of the Treaty on the Functioning of the European Union (TFEU). The European Semester synchronised the timing of these two assessments by envisaging a simultaneous evaluation of stability and convergence programmes (SCPs) and national reform programmes (NRPs).

The second objective of the European Semester is to introduce a cross-cutting dimension of surveillance at the beginning of the year, with an overview of the main economic challenges in the Annual Growth Survey and with the publication of the euro-area recommendation. In May of each year, the Commission prepares draft country-specific recommendations (CSRs) containing initial guidance for the fiscal and structural policies of Member States, which are later adopted by the Council. The national guidance provided by the CSRs takes into account the cross-cutting dimension provided by the euro-area recommendation.

The third objective of the European Semester is to strengthen the surveillance of national policies, in full respect of domestic institutional arrangements. The crisis was, in part, caused by earlier failures to comply with the rules, highlighting how existing surveillance procedures were not sufficiently comprehensive. This is particularly relevant for the euro area, where economic policy coordination is of paramount importance, due to the possibility that policy errors may trigger sizeable cross-country spillovers. As discussed in Chapter 2 with the adoption of the two-pack reform, Regulation (EU) 473/2013 established that euro-area Member States are expected to submit their draft budgetary plans (DBPs) to the Commission by mid-October of each year. When preparing their DBPs, Member States must take into account the guidance received in the CSRs. The Commission then issues an opinion on each DBP in November, assessing its compliance with the rules. Within the European Semester, the Commission and the Council undertake a continuous cycle of surveillance, which includes an evaluation of how initial guidance was incorporated into national policies, an in-year

assessment of progress in the implementation, and a final assessment of compliance with the rules.

### 3.3.2. The assessment of medium-term budgetary plans

#### The legal basis for assessing Member States medium-term fiscal plans

Establishing a clearer and more binding medium-term framework for the planning and control of public finances is considered a prerequisite for sound fiscal policies. In the EU fiscal framework, the SCPs are intended to inform on the Member States' medium-term budgetary plans – and their underlying assumptions – for the multilateral surveillance under the terms of Article 121 TFEU. Provisions on SCPs have been part of the EU fiscal framework since its inception in 1997 (i.e. Section II and III of the EC Regulation 1466/1997). However, it was only in July 2001, when the Council adopted a code of conduct on the content and format of SCPs, that the SCPs acquired a more standardised structure.

The 2005 reform of the SGP recommended a higher involvement of national institutions in preparing the medium-term budgetary programmes and a greater role of parliaments in discussing them. In 2007, with the aim of strengthening the link between SCPs and annual budgetary plans and reducing the gaps between initial targets and outcomes, the Commission proposed several improvements to the procedure, including a change in the calendars for preparing the SCPs (European Commission, 2007). As a result, the deadline for submitting SCPs changed in 2009, from the end of the year to April.

In 2011, the six-pack reform officially aimed at further strengthening the role of the SCPs in the EU fiscal framework. Firstly, the reform fully integrated the SCPs into the European Semester for EU economic policy coordination, including by providing an assessment of the programmes in the country-specific recommendations (CSRs). It also fixed in the law the timing for submitting SCPs. Secondly, the reform set mandatory minimum national requirements for accounting and statistics. In particular, the reform provided that official macroeconomic forecasts have to be produced or endorsed by independent fiscal institutions.

### Member States' adherence to medium-term plans

There are two prominent causes of non-compliance with fiscal rules: deliberately planned deviations (i.e. poor compliance from the start) and slippages in the execution of budgetary plans (i.e. poor execution). Eyraud, Gaspar and Poghosyan (2017) have examined stability programmes for a subset of euro-area countries from 1998 to 2013, focusing on cases of non-compliance with either the deficit or the debt rule. They found that the main driver of poor compliance at the end was a weak execution of budgetary plans. The final observed deviation from plans could be due to factors outside government's control, such as negative surprises in growth or inflation. However, poor execution could also mask intentional biases built into budgetary plans (e.g. a deliberate underestimation of deficits) or a weak link between medium-term budgetary plans and the national budgetary process.

A comparison between plans and outcomes appears to corroborate the findings of earlier studies of a weak execution of budgetary plans. The following set of charts (Graph 3.6) compares, for some EU Member States, the headline budget balances, as projected in successive stability and convergence programmes (1998-2019), with outcomes. These latter refer to the latest available information (i.e. Commission spring 2019 forecast). Despite efforts to strengthen the effectiveness of countries' medium-term budgetary plans, gaps between projected fiscal targets and outcomes remain a recurring feature, rather than an exceptional circumstance, especially for some countries.

Of note, budget balances in countries with traditionally very high debt-to-GDP ratios (such as Belgium, France and Italy) came out almost constantly lower than initially planned in their respective programmes, both before and after the crisis. While missing fiscal targets during unexpected downturns is understandable, the significant and continuous gaps between plans and outcomes in the most recent years are critical. Gaps between projections and outcomes for Germany and, to a lesser extent, for the Netherlands and Austria, show a clear change in direction. While until 2005-2007 budget balances often came in lower than planned, after the crisis, projections were almost constantly on the conservative side. The chart for Spain shows exactly the opposite: outcomes in line with or above targets before the

crisis and overly optimistic budgetary plans in the years after the crisis.

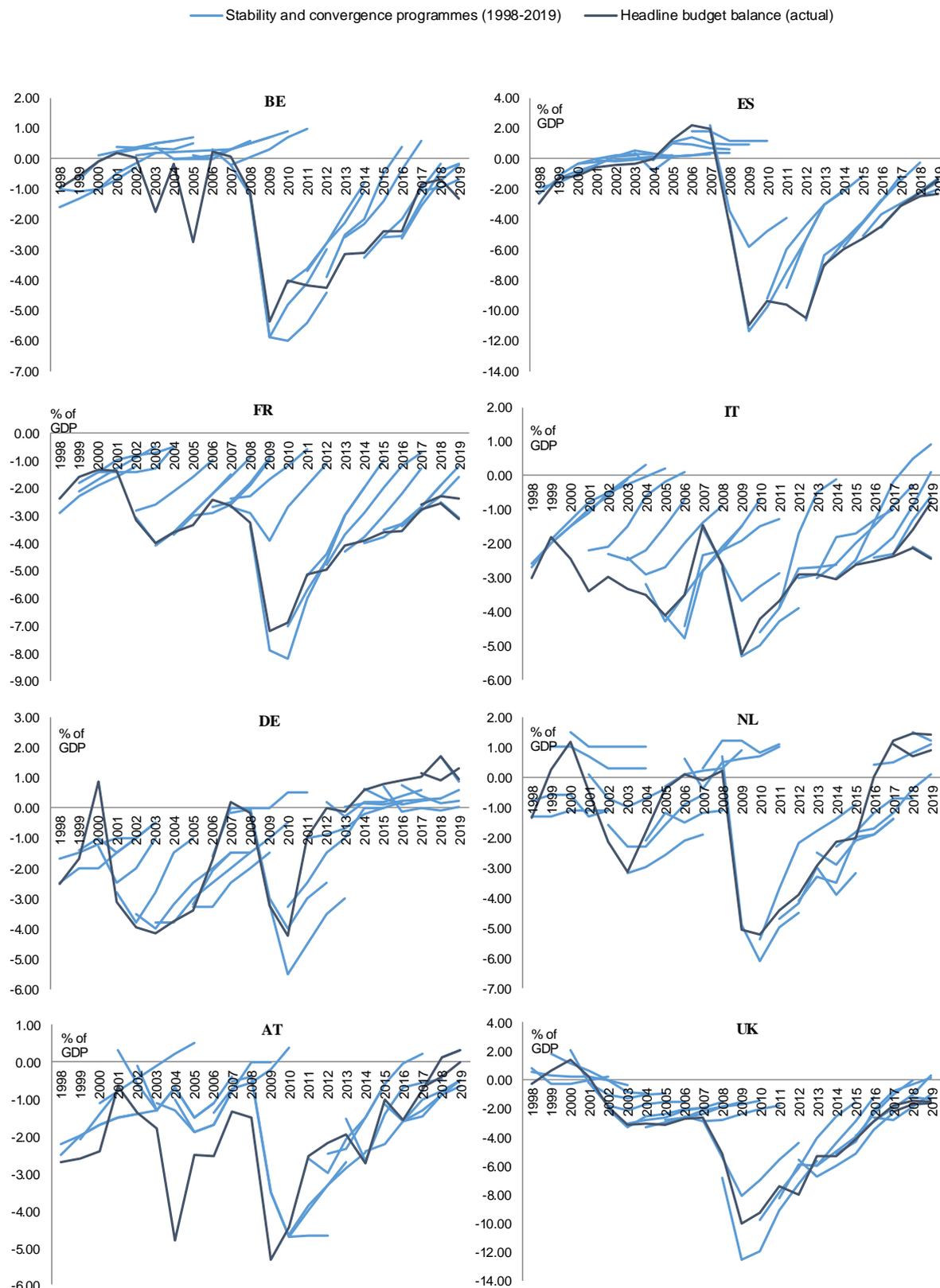
The second set of charts (Graph 3.7) compares, for the same EU Member States, nominal GDP projections in the stability and convergence programmes (1998-2019) with actual nominal GDP growth (i.e. Commission spring 2019 forecast). Unsurprisingly, results mirror the findings for the budgetary targets. Lower-than-planned budget balances were frequently associated with negative GDP growth surprises.

Gaps between projections underlying the SCPs and outcomes appear to have somewhat narrowed in the most recent years, in conjunction with the reforms of the EU fiscal framework assigning to national independent fiscal institutions (IFIs) the role of assessing, and eventually endorsing, the macroeconomic assumptions underpinning governments budgetary plans. However, evidence suggests that there is still room for improvement, particularly in Member States where medium-term fiscal plans display a consistently optimistic bias.

### Outstanding institutional challenges

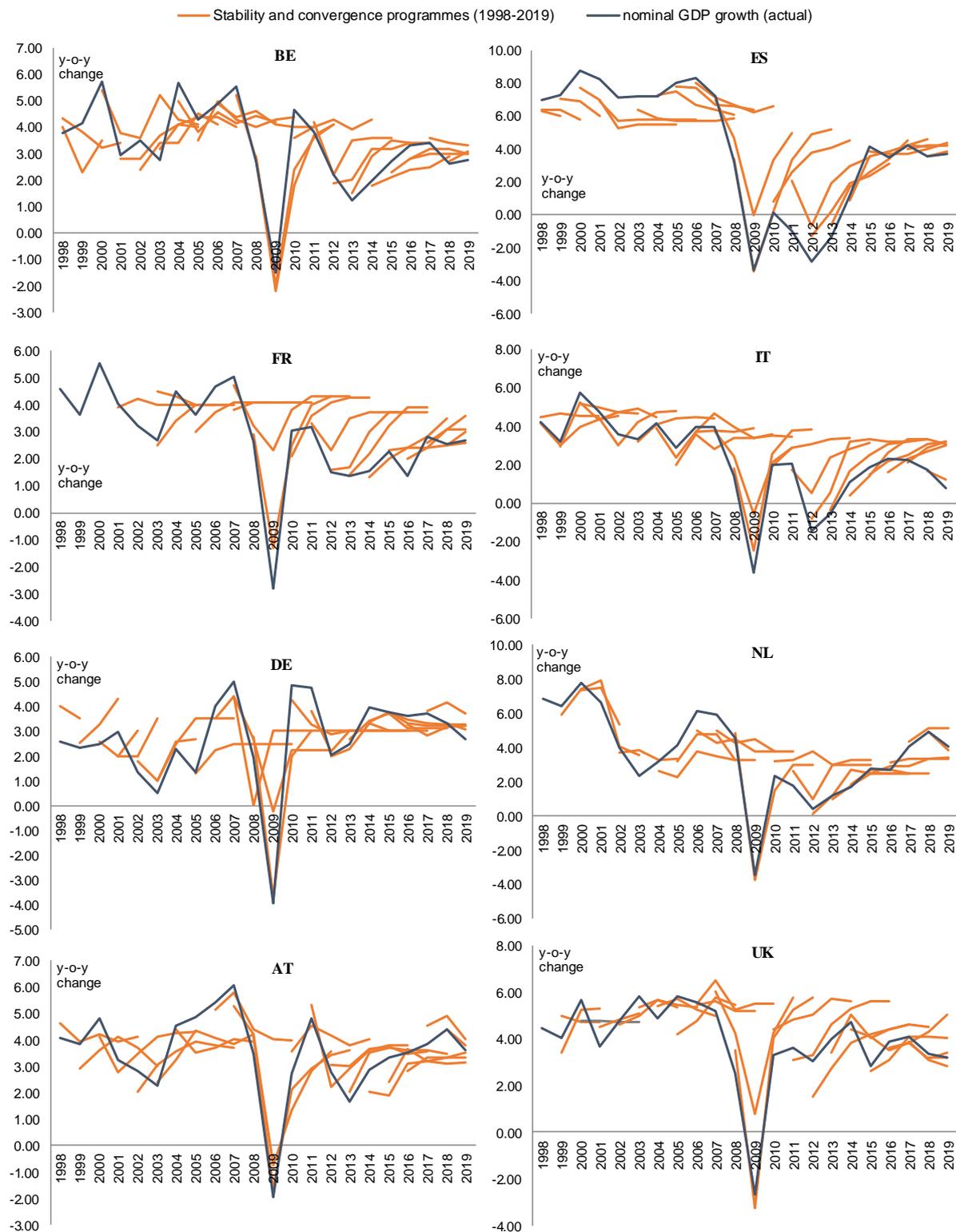
A number of challenges remain in the current institutional set-up. Firstly, a common deadline (i.e. end of April) for all EU Member States to submit SCPs, while necessary in a fully integrated framework, has become quite challenging from a practical perspective. Before the six-pack reform, the Commission issued a dedicated opinion on the assessment of SCPs. In the current framework, the assessment is replaced by a single legal act covering both the opinion on the SCPs and the country-specific recommendations (CSRs). As a consequence, the assessment of SCPs has a much less prominent role in the surveillance framework. In particular, the time between the publication of the Commission assessments and the adoption of CSRs by the Council appeared most of the time insufficient to enable an appropriate multilateral check. The joint examination (by the Commission and the Council) of medium-term budgetary plans is often limited to a paragraph in the CSRs.

Graph 3.6: **Headline budget balance: stability and convergence programmes vs outcomes**



Source: European Commission

Graph 3.7: Nominal GDP growth: stability and convergence programmes vs outcomes

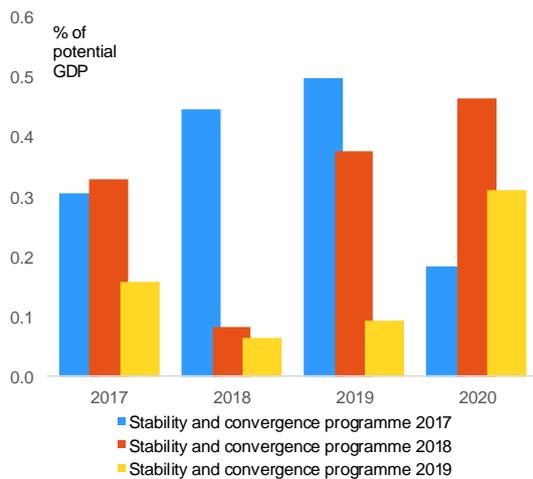


Source: European Commission

Secondly, with the two-pack reform, the obligation for the euro-area Member States to submit by 15 October their draft budgets to the Commission and the Eurogroup before their adoption by national parliaments has shifted political attention to the annual budget (see next section). Consequently, the analysis has also moved from medium-term to short-term fiscal developments.

Given that the adoption of opinions on draft budgetary plans remains ultimately a Commission act, which often entails quite intense bilateral discussions with Member States, the re-focus on annual budgetary plans has also shifted the nature of the fiscal surveillance from a multilateral to a bilateral dimension. Therefore, fiscal projections for the outer years as reported by EU Member States in their SCPs have lost value, with targets most of the time moving in line with requirements. This is evidenced by the tendency to regularly backload structural adjustments (Graph 3.8).

Graph 3.8: **Planned fiscal adjustments since 2017 (euro-area countries not at MTO)**



Notes: (1) Changes in the 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) Euro area countries not at MTO at the beginning of the 2018 surveillance cycle: AT, BE, FI, FR, IE, IT, LV, PT, SI, SK. The analysis also included ES.  
**Source:** European Commission, own calculations.

If the information available in the SCPs has increased following the various innovations to the EU fiscal framework, more efforts are needed to strengthen the link between the medium-term fiscal plans and the national budgetary process. Unbiased medium-term budgetary planning is crucial for an effective functioning of the SGP. The reform proposals outlined in Chapter 6 aim at strengthening the medium-term orientation of fiscal policymaking.

### 3.3.3. The assessment of draft budgetary plans

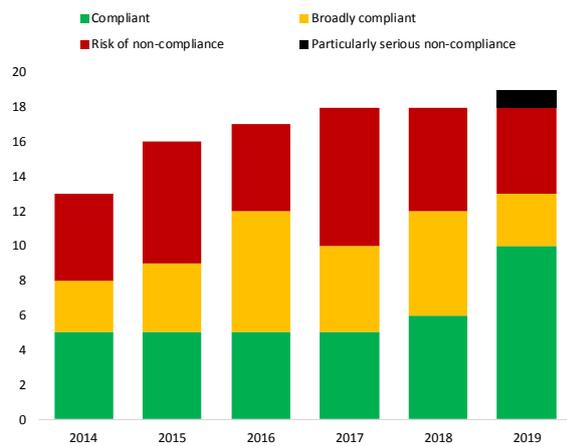
Since the two-pack reform in 2013, every year in autumn euro-area countries are required to present their DBPs for the following year to the Commission and the Eurogroup. The purpose of the DBPs process was to improve the surveillance and coordination of fiscal policies in the euro area by identifying and correcting at an early stage any risks of deviating from the recommended budgetary targets<sup>(41)</sup>. It empowers the Commission to issue a negative opinion if it identifies a case of ‘particularly serious non-compliance’, which would require the country to submit a revised DBP<sup>(42)</sup>.

From 2014 to 2019, the track record of Member States’ adherence to fiscal requirements was mixed (Graph 3.9). Until 2018, around one third of the draft budgets submitted each year were in full compliance with fiscal requirements, and in 2019 more than half of draft budgets were fully compliant. At the same time, between 30% and 45% of draft budgets submitted in any given year were deemed to be at risk of non-compliance with the rules, which means that the Commission identified a significant deviation from the fiscal guidance given to Member States. The remaining draft budgets were deemed to be broadly compliant with the rules, in the sense that the Commission identified a slippage from fiscal targets, but it was below the threshold of significance. For Member States under the preventive arm, this is a deviation of 0.5% of GDP in a single year or cumulatively over two years.

<sup>(41)</sup> The Commission assesses the DBPs against the requirements of the SGP and the fiscal CSRs published in spring, and issues opinions. The Commission opinion, an autonomous legal act that does not involve the Council, concludes whether the DBP is ‘compliant’, ‘broadly compliant’ or ‘at risk of non-compliance’ with the provisions of the SGP.

<sup>(42)</sup> Regulation (EU) 473/2013: ‘In the exceptional cases where, after consulting the Member State concerned, the Commission identifies in the draft budgetary plan particularly serious non-compliance with the budgetary policy obligations laid down in the SGP, the Commission, in its opinion on the draft budgetary plan, should request a revised draft budgetary plan, in accordance with this Regulation’. The Code of Conduct of the two pack gives examples of situations, which could be considered constituting particularly serious non-compliance.

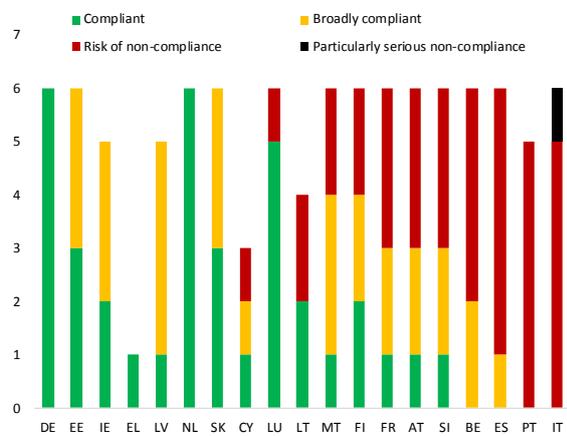
Graph 3.9: Compliance of draft budgetary plans by year (number of DBPs)



Source: European Commission, own calculations.

Adherence to fiscal guidance varies widely among Member States. While some Member States have never presented draft budgets deemed to be at risk of non-compliance, other Member States have never presented draft budgets that were at least broadly compliant with the rules (Graph 3.10).

Graph 3.10: Compliance of draft budgetary plans by country (number of DBPs)



Source: European Commission, own calculations.

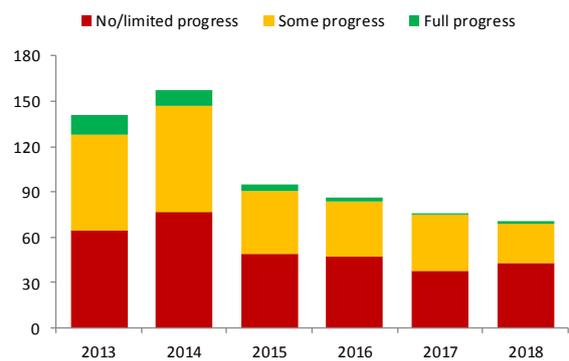
### 3.3.4. Structural policy coordination

The track record of compliance with the structural side of EU economic surveillance is less positive<sup>(43)</sup>. On average, from 2013 onwards, there has been no or limited progress in around half of the CSRs addressed to Member States (Graph 3.11). Progress in implementing the CSRs has also

<sup>(43)</sup> Structural reforms aim to tackle obstacles to the economies' growth potential and its drivers in the economy, such as job creation, investment and productivity, by liberalisation of labour, products and service markets.

been progressively declining over the years: most notably, it has not improved since the European Semester's streamlining in 2015, when the number of recommendations addressed to Member States was substantially reduced. This partly reflects the more sensitive political nature of structural reforms compared to fiscal policies. It may also reflect the lower degree of enforcement of the structural side of the EU economic governance framework compared to the fiscal side.

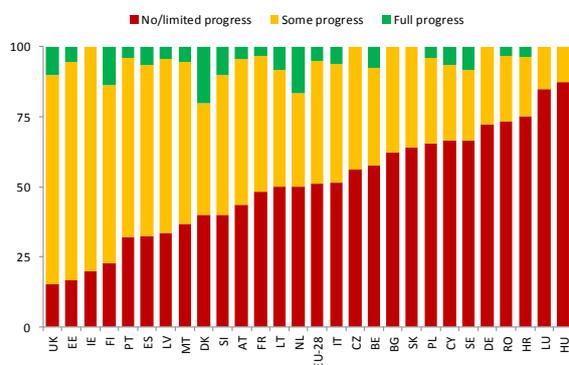
Graph 3.11: Implementation of CSRs by year (number of recommendations)



Source: European Commission, own calculations.

Once again, there is substantial divergence across Member States in the implementation of the CSRs (Graph 3.12). While in only a few instances the Commission has considered Member States to have made full progress with the implementation of their recommendations, a number of Member States have at least made some progress with most of the recommendations received, whereas other Member States has made limited or no progress on most recommendations.

Graph 3.12: Implementation of CSRs by Member States



Greece did not receive recommendations in the years considered because it was in the economic adjustment programme.

Source: European Commission, own calculations.

### 3.4. DEBT REDUCTION

While a debt anchor has always been part of the SGP, it was originally not made operational. The Maastricht Treaty establishes a reference value for the public debts of EU Member States at 60% of GDP, and high-debt Member States must ensure that their debt-to-GDP ratio is ‘sufficiently diminishing’ and approaching the reference value ‘at a satisfactory pace’. While non-compliance with the debt criterion should lead to the opening of an EDP, this was never considered before the six-pack reform. This is partly because a debt anchor does not immediately translate into an operational target, due to the fact that short-term debt dynamics are affected by a number of factors which are not directly under the control of the government, namely economic growth, inflation and interest rates. Moreover, as long as nominal GDP growth was sufficiently high, respecting the 3% of GDP deficit rule automatically entailed compliance with the debt rule.

With the adoption of the six-pack reform, Regulation (EU) 1177/2011 operationalises the debt rule. It establishes that the debt ratio is ‘sufficiently diminishing’ and approaching the reference value ‘at a satisfactory pace’ if ‘the differential with respect to the reference value has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data is available’. The Regulation also establishes that the debt requirement is fulfilled if ‘the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which the data is available’. Furthermore, the Regulation specifies that ‘[i]n implementing the debt ratio adjustment benchmark, account shall be taken of the influence of the cycle on the pace of debt reduction’. Consequently, compliance with the debt criterion is established considering three separate benchmarks for the speed at which the debt ratio is reduced.

In the context of the EDP, the debt criterion is therefore put on par with the deficit criterion. Whenever a Member State deviates from the debt-reduction benchmark, in its three configurations, the Commission prepares a report under Article 126(3) TFEU to assess whether the government is in breach of the debt criterion, and therefore whether an EDP should be launched. In its

assessment, the Commission is required to take into account any other relevant factor that may justify non-compliance with the debt rule. The assessment of these relevant factors is therefore a crucial component of the implementation of the debt criterion.

Article 126(3) TFEU establishes that the Commission has to take into account ‘all other relevant factors, including the medium-term economic and budgetary position of the Member State’ when assessing compliance with the debt criterion. Regulation (EU) 1177/2011 further clarifies what the other relevant factors are that should be taken into account. In particular, the Regulation requires the Commission to assess the following: (i) the developments in the medium-term economic position, in particular potential growth; (ii) the developments in the medium-term budgetary position, in particular the record of adjustment towards the MTO; and (iii) the developments in the medium-term government debt position, its dynamics and sustainability, in particular risk factors, stock-flow adjustments, accumulated reserves and other financial assets, and implicit liabilities.

#### 3.4.1. High-debt Member States and the debt criterion

While the debt rule was operationalised with the six-pack reform of 2011, Regulation (EU) 1177/2011 envisaged a transition period for Member States that were under an excessive deficit procedure at the time. These Member States were exempt from complying with the full debt-reduction benchmark in the three years following the correction of the excessive deficit, provided that they made sufficient progress towards compliance<sup>(44)</sup>. Therefore, compliance with the debt reduction benchmark has not been assessed for a number of high-debt Member States that were under the EDP until recently. In particular, of all the Member States which ended up with an average debt ratio above 90% of GDP after the crisis (see Box 3.1), Greece, Spain, France and Portugal corrected their excessive deficit in 2016 or later. Ireland and Cyprus, conversely, benefitted from a strong growth momentum after the crisis, which helped them achieve a faster debt correction than provided for by the debt rule. Finally, Belgium

<sup>(44)</sup> Sufficient progress towards compliance is defined as the minimum linear structural adjustment that would have ensured compliance with the debt rule at the end of the three-year transition period. See the Vade-mecum of the SGP.

and Italy have found it difficult to achieve the required debt reduction, with the shortfall being particularly significant for Italy.

Since 2013, the Commission has issued several reports under Article 126(3) TFEU to assess compliance with the debt criterion for Member States in breach of the debt rule: Italy, Belgium and Finland (in the latter case, the debt ratio exceeded the 60% of GDP reference value from below). With two exceptions, the Commission determined in its assessments that other relevant factors justified the non-respect of the debt reduction benchmark, and therefore determined that a breach of the rules did not occur. In the practice matured until now, two relevant factors have been crucial in assessing compliance. The first is the role of stock-flow adjustments, particularly in relation to financial contributions to the European Stability Mechanism (ESM): if the debt rule is breached solely on account of these factors, then the debt criterion is not deemed to be breached. The second key relevant factor is compliance with the preventive arm: in this case, even a partial fulfilment of this requirement (i.e. a broad compliance in the SGP jargon) has been deemed sufficient to establish compliance with the debt criterion.

By considering the MTO as a relevant factor for compliance with the debt criterion, the debt rule has introduced a link between the preventive and the corrective arms of the SGP. This relationship is grounded on the notion that the MTO is defined to take into account the debt position of the Member States, and therefore compliance with the preventive arm should ensure, under normal economic circumstances and over the medium-term, a pace of debt reduction that is at least as fast as the one required by the debt reduction benchmark.

Table 3.4: **Other relevant factors considered in assessing the debt criterion under Art.126 (3) reports**

Country	Date	Adherence to MTO	Structural reform	Economic conditions	Stock-flow adjustments	Breach
Belgium	27-05-2015	✓	✓	✓		
	18-05-2016	✓	✓	✓		
	22-05-2017	~	✓	~		
	23-05-2018	~	✓	~		
Finland	15-11-2013			✓	✓	
	02-06-2014				✓	
	27-02-2015			✓	✓	
	13-05-2015			~	~	YES
	16-11-2015	✓		~	~	
	18-05-2016	✓		✓	~	
	22-05-2017	✓	✓	~	~	
Italy	27-02-2015	✓	✓	✓		
	18-05-2016	✓	✓	✓		
	22-02-2017	~				
	23-05-2018	~	~			
	21-11-2018					YES

Note: '✓' indicates that the relevant factor fully applies; '~' indicates that the relevant factor has been acknowledged with some qualifier.

Source: European Commission.

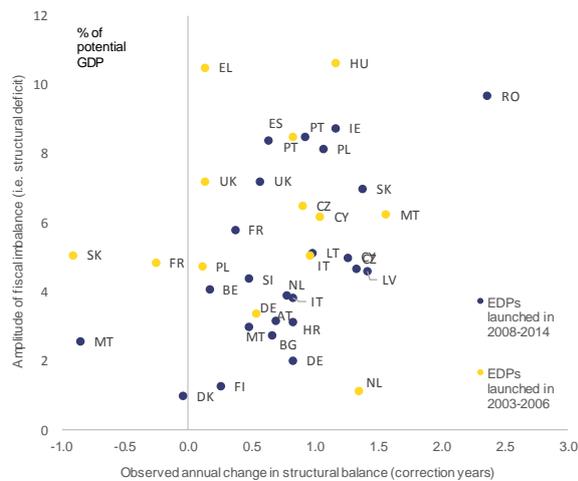
### 3.5. CORRECTION OF EXCESSIVE DEFICITS

Article 126 TFEU establishes that deviations from the 3% of GDP reference value are a 'gross error' that need to be corrected. The original justification for this reference value rested on the consideration that maintaining a 3% of GDP budget deficit would be compatible with maintaining a 60% debt-to-GDP ratio under the assumptions of a 3% growth rate of real GDP and a 2% rate of inflation. However, over the last 20 years, the EU and the euro area grew at average annual rates of 1.6% and 1.4% respectively, raising doubts about the adequacy of the deficit reference value in ensuring debt sustainability in the present environment.

Looking at long-term fiscal developments, it appears that the 3% of GDP deficit rule contributed to better fiscal outcomes than before the introduction of the SGP<sup>(45)</sup>. Nevertheless, between 1998 and 2018 there were 38 country-EDP episodes corresponding to almost 40% of the entire country-year sample. The average duration of an EDP was around four and half years but varied across time and countries, with those opened in the aftermath of the 2008-2009 economic and financial crisis lasting longer, five years on average.

<sup>(45)</sup> European Commission (2018b).

Graph 3.13: Annual changes in the structural balance vs depth of imbalances (EDP procedures)



Notes: (1) The chart uses the most recent estimates for the structural budget balance (i.e. the Commission 2019 spring forecast). (2) The depth, or amplitude, of the fiscal imbalance is measured as the largest estimated structural deficit in the EDP period. (3) The correction years refer only to the years of EDP in which the country was required to improve its underlying fiscal position. (4) For graphical reasons, the chart does not include the 2009-2016 EDP for Greece (i.e. depth of fiscal imbalance = 14.7% of GDP, observed average annual change in the structural balance = 2.9% of GDP).

Source: European Commission, own calculations.

The track-record of compliance with EDP recommendations before the crisis was mixed. On several occasions, Member States benefited from an extension of the deadline to correct their excessive deficit, despite not having taken effective action to comply with the required fiscal effort (Table 3.6). This was due to the lack of a suitable enforcement of the rules before the reforms. For instance, Article 126 TFEU always envisaged the possibility to impose fines in cases of non-compliance with the corrective arm of the SGP. However, sanctions were never used.

The six-pack reform substantially strengthened the enforcement of the EDP. Regulation (EU) 1173/2011 introduced a graduated system of financial sanctions for euro-area Member States, which applies also in the preventive arm of the SGP. At the same time, the reformed corrective arm requires Member States to report on effective action shortly after an EDP is launched, thus immediately opening the possibility for sanctions in case of non-compliance.

During the last economic and financial crisis, 25 EDPs were launched and 14 were also extended (Graph 3.14). Most of the revised EDP recommendations to the Member States were due to adverse economic events, with the exception of Belgium. In the aftermath of the crisis, the

extensions of the EDPs were associated with non-effective action.

Graph 3.14: Extension of excessive deficit procedures (EDPs)



Notes: In the case of the Netherlands, the EDP was extended in 2013 for one more year, but they corrected the excessive deficit in line with the first recommendation deadline.

Source: European Commission, own calculations.

Following the abrogation of the EDP for Spain, 2019 is the first year since 2002 in which no euro area Member State has an excessive deficit. Although euro-area Member States succeeded in bringing their headline deficits below 3% of GDP, there were still significant shortfalls in a number of countries with respect to the required structural adjustment, as reflected in the official Commission documents assessing compliance with EDP requirements (Table 3.5). Deviations from the required structural adjustment were considerable, in particular in the case of France and Spain. In some cases, shortfalls occurred in the backdrop of a stronger-than-expected economic recovery. As emphasised in the first two annual reports of the EFB, countries under EDP have an incentive to follow a nominal strategy, substituting politically costly consolidation measures with revenue windfalls.

Unfortunately, an accurate assessment of actual fiscal efforts, which requires a correction of the observed change in the structural balance to take into account the impact of revisions in the macro-economic assumptions underlying the initial Council recommendations, is only available for some countries and for the more recent EDPs. Therefore, a correct comparison between the required structural adjustment and the actual

structural efforts over the whole set of EDP episodes is not feasible. Graph 3.15 only provides a crude comparison between the cumulative required structural adjustment (based on the Council's decisions and recommendations, taking into account the most recent revisions, if any) and the observed change in the structural balance.

**Table 3.5: Measures of fiscal efforts for Member States under EDP**

reference period	Cumulative change in structural balance			Based on measures	
	EDP requirement	observed (unadjusted)	observed (adjusted)	EDP requirement	fiscal effort (bottom up)
<b>ES (II)</b> 2016-2018	0.6	-0.6	-1.2	1.0	0.1
<b>ES (I)</b> 2013-2015	2.7	0.6	-0.2	3.0	0.0
<b>FR (II)</b> 2015-2017	2.2	0.9	0.7	2.7	1.1
<b>FR (I)</b> 2013-2014	2.1	1.2	1.6	1.0	0.8
<b>PT (II)</b> 2016	0.0	0.3	0.9	0.3	1.2
<b>PT (I)</b> 2013-2015	2.5	1.1	-0.1	-	-
<b>UK (II)</b> 2016-2017	1.6	1.9	1.4	-	-
<b>UK (I)</b> 2011-2015	8.8	3.5	5.5	-	-
<b>CY</b> 2013-2015	2.3	3.0	2.4	-	-
<b>SI</b> 2013-2015	1.7	-0.6	-1.3	4.0	1.5
<b>BE (II)</b> 2013	1.0	0.8	1.0	0.3	0.3
<b>BE (I)</b> 2010-2012	2.3	0.9	1.0	-	2.0

Notes: (1) The table shows the structural adjustment required and observed under EDP, cumulated over subsequent (non-overlapping) revised recommendations, for which a comprehensive assessment of the delivered fiscal effort is available. (2) The adjusted change in the structural balance considers: (i) the impact of revisions in potential output growth compared to that underlying the growth scenario in the Council recommendation; (ii) the impact of revisions on the composition of economic growth or of other windfalls or shortfalls on revenue; and (iii) the possible impact of other unexpected events. (3) The fiscal effort estimated on the basis of policy measures (bottom-up approach) is an assessment of the impact of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and outcomes.

**Source:** European Commission.

Discretion has also been increasingly used in implementing the corrective arm of the SGP. The most notable cases were those of Spain and Portugal in 2016. Firstly, in spring of the same year, the Commission's draft CSRs for Portugal and Spain extended the EDP deadline by 1 year, reducing the deficit reduction requirements. This approach departed from established practice, as it was not preceded by a new Council recommendation under Article 126(7) TFEU<sup>(46)</sup>. Secondly, the Commission delayed its assessment of effective action under the corrective arm of the SGP for Spain and Portugal until July 2016, despite having proposed already in May to extend the deadline for correction. Finally, on 27 July 2016, having established that Spain and Portugal had not taken effective action in response to EDP recommendations, the Commission assessed that, while neither country suffered from exceptional economic circumstances, the reasons put forward by the national authorities warranted a cancellation

<sup>(46)</sup> While EDP recommendations are an instrument of the corrective arm of the SGP, the CSRs are part of the preventive arm: the latter cannot amend the former.

of the fine of 0.2 % of GDP for both countries. The Council adopted the relevant implementing decisions on 5 August 2016. The reverse qualified majority voting (RQMV) may have made the Commission more reluctant to propose sanctions, a point to which we will come back in Chapter 6.

In 2016, the Economic and Financial Committee (EFC) adopted an opinion, subsequently endorsed by the ECOFIN Council<sup>(47)</sup>, which introduced the expenditure benchmark as a third indicator in the corrective arm of the Pact.

**Graph 3.15: Required fiscal effort vs. actual change in structural balance under the EDP**



Notes: (1) The cumulative change in the structural balance is based on the structural budget balances, as estimated in the Commission 2019 spring forecast. Up to 2009, the structural budget balances are calculated from the cyclically-adjusted budget balances (from the Commission 2019 spring forecast) corrected for the one-offs (from the Commission 2014 spring forecast). (2) The required fiscal efforts are based on the Council's EDP decisions and recommendations, including revisions (see Table 3.1 for more details). (3) For readability, country labels are indicated only for EDPs opened after 2008.

**Source:** European Commission, own calculations.

In particular, the EFC opinion clarifies that Council recommendations to countries found to have an excessive deficit will, on top of setting annual deficit targets in both headline and structural terms, also define an expenditure benchmark.

<sup>(47)</sup> Improving the Assessment of effective action in the context of the Excessive Deficit Procedure – A specification of the methodology (Opinion of the Economic and Financial Committee), 29 November 2016. <http://data.consilium.europa.eu/doc/document/ST-14813-2016-INIT/en/pdf>

Table 3.6: Overview of excessive deficit procedures (EDPs)

Country	Commission report (initial)	Council decision (opening)	Council decision (closing)	Deadline postponed (yes/no)	Years in EDP	Overall duration (months)	Correction years	Required structural effort (cumulative)
<b>EDPs launched in 2008-2014</b>								
<b>AT</b>	07-10-2009	02-12-2009	20-06-2014	no	2009-2013	54	2011-2013	2.3
<b>BE</b>	11-11-2009	02-12-2009	20-06-2014	yes	2009-2013	54	2010-2013	3.3
<b>BG</b>	12-05-2010	13-07-2010	22-06-2012	no	2010-2011	23	2011	0.8
<b>CY</b>	12-05-2010	13-07-2010	17-06-2016	yes	2010-2015	71	2011-2015	5.3
<b>CZ</b>	07-10-2009	02-12-2009	20-06-2014	no	2009-2013	54	2010-2013	4.0
<b>DE</b>	07-10-2009	02-12-2009	22-06-2012	shorten	2009-2011	30	2011	0.6
<b>DK</b>	12-05-2010	13-07-2010	20-06-2014	no	2010-2013	47	2011-2013	1.8
<b>EL</b>	18-02-2009	27-04-2009	19-09-2017	yes	2009-2016	100	2010-2016	
<b>ES</b>	19-02-2009	28-04-2009	05-07-2019	yes	2009-2018	122	2011-2018	9.0
<b>FI</b>	12-05-2010	13-07-2010	12-07-2011	no	2010-2011	11	2011	0.6
<b>FR</b>	18-02-2009	27-04-2009	22-06-2018	yes	2009-2017	109	2010-2017	7.3
<b>HR</b>	15-11-2013	28-01-2014	16-06-2017	no	2014-2016	40	2014-2016	2.1
<b>IE</b>	18-02-2009	27-04-2009	17-06-2016	yes	2009-2015	85	2011-2015	9.5
<b>IT</b>	07-10-2009	02-12-2009	21-06-2013	no	2009-2012	42	2010-2012	1.8
<b>LT</b>	13-05-2009	07-07-2009	21-06-2013	yes	2009-2012	47	2010-2012	6.8
<b>LV</b>	18-02-2009	07-07-2009	21-06-2013	no	2009-2012	47	2010-2012	8.3
<b>MT</b>	13-05-2009	07-07-2009	04-12-2012	yes	2009-2011	40	2010-2011	1.5
<b>MT</b>	21-05-2013	21-06-2013	19-06-2015	no	2013-2014	23	2014	1.4
<b>NL</b>	07-10-2009	02-12-2009	20-06-2014	yes	2009-2013	54	2011-2013	2.1
<b>PL</b>	13-05-2009	07-07-2009	19-06-2015	yes	2009-2014	71	2010-2014	5.6
<b>PT</b>	07-10-2009	02-12-2009	16-06-2017	yes	2009-2016	90	2010-2016	7.3
<b>RO</b>	13-05-2009	07-07-2009	21-06-2013	yes	2009-2012	47	2010-2012	5.3
<b>SI</b>	07-10-2009	02-12-2009	17-06-2016	yes	2009-2015	78	2010-2015	4.0
<b>SK</b>	07-10-2009	02-12-2009	20-06-2014	no	2009-2013	54	2010-2013	4.0
<b>UK</b>	11-06-2008	05-09-2008	05-12-2017	yes	2009-2016	111	2010-2016	9.2
<b>EDPs launched in 2003-2006</b>								
<b>CY</b>	12-05-2004	05-07-2004	11-07-2006	no	2004-2005	24	2005	0.6
<b>CZ</b>	24-06-2004	05-07-2004	03-06-2008	shorten	2004-2007	46	2004-2007	2.4
<b>DE</b>	19-11-2002	21-01-2003	05-06-2007	yes	2003-2006	52	2004-2006	1.7
<b>EL</b>	19-05-2004	05-07-2004	05-06-2007	yes	2004-2006	35	2004-2006	1.6
<b>FR</b>	02-04-2003	03-06-2003	30-01-2007	yes	2003-2005	43	2003-2005	1.9
<b>HU</b>	12-05-2004	05-07-2004	21-06-2013	yes	2004-2012	107	2006-2012	10.3
<b>IT</b>	07-06-2005	28-07-2005	03-06-2008	yes	2005-2007	34	2006-2007	1.6
<b>MT</b>	12-05-2004	05-07-2004	05-06-2007	no	2004-2006	35	2005-2006	1.2
<b>NL</b>	28-04-2004	02-06-2004	07-06-2005	no	2004-2005	12	2005	0.6
<b>PL</b>	12-05-2004	05-07-2004	08-07-2008	no	2004-2007	48	2005-2007	1.8
<b>PT</b>	22-07-2005	20-09-2005	03-06-2008	no	2005-2007	32	2006-2007	2.3
<b>SK</b>	12-05-2004	05-07-2004	03-06-2008	no	2004-2007	46	2005-2007	1.8
<b>UK</b>	21-09-2005	24-01-2006	09-10-2007	no	2005-2007	20	2006-2007	1.2

Notes: (1) The overall duration of the EDP refers to the period from the date of the Council's decision on the existence of an excessive deficit and the opening of an EDP, to the abrogation of the procedure. (2) The correction years refer only to the years of EDP in which the country was required to improve its underlying fiscal position. Therefore, years in which a country was allowed to implement expansionary fiscal policies (e.g. Germany in 2010) or where unexpected adverse economic events with major unfavourable consequences for government finances occurred (e.g. Ireland in 2010) are excluded. (3) Required fiscal efforts are based on the Council's decisions and recommendations, taking into account the most recent revisions, if any. (4) The table does not include the required fiscal effort for Greece, given the multiple revisions and the economic adjustment programmes for Greece over the same period. (5) In the case of Slovakia, part of the structural deterioration in 2005-2007 was attributed to the introduction of the second funded pension pillar. (6) The table does not include excessive deficit procedures launched before the introduction of the Pact.

Source: European Commission, EFB own calculations.

While the stated objective of the EFC opinion is sensible (i.e. the expenditure benchmark involves variables directly controlled by policymakers at national level and is presented as having considerable advantages in terms of predictability, stability and communication), the new approach raises the following concerns. Firstly, the new approach will only affect future EDP recommendations. Therefore, it remains untested. Secondly, the agreement is to be applied within the existing legal framework. Therefore, the so-called nominal strategy, rooted in the Treaty, will remain. Third, since the expenditure benchmark does not replace the other indicators, complexity increases.

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

On a similar note, in April 2016, the European Court of Auditors (ECA) issued a special report on the implementation of the EDP. They found that the effective implementation of the corrective arm of the SGP was still problematic. The report emphasised that, despite the Commission's efforts to better adapt and clarify the procedure, the application of the rules was still lacking consistency and transparency, while rules for assessing effective action had become increasingly complex. Overall, the ECA's report concluded that the EDP continued to over-emphasise the criterion of deficit over debt, while more attention should be devoted to monitoring structural reforms, an important aspect of actions to be taken to correct fiscal imbalances <sup>(48)</sup>.

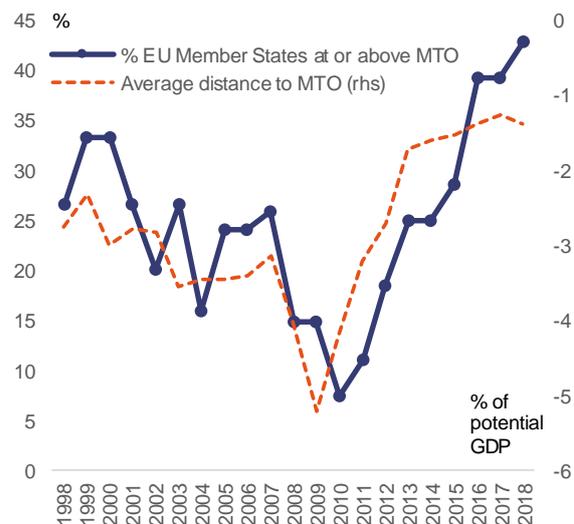
### 3.6. CONVERGENCE TOWARDS THE MEDIUM-TERM OBJECTIVE

As shown earlier in this chapter, existing rules, combined with poor enforcement, did not ensure sound fiscal policy in the pre-crisis period. In particular, countries were not able to take advantage of favourable cyclical conditions to correct imbalances and build up fiscal buffers. For this reason, the six-pack reform has placed much emphasis on making the preventive arm of the SGP more effective, including by strengthening the

early detection and correction of emerging imbalances, so to avoid repeating the mistakes of the past.

Under the preventive arm, Member States are required to progress towards their medium-term budgetary objective (MTO) at a sufficient pace and maintain it once it is reached. In this respect, the number of Member States that have reached their MTOs has been steadily increasing since the 2011 reform, and on the back of a protracted economic recovery. Similarly, for countries below their MTOs, gaps have narrowed (Graph 3.16). Nevertheless, the majority of Member States are estimated to be currently below their MTOs and a significant gap with the MTO remains. In addition, some Member States (i.e. Belgium, France, Italy, Poland, Portugal, Slovenia and Slovakia) have never achieved their MTO in the last 20 years.

Graph 3.16: Medium-term budgetary objective (MTO): achievers and average remaining gap



Notes: (1) Before 2006, MTO was equal to a balanced budget in structural terms for all Member States. (2) Position vis-à-vis the MTO based on actual estimation of the structural balance as from the Commission spring 2019 forecast. (3) Until 2003, the structural improvement is measured by the change in the cyclically adjusted balance. It is corrected for the proceeds of the sales from mobile phone licences in 2000-2001 but not for other possible one-offs. (4) The average distance to MTO refers only to countries not yet at MTO in that respective year. **Source:** European Commission, own calculations.

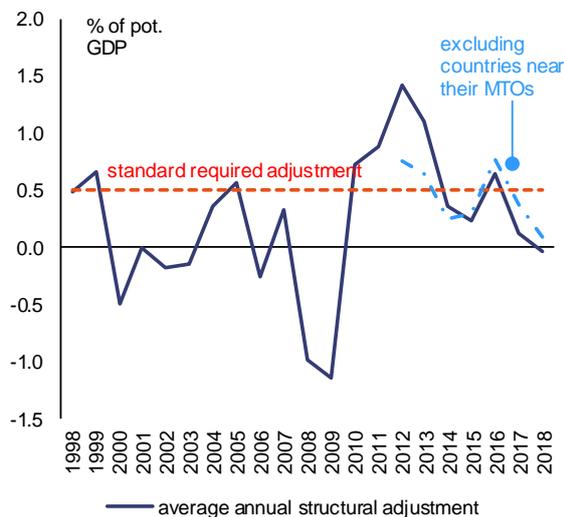
Compared to the pre-crisis period, the speed of adjustment towards the MTO has also increased since 2011 (Graph 3.17). From 2012 onwards, the average annual improvement in the structural balance for country-year below their MTOs has been around 0.5% of GDP, 0.4 percentage points above the average pace observed in 1998-2007. However, the peak of adjustment coincided with most Member States being in EDP and/or under significant market pressure (i.e. between 2010 and

<sup>(48)</sup> European Court of Auditors (2016).

2014). In recent years, the speed of adjustment towards the MTO shows a clear loss of momentum, especially in 2016-2018<sup>(49)</sup>. This is particularly worrying, especially because it occurred (once more) when the economic recovery was strengthening.

The declining speed of adjustment does not appear to be linked to an increasing number of countries approaching their MTOs. Excluding Member States whose gap with the MTO is smaller than 0.5% of GDP, the descending trend of adjustment remains (Graph 3.17). Therefore, given the importance of a correct functioning of the preventive arm during economic upturns, it is essential to understand the causes of such a trend and to find remedies.

Graph 3.17: Annual average pace of adjustment towards MTO (EU Member States, 1998-2018)



Notes: (1) The adjustment pace is the annual change of the structural budget balance. It is calculated as the unweighted average structural adjustment in time  $t$  only for countries below their respective MTO in  $t-1$ , including countries in EDP. (2) Until 2003, annual structural adjustment is measured by the change in the cyclically-adjusted balance. It is corrected for the proceeds from the sales of mobile phone licences in 2000-2001 but not for other possible one-offs. (3) The light blue dashed line is the annual change in the average pace of adjustment excluding countries whose gap with the MTO is smaller than 0.5% of GDP. **Source:** European Commission, EFB own calculations.

### 3.6.1. Competing indicators in the assessment of compliance

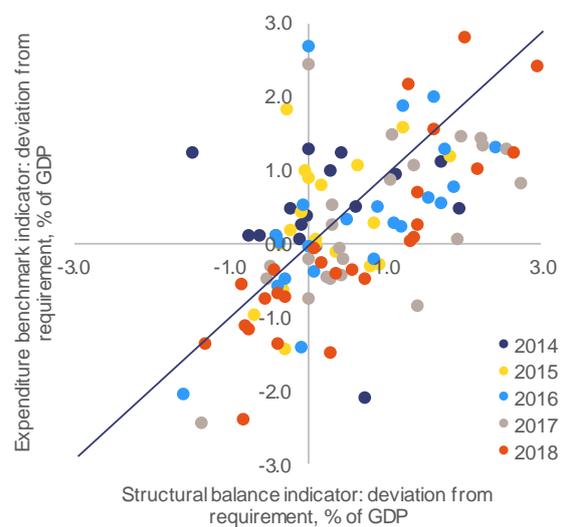
One of the main innovations of the six-pack reform was the introduction of the expenditure benchmark for assessing compliance under the preventive arm of the SGP. Since then, compliance with the required structural adjustment is assessed on the basis of two complementary pillars, namely

<sup>(49)</sup> See also European Commission (2018b), page 115.

the change in the structural balance and the expenditure benchmark. In cases where at least one indicator points to a significant deviation from the requirements, the Commission's overall assessment is critical in determining compliance with the EU rules.

While the two compliance indicators are conceptually equivalent and should lead to the same conclusions<sup>(50)</sup>, this theoretical equivalence is not observable in practice because – in line with the methods agreed between the Commission and the Council – the two indicators have been implemented with different aggregates and data inputs. As a result, for a given country and a given year, they do not necessarily provide the same estimate and can diverge quite substantially.

Graph 3.18: Deviation from requirements: structural balance and expenditure benchmark indicators (2014-2018)



Notes: A negative deviation means that the country fell short of meeting its MTO or deviated from the required adjustment path towards it. A point below the 45-degree line indicates that the expenditure benchmark was a more binding indicator than the structural balance.

**Source:** European Commission.

Based on the final assessments of the surveillance years 2014-2018, Graph 3.18 shows the deviations from the required fiscal adjustments as measured by the two metrics. The readings from the

<sup>(50)</sup> Both the structural balance and the expenditure benchmark indicators measure the government's fiscal effort to achieve the required structural adjustment. However, the indicators gauge it from a different angle: the structural budget balance by removing from the headline budget all the elements that do not directly result from discretionary measures; the expenditure benchmark by comparing the growth rate of discretionary government expenditure, net of discretionary revenue measures, with potential output growth over the medium term. A detailed account of the theoretical equivalence is provided in Box II.2.1 of European Commission (2011).

structural balance and the expenditure benchmark can differ quite visibly. In a few cases, signals were even in the opposite direction (i.e. points lying in the first and fourth quadrant). In addition, with the economy steadily recovering, the expenditure benchmark became the more constraining rule for the majority of Member States (i.e. points lying below the 45-degree line).

As evidenced in the first and second annual reports of the EFB, these divergent signals, which the Commission tries to reconcile in its overall assessment, enhanced the room for discretion in the application of the SGP and strengthened the perception opacity. In some documented cases, the Commission's overall assessment remained highly judgemental, giving further ammunition to criticisms of a too lenient implementation of the Pact.

The EFC opinion of November 2016 on improving the predictability and transparency of the SGP intended to reduce potential conflicts from diverging signals by giving more prominence to the expenditure benchmark <sup>(51)</sup>. It also added some clarity about how to appraise the relative strengths of the two indicators. However, it fell short of solving the problem, as the overall assessments continued to be largely based on the reading from the two indicators.

In recent years, with the expenditure benchmark becoming the most stringent indicator of compliance for many Member States, we have also noticed an increasingly widespread tendency to adjust the expenditure benchmark in an ad hoc manner to lower the consolidation requirement (see 2017 EFB annual report, Section 2.2.2). In a few cases, the Commission's final assessment has not been conclusive, although both indicators were showing a significant deviation from the required adjustment. The Commission justified its 'non'-decisions by taking into account other factors, beyond the numerical reading of the two compliance indicators. This came on top of the application of the so-called 'margin of discretion', a qualitative assessment of the country's economic conditions – taking into account the right balance

between stabilisation and sustainability needs – that the Commission introduced in 2017 <sup>(52)</sup>.

### 3.6.2. The use of flexibility

EFB (2018b) provides an independent assessment of the implementation of the flexibility provisions agreed in 2015 and applied since then <sup>(53)</sup>. The assessment takes into account budgetary outcomes as well as the interaction with the unusual event clause, an element of flexibility introduced with the 2011 reform of the SGP that accounts for the budgetary impact of events outside the control of government.

As far as the sustainability of public finances is concerned, the overall message emerging from our independent assessment was that the flexibility provisions agreed in 2015 fell short of expectations. In practice, the impact has been relatively small compared to the original scope of the interpretative innovations brought into the SGP, which came at the price of further increasing the degree of judgement and ultimately undermining both transparency and predictability. At the same time, the cumulative effect of different forms of flexibility has lengthened the period of convergence towards the MTO, especially for high-debt countries.

Graph 3.19 shows the challenge of striking the right balance between the different objectives of making public finances more sustainable on the one hand, and stabilising the economy, on the other. Based on data from different editions of the fiscal sustainability reports of the Commission <sup>(54)</sup>, the graph indicates that for countries that made use of flexibilities, the medium-term sustainability of public finances has not improved in the last four years and even worsened in the case of the long-term analysis <sup>(55)</sup>. At the same time, although assessing the contribution of reforms, and in general the contribution of any form of flexibility, to economic growth remains problematic, the prospect of growth has improved only marginally for this group of countries compared to Member States that did not make use of flexibilities.

<sup>(51)</sup> Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm (Opinion of the Economic and Financial Committee), 29 November 2016. <http://data.consilium.europa.eu/doc/document/ST-14814-2016-INIT/en/pdf>.

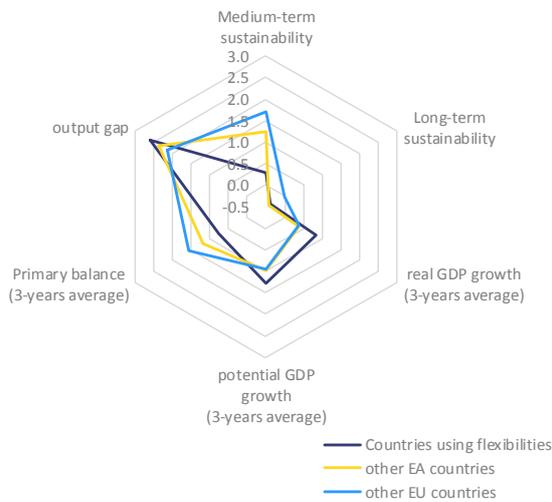
<sup>(52)</sup> See European Fiscal Board (2017).

<sup>(53)</sup> In January 2015, the Commission issued a Communication on Making the best use of the flexibility within the existing rules of the Stability and Growth Pact (SGP), COM(2015)12 final.

<sup>(54)</sup> European Commission (2016a, 2019b).

<sup>(55)</sup> For a definition of the Commission's medium-term and long-term indicators of sustainability of public finances (i.e. the S1 and S2 indicators, respectively), refer to the Glossary.

Graph 3.19: Use of flexibility in the SGP: balancing sustainability and growth objectives (2015-2018)



Notes: (1) The chart shows the change in macro and fiscal indicators, including relevant fiscal sustainability indicators, between 2015 and 2018, for different groups of countries. (2) Data are from the 2015 and 2018 fiscal sustainability reports. (3) Countries that since 2015 have used flexibility under the SGP, including unusual event clauses, are Belgium, Italy, Latvia, Lithuania, Hungary, Austria, Slovenia and Finland. (4) The long and medium-term indicators refer to the change in the S2 and S1 sustainability indicators with reversed sign (i.e. an increase corresponds to an improvement of the fiscal sustainability). (5) The 3-years average covers the year of assessment and two years of forecast.

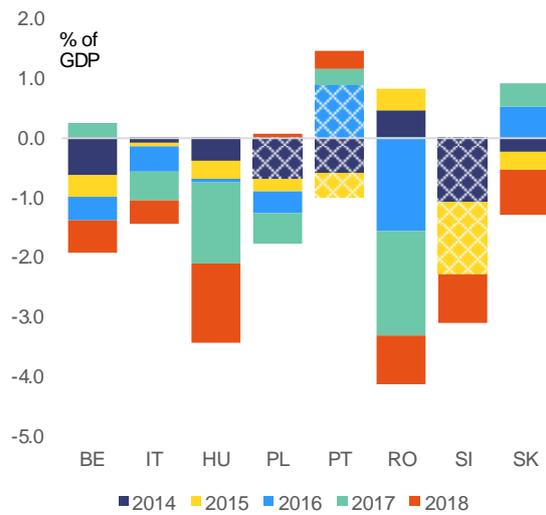
Source: European Commission, own calculations.

Turning to budgetary outcomes, in terms of Member States' compliance with the numerical indicator, the first four years of application of the flexibility clauses present a rather mixed picture. Although flexibility provisions, including the unusual event clauses, reduced the required fiscal adjustment by sizeable amounts, some Member States nevertheless failed to observe the more comfortable adjustment path.

### 3.6.3. The margin of broad compliance

By explicitly stipulating that some deviation from the adjustment path towards the MTO does not lead to new procedural steps, the six-pack reform provided for a margin of error in the assessment of the preventive arm of the SGP. The stated reason for this margin is that measuring discretionary fiscal policy is inherently difficult, and the two indicators used in the preventive arm (the structural balance and the expenditure benchmark) are subject to uncertainty. However, it is not stipulated that Member States should compensate for past deviations, which provides for biased incentives. If a country regularly and deliberately pursues a budgetary strategy to exploit such a margin, it inevitably results in a slowdown of the adjustment path towards the MTO.

Graph 3.20: Deviation from the required structural adjustment over 2014-2018



Notes: The chart reports the deviations by some EU Member States from the required improvements to their structural balance as indicated in the final Commission assessment of compliance with the preventive and the corrective (i.e. the patterned bars) arms of the SGP. A positive (negative) deviation indicates that the country did more (less) than required. (2) As for deviations in the corrective arm of the SGP, the observed change in the structural balance is adjusted to take into account (i) the impact of revisions in potential output growth compared to that underlying the growth scenario in the recommendation; (ii) the impact of revisions on the composition of economic growth or the impact of other windfalls or shortfalls on revenue; and (iii) the possible impact of other unexpected events.

Source: European Commission.

Graph 3.20 shows, for some EU Member States, the cumulative observed deviations from the required improvements to the structural balance, as estimated by the Commission in its final assessments of compliance (i.e. spring t+1) for the 2014-2018 surveillance years. For completeness, the graph also considers the deviations in case countries were in EDP during that period (i.e. the patterned bars). For some Member States, past negative deviations have never been compensated with overachievements. Romania and Hungary were the only countries that have been subject to the significant deviation procedure since 2017 and 2018 respectively. In other cases, Member States have accumulated substantial deviations from the adjustment path towards the MTO since 2014. However, this did not lead to the opening of any significant deviation procedure because deviations were deemed to be below the threshold of significance. For the sake of clarity, deviations already took into account all possible forms of flexibility, including unusual event clauses or the so-called 'margin of discretion'.

The slow pace of adjustment towards the MTO was also criticised by the European Court of Justice in a special report on the implementation of

the preventive arm of the SGP issued in July 2018 <sup>(56)</sup>. In particular, the Court was very critical of the extensive use of flexibility clauses and the cumulative effect of the allowed deviations, including the full exploitation of the so-called ‘margin of broad compliance’.

### 3.7. INDEPENDENT FISCAL INSTITUTIONS AT NATIONAL LEVEL

Fiscal rules have been the traditional instrument used to address the two predominant biases of discretionary fiscal policy: the existence of a deficit bias and the temptation to spend temporary revenue windfalls, which is at the source of pro-cyclical policies. Fiscal rules aim at improving the quality of fiscal policies by directly constraining policymakers’ action. Another way to correct policy biases is to rely on independent fiscal institutions (IFIs), which are expert bodies that can make unbiased assessments. However, even when the IFI’s is in line with best practice, there is a risk that the IFI’s is weakened by the government.

#### 3.7.1. The rationale for independent fiscal institutions

Independent bodies were originally conceived as a substitute for fiscal rules. In this original vision, governments would delegate their policymaking prerogatives to independent fiscal authorities, which would directly intervene in the budgetary process <sup>(57)</sup>. This view was inspired by the earlier experience matured on monetary policy, where independent central banks were directly empowered with taking interest rates decisions. This view did not ultimately gain popularity: policymakers have been particularly reluctant to delegate their authority over budgetary matters, and to date there are no examples of fully-fledged independent fiscal authorities. The predominant reason behind this reluctance presumably lies in the inherently political nature of fiscal policy, which stems from the fact that all budgetary decisions ultimately have distributional consequences. For instance, the largest spending items in the government budget – which are typically related to pension, healthcare, education and welfare – have a clear redistributive impact. Also, the design of tax systems involves numerous distributive choices, such as the degree of progressivity of tax rates, the distribution of the tax burden between labour and

portfolio income, and the appropriate balance between income and consumption taxes. Even the most basic decision of whether to run a deficit or a surplus entails an inter-temporal redistribution, which explains why policymakers have been traditionally reluctant to delegate away even their simple control over the bottom line of the government budget.

Today, IFIs are usually intended as advisory bodies, which improve the quality of fiscal policy by raising public awareness and transparency about the nature and consequences of policymakers’ decisions. IFIs have gained significant prominence in recent years, as their numbers have increased both within the EU and outside. Their aim is to exert a soft influence on the budgetary process, either by providing inputs to policymakers’ decisions – such as producing independent forecasts – or by assessing the appropriateness of government policies in safeguarding fiscal sustainability (see example of Swedish Fiscal Policy Council). IFIs are therefore involved in real-time in the budgetary process, and their role goes beyond merely auditing government activities. They do not, however, have the authority to take direct policy decisions, as this prerogative remains in the hands of governments, which may ultimately decide to depart from the advice received by the IFIs.

By fostering transparency and government accountability, IFIs are an important complement to fiscal rules. Fiscal rules alone may be ineffective in correcting policy biases: this is notably the case in countries where fiscal frameworks lack ownership. For instance, asymmetric information on the part of the voters has been identified as one of the sources of the deficit bias. Voters may be unaware of the true state of public finances, or they may be unable to understand the implications of inter-temporal government budget constraints, and specifically the fact that current policy decisions exert a constraint on future policies. Under such circumstances, fiscal rules may be difficult to enforce because policymakers do not face any political cost of breaking them: on the contrary, voters may even pressure the government to violate fiscal rules if they do not understand the benefits of budgetary discipline. In this case, IFIs can help to improve public support for fiscal frameworks by improving voters’ awareness of fiscal issues, and by explaining the economic consequences of budgetary measures. By fostering a ‘stability culture’, IFIs can raise the political costs that governments face when deviating from fiscal

<sup>(56)</sup> European Court of Auditors (2018b).

<sup>(57)</sup> See Fatás and Mihov (2003) and Wyplosz (2005).

rules, and this in turn strengthens the enforceability of fiscal frameworks.

On the other hand, IFIs alone may fail in fostering fiscal discipline because their advisory role merely constitutes a soft form of correction. In particular, they may suffer from a lack of authority when they try to influence the budgetary process. Fiscal rules can strengthen the authority of IFIs by providing explicit budgetary targets, thus relieving them of the burden of coming up with their own definition of what should be the appropriate direction of fiscal policy. IFIs can thus base their recommendations and advice on the legal provisions of the existing fiscal frameworks, which have been adopted by parliament.

However, not all IFIs are created equal. In particular, their mere existence is only limited to their effect on better fiscal performance<sup>(58)</sup> and what really matters are their structural characteristics. Four key characteristics of IFIs seem to have a positive impact on budgetary performance: (i) independence or functional autonomy; (ii) their collocation within an existing fiscal framework, with the IFI mandated to assess compliance with fiscal rules; (iii) an explicit input role in the budgetary process, such as scoring budgetary measures or validating government forecasts; and (iv) high media impact<sup>(59)</sup>. These findings in the economic literature inspired the reforms of EU economic governance.

### 3.7.2. European legislation on independent fiscal institutions

As recalled in Chapter 2, an explicit role for IFIs in the EU economic governance framework was first introduced with Directive 2011/85/EU of 8 November 2011. The directive lays down requirements for budgetary frameworks of the Member States and was adopted as part of the six-pack reform. It provides for the establishment of national fiscal rules which contain provisions for ‘the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States’.

The Treaty on Stability, Coordination and Governance (TSCG), which entered into force on

1 January 2013, also envisages a role for IFIs. The Treaty is binding for 22 Member States (all euro-area countries together with Bulgaria, Denmark and Romania), and requires that signatories establish a balanced budget rule in their domestic legal frameworks. Article 3(2) of the Treaty establishes that IFIs will monitor compliance with fiscal requirements, and asks the Commission to establish common principles for their setup.

As part of these common principles<sup>(60)</sup>, the Commission established that ‘independent bodies or bodies with functional autonomy’ should provide three separate assessments. (i) They should assess the occurrence of circumstances warranting the activation of the correction mechanism in case of deviation from fiscal targets. (ii) They should monitor whether the correction is proceeding in accordance with the rules. (iii) They should assess the occurrence of circumstances that warrant triggering, extending or exiting the escape clauses. The Commission also advocated for the introduction of a ‘comply or explain’ principle, which would require governments to justify any deviation from the advice of the IFIs.

While acknowledging that the design of IFIs should take into account the existing country-specific institutional environment, the Commission also established a series of common principles<sup>(61)</sup> to ensure the functional autonomy of IFIs: (i) IFIs should have a statutory regime grounded in law; (ii) they should have freedom from interference and should not take instructions, while at the same time having the capacity to communicate publicly in a timely manner; (iii) Staff should be appointed on the basis of their experience and competence; and (iv) they should have sufficient resources, and appropriate access to information.

Finally, two-pack Regulation 473/2013 includes further provisions for IFIs that apply to euro-area Member States. Article 5 establishes that euro-area countries should set up IFIs to monitor compliance with numerical fiscal rules, and that the IFIs should provide a public assessment on: (i) the occurrence of circumstances leading to the activation of the correction mechanism for cases of significant observed deviation from the MTO or the adjustment path towards it; (ii) whether the budgetary correction is proceeding in accordance

<sup>(58)</sup> See Beetsma et al. (2019).

<sup>(59)</sup> See IMF (2013) for an empirical study on the effectiveness of fiscal councils.

<sup>(60)</sup> See COM(2012) 342 final. Communication from the Commission on common principles on national fiscal correction mechanisms.

<sup>(61)</sup> See COM(2012) 342 final. Communication from the Commission on common principles on national fiscal correction mechanisms.

with national rules and plans; and (iii) any occurrence or cessation of circumstances which may allow a temporary deviation from the MTO or the adjustment path towards it, provided that such a deviation does not endanger fiscal sustainability in the medium term. The regulation also identifies the necessary requirements that IFIs must have to safeguard their independence, which follow the common principles identified by the Commission for the TSCG.

### 3.7.3. Independent fiscal institutions in EU fiscal surveillance

EU legislation establishes the broad principles that Member States must follow when setting up national IFIs, without imposing any concrete design requirement. This acknowledges that – to ensure their effective functioning – IFIs must be designed in a manner that is compatible with the domestic institutional environment and with national traditions. Since the main purpose of IFIs is to correct for policymakers' biases, and since the source of such biases is likely different across countries, the design of national IFIs should reflect country-specific needs and shortcomings.

Accordingly, the landscape of EU IFIs presents a great deal of variety. Some IFIs have been set up as independent organisations, while others have been created as functionally autonomous entities within existing bodies, such as the parliament, the ministry of finance or the national central bank. Full independence is not always necessary for an IFI to be successful. In particular, there are several reasons why incorporating an IFI within an existing institution could be a good idea. The most prominent reason is access to a sufficient budget: a government may be tempted to infringe on the independence of an IFI by cutting its funding, and this could be avoided by incorporating the IFI in an existing institution. Another important reason is access to information, and establishing an IFI within an institution which can supply relevant data – for instance information about draft policy measures – can make the IFI more effective.

EU IFIs also widely differ in terms of their mandates. EU legislation imposes a minimum set of tasks that IFIs have to carry out, such as monitoring compliance with national rules or – for euro-area countries – assuring the quality of budgetary forecasts underpinning the draft budgets. Many Member States have nonetheless established IFIs with broader mandates, which

include other important tasks, such as the costing of policy measures, monitoring developments in sub-national budgets and assessing the impact of political programmes ahead of elections.

While the experience gained so far has been limited, the establishment of national IFIs has nonetheless been an important step forward in strengthening the EU economic governance framework.

#### Improving accountability – the case of Romania

The Romanian Fiscal Council has proved very effective in raising transparency and government accountability. When the draft budgets presented by the government for 2016 and 2017 planned a deviation from SGP requirement, the Fiscal Council was forceful in its assessment of the risks involved. The Fiscal Council performed a continuous assessment of budgetary implementation and made public recommendations to address fiscal slippages<sup>(62)</sup>. While the government did not in the end follow its warnings, the activity of the Romanian Fiscal Council has nonetheless been fruitful in raising public awareness of government policies and ultimately in ensuring the political accountability of policymakers.

#### Improving forecast accuracy – the case of Italy

The Italian Parliamentary Budget Office (PBO) was very effective in improving the quality of government forecasts during the 2017 budgetary cycle. The PBO did not endorse the government's policy macroeconomic scenario in autumn 2016, as it found the GDP growth projections too optimistic. The divergence between the government and the PBO was due to a different quantification of the impact of budgetary measures. This is why the PBO only endorsed the government's trend scenario, based on a no-policy-change assumption, but not the policy scenario, which included the measures provided for in the government's plans. Following a parliamentary hearing, the government was forced to use a more conservative approach in designing its policy scenario, and on 17 October 2016, the PBO endorsed the forecast for 2017. Of note, in spring 2016 the PBO had already flagged that the government's projections underpinning the stability

<sup>(62)</sup> European Fiscal Board (2018b).

programme were on the optimistic side, while the Commission found them plausible at the time <sup>(63)</sup>.

### Safeguarding independence – the case of Spain

In Spain, the Independent Authority of Fiscal Responsibility (AIReF) has successfully safeguarded its independence, with respect to access to information. While the law establishing AIReF laid down widespread legal protocols for accessing information, the implementing protocols that followed reduced the degree of information that the AIReF was entitled to receive. Consequently, in May 2016, the AIReF filed a case against the central government. In March 2018, a decree removed many of the limitations.

### 3.8. MACROECONOMIC IMBALANCE PROCEDURE

In this section, we briefly present the macroeconomic imbalances procedure (MIP), which came into force as part of the six-pack reform in December 2011. It was introduced in the midst of the economic and financial crisis, with the aim of strengthening the monitoring and surveillance of macroeconomic policies, to prevent and correct macroeconomic imbalances in EU Member States. The introduction of the MIP in the aftermath of the crisis was an important step forward, raising awareness of the build-up of unsustainable developments beyond public finances.

The legal framework of the macroeconomic imbalances procedure (MIP) is based on two regulations. The first is Regulation 1176/2011, which specifies the details on the prevention and correction of macroeconomic imbalances and applies to all EU Member States. The second is Regulation 1174/2011, which focuses on enforcement measures to correct excessive macroeconomic imbalances, including the possibility of sanctions, and it applies to euro-area countries. The main Treaty basis for the MIP is Article 121 of the Treaty on the Functioning of the European Union (TFEU), including Article 136 TFEU for Regulation 1174/2011.

The annual cycle of MIP surveillance starts with the publication of the alert mechanism report by the Commission, which assesses the economic

situation within EU countries on the basis of a scoreboard of 14 headline indicators and 28 auxiliary indicators. These indicators cover both external and internal imbalances, such as unemployment developments, excess private sector leverage, government debt, price and cost imbalances. An in-depth review is then carried out for those Member States whose situation warrants particular attention. This review assesses the existence and severity of imbalances and produces an overall assessment <sup>(64)</sup> of ‘no imbalances’, ‘imbalances’, ‘excessive imbalances’ or ‘excessive imbalances with corrective action’, which may trigger the excessive imbalance procedure.

### Implementation of the MIP

This section discusses the effectiveness of the MIP, based on eight years of experience (2012-2019). Since it is beyond the European Fiscal Board’s mandate to assess the effectiveness of the MIP, this report will examine how the MIP surveillance has evolved with the policy responses in Member States, based on the facts and including the results of some analysis done to date. The MIP differs from the SGP in one important aspect: macroeconomic imbalances are not directly under the control of Member States, unlike in the case for taxation and government spending decisions. However, the SGP and the MIP remain closely linked.

During the first five years of the MIP (2012-2016), the number of countries subject to an in-depth review rose steadily from 12 to 19. In 2016, out of these 19 countries: six were identified with excessive imbalances, seven with imbalances and six with no imbalances (see Graph 3.21). This increase also includes Croatia’s accession to the EU in 2014 and the exiting of several countries from the economic adjustment programmes, which were all found to be with imbalances or excessive imbalances soon after those exits. Since then a gradual decline of macroeconomic imbalances across EU Member States has occurred, with only three countries in excessive imbalances since 2018. However, the number of countries experiencing imbalances in 2019 increased to 13, from 11 in

<sup>(64)</sup> Procedural changes to MIP: The scoreboard started with 11 indicators, but they were extended to 14. Also the number of categories has changed over time (2012: 5, 2013: 6; 2014-2015: 6; 2016-2018: 4).

<sup>(63)</sup> European Fiscal Board (2018b).

2018. The Commission has not yet launched the excessive imbalances procedure (EIP).

Between 2012 and 2019, the Commission identified 104 occasions, when Member States were having imbalances (76) or excessive imbalances (28). Often the Member States identified with (excessive) imbalances remained in the same category over several years, reflecting also the lasting nature of some of the underlying weaknesses and the fact that corrective policies have not been always implemented substantially or fully. To date only Slovenia has been able to improve from the ‘excessive imbalances’ to the ‘no imbalances’ category.

The available evidence suggests that countries that the Commission identified as having excessive imbalances or imbalances have in general received more recommendations and implemented more reforms, in comparison to Member States with no imbalances<sup>(65)</sup>. It is debated whether countries identified with imbalances exhibit statistically significant higher compliance rates after taking into account other factors that may impact reform implementation. One possible explanation of this behaviour is that the number of recommendations works more on the principle ‘less is more’, meaning that when a country receives more recommendations it is less likely that it will comply with them<sup>(66)</sup>. However, the MIP has been successful in raising awareness about imbalances and the associated need for preventive and corrective measures among the broader public, and among the relevant EU and national policymakers<sup>(67)</sup>.

Compliance with recommendations in countries under MIP surveillance has been on average rather weak, and it has worsened in recent years. Implementation rates have fallen substantially since 2014. The share of no or limited progress was 40% on average before 2015, and it has increased to 60% since then. Reasons for low implementation can be found in a weak or unclear link between the economic analysis and MIP-CSRs<sup>(68)</sup>. Political acceptability and ownership of reforms increases, thereby facilitating their implementation, when the reader understands the rationale behind the recommendation.

<sup>(65)</sup> See European Commission (2016b), Pierluigi and Sondermann (2018), Efstathiou and Wolff (2019).

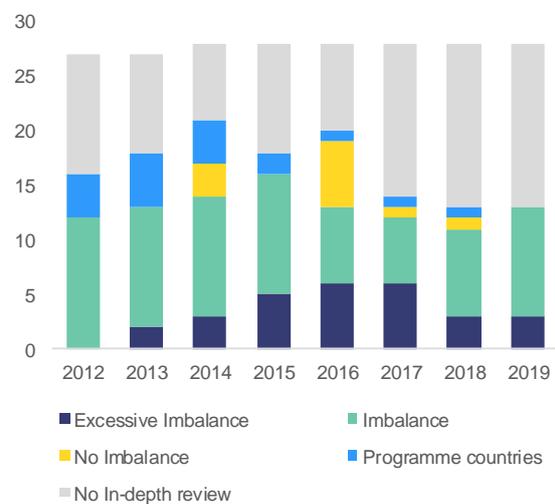
<sup>(66)</sup> See Efstathiou and Wolff (2019).

<sup>(67)</sup> See European Commission (2016b), Pierluigi and Sondermann (2018).

<sup>(68)</sup> See European Court of Auditors (2018a).

In addition, clear criteria for the classification of imbalances are missing, especially why the Commission has never proposed an EIP. Given the lack of explanation by the Commission for not proposing an EIP, the process seems political rather than technical. Moreover, the MIP-CSRs for Member States are not always consistent with the euro-area recommendations. Also the timeframe for implementation can be very challenging, especially without a concrete analysis underpinning the sequencing and packaging of suggested reforms, and therefore the estimated impact on the economy.

Graph 3.21: Macroeconomic imbalance procedure (MIP): country classification



Note: The graph refers to the streamlined categories applied from the 2016 cycle onwards.

Source: European Commission.

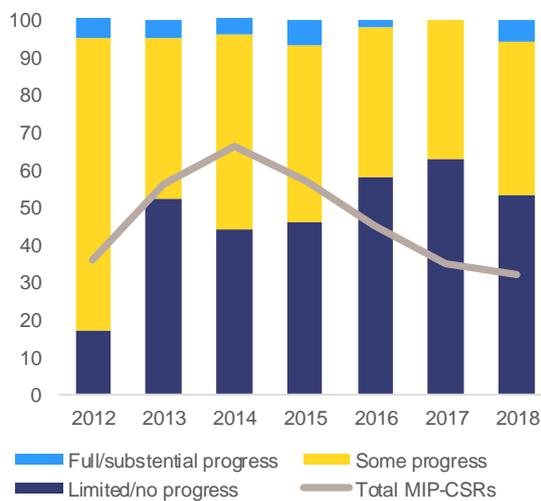
The decrease in countries’ compliance with the MIP-related country-specific recommendations over these last few years can mainly be explained by the improved macroeconomic situation and the reduced market pressure, thus obviating the need to tackle imbalances, and by the streamlining of the European Semester in 2015, which reduced the visibility and transparency of the MIP. The results of empirical studies also point to weaker implementation when the recommendations are not backed by EU enforcement rules (e.g., the possibility of sanctions), during election years (risk of political costs) and weak institutions (quality and fragmentation of governments matters)<sup>(69)</sup>.

<sup>(69)</sup> See Bricongne and Turrini (2017), Efstathiou and Wolff (2018, 2019).

Looking forward, there are several possible ways<sup>(70)</sup> to increase the significance of the MIP process, such as: (i) using MIP to its full potential, including the excessive imbalances procedure (EIP)<sup>(71)</sup>; (ii) enhanced communication with Member States and ownership; (iii) increasing transparency of the process by advancing analysis (e.g. forward-looking indicators), specifying more detailed policy action and setting a more realistic timeframe for implementation of recommendation; (iv) increasing credibility by clarifying the criteria and process for classifying imbalances; (v) aligning Member States' recommendations with the euro-area ones; and (vi) linking the MIP with fiscal surveillance.

MTO. This would address the risks that imbalances may pose to fiscal sustainability.

Graph 3.22: Implementation of MIP-related CSRs by Member States (in percentage)



Source: European Commission.

The last point was already presented in the EFB 2017 annual report, where the Board proposed to introduce a link to the macroeconomic imbalance procedure in the SGP by regulating the speed of adjustment towards the MTO in relation to Member States' macroeconomic imbalances. For example, Member States with large private debts and current account deficits could be required to speed up their adjustment towards the MTO or even to achieve a higher MTO. Conversely, Member States with persistent current account surpluses could be allowed to slow down their adjustment towards the MTO or to aim for a lower

<sup>(70)</sup> See European Court of Auditors (2018a), Pierluigi and Sondermann (2018). See also the presentation by Codogno at the Economic Policy Committee Seminar held in Brussels on 23 January 2019: <https://sep.luiss.it/news/2019/01/25/mip-surveillance-macroeconomic-imbalances-experience-and-open-issues-lorenzo-codogno>.

<sup>(71)</sup> See Zoppè (2019).

## 4. COUNTER-CYCLICAL FISCAL STABILISATION

### KEY FINDINGS

- The initial version of the Stability and Growth Pact (SGP) entailed some pro-cyclical bias in fiscal policies as it focused on nominal variables and sustainability rather than cyclical stabilisation.
- The six-pack reform and subsequent reinterpretation of the EU fiscal rules have included elements intended to reduce the pro-cyclicality of fiscal policy, notably by adjusting fiscal requirements to cyclical conditions and acknowledging the costs of certain unusual events and growth-enhancing measures.
- Compared to the uniform adjustment requirement that prevailed before 2011, the reformed requirements under the preventive arm of the Pact have provided some fiscal leeway to countries with stabilisation needs. On the other hand, the adjustment requirements have been strengthened for high-debt countries.
- Between 1999 and 2018, empirical analysis identifies only one period of counter-cyclical fiscal expansion in 2009, as a coordinated response to the global economic and financial crisis.
- By contrast, there have been two episodes of pro-cyclicality: a pro-cyclical fiscal expansion in 2000 after the euro was adopted, and sizeable pro-cyclical fiscal consolidation in 2012-2013, amid pressure from financial markets and sustainability concerns.
- These pro- and counter-cyclical episodes have generally been more pronounced in countries with debt exceeding 90% of GDP.
- Outside these periods, the fiscal stance in the EU and the euro area as a whole has been broadly neutral most of the time since 1999.
- There has not been any case of aggregate counter-cyclical fiscal contraction in good economic times. In 2003-2007, in particular, a chance was missed to build fiscal buffers. The same happened again in 2017.
- Econometric analysis covering both EU and non-EU countries also finds that discretionary fiscal policies tend to be pro-cyclical, all the more so when the economy is recovering or expanding and when public debt is high.
- The analysis does not find evidence of reduced pro-cyclicality since the entry into force of the six-pack reform.
- Since 2011, discretionary fiscal policies in the EU have gone in the opposite direction from automatic fiscal stabilisers at least half of the time, and more frequently so in the very high-debt countries. This is much more often than in the previous decade.
- While we cannot easily disentangle what is due to the fiscal framework or to the economic and political context, the six-pack reform and subsequent reinterpretations of the rules have *de facto* neither reduced pro-cyclicality nor sufficiently encouraged counter-cyclicality.
- In 2012-2014, some Member States could not benefit from sufficient fiscal leeway to address the double-dip recession, because of overwhelming sustainability concerns. Conversely, the increased flexibility introduced in 2015 came too late, when the recovery was already well advanced.
- Pro-cyclical tightening during the crisis was particularly pronounced in countries with high debt that had not taken advantage of the good times preceding the crisis to create fiscal buffers.
- Addressing the pro-cyclical nature of fiscal policy making, especially when economic times are good, needs to be a key objective of any reform of the EU fiscal rules, including by a better differentiation of adjustment requirements or, possibly, of fiscal targets.

One important objective that fiscal frameworks should aim for is to ensure that fiscal policy can play a counter-cyclical role and thus stabilise economic activity around its potential level. Crucially, any framework should prevent pro-cyclical fiscal policies, i.e. fiscal expansion when the economy is strong and fiscal austerity during downturns or recessions.

A vast empirical literature on fiscal stabilisation shows that fiscal policies tend to be pro-cyclical or at best a-cyclical. The findings differ depending on whether real-time or outturn data are used, and discretionary measures and/or automatic fiscal stabilisers are included <sup>(72)</sup>. Research conducted by the EFB secretariat also shows that pro-cyclicality in good times is explained not only by errors in real-time estimates of cyclical conditions, but also by a willingness of policymakers to avoid counter-cyclical interventions in good times <sup>(73)</sup>.

As highlighted in Chapter 2, the EU fiscal framework poses challenges to fiscal stabilisation. The original focus of the Stability and Growth Pact (SGP) was on sustainability, limiting fiscal stabilisation mainly to automatic fiscal stabilisers rather than envisaging discretionary interventions. The Pact requires Member States to consolidate until they achieve a sound budgetary position, unless the economic situation is seriously adverse. Moreover, at least in its initial version, the Pact focused on nominal variables, involving some pro-cyclical bias as shown in Chapter 3.

From 1997 to 2018, several reforms and innovations have made the Pact move from rigid rules based on nominal variables to a flexible framework giving a more prominent role to stabilisation considerations. At the country level, this includes the introduction of the structural balance, country-specific objectives and flexibility provisions. At the euro area level as well, the stabilisation perspective was reinforced, notably with the two-pack Regulation (EU) No 473/2013 requiring the Commission to ‘make an overall assessment of the budgetary situation and prospects in the euro area as a whole’ based on the Member States’ draft budgetary plans, including the impact of aggregated budgetary measures on economic growth.

<sup>(72)</sup> See Beetsma and Giuliodori (2010), Cimadomo (2012), Debrun and Kapoor (2010), European Commission (2018b), Gavin and Perotti (1997), Golinelli and Momigliano (2006), Kaminsky et al. (2004), Lane (2003), OECD (2003), Orphanides and van Norden (2002), Talvi and Végh (2005).

<sup>(73)</sup> See European Fiscal Board (2018a) and Larch et al. (2019).

This chapter first describes the main innovations introduced since 2011 to make fiscal policies more counter-cyclical. They include flexibility provisions for cyclical conditions, as formalised by the matrix of requirements, and various clauses to deal with economic downturns, growth-enhancing policy measures and events outside the control of government. It then assesses whether this has been successful, in particular by comparing the fiscal requirements before and after the reforms for the preventive arm countries. Moving on to observed fiscal policies in all Member States, empirical analysis – including econometric analysis prepared jointly with the European Commission’s Joint Research Centre – assesses whether discretionary fiscal policies have actually been counter-cyclical, and whether the reforms have made a difference. Finally, it assesses the total impact of fiscal policies, including the role of automatic stabilisers.

#### 4.1. ELEMENTS OF THE REFORMS AIMING TO REDUCE PRO-CYCLICALITY

Before the six-pack reform, the 2005 reform had made a crucial first step in reducing the inherent pro-cyclicality of fiscal rules. Until then, the Pact focused on nominal variables, entailing some pro-cyclical bias, as shown in Chapters 2 and 3, and the objective of achieving budget positions ‘close to balance or in surplus’ in the medium term remained vague. The 2005 reform introduced the structural balance, thus moving the focus onto variables corrected for the economic cycle. It also required each Member State to set a country-specific medium-term budgetary objective (MTO) for the structural balance and to progress towards it at the benchmark pace of 0.5% of GDP per year, with ‘a higher adjustment effort (...) in economic good times, whereas the effort may be more limited in economic bad times’. However relevant from an economic point of view, this reform was still not sufficient to bring Member States to build fiscal buffers in a counter-cyclical fashion in the years that preceded the global economic and financial crisis of 2008-2009. This was partly because real-time assessments of cyclical conditions failed to identify good economic times, and partly because political economy motives prevailed over the objective of fiscal stabilisation.

Since 2011, the Pact has moved further away from rigidity and nominal variables, towards more flexibility and increased consideration for stabilisation. Several elements introduced by the

six-pack and two-pack reforms were meant, directly or indirectly, to make fiscal rules induce less pro-cyclical fiscal policies. In 2015, the Commission issued a Communication on flexibility within the SGP; this constituted a Commission initiative to use the flexibility allowed under the rules and was made possible by the earlier reforms.

The changes to the Pact can be grouped into two categories. The first category consists in fine-tuning fiscal requirements to country-specific situations, notably in terms of stabilisation needs. The matrix of requirements, defined in 2015 for countries subject to the preventive arm of the Pact, falls under this category. It has replaced the previous benchmark – an annual improvement of the structural balance of 0.5% of GDP – by a required effort ranging from 0 to 1% of GDP, depending on the cyclical position, the debt level and the risks to public finance sustainability. It was, however, more a clarification than a full innovation: it quantified and formalised the notion of making a stronger fiscal effort in good times and a more limited one in bad times, which was already present in qualitative terms before. A further innovation was brought in by the margin of discretion the Commission applied in 2018 to balance the objectives of stabilisation and sustainability, i.e. reduce the effort required in the matrix if this was found to be at odds with stabilisation needs in the country.

The second category of changes consists in allowing temporary deviations from fiscal requirements or even suspending requirements. The Pact provides such allowances in several situations. The aim can be to avoid pro-cyclical fiscal contractions: what is known as the ‘general escape clause’ for the euro area or the EU as a whole, and as the ‘waiver’ for individual countries, can be activated, notably in case of a severe economic downturn or negative growth. Requirements can also be reduced to enable governments to face additional costs linked to shocks outside their control: this is covered by the unusual event clause. Finally, the aim can be to foster growth-enhancing policies by relaxing fiscal requirements in case of structural reforms and public investment; this is addressed by the flexibility clauses presented in the 2015 Communication on flexibility. Although their ultimate aim is to strengthen the long-term sustainability of public finances, in practice the flexibility clauses were introduced mostly to mitigate fiscal requirements and give governments

more leeway during the end of the recovery from the crisis. Of note, some elements were not complete innovations but rather updates or extensions of existing practice. For instance, there was already a clause covering pension system reforms and a first version of the investment clause prior to 2015.

While the waiver was activated for Italy and Finland, the general escape clause was not used in 2012–2013 despite negative growth. Why this did not happen may reflect several issues: policymakers underestimated the contractionary impact of fiscal contractions because they had wrong assumptions about the fiscal multipliers; they failed to anticipate the stronger contractionary effect of a simultaneous fiscal tightening in nearly all Member States; and concerns about sustainability and strong pressure from financial markets were pushing to consolidate beyond what the Pact required.

The recent reforms have modified the size of adjustment requirements only for countries under the preventive arm and not yet at MTO. By contrast, for countries subject to excessive deficit procedures, the changes affect the duration of the procedures and the indicators of compliance but not the requirements themselves. For countries that have achieved their MTO, there is, as was the case before the reform, no requirement to consolidate further; still, some of these countries have benefited from clauses which have allowed them to deviate temporarily from their MTO. To assess the impact of the recent reforms on fiscal requirements for countries that are in the preventive arm and not at MTO, Graph 4.1 compares the requirements actually addressed to Member States since 2012 with those that would have prevailed in the absence of reforms. In 2011, only three small countries were subject to the preventive arm and two of them were at their MTO (Graph 4.2). The core concern of fiscal surveillance at the time regarded the vast majority of countries subject to excessive deficit procedures. Our calculations therefore start in 2012, when the six-pack reform really entered into force.

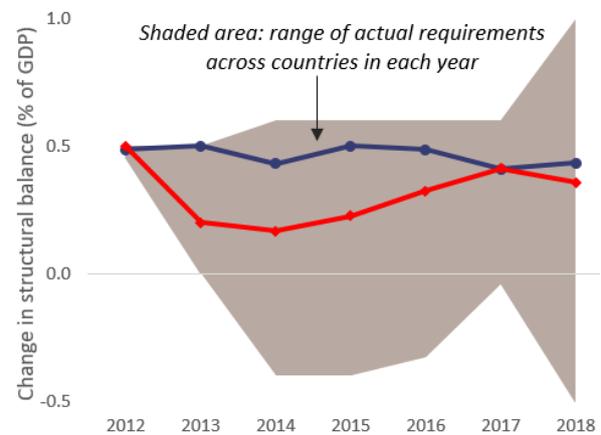
The assumptions underpinning Graph 4.1 are as follows. The baseline (in red) is the simple average of the actual *ex post* requirements used by the Commission in spring  $t+1$  to assess compliance in year  $t$ . The counterfactual (in blue) is the simple average across countries of the benchmark annual improvement in the structural balance of 0.5% of GDP until the MTO is achieved. The qualitative

notion of modulating the effort over the cycle, which prevailed before the matrix of requirements was introduced, is not taken into account in the calculations. The baseline and the counterfactual share common features: these are simple averages of country-specific requirements; they are based on the same data, i.e. spring t+1 estimates <sup>(74)</sup>; the adjustment required is limited to the distance to MTO if it is smaller than 0.5; and the list of countries under consideration is the same. The differences between the baseline and the counterfactual therefore reflect only the changes in requirements introduced by the post-2011 reforms and innovations: the matrix of requirements, the various clauses, the margin of discretion, and tightened requirements under the significant deviation procedure.

From 2013 to 2018, the actual requirements were on average below what the benchmark would have implied, except in 2017. The difference is due to three factors: (i) the recourse to clauses – including the first version of the investment clause and the pension reform clause before 2015; (ii) the activation of the waiver for Italy and Finland in years when real GDP growth was negative <sup>(75)</sup>; and (iii) the use of the margin of discretion in 2018. By reducing the required consolidation in years of downturn or slow recovery, flexibility thus gave some leeway for stabilisation.

On the other hand, flexibility has not only led to lower requirements compared to the benchmark. As shown by the shaded area, the most stringent requirements under the preventive arm have exceeded 0.5% of GDP every year since 2014. This is because the matrix of requirements (applied retrospectively for 2014) implies an effort above the benchmark for countries with a debt exceeding 60% of GDP, provided that their output gap is not below -1.5% of GDP, and in low-debt countries in good economic times. This also reflects the tighter requirements under the significant deviation procedure.

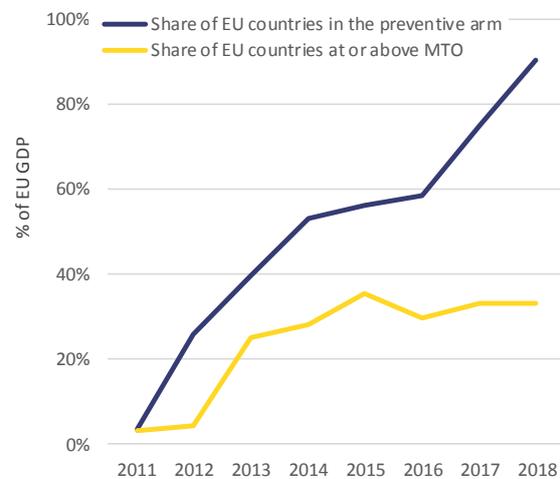
Graph 4.1: Final requirements vs pre-reform benchmark for countries in the preventive arm not at MTO, 2012-2018



Notes: (1) Simple averages of consolidation requirements. (2) The 0.5 benchmark is an annual improvement of the structural balance by 0.5% of GDP or by the remaining distance to the MTO if it is smaller than 0.5% of GDP. (3) The actual requirements for year t are the ones used to assess compliance in spring t+1. (4) The spring t+1 estimates for the structural balance come from a data set used in European Commission (2018b) and were kindly shared by DG ECFIN. (5) The shaded area shows, for each year, the range between the least demanding and most demanding structural effort required from the countries in the preventive arm not at MTO.

Source: European Commission, own calculations.

Graph 4.2: Share of EU countries in the preventive arm and at MTO, 2011-2018



Source: European Commission, own calculations.

#### 4.2. HAVE THE OBSERVED FISCAL POLICIES MITIGATED CYCLICAL FLUCTUATIONS?

The empirical analysis developed below addresses two main questions. First, have discretionary fiscal policies, i.e. the fiscal stance, been counter-cyclical in the EU? Second, what has been the total impact of fiscal policy, considering not only discretionary fiscal policy but also automatic fiscal stabilisers? This analysis also assesses whether the SGP

<sup>(74)</sup> The structural balance numbers are from the database used in European Commission (2018b).

<sup>(75)</sup> Italy was, however, at the same time subject to a more stringent requirement on the debt criterion side, namely a structural effort of 0.7% of GDP in 2013.

reforms and innovations introduced in 2011 have reduced pro-cyclicality in practice. We do not have a counterfactual to assess what fiscal stance would have prevailed if the reforms had not taken place; but to put the current situation in perspective, the analysis covers the whole history of the SGP, also extending, subject to data availability, to pre-SGP times and non-EU countries to allow further comparisons.

#### 4.2.1. Has the fiscal stance been counter-cyclical?

The first part of the analysis focuses on the fiscal stance. It is based both on a graphical comparison of the fiscal stance with various indicators of cyclical conditions and on econometric analysis.

The snake graphs presented in Graphs 4.3 to 4.5 cover 1999-2018 for the EU and 1997-2018 for non-EU countries. For EU countries, the fiscal stance is measured by the change in the cyclically-adjusted primary balance until 2003 and by the change in the structural primary balance – i.e. corrected for one-off and temporary measures – after that. For 2000-2001, we correct the cyclically-adjusted primary balance for the proceeds from the auctioning off of universal mobile telecommunications systems (UMTS) licences for mobile phones, as they had a sizeable deficit-reducing one-off impact in some countries and amounted to approximately 1% of GDP in the EU as a whole<sup>(76)</sup>. For non-EU countries, the structural primary balance is used over the whole period. To measure economic slack, three indicators are considered: the output gap in level and in change, and the change in the unemployment rate<sup>(77)</sup>. We use the latest available *ex post* estimates, namely the Commission 2019 spring forecast for EU countries and the OECD's May 2019 Economic Outlook for non-EU countries. As in other parts of this report, EU countries are grouped into three categories, depending on their average debt level in 2011-2018<sup>(78)</sup>. The four non-EU countries under

consideration are the United States, Japan, Canada and Switzerland.

The first finding that emerges from the graphs is that the choice of the cyclical indicator matters only for some years but not for the general picture. Using different cyclical indicators results in classifying certain years as good economic times according to one indicator, and bad according to another. This happens, in particular, when the same indicator is used in level or in change: the EU output gap in 2008 was still positive but falling; conversely, in 2010 and 2011, it was still negative but narrowing (Graph 4.3). While this may lead to categorising the fiscal stance in these years in opposite manners, this is mainly a matter of timing. All the indicators considered point to a counter-cyclical fiscal expansion around the year 2009 and a pro-cyclical fiscal contraction in 2012-2013. In addition, the change in output gap and the change in the unemployment rate give a similar picture, which makes us more confident about the results.

The second finding is that, outside well-identified episodes of pro- and counter-cyclicality, the fiscal stance in the EU and the euro area has remained within a broadly neutral range most of the time since 1999. There was a brief period of pro-cyclical fiscal expansion in 2000 and to some extent 2001, which partly reflected consolidation fatigue after the run-up to the adoption of the euro. The fiscal expansion of 2008-2010 was clearly counter-cyclical in 2009, as well as in 2008 and/or 2010 depending on the cyclical indicator. This fiscal stimulus was a necessary reaction to the global economic and financial crisis and it was coordinated under the European economic recovery plan (see Chapter 2). This was followed by a period of pro-cyclical fiscal contraction in 2011-2013. Apart from those three episodes, the fiscal stance has been broadly neutral, that is, the change in the cyclically adjusted or structural primary balance has not exceeded  $\pm 0.25\%$  of GDP.

Strikingly, counter-cyclicality in the EU and the euro area has been concentrated in bad economic times. By contrast, there are no cases of aggregate counter-cyclical fiscal contraction in good times. The period 2003-2007, in particular, illustrates a missed chance for counter-cyclical fiscal

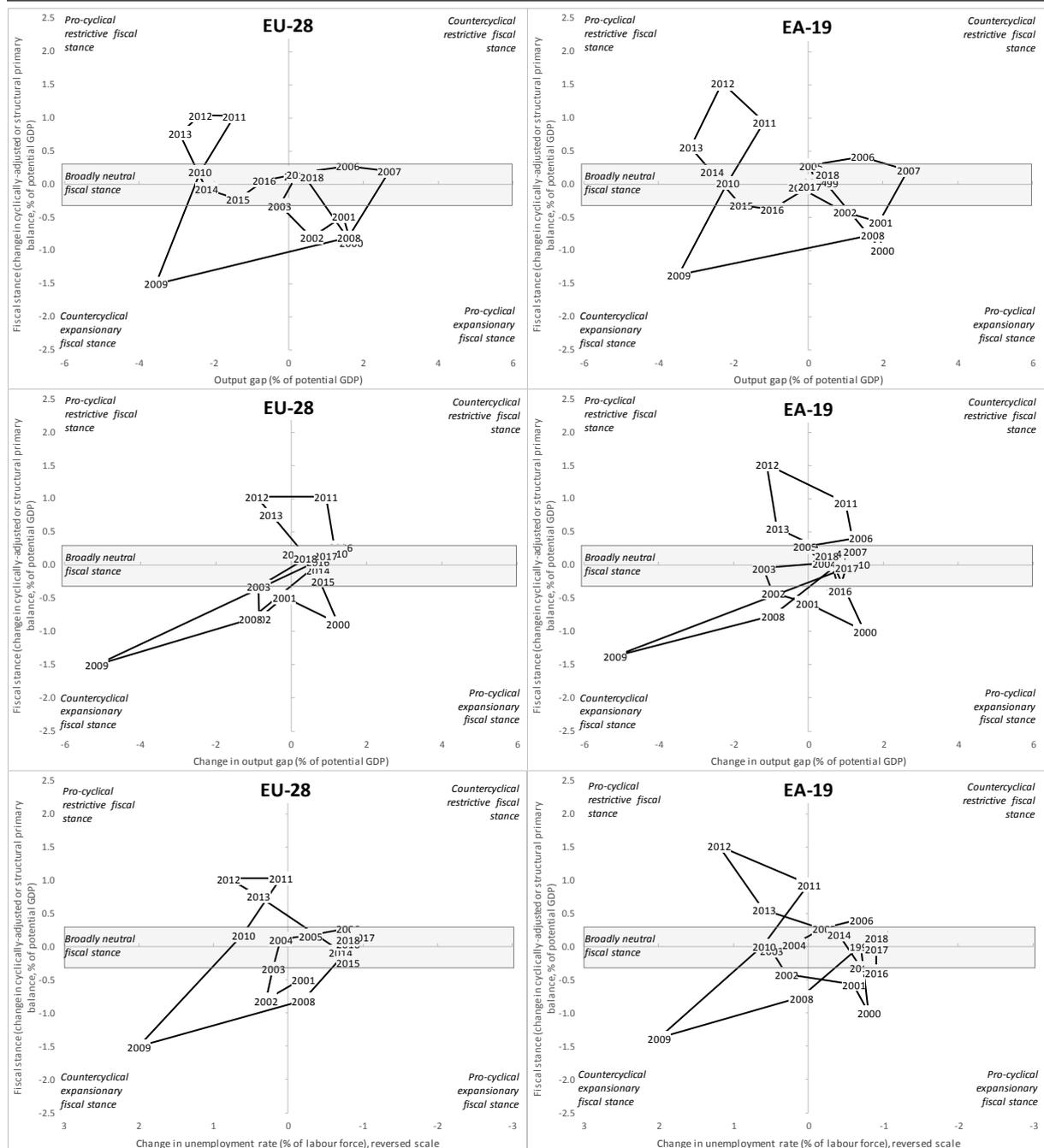
<sup>(76)</sup> By convention, the revenues associated with the sale of UMTS licences are treated as the sale of an asset and recorded as a negative investment, thus improving the general government budget balance.

<sup>(77)</sup> We do not use the unemployment rate in level, as it brings little information about the cyclical position: the equilibrium level is non-observable and differs across countries and over time

<sup>(78)</sup> The very high-debt countries (with debt ratios above 90% of GDP) shown in red include Belgium, Ireland, Greece, Spain, France, Italy, Cyprus and Portugal. The high-debt countries (between 60% and 90% of GDP) in yellow are Germany, Croatia (starting in 2002 due to data availability), Hungary, Malta, the Netherlands, Austria, Slovenia and the United Kingdom. Finally,

the low-debt countries (below 60% of GDP) in green are Bulgaria, the Czech Republic, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia, Sweden and Finland.

Graph 4.3: Fiscal stance in the EU and the euro area, 1999-2018



Notes: (1) The graphs show the fiscal stance against the output gap (top), the change in output gap (middle) and the change in employment rate (bottom). (2) Unemployment rate data for the EU-28 starts in 2000. (3) Until 2003, the fiscal stance is measured by the change in the cyclically-adjusted primary balance. It is corrected for the proceeds from the sale of mobile phone licences in 2000-2001 but not for other possible one-offs. (4) To facilitate comparisons across graphs, the change in the unemployment rate is shown on a reversed scale.

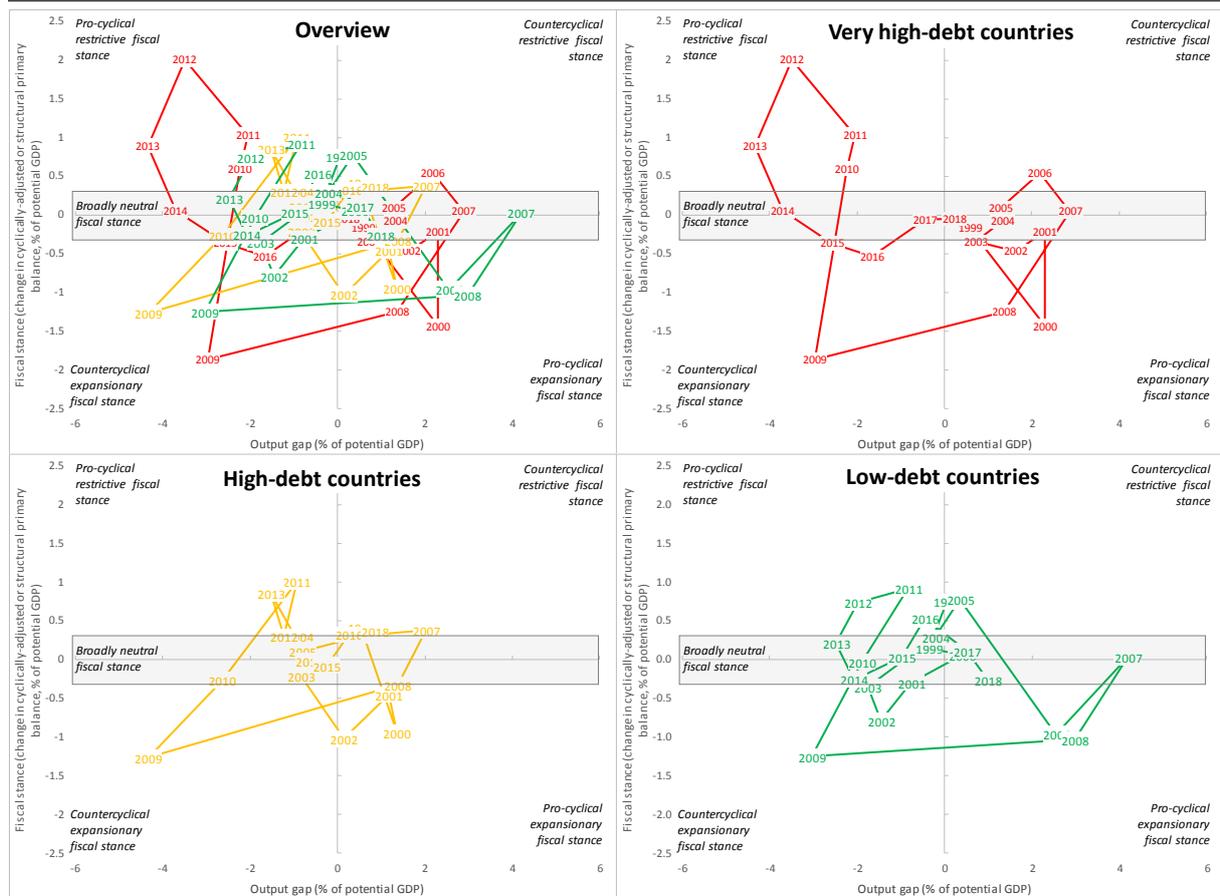
Source: European Commission, own calculations.

consolidation in what is now known as years of economic boom – partly because good economic times were not correctly identified at the time. Similarly, since 2014, the fiscal stance has been broadly neutral to slightly expansionary. While this was justified to support a long and fragile recovery, it became more pro-cyclical after the economy had

returned to normal, and resulted once again in failing to build fiscal buffers in good times.

Turning to groups of countries, pro-cyclical and counter-cyclical episodes have generally been more pronounced in countries with debt above 90% of GDP (Graph 4.4). In these countries, both the fiscal expansion in 2009 and the fiscal contraction

Graph 4.4: Fiscal stance by group of EU countries, 1999-2018



Notes: (1) Averages weighted by GDP. (2) Very high-debt countries: Belgium, Ireland, Greece, Spain, France, Italy, Cyprus and Portugal. High-debt countries: Germany, Croatia (starting in 2002 due to data availability), Hungary, Malta, the Netherlands, Austria, Slovenia and the United Kingdom. Low-debt countries: Bulgaria, the Czech Republic, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia, Sweden and Finland. (3) Until 2003, the fiscal stance is measured by the change in the cyclically-adjusted primary balance. It is corrected for the proceeds from the sale of mobile phone licences in 2000-2001 but not for other possible one-offs.

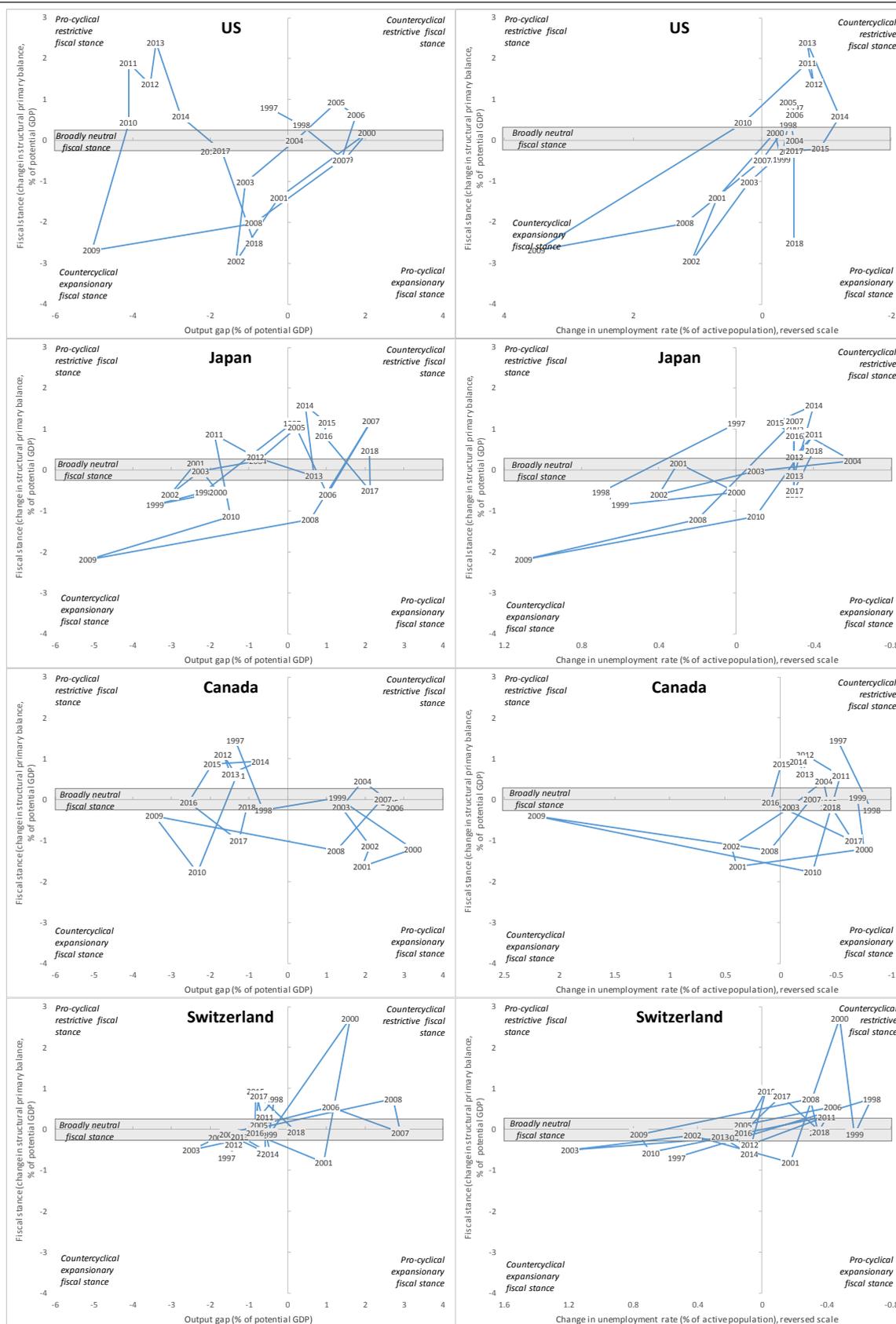
Source: European Commission, own calculations.

in 2012 were larger than in the rest of the EU. By comparison, the remaining EU countries have kept their fiscal stances on average between +1% and -1% of GDP. This was also the case in 2009 when their output gap was on average at least as large as in the very high-debt countries and they generally had more fiscal leeway to support demand. On the other hand, in 2009, the unemployment rate was on average higher and increased faster in the very high-debt countries than in the rest of the EU, making the need for support more pressing. As regards the pro-cyclical contraction of 2011-2013, while the fiscal effort remained below 1% of GDP in Belgium and France, the most dramatic consolidation measures were concentrated in countries that were subject to macroeconomic adjustment programmes (Greece from 2010, Ireland and Portugal in 2011-2013, Spain in 2012-2013 and Cyprus in 2013) and in Italy in 2012. Several countries also consolidated by more than 2% of GDP in a single year, although

their debt ratios were lower, including Croatia, Hungary, Poland, Romania, Slovenia and Slovakia. At the time, sustainability concerns dominated everything else, and pressure from financial markets was particularly intense; the consequences of no consolidation might have been even worse than the adverse economic, social and political consequences of fiscal austerity.

Overall, with pro-cyclical consolidation in 2011-2013 and a lack of counter-cyclical buffer-building in 2017, the recent reforms do not appear to have reduced pro-cyclicality nor encouraged counter-cyclicality.

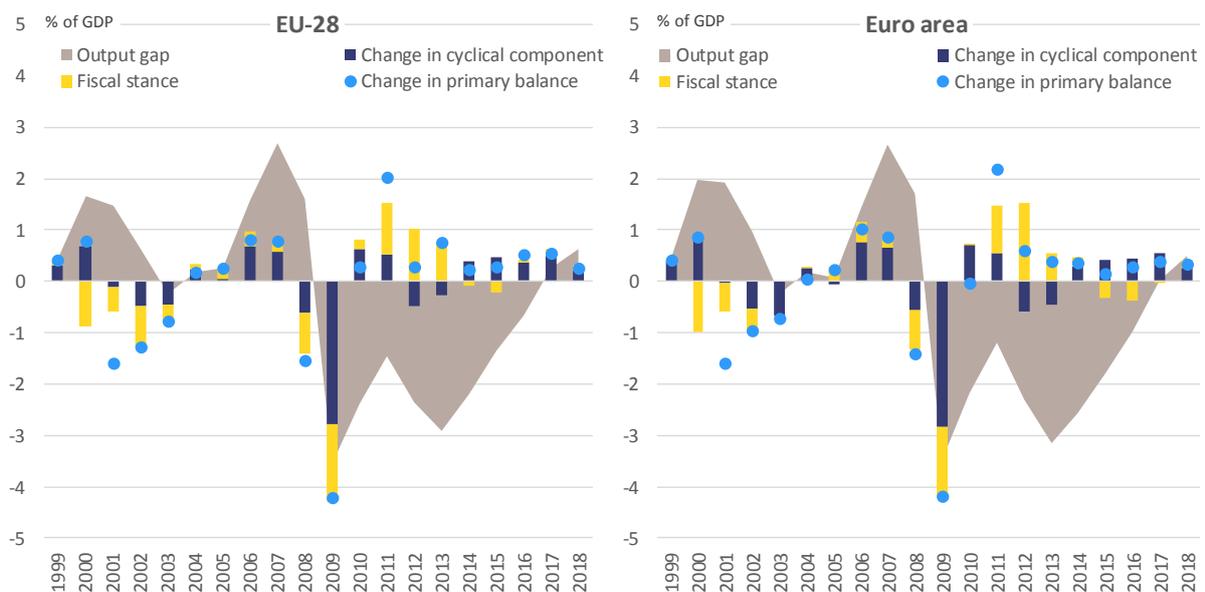
Graph 4.5: Fiscal stance in selected non-EU countries, 1997-2018



Notes: The graphs show the fiscal stance against the output gap (left) and against the change in the unemployment rate (right).

Source: European Commission, OECD, own calculations.

Graph 4.6: Discretionary fiscal policy and automatic fiscal stabilisers in the EU and the euro area, 1999-2018



Notes: (1) Until 2003, the fiscal stance is measured by the change in the cyclically-adjusted balance, corrected for the one-off proceeds from the sale of mobile phone licences in 2000-2001. From 2004, the fiscal stance is measured by the change in the structural primary balance, which is corrected for one-offs and temporary measures. (2) Gaps between the change in primary balance and the sum of its components are the residuals, i.e. the change in one-offs. (3) EU numbers include Croatia from 2003.

Source: European Commission, own calculations.

By comparison with non-EU countries, the graphs do not provide compelling evidence that the EU fiscal framework performs better or worse in terms of pro-cyclicality. The four non-EU countries under consideration show some periods of counter- and pro-cyclicality, to various extents (Graph 4.5). The main difference compared to the EU is that there have been episodes of counter-cyclical fiscal contractions in all four countries, at least when the cyclical position is measured by the change in the unemployment rate. The largest fiscal shocks are found in the United States, where the fiscal stance seems to be more counter-cyclical than average, based on the change in the unemployment rate indicator. A common feature across all four countries is the significant impact of the global economic and financial crisis in 2009 in terms of output gap and unemployment, although less markedly so in Switzerland. The fiscal stimulus of 2009 was therefore counter-cyclical in non-EU countries as well. By contrast, the fiscal consolidation that took place in 2011-2013 in North America appears both pro-cyclical, considering that the output gap was negative, and counter-cyclical, in view of the decreasing unemployment rate.

These findings are confirmed by econometric analysis. A panel data approach covering all EU Member States and 8 non-EU developed countries finds that discretionary fiscal policies tend to be

pro-cyclical when the cycle is measured by the change in the output gap or in the unemployment rate (Box 4.1). There are also indications that pro-cyclicality is more marked when the economic cycle improves and when public debt exceeds 80% of GDP. Moreover, fiscal policies tend to be more pro-cyclical in EU Member States than in the non-EU countries of the sample. Finally, unlike the 2005 reform of the SGP, the six-pack reform does not appear to have reduced pro-cyclicality. While these findings have to be interpreted with some care as some of them differ across indicators and estimation methods, the various specifications often point in the same direction and are consistent with the graphical analysis of this chapter.

### Box 4.1: Fiscal stabilisation and debt reduction: an econometric analysis

This box summarises the findings of an econometric analysis conducted in collaboration with the Commission's Joint Research Centre <sup>(1)</sup>. It aims to (i) assess whether discretionary fiscal policies tend to be pro-cyclical, (ii) identify drivers of pro-cyclicality and (iii) assess whether the six-pack reform and subsequent changes to the EU fiscal rules have had an impact on pro-cyclicality. It also analyses what drives changes in the debt-to-GDP ratio over the medium term.

The panel data analysis covers a set of 36 developed countries, including the 28 EU Member States, Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the US, from 1970 – or later, depending on the country and control variables – to 2017. For robustness, it uses several estimation methods; the annex includes tables with a selection of estimation outputs.

To analyse fiscal stabilisation, the following specification is estimated using annual data:

$$impulse_{i,t} = \beta_1 impulse_{i,t-1} + \beta_2 cycle_{i,t} + \beta_3 X_{i,t-1} + dummies + \theta_t + \delta_i + u_{i,t}$$

where  $impulse_{i,t}$  is the change in the cyclically-adjusted primary balance (CAPB) as a percentage of GDP and measures the fiscal impulse, i.e. the direction and size of discretionary fiscal policy. To test the robustness of findings, three cyclical indicators ( $cycle_{i,t}$ ) are envisaged: the change in the output gap as measured ex post, the change in the unemployment rate, and the change in the annual average of the OECD's Composite Leading Indicator (CLI). The control variables considered for vector  $X_{i,t-1}$  include standard variables used in the literature for such analysis: public debt, the age dependency ratio (i.e. the share of the population over 65 years of age) and the number of changes in government. The dummies identify different categories of crises <sup>(2)</sup>, election years and EU financial assistance programmes. Moreover, and of particular relevance for this review, we use dummies for EU membership, for years preceding the adoption of the euro and for the different reforms of the SGP. Finally, there are year and country fixed effects and an error term.

The analysis confirms a result widely shared in the literature, namely that fiscal policies tend to be pro-cyclical, as the CAPB deteriorates when the economic cycle improves (Table 1). This result holds at least for two of the cyclical indicators that were tested – the change in the output gap and the change in the unemployment rate – and it is particularly robust when the change in the output gap is used. While the third cyclical indicator – the CLI – does not lead to statistically significant results, the estimates also point towards pro-cyclicality, supporting the general picture.

Table 1:

#### Pro-cyclicality results by cyclical indicator and estimation method

Estimation method	FE/LSDVc	2SLS	GMM
Change in the output gap	Pro-cyclical ***	Pro-cyclical *	Pro-cyclical (depends on the specification)
Change in the unemployment rate	Pro-cyclical ***	(Pro-cyclical)	(Pro-cyclical)
OECD composite leading indicator	(Pro-cyclical)	(Pro-cyclical)	(Pro-cyclical)

Notes: (1) FE: fixed effects. LSDVc: bias-corrected least-squares dummy variable estimator. 2SLS: two-stage least squares fixed-effects. GMM: generalised method of moments. (2) \*\*\*: significant at the 1% level. \*\*: significant at the 5% level. \*: significant at the 10% level. (): not significant.

Turning to the drivers of pro-cyclicality, we find several non-linearities in the fiscal reaction function (Table 2). These results are obtained by interacting the cyclical indicator with various dummies. First, we find that pro-cyclicality is stronger when economic activity strengthens: fiscal policies tend to be more pro-cyclical than average for positive changes in the output gap. Second, high or very high levels of debt tend to coincide with stronger pro-cyclicality – this does not seem surprising, because when the cycle worsens, these countries have for sustainability reasons no other choice but to contract. Third, pro-cyclicality tends to be stronger in EU countries than in the other advanced economies of the sample. Fourth, while the first years of the SGP coincide with stronger pro-cyclicality,

<sup>(1)</sup> Many thanks to Wouter van der Wielen for his valuable input.

<sup>(2)</sup> Following Laeven and Valencia (2013 and 2018).

(Continued on the next page)

Box (continued)

the 2005 reform appears to have weakened pro-cyclicality; by contrast, the impact on pro-cyclicality of the six-pack and subsequent reforms does not come out significantly.

Most of the models and cyclical indicators we use point in the same direction, suggesting that the findings are robust. The differences are mainly in terms of statistical significance. The results generally appear stronger with the FE/LSDVc models than in 2SLS and GMM models for two methodological reasons. On the one hand, the results in the FE/LSDVc specifications may look stronger than they are, because a possible simultaneity bias between discretionary fiscal policy and the cycle potentially causes a problem of endogeneity. On the other hand, to correct for endogeneity, the 2SLS and GMM specifications use lags of the available variables for instrumenting <sup>(3)</sup>; as we use many time dummies, this results in a large number of instruments, which may artificially weaken the results.

Table 2:

Drivers of pro-cyclicality by cyclical indicator and estimation method

Factor	FE/LSDVc	2SLS	GMM
<b>Positive change in the output gap</b>	Stronger pro-cyclicality *OG (UR) (CLI)	Stronger pro-cyclicality (UR) Weaker pro-cyclicality (OG) (CLI)	Stronger pro-cyclicality (OG) *UR (CLI)
<b>High debt-to-GDP ratio</b>	Stronger pro-cyclicality if debt > 90% of GDP **UR; Not significant otherwise	Stronger pro-cyclicality if debt > 80% *UR; Weaker pro-cyclicality if debt < 70% *CLI; Not significant otherwise	Stronger or weaker pro- cyclicality depending on the cut- off level and cyclical indicator, never significant
<b>EU membership</b>	Stronger pro-cyclicality ***OG **UR *CLI	Stronger pro-cyclicality (OG) (UR) (CLI)	Stronger or weaker pro- cyclicality depending on the cyclical indicator, never significant
<b>Years preceding euro adoption</b>	Stronger pro-cyclicality (OG) **UR ***CLI	Stronger pro-cyclicality *OG *UR (CLI)	Stronger pro-cyclicality (OG) (UR) (CLI)
<b>SGP as of 1999</b>	Stronger pro-cyclicality (OG) (UR) **CLI	Stronger pro-cyclicality *OG (UR) (CLI)	Stronger or weaker pro- cyclicality depending on the indicator, never significant
<b>SGP as of 2005 reform</b>	Weaker pro-cyclicality (OG) (UR) **CLI	Weaker pro-cyclicality (OG) (UR) *CLI	Stronger pro-cyclicality (OG) **CLI Weaker pro-cyclicality (UR)
<b>SGP as of six-pack reform</b>	Stronger pro-cyclicality (OG) (UR) (CLI)	Stronger pro-cyclicality (OG) (UR) (CLI)	Weaker pro-cyclicality (OG) (UR) (CLI)

Notes: (1) FE: fixed effects. LSDVc: bias-corrected least-squares dummy variable estimator. 2SLS: two-stage least squares fixed-effects. GMM: generalised method of moments. (2) \*\*\*: significant at the 1% level. \*\*: significant at the 5% level. \*: significant at the 10% level. (3) OG, UR, CLI: when the cycle is measured by the change in the output gap, the change in the unemployment rate and the OECD CLI, respectively. For instance, "\*\*\*OG" means "significant at the 1% level when the cyclical indicator is the change in the output gap."

Irrespective of the cycle, we find that higher debt levels, years following elections, participation in EU financial assistance programmes and years following currency crises are correlated with fiscal consolidation (Table 3). Conversely, an older population (until 2011) <sup>(4)</sup>, more frequent changes in government and years following sovereign debt crises and systemic banking crises tend to be correlated with fiscal expansions.

<sup>(3)</sup> In particular, in a first-stage regression the lags of the variables are used to construct an alternative measure of the cycle using prediction such that the cycle is uncorrelated with the error term of the final regression.

<sup>(4)</sup> In 2012-2017, the age dependency ratio has a sizeable positive coefficient.

(Continued on the next page)

Box (continued)

Table 3:

Impact of explanatory variables on the change in CAPB, by cyclical indicator and estimation method

Explanatory variable		Estimation method and cyclical indicator			FE			LSDVc			2SLS			GMM		
		OG	UR	CLI	OG	UR	CLI	OG	UR	CLI	OG	UR	CLI			
CONTROL VARIABLES	Debt-to-GDP ratio (t-1)	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	+++	
	Age dependency ratio (t-1)	-	--	---	--	---	--	--	---	--	---	-	-	--	-	
	Number of changes in government (t-1)	--	-	(-)	--	(-)	(-)	(-)	(-)	(-)	(-)	-	(-)	(-)	-	
DUMMIES	Election year (t-1)	++	+	+	++	++	+	++	++	+	++	(+)	(+)	(+)	(+)	
	Global economic and financial crisis of 2008-2009 (t)	(+)	(+)	---	--	(-)	-	---	---	---	---	-	(-)	---	-	
	Sovereign debt crisis (t-1)	---	---	---	---	---	---	---	---	---	---	---	---	---	-	
	Systemic banking crisis (t-1)	--	(-)	(-)	--	(-)	--	(-)	(-)	-	-	(-)	(-)	(-)	(-)	
	Currency crisis (t-1)	(-)	++	(+)	(-)	+++	(+)	(+)	+++	(+)	(+)	(-)	+	(+)	(+)	
	EU programme (t-1)	+++	+++	++	+++	+++	+++	(+)	(+)	(+)	(+)	(+)	(+)	(+)	(+)	

Notes: (1) FE: fixed effects. LSDVc: bias-corrected least-squares dummy variable estimator. 2SLS: two-stage least squares fixed-effects. GMM: generalised method of moments. (2) OG, UR, CLI: when the cycle is measured by the change in the output gap, the change in the unemployment rate and the OECD CLI, respectively. (3) +++ or ---: significant at the 1% level. ++ or --: significant at the 5% level. + or -: significant at the 10% level. (+) or (-): not significant.

To assess what drives the evolution of the debt-to-GDP ratio over longer periods, the following specification is estimated over 4-year periods starting with 1960-1963:

$$\Delta debt_{i,t} = \beta_1 \Delta debt_{i,t-1} + \beta_2 X_{i,t} + dummies + \theta_t + \delta_i + u_{i,t}$$

where  $\Delta debt_{i,t}$  is the average change in the debt-to-GDP ratio over 4 years. The control variables include 4-year averages of nominal GDP growth, the debt-to-GDP ratio, the unemployment rate, the current account balance and the age dependency ratio. As above, we use dummies in particular for EU programmes and SGP reforms.

We find that debt tends to increase where the unemployment rate is higher and the population older, while it tends to decrease where the debt ratio is higher and when nominal GDP growth is higher and the current account more in surplus. Debt has also tended to decline in countries that were subject to EU financial assistance programmes and in the years preceding the euro adoption. These results are robust across estimation methods, with differences only in the degree of significance. The impact of the SGP and its reforms, on the other hand, is not statistically significant.

#### 4.2.2. Combined impact of discretionary fiscal policies and automatic stabilisers

For completeness, the analysis cannot address only discretionary fiscal policy but also needs to take into account the role of automatic fiscal stabilisers. By nature, automatic stabilisers play a counter-cyclical role, which may be topped up or offset by discretionary policy measures. The issue is then to assess the relative weight and direction of discretionary fiscal policy compared to automatic fiscal stabilisers, and whether the total impact has been pro- or counter-cyclical.

We break down the change in the budget balance between (i) the change in the cyclical component, to measure automatic stabilisers, and (ii) the fiscal

stance, to measure discretionary fiscal policy<sup>(79)</sup>. To avoid the discrepancy due to interest payments, we use the primary balance instead of the budget balance. As above, in the EU the fiscal stance is measured by the change in the cyclically-adjusted primary balance until 2003, corrected for one-off UMTS proceeds in 2000-2001, and by the change in the structural primary balance after that. In Graphs 4.6 and 4.7, the residuals are due to one-offs, which are included in the primary balance and the cyclically-adjusted primary balance but not in the structural primary balance.

This analysis corroborates the findings of pro-cyclicality and missed chances of counter-cyclical consolidation. In 2003-2007, the marginally restrictive fiscal stance barely reinforced the impact

<sup>(79)</sup> Following Van den Noord (2000).

of automatic stabilisers, confirming that governments missed an opportunity to build buffers. The counter-cyclical fiscal stimulus in 2008-2009 logically came on top of automatic fiscal stabilisers. In the EU as a whole, in 2008 the discretionary fiscal stimulus (including one-offs) amounted to 0.9% of GDP. This was 1½ times larger than the impact of automatic stabilisers. In 2009, the stimulus increased to 1.4% of GDP, which, given the extent of the recession, was only half the size of the automatic stabilisers. In 2012-2013, the restrictive impact of fiscal consolidation was partly mitigated by automatic stabilisers, but the net impact was still restrictive, i.e. pro-cyclical. Finally, in 2015-2016, a slight discretionary fiscal expansion took place in the euro area alongside the declining support of automatic fiscal stabilisers, and fiscal policy in 2017-2018 showed similarities with 2003-2007.

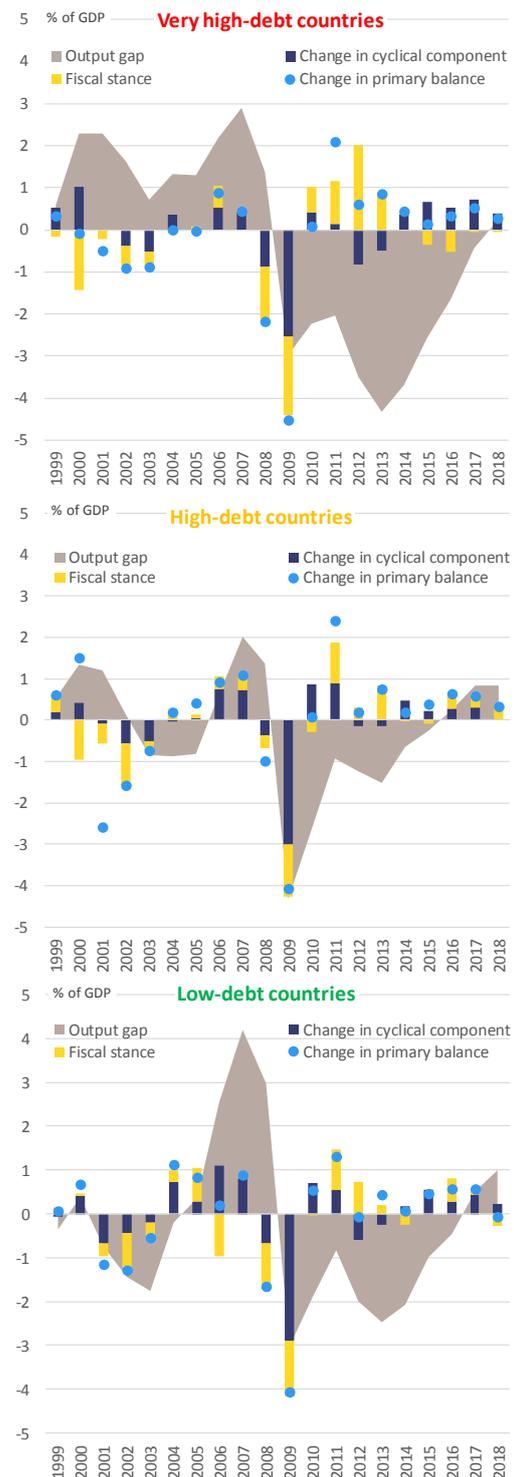
Table 4.1: Discretionary fiscal policy vs automatic stabilisers

	Frequency of discretionary fiscal policy offsetting automatic fiscal stabilisers	
	1999-2010	2011-2018
<b>Euro area</b>	17%	63%
<b>EU-28</b>	8%	50%
of which		
<b>Very high-debt countries</b>	33%	75%
<b>High-debt countries</b>	25%	50%
<b>Low-debt countries</b>	25%	50%
<b>US</b>	33%	50%
<b>Japan</b>	42%	75%
<b>Canada</b>	50%	50%
<b>Switzerland</b>	33%	63%

(1) How to read the table: in the euro area, discretionary fiscal policy went in the opposite direction from automatic stabilisers (i.e. was pro-cyclical) 17% of the time in 1999-2010 but 63% of the time in 2011-2018. (2) Group averages are weighted by GDP. (3) Very high-debt countries: Belgium, Ireland, Greece, Spain, France, Italy, Cyprus and Portugal. High-debt countries: Germany, Croatia (starting in 2002 due to data availability), Hungary, Malta, the Netherlands, Austria, Slovenia and the United Kingdom. Low-debt countries: Bulgaria, the Czech Republic, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia, Sweden and Finland.

Source: European Commission, OECD, own calculations.

Graph 4.7: Discretionary fiscal policy and automatic fiscal stabilisers by group of countries, 1999-2018



Notes: (1) Averages weighted by GDP. (2) Very high-debt countries: Belgium, Ireland, Greece, Spain, France, Italy, Cyprus and Portugal. High-debt countries: Germany, Croatia (starting in 2002 due to data availability), Hungary, Malta, the Netherlands, Austria, Slovenia and the United Kingdom. Low-debt countries: Bulgaria, the Czech Republic, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia, Sweden and Finland. (3) Data for Croatia start in 2002.

Source: European Commission, own calculations.

Since 2011, discretionary fiscal policies in the EU have gone in the opposite direction from automatic stabilisers much more frequently than before (Table 4.1). The frequency of pro-cyclical discretionary policies has increased from once per decade to every other year in the EU as a whole. In the euro area, the rate has increased to two thirds of the time, and 3 years out of 4 in the very high-debt countries. The years of discretionary pro-cyclicality in these countries include the 2011-2013 consolidation and the fiscal expansion in 2015-2016, when the output gap was rapidly narrowing, although from a double-dip recession that was more marked than in the rest of the EU (Graph 4.7). In the countries with a debt ratio of 60% to 90% of GDP, the slightly restrictive fiscal stance in 2016-2018 topped up automatic stabilisers, building fiscal space.

Overall, the empirical analysis shows that the reforms and innovations implemented since 2011 have not led to more counter-cyclical fiscal policies. The period started with an episode of drastic pro-cyclical fiscal contraction in 2011-2013, when sustainability concerns dominated stabilisation considerations. Since 2014, fiscal policy has returned to where it already was most of the time before the six-pack reform, that is, a 'noisy' area of broadly neutral fiscal stances, including in years of strong economic growth when counter-cyclical consolidation to build fiscal buffers would have been more advisable.

There are multiple reasons for fiscal pro-cyclicality, both general and specific to the EU. The pro-cyclical bias in good times, largely confirmed by empirical evidence, is well documented in the political economy literature and relates to information asymmetry, short-sightedness and electoral considerations among other things. In the EU, pro-cyclicality in bad times is driven by the focus on sustainability, reinforced by pressure from financial markets during the euro-area sovereign debt crisis. The absence of a central fiscal capacity has also played a role, because such a capacity would have dampened the fiscal deterioration,

thus alleviating sustainability and capital markets pressures.

The general conclusion from our analysis is that increased flexibility did not step in at the right time. After 2011 and prior to the 2015 Communication on flexibility, the Pact already included some elements of flexibility which were applied, although with a limited impact on aggregate. Some deadlines for correcting excessive deficit procedures were extended, some countries were relieved from consolidation requirements because they faced negative economic growth (but were still asked to consolidate because of their high debt), and adjustment requirements were reduced in some countries that were conducting structural reforms of their pension systems or using the first version of the investment clause. This was far from sufficient to tackle the double-dip recession, but overwhelming sustainability challenges implied that it was not possible to replicate the fiscal stimulus provided under the European economic recovery plan. In 2015, under reduced pressure from financial markets, the Commission highlighted its intention to use existing flexibility possibilities within the Pact to allow more fiscal support to the recovery; but by the time Member States could use that flexibility, their recovery was already well advanced. In November 2016, the Commission Communication calling for fiscal support to the recovery in 2017 was also a case of mistiming, as 2017 turned out to be a year of unexpectedly strong economic expansion and missed counter-cyclical consolidation<sup>(80)</sup>.

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<sup>(80)</sup> European Fiscal Board (2018b).

# 5. QUALITY OF PUBLIC FINANCES

## KEY FINDINGS

- Enhancing the quality of public finances (QPF) is a key component of a fiscal policy oriented towards sustainable long-term growth.
- The quality of public finances is a multi-faceted concept that encompasses dimensions that range from the size of government to the structure and efficiency of revenue systems.
- The Stability and Growth Pact (SGP) in its current form remains largely agnostic about the composition of public finances.
- The EU fiscal governance framework accounts for improving the quality of public finances via the country-specific recommendations (CSRs) in the European Semester.
- The two-pack reform has introduced additional monitoring requirements with a clear QPF dimension.
- Euro-area Member States subject to an excessive deficit procedure (EDP) have to submit an ‘economic partnership programme’ (EPP). The EPP is a roadmap for fiscal structural reforms to correct the excessive deficit.
- So far only two Member States have applied to use the flexibility under the investment clause of the SGP.
- In several euro-area Member States public investment as a share of current primary expenditure has decreased on average between 2011 and 2018 compared to 1998-2007. The reduction in public investment is particularly pronounced for very-high debt countries.
- The decline in public investment, as a share of current primary expenditure, is particularly evident in Member States under the EDP.
- More generally, during episodes of fiscal retrenchment, public investment has suffered disproportionately from cuts. This is because investment is often one of the most politically easy items to cut in the budget.
- Low-debt countries tend to have smaller government and higher levels of public investment as a share of current primary expenditure.
- Despite the long-term benefits of increasing the share of productive public expenditure in R&D, education and transport, most Member States have reduced their GDP-share of productive public spending in 2017 when compared to 2001.
- A more efficient revenue system tends to facilitate better compliance with the EU fiscal rules.
- The annual assessment of the implementation of the CSRs for public investment, education and taxation under the European Semester shows that implementation of recommendations has been weaker since 2016.
- Fiscal rules should not generate incentives to pursue distortionary policies. To prevent misallocation of resources, some key expenditure categories, such as productive investment, could be protected.

## 5.1. IMPROVING THE QUALITY OF PUBLIC FINANCES

Improving the quality of public finances (QPF) is a key component of a fiscal policy oriented towards enhancing an economy's long-term growth potential. It shifts the focus from short-term considerations about the impact of fiscal policy towards achieving sustainable economic growth for future generations. The need for strengthening the quality of public finances arises from the challenges of ageing societies, the costs of climate change and pressures originating from intensified global competition.

QPF is a multi-faceted concept. It 'comprises policies that not only ensure sound budgetary positions and long-term sustainability but also those that raise the production potential and facilitate the economy to adjust to shocks' <sup>(81)</sup>. Most importantly for the purpose of this review, the design of the fiscal rules, institutions and procedures, as enshrined in the six and two-pack reforms, can directly or indirectly influence four key QPF dimensions. These are: '(i) the size of government, (ii) the level and sustainability of fiscal positions, (iii) the composition and efficiency of expenditure and (iv) the structure and efficiency of revenue systems' <sup>(82)</sup>. Targeted policies designed to improve all four of these QPF dimensions can be potentially growth-enhancing. For instance, flexibility provisions for public investment and structural reforms under the EU fiscal rules could benefit the composition and efficiency of expenditure. Finally, various interlinkages exist between the implementation of structural reforms and the quality of public finances. Some structural reforms can for instance affect the composition and efficiency of public expenditure – a key dimension of QPF.

An expenditure strategy geared towards increasing the share of public investment will likely have growth-enhancing effects <sup>(83)</sup>. This result seems to hold true especially for productive investments in the areas of education, research & development, public infrastructure and transport <sup>(84)</sup>. These types of investment tend to have beneficial effects for an

economy in the medium- to long-term depending on their capacity to 'address market failures and provide public goods' <sup>(85)</sup>. Generally, efficiency increases in public spending, meaning that reduced inputs will achieve the same output level and are always desirable because they free up fiscal space. As a result, a Member State can direct the additional resources towards addressing the most pressing structural weaknesses. In this regard, the EU fiscal framework encourages Member States to realise these efficiency gains.

Finding the appropriate composition of public spending is another important task for policymakers. The EU fiscal framework should support policymakers in this endeavour and encourage the use of 'productive' investments to the extent possible. Moving QPF centre stage can have several beneficial knock-on effects, such as achieving more sustainable fiscal positions and higher compliance rates.

Finally, QPF considerations are particularly important in the design of fiscal rules because policymakers have a tendency to focus on investment cuts during times of fiscal retrenchment. This problem has been particularly acute in the aftermath of the Great Recession. Graph 5.1 compares the combined productive public expenditure on R&D, education and transport as a share of total primary expenditure for the years 2007 and 2017. Despite the long-term benefits of increasing the share of productive public expenditure, after the Great Recession most Member States implemented fiscal adjustment plans that hit disproportionately productive investment. A similar picture emerges when looking at productive public expenditures as share of GDP (Graph 5.2). In sum, the design of fiscal rules should take into account QPF considerations or at least not affect the QPF, in order to avoid generating allocative distortions in the economy.

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<sup>(85)</sup> European Commission (2008), p.155.

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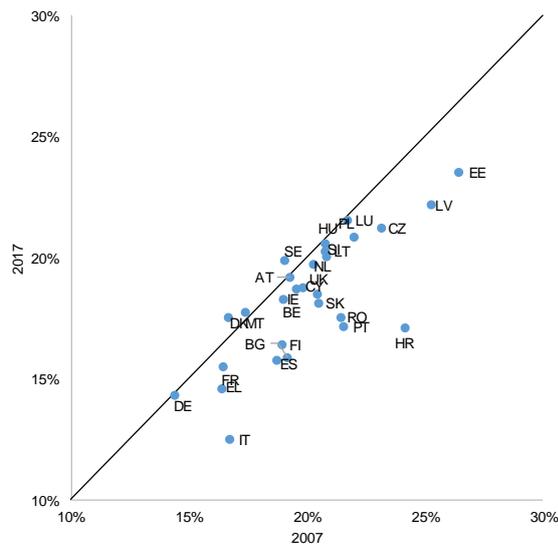
<sup>(81)</sup> Barrios and Schaechter (2008), p.7; European Commission (2016c), p.63-111.

<sup>(82)</sup> Barrios and Schaechter (2008), p.7.

<sup>(83)</sup> European Commission (2008), p.128.

<sup>(84)</sup> Gemmell et al. (2016); according to the European System of National and Regional Accounts (ESA2010), of these expenditure categories only expenditure on research and development is statistically recognised as investment.

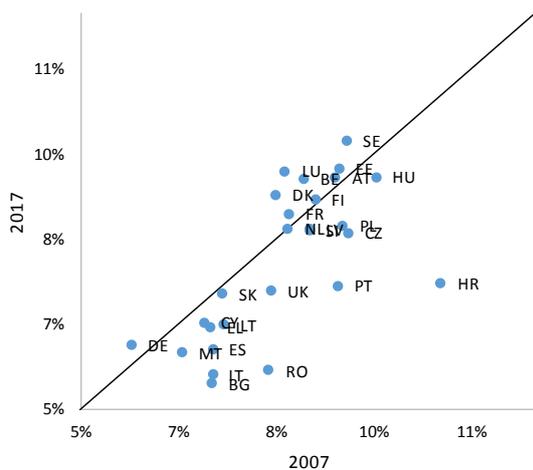
Graph 5.1: Share of productive public expenditures in total primary expenditure, 2007 and 2017



(1) Productive public expenditure is defined as the sum of government expenditure on R&D, education and transport.

Source: European Commission.

Graph 5.2: Share of productive public expenditure in GDP, 2007 and 2017



(1) Productive public expenditure is defined as the sum of government expenditure on R&D, education and transport.

Source: European Commission.

## 5.2. THE QUALITY OF PUBLIC FINANCES DIMENSION OF EU FISCAL RULES

The insight that the composition and efficiency of public spending matter for the overall quality of public finances also has a direct effect on the design of the EU fiscal rules and the capacity to comply with them. Public finances of improved quality will generate more resources in the long run and thus facilitate compliance with the EU fiscal rule framework. In addition, Member States

boosting public investments, whose beneficial effects might only accrue with a significant time lag, ought not to be sanctioned when compliance is assessed. Rather, the EU fiscal framework should incentivise Member States to undertake fiscal policies that improve QPF. As a result, successive reforms of the Stability and Growth Pact (SGP) have gradually woven in this important aspect into the EU fiscal rules.

The 2005 revisions of the SGP marked a first small step in this regard. In particular, these reforms have put an emphasis on fostering the medium-term orientation of public finances, and they incorporated into the SGP a few considerations on QPF<sup>(86)</sup>. For instance, the reform of the preventive arm specified that the impact of major structural reforms with a direct long-term cost-saving effect, including by raising potential growth, should be considered when defining the adjustment path towards the MTO, and in allowing a temporary deviation from it. At the same time, the reform of the corrective arm mentions QPF as one of the ‘other relevant factors’ that should be considered when assessing the existence of an excessive deficit under Art. 126 TFEU.

Later specifications of the SGP have continued to include provisions on QPF. In January 2015, the European Commission issued a Communication that operationalised the flexibility provisions<sup>(87)</sup>. Member States that had not applied for flexibility until then were encouraged to do so as a result. The European Fiscal Board reviewed the flexibility clauses of the SGP in detail in its 2018 annual report<sup>(88)</sup>. The investment clause is particularly noteworthy in this regard, because it takes account of the budgetary costs related to higher investment expenditure in the case of a temporary deviation from the medium-term budgetary objective (MTO)<sup>(89)</sup>. The eligibility conditions regarding the business cycle for granting flexibility under the investment clause are relatively restrictive. An eligible Member State must be in bad economic times, i.e. the estimated output gap must be below -1.5% of GDP or it must show negative GDP growth<sup>(90)</sup>. Another eligibility condition is that total public investment in absolute terms must not decline ex post if flexibility under

<sup>(86)</sup> European Commission (2008), p.129.

<sup>(87)</sup> European Commission (2015), ‘Making the best use of the flexibility within the existing rules of the Stability and Growth Pact’, COM(2015) 12 final, January.

<sup>(88)</sup> European Fiscal Board (2018b), p.61-69.

<sup>(89)</sup> European Fiscal Board (2018b), p.62.

<sup>(90)</sup> European Fiscal Board (2018b), p.63.

the investment clause is to be granted. The underlying rationale is that co-financed expenditure should not replace nationally financed expenditure. Only expenditures on projects co-funded by certain EU programmes (such as the European Fund for Strategic Investments ('Juncker fund') among others) are eligible.

A striking finding of the EFB's flexibility review is that due to the restrictive eligibility criteria related to the business cycle, only two Member States (Italy and Finland) have so far applied to use the flexibility under the investment clause. Furthermore, even though Member States should ideally request flexibility in the spring of the preceding year in their respective stability and convergence programme, in practice, Member States often request flexibility only at a later stage in the fiscal surveillance cycle<sup>(91)</sup>. The experience matured so far suggests that flexibility is used de facto as an escape clause to avoid an assessment of non-compliance with the EU fiscal rules. If the flexibility clause's objective is to incentivise a Member State to increase public investment, then the rule needs to be adjusted<sup>(92)</sup>. But this also underlines the importance of the stability and convergence programmes, which are supposed to provide a detailed list of measures to improve QPF.

Regulation (EU) 473/2013 of the two-pack reform has introduced additional monitoring requirements that possess a clear QPF dimension. Euro area Member States subject to an excessive deficit procedure (EDP) are required to submit economic partnership programmes (EPP). The function of the EPP is 'to act as a roadmap for the fiscal structural reforms'<sup>(93)</sup>. As such, it details the measures a euro-area Member State deems essential to correct its excessive deficit. More specifically, an EPP should build on the existing country-specific recommendations (CSRs) to identify reforms in the areas of taxation, pensions, health care and budgetary frameworks necessary to correct the excessive deficit in a long-lasting manner<sup>(94)</sup>. An EPP is thus supposed to intensify the coordination between budgetary and structural policies as part of the European Semester. However, the EPP is only supposed to be a one-off document that after the first assessment by the Council, acting on a proposal by the Commission, is monitored through

the European Semester framework, i.e. through the national reform programmes and/or the stability programme. However, there is no mechanism in place that enables the Commission to diligently monitor to what extent Member States are following up on the commitments specified in their EPP.

The code of conduct of the two-pack does not include specific guidance on the content nor the timeline for implementing the proposed reforms, even though a template structure is provided to maintain cross-country consistency<sup>(95)</sup>. Member States are supposed to update their national reform programmes and/or stability programmes in view of the EPP. In practice, it is difficult to trace which parts of the EPP make their way into these programmes. Given that there is no follow-up discussion about the EPP after their adoption, it makes it very difficult to monitor the implementation of the EPPs. Since 2013, six euro area Member States (France, Malta, the Netherlands, Portugal, Slovenia and Spain) have submitted an EPP to the Commission and the Council. Euro area Member States under a macroeconomic adjustment programme or under an excessive imbalance procedure do not have to submit an EPP. The reason is that a financial assistance programme tied to policy conditionality is more effective. With the exception of Portugal, all EPPs were submitted in autumn 2013 and received a Council opinion shortly afterwards in December. In sum, past efforts to harness the synergies between the EU fiscal rules and QPF have gone in the right direction but an implementation gap remains. In addition, there is a risk that aspects related to the QPF have turned into a purely procedural feature of the EU fiscal surveillance cycle. The procedure for monitoring the EPP – a key innovation of the two-pack reform – underpins this conclusion.

<sup>(95)</sup> Code of Conduct of the two-pack reform (2016), p.18-20. [https://ec.europa.eu/economy\\_finance/economic\\_governance/wp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](https://ec.europa.eu/economy_finance/economic_governance/wp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)

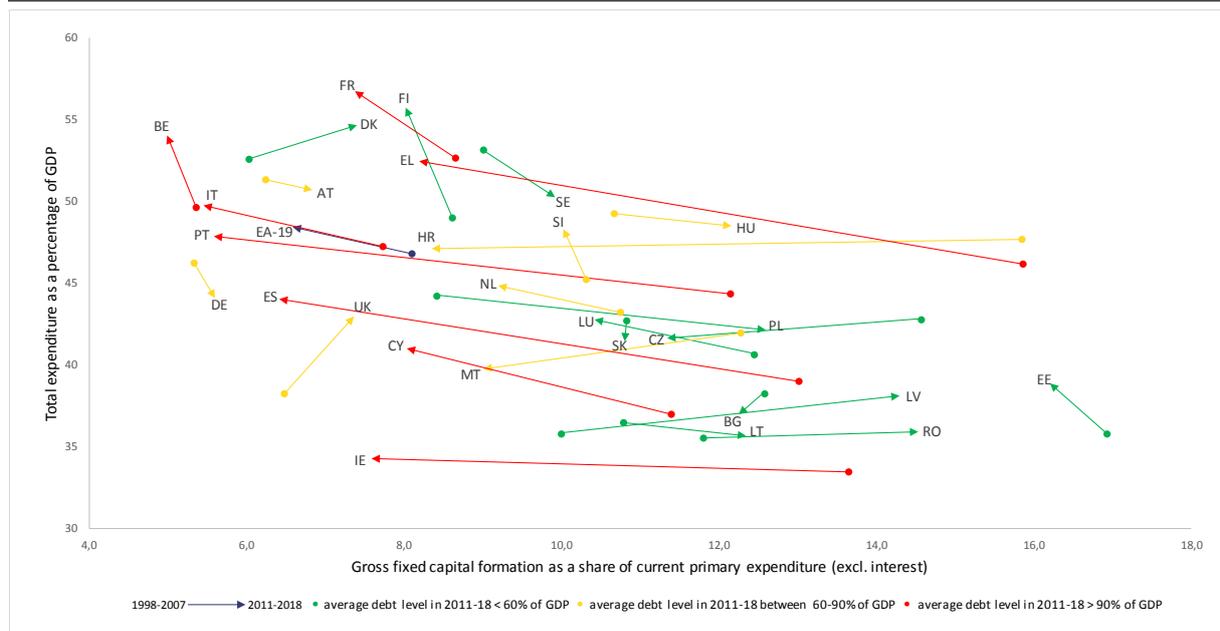
<sup>(91)</sup> European Fiscal Board (2018b), p.64.

<sup>(92)</sup> European Court of Auditors (2018b), p.69.

<sup>(93)</sup> European Commission (2018a), p.106.

<sup>(94)</sup> European Commission (2018a), p.106.

Graph 5.3: Size of government and public investment for EU Member States



(1) Data are averages for 1998-2007 compared to averages for 2011-2018 excluding the period 2008-2010. (2) No data available for HR for the period 1998-2000.  
**Source:** European Commission.

### 5.3. PUBLIC INVESTMENT

There is a recurring debate about the interplay between public investment and the EU fiscal rules, whose intensity has ratcheted up. In this section, we take a close look at the quality of public finances in order to obtain leads on how to revise the fiscal rules to encourage it. It would be important to assess the effects that different types of public investment have on the business cycle before relating them to the EU fiscal rules, but a consensus on this issue has yet to emerge. One point of view seems to be that certain types of 'productive' public investment should be taken into account when compliance with the EU fiscal rules is assessed due to their beneficial effects<sup>(96)</sup>. This argument is based on the premise that by increasing public investment, potential future output would increase. Earlier findings by the Economic Policy Committee Working Group suggested that Member States had indeed identified growth-enhancing areas like education, R&D and public infrastructure as expenditure priorities but that these tend to be crowded out by more pressing expenditure categories during the budgetary planning and execution phases<sup>(97)</sup>.

During periods of fiscal consolidation, public investment tends to bear the brunt of the

expenditure cuts because cutting public investment spending is politically and legislatively easier to implement compared to other spending categories that are deeply entrenched in the budgetary process<sup>(98)</sup>. In contrast to other fiscal consolidation instruments, reducing public investment can have a sizeable negative effect on economic activity in the short term, due to its large fiscal multiplier<sup>(99)</sup>. One view is that EU fiscal rules should not be agnostic about the treatment of public investment, and should rather encourage Member States to raise it<sup>(100)</sup>. Especially those countries with a lower level of gross fixed capital formation could reap large growth benefits from increases in public investment<sup>(101)</sup>. The other view is more cautious about the feasibility of the EU fiscal rules considering public investment. First, investment is one of the most pro-cyclical components of government spending<sup>(102)</sup>. Any conclusions about the stifling effects of fiscal rules on the level of public investment need to be interpreted with a necessary degree of caution. Second, a compliance assessment of the EU fiscal rules that takes public investment into account could create incentives for governments to reclassify current spending as public

<sup>(98)</sup> Kopits and Symansky (1998), p.12; Easterly et al. (2007); European Commission (2016c), p.74.

<sup>(99)</sup> Cournède et al. (2013), p. 22.

<sup>(100)</sup> See Blanchard and Giavazzi (2004); Pisani-Ferry (2019).

<sup>(101)</sup> Fournier (2016), p.13.

<sup>(102)</sup> Lane (2003), p.2668.

<sup>(96)</sup> OECD (2016), pp.63-99.; Easterly et al. (2007).

<sup>(97)</sup> Deroose and Kastrop (2008), p.14.

investment<sup>(103)</sup>. Third, the current way of governmental accounting does not sufficiently take into account the depreciation of public capital<sup>(104)</sup>. This could add another layer of complexity, because different countries face different absolute amounts of depreciation<sup>(105)</sup>. Proponents of this alternative view stress that there is no evidence that excluding public investment from fiscal targets would necessarily improve long-term economic performance<sup>(106)</sup>.

Graph 5.3 shows data for the size of government (i.e. the total expenditure as percentage of GDP) and public investment (i.e. gross fixed capital formation as a share of current primary expenditure excluding interest). It compares the averages for 2011-2018 with the averages for 1998-2007. Graph 5.3 indicates a broad tendency that smaller government correlates with a higher level of public investment as a share of current primary expenditure. For a given size of the government sector, a more efficient public good provision can free up resources for public investment.

Another striking picture that emerges from Graph 5.3 is that Member States subject to a financial assistance programme have seen their public investment shares declining. However, this decline in public investment viewed in isolation does not necessarily mean that it will be harmful. In certain cases, the quality of public investments was low, and decreasing its level might have gone hand in hand with increases in overall efficiency. The conditionality attached to financial assistance programmes has had a decisive impact on QPF, directly affecting the composition and efficiency of government spending. Juxtaposing Member States that have undergone a financial assistance programme (i.e. Greece, Portugal, Cyprus, Ireland and Spain) with very high debt Member States (i.e. Belgium, France and Italy) offers an instructive comparison. Despite excluding the global economic and financial crisis (2008-2010), in the very high debt countries (Belgium, France and Italy – marked in red in Graph 5.3) public investment to current primary expenditure has decreased on average between 2011 and 2018 compared to 1998-2007. However, the decrease in public investment is moderate when compared to the programme countries. This empirical evidence points to the

less beneficial side effects of rapid fiscal consolidation and highlights the crucial trade-off between cutting public investments or cutting social expenditures. Empirical analyses found that high debt levels tend to hamper public investment<sup>(107)</sup>. However, high quality institutions and strong fiscal rules can mitigate the dampening effect of high debt levels on public investment. Moreover, coordination failures between the different levels of government can contribute to low public investment. Sub-national levels of government are key providers of public investment with the capacity to identify investment needs at the regional level<sup>(108)</sup>. However, the central government is not exposed to the same biases as the sub-national levels. It might therefore be less prone to capture by local companies and thus can increase cost-efficiency<sup>(109)</sup>.

Low-debt countries tend to have smaller government and a higher level of public investment as a share of current primary expenditure. A small group of low-debt Nordic Member States (Denmark, Finland, Sweden) tends to have larger government combined with a lower level of public investment as a share of current primary expenditure. In these countries characterised by a well-functioning state capacity, higher spending might be less costly in terms of taxation and growth<sup>(110)</sup>.

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<sup>(107)</sup> Bacchiocchi et al. (2011); European Commission (2017), p.152.

<sup>(108)</sup> European Commission (2017), p.145.

<sup>(109)</sup> European Commission (2017), p.145.

<sup>(110)</sup> Cournède et al. (2018).

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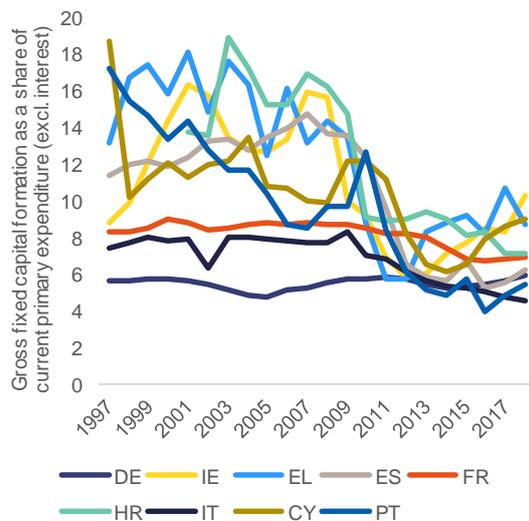
<sup>(103)</sup> Blanchard and Giavazzi (2004), p.9.

<sup>(104)</sup> Blanchard and Giavazzi (2004), p.4; see also European Commission (2016c), p. 70-73 for some statistical caveats applying to gross fixed capital formation.

<sup>(105)</sup> Perea and Valila (2005), p.9.

<sup>(106)</sup> Perea and Valila (2005), p.7.

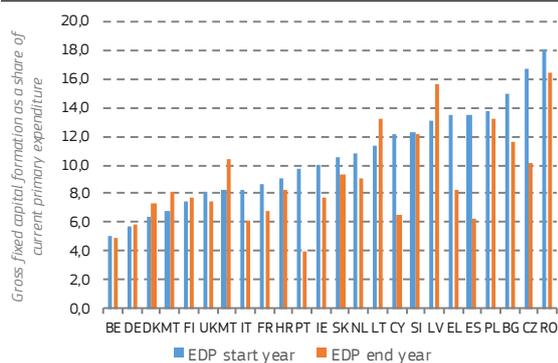
Graph 5.4: Public investment as a share of current primary expenditure, 1997-2018



Source: European Commission.

Member States under an EDP are bound to step up their efforts to correct their deficit. This might lead to significant reductions in gross fixed capital formation as a share of current primary expenditure during the period of the EDP. A closer look at the EDP procedures launched between 2008 and 2014 reveals that the initial level of public investment as a share of current primary expenditure matters for its future evolution during the period of the EDP.

Graph 5.5: Public investment as a share of current primary expenditure (first and last year of an EDP)



(1) Only EDPs launched between 2008 and 2014 are considered; (2) for MT, two EDPs were opened during the period; (3) The EDP periods correspond to the data presented in Table 3.6 of Chapter 3.

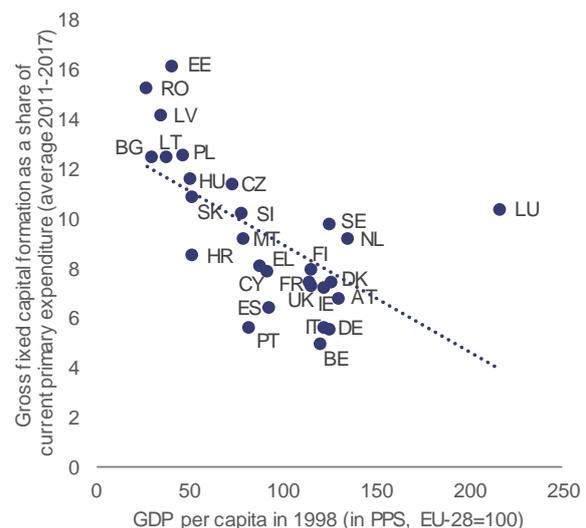
Source: European Commission.

Member States with high initial levels of public investment as a share of current primary expenditure during their first year under the EDP have a tendency to lower public investment by the end year of the EDP. However, Member States

with already low levels of public investment as a share of current primary expenditure try to keep them stable or reduce them only marginally. During the EDPs launched between 2008-2014 only Latvia, Lithuania, Malta, Denmark, Finland and Germany were able to increase public investment as a share of current primary expenditure when comparing the share during the first and the last year of the EDP. In sum, Graph 5.5 suggests that public investment can be quite vulnerable to the consolidation efforts during an EDP, depending on its initial level.

Graph 5.6 indicates that in newer Member States (Bulgaria, Czechia, Estonia, Croatia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Romania, Slovenia, Slovakia), the level of public investment as a share of current primary expenditure (on average between 2011-2017) has been high when plotted against their GDP per capita in 1998. This group of countries started from significantly lower levels of GDP per capita in 1998 (measured in purchasing power standard). Moreover, these countries had to address their public investment gap, given their low level of infrastructure development and public capital formation. Strong growth rates facilitated this 'catching up' process and helped to sustain the boost in public investment.

Graph 5.6: Public Investment (average 2011-2017) and GDP per capita (in 1998)



(1) GDP per capita in 1998 (in purchasing power standard (PPS), EU-28=100)

Source: European Commission.

Funds dispersed via the EU cohesion funds have also exerted a strong impact on public investment levels in certain Member States (whose gross national income per capita is below 90% of the EU

average), especially in the Western Balkan region. Any analysis of gross fixed capital formation in these countries needs to take this additional EU funding into account<sup>(111)</sup>. During the euro-area sovereign debt crisis from 2011 to 2013, the Commission accepted a reduction in the share of national co-financing of Member States, which led to an overall decrease in the amount of public investment<sup>(112)</sup>. However, it had the beneficial effect of enabling Member States to complete projects already started and improve their cash flow. Over time, the interlinkages between EU cohesion policy and the European Semester have increased through the CSRs. An indirect link with the EU fiscal framework exists because under certain conditions the Council can suspend the disbursement of cohesion funds.

Graph 5.6 also shows that Member States deeply affected by the euro-area sovereign debt crisis tend to be located below the trend line. Member States with a financial assistance programme had a higher GDP per capita in 1998 compared to new Member States but maintained much lower levels of public investment on average from 2011 to 2017.

Finally, the size of government measured as total expenditure as a percentage of GDP is another key dimension of QPF. A desirable level of public expenditure might lie in the range of 30-35% of GDP<sup>(113)</sup>. Very effective governments could even spend around 40% of GDP for equal income distribution<sup>(114)</sup>. If governments become relatively large, they run the risk of having to finance the excessive expenditures through new taxes, dragging on economic activity and growth. The problem in this regard is to address the trade-off between equity and efficiency. However, the size of government depends on various factors such as the state of ‘maturity’ and the level of openness of an economy<sup>(115)</sup>. This warrants an extremely cautious interpretation of these empirical findings.

An empirical study assessing the efficiency of public spending in 20 OECD countries has constructed a composite indicator of public sector efficiency that encompasses administration, education, health and infrastructure but also distribution, stabilisation, and economic performance<sup>(116)</sup>. It argues that overall, countries

with a higher level of expenditure perform less efficiently in these areas than countries with a lower level of public spending. However, country-specific factors need to be taken into account. Ultimately, the provision of public goods needs to reflect political preferences.

#### 5.4. EDUCATION SPENDING

Areas prone to market failure benefit from governmental intervention aimed at providing public goods and growth-enhancing services. Government spending on education is a case in point that deserves attention given its potentially large long-term impact on output. The literature on QPF uses a simple metric to determine the efficiency in a given spending category by comparing input and output (‘production efficiency’). An individual country’s performance is compared to the best performer. For education, the most commonly used measure of output is the PISA score, i.e. the Programme for International Student Assessment which evaluates the quality of different educational systems by testing students’ ability in science, mathematics and reading. A comprehensive QPF analysis tries to answer how output can be raised while keeping input constant. In contrast, measures of input efficiency assess how to maintain a constant level of output with reduced inputs.

Applied to education, a measure of input efficiency would show by how much education spending could be reduced without causing a reduction of the PISA score. The OECD found that for 2011 to 2015 the average share of total government expenditure on primary to tertiary education stayed relatively stable for OECD countries (around 11% of total government expenditure)<sup>(117)</sup>. However, this share decreased in half of the OECD countries, whereas ‘in others the share increased by more than 10% over the same period’<sup>(118)</sup>. When taking into account a longer time span between 2005 and 2015 that covers the 2008 global economic and financial crisis, the OECD found that ‘total public expenditure on primary to tertiary education as a percentage of total public expenditure decreased in two-thirds of OECD countries’<sup>(119)</sup>, although this could partly reflect the effects of ageing and the decline of fertility rates.

<sup>(111)</sup> European Commission (2016c), p.77-78.

<sup>(112)</sup> Berkowitz et al. (2015), p.13.

<sup>(113)</sup> Afonso and Schuknecht (2019); Tanzi and Schuknecht (2000).

<sup>(114)</sup> Afonso and Schuknecht (2019).

<sup>(115)</sup> See Rodrik (1998).

<sup>(116)</sup> Afonso and Kazemi (2017).

<sup>(117)</sup> OECD (2018), p.280.

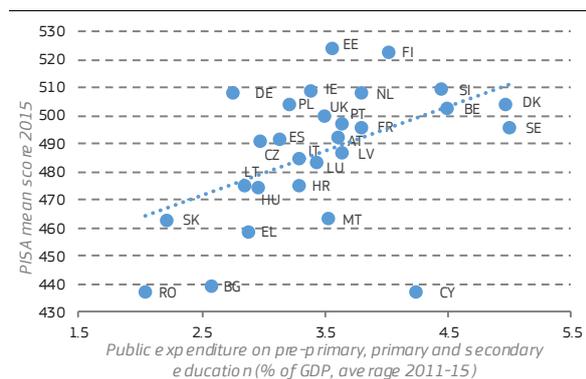
<sup>(118)</sup> OECD (2018), p.280.

<sup>(119)</sup> OECD (2018), p.283.

An earlier study<sup>(120)</sup> undertook a systematic comparison between the output (measured by the PISA score) and the inputs used (teachers per student, time spent at school) for 25 countries, while taking into account parents' educational attainment and a country's GDP per capita. The empirical evidence suggests that inefficiencies in education spending can be significant. These estimates indicate that an increase of 11.6% of the educational results could be achieved utilising the same input level. However, they caution that environmental factors such as household economic background (proxied as GDP per capita) and parents' educational attainment are highly correlated with output scores. The finding that considerable efficiency gains in public spending could be realised has been corroborated empirically<sup>(121)</sup>. One empirical study has constructed a composite indicator to measure public sector performance and efficiency of the 10 Member States that joined the EU on 1 May 2004<sup>(122)</sup>. This composite indicator encompassed among other factors information on administration, education and health. Supporting evidence was found for the claim that high education levels might boost public expenditure efficiency.

Given the importance of educational attainment for the long-run growth prospects of a country and the significant size of education spending in terms of GDP, this section tries to link empirically the level of public expenditure on education (in % of GDP) with a country's PISA mean score.

Graph 5.7: Public expenditure on pre-primary, primary and secondary education and educational attainment



(1) The PISA mean score is calculated as the unweighted average of the PISA scores in mathematics, science and reading.

Source: OECD and European Commission.

First, Graph 5.7 shows that PISA mean scores tend to be positively related to education spending. Second, in line with earlier findings, efficiency gains in education remain unexploited<sup>(123)</sup>. There was a wide dispersion of PISA mean scores among Member States in 2015. This holds true even when focussing on certain groups of countries with broadly similar levels of public expenditure on pre-primary, primary and secondary education (in % of GDP) on average from 2011 to 2015. Among the top performers are Estonia and Finland, but Germany and Poland too obtained high PISA mean scores in 2015 with relatively few inputs.

Overall, this sub-section has provided tentative evidence that further efficiency gains could be achieved in some countries. While fiscal rules cannot directly incentivize countries to enhance the efficiency of public expenditures, they can nonetheless indirectly affect the quality of public finances by changing the composition of public expenditures.

## 5.5. TAXATION

Taxation is the basis for providing public goods and services. Efficient taxation systems facilitate the redistribution of income in a growth-enhancing manner. They also address negative externalities and channel scarce resources into a specific direction, for example, as part of a wider industrial policy<sup>(124)</sup>. The structure and efficiency of revenue systems also have important repercussions for compliance with fiscal rules. First, efficient taxation systems have a greater capacity to generate a reliable stream of revenue and are therefore more conducive to the long-term objective of fiscal sustainability. Second, more efficient taxation systems are also less distortionary and are therefore growth-enhancing. Some Member States have implemented revenue rules at the national level that might also indirectly affect the quality of public finances<sup>(125)</sup>. In particular, tax reforms can reduce economic distortions and strengthen potential growth by combining lower tax rates with a broadened tax base<sup>(126)</sup>.

Graph 5.8 uses the 'paying taxes score', an index developed by the World Bank to measure the

<sup>(123)</sup> European Commission (2008), p.143.; Dutu and Sicari (2016), p.10-12.

<sup>(124)</sup> European Commission (2008), p.145.

<sup>(125)</sup> European Commission (2018b), p.133.

<sup>(126)</sup> European Commission (2008), p.169.

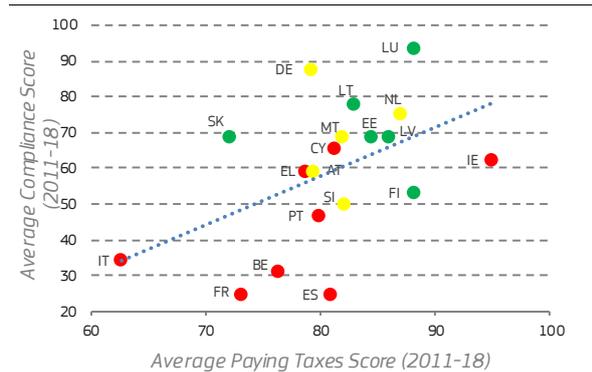
<sup>(120)</sup> Afonso and St. Aubyn (2006).

<sup>(121)</sup> Afonso, Schuknecht and Tanzi (2006).

<sup>(122)</sup> Afonso, Schuknecht and Tanzi (2006).

efficiency of a tax system. It measures ‘the different taxes and mandatory contributions that a medium-size company must pay in a given year, the administrative burden of paying taxes and contributions and the administrative burden of complying with two postfiling processes (VAT refund, and tax audit) per calendar year’<sup>(127)</sup>. The average index score for 2011-2018 is plotted against the average compliance score for the euro-area Member States with the four EU fiscal rules (deficit rule, debt rule, structural balance rule, and expenditure benchmark rule) for the same period. The picture that emerges points towards a positive relationship between the two indicators. Thus, the empirical evidence is in line with the hypothesis that a more efficient corporate revenue system correlates with better compliance with the EU fiscal rules. It highlights the importance of further improving the quality of public finances through structural reforms directed at the revenue system.

Graph 5.8: Efficiency of revenue system and compliance with EU fiscal rules



(1) The average compliance rate is the average percentage of compliance of a country with the four EU fiscal rules across the period. (2) The Paying Taxes Score is an index that measures (i) the total tax and contribution rate (the cost of all taxes borne, as a % of commercial profit), (ii) the time needed to comply with the major taxes (profit taxes, (iii) labour taxes and mandatory contributions, and consumption taxes), (iv) the number of tax payments and the post-filing index that measures the process of claiming a VAT refund and going through a corporate income tax audit. A higher Average Paying Taxes Score indicates a more efficient tax system.

Source: World Bank.

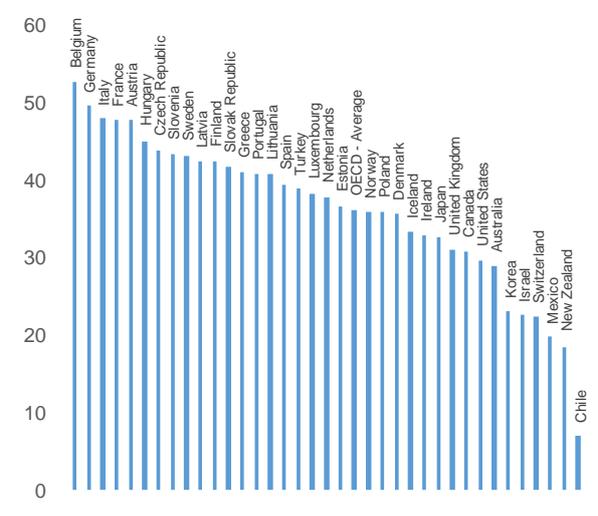
The tax wedge is the commonly used indicator to measure ‘the difference between the labour costs to the employer and the corresponding net take-home pay of the employee. It is calculated as the sum of the total personal income tax and social security contributions paid by employees and employers, minus cash benefits received, as a proportion of the total labour costs for employers’<sup>(128)</sup>.

<sup>(127)</sup> For more information on the methodology see: <http://www.doingbusiness.org/en/methodology/paying-taxes>

<sup>(128)</sup> OECD (2019), p.15.

Graph 5.9 shows the average tax wedge for a single person in 2018. Taxes on labour usually consist of the personal income tax, the employer and the employee social security contributions. The five highest average tax wedges for single persons earning 100% of the average wage in the private sector in 2018 were in Belgium, Germany, Italy, France and Austria. The lowest average tax wedges were in non-EU countries like Chile, New Zealand, Mexico, Switzerland and Israel. In general, a high tax wedge can create disincentives for supplying labour and could ultimately stifle a country’s growth prospects.

Graph 5.9: Average tax wedge, single person 100% of average gross wage in the private sector, 2018



(1) The tax wedge measures the difference between the labour costs to the employer and the corresponding net take-home pay of the employee. (2) No data are available for BG, CY, LT, MT, RO. Averages are unweighted.

Source: OECD.

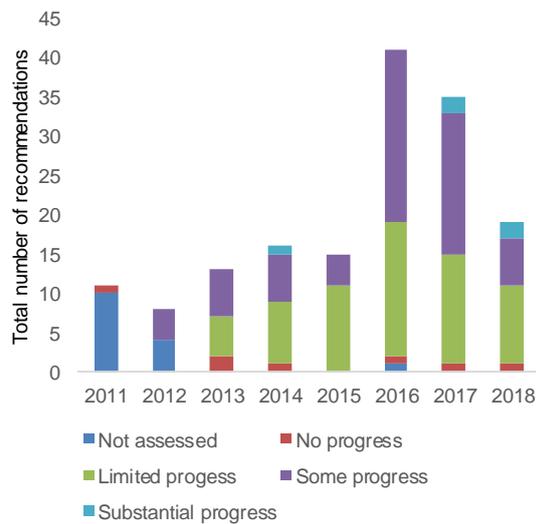
## 5.6. THE EUROPEAN SEMESTER AND THE QUALITY OF PUBLIC FINANCES

The European Semester is the main tool to improve the quality of public finances. In particular, the country-specific recommendations (CSRs) target, among other areas, public investment, education and taxation, as discussed in this chapter. While the previous sections have established the rationale for why these areas deserve particular attention, this sub-section takes a closer look at the implementation rate of the CSRs targeted at these three areas.

Graph 5.10 shows that the implementation rate of CSRs related to public investment is still low. Until 2015 the majority of CSRs on public investment

showed no or limited progress. The frequency of investment-related CSRs increased substantially in 2016, and about half of them showed some progress. After 2016 the absolute number of CSRs on investment declined again but stayed above the 2015 level. However, only a few CSRs indicate that substantial progress has been achieved.

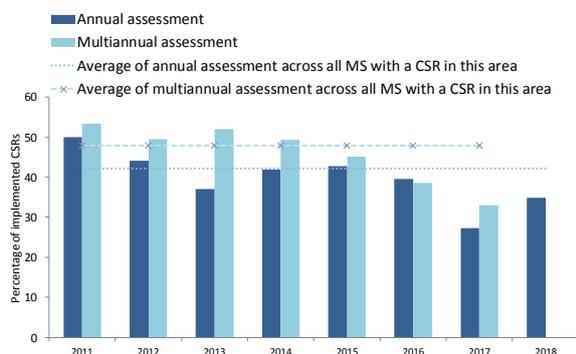
**Graph 5.10: Implementation assessment of CSRs on investment (2011-2018)**



*Source:* European Commission.

Graph 5.11 shows that the implementation rate of CSRs on education was high when the European Semester started in 2011. Since then, the implementation rate has gone down and reached its low point in 2017. The annual and the multiannual assessment in 2017 indicated that the implementation rate for education had dropped.

**Graph 5.11: Implementation assessment of CSRs on education (2011-2018)**

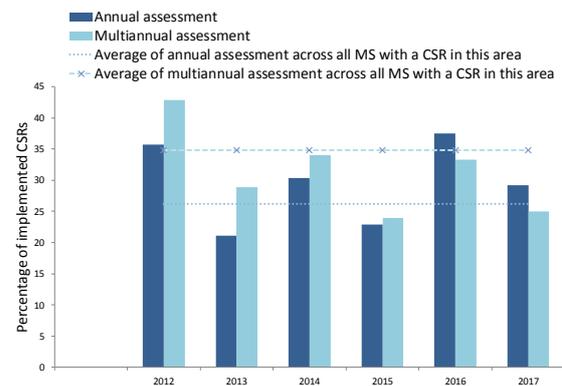


(1) 2011 annual assessment: Different CSR assessment categories. (2) The multiannual CSR assessment looks at implementation from the time the CSRs were first adopted in 2011 until the 2019 May Chapeau Communication.

*Source:* European Commission.

Graph 5.12 shows that the implementation rate of CSRs on broadening the tax bases is rather low. According to the annual assessment, only approximately one quarter of the CSRs on broadening the tax bases were implemented on average between 2012 and 2017. The annual CSR assessment is below average for 2013 and 2015.

**Graph 5.12: Implementation assessment of CSRs on broadening tax bases (2012-17)**



(1) The multiannual CSR assessment looks at implementation from the time the CSRs were first adopted in 2011 until the 2019 May Chapeau Communication.

*Source:* European Commission.

In sum, in spite of the beneficial effects on the long-term growth prospects that would ensue from a full implementation of the CSRs, their assessment in the areas of public investment, education and taxation shows that their implementation rate remains subdued.

## 6. POLICY RECOMMENDATIONS

### KEY FINDINGS

- The European Fiscal Board (EFB) identified multiple sources of unnecessary complexity, calling for a simplification of the existing EU fiscal framework.
- The sources of unnecessary complexity include: (i) an excessive reliance on unobservable indicators; (ii) badly timed use of flexibility encouraging pro-cyclical fiscal policy; (iii) a tendency towards postponing fiscal adjustments to the outer years of the stability and convergence programmes.
- In combination, these complexities have encouraged, and been reinforced by, increasing bilateralisation and a diminishing role for peer review in surveillance. Reverse qualified majority voting (RQMV) has also contributed to this trend.
- The EFB proposes to rely on a simple medium-term debt ceiling and one operational target, namely, a ceiling on the growth rate of primary expenditure net of discretionary revenue measures, and a general escape clause triggered based on independent economic judgement.
- Our proposal would link net primary expenditure growth to potential growth and would thus have a stabilising effect on the economy. It also strengthens medium-term budgetary planning by fixing the net primary expenditure growth ceiling for a period of three years.
- The rationale for introducing flexibility in the Stability and Growth Pact (SGP) was to reconcile stabilisation and sustainability, while improving the quality of public finances. This objective remains appropriate. However, it could be better achieved if the use of flexibility would be based exclusively on independent economic judgement.
- The Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission should play a more independent role, to be defined in secondary legislation, in carrying out economic analysis and providing advice to the College of Commissioners.
- RQMV should be abolished and a full-time chair of the Eurogroup, neither a serving Finance Minister nor a Commissioner, should be appointed.
- Financial sanctions in case of non-compliance with the EU fiscal framework have not worked because it is politically difficult to agree on them. Making access to funds from a potential central fiscal capacity conditional upon compliance with the EU fiscal rules could improve compliance.
- Going beyond uniform rules, medium-term debt targets could be made country-specific based on a mutual agreement between Member States covering a seven-year cycle, staggered against the multiannual financial framework of the EU. High-debt countries would commit to reduce their debt, and symmetrically low-debt countries would commit to increase growth-enhancing government expenditure, in particular those that have positive cross-border spillovers. The proposed agreement would effectively implement a euro area aggregate fiscal stance.
- The links between net expenditure growth and the macroeconomic imbalance procedure could be explored further.

## 6.1. OVERVIEW

Chapter 2 reviewed the motivations for the EU fiscal rules from the perspective of the Maastricht Treaty as well as from that of the six and two-pack reforms. Chapters 3-5 evaluated to what extent the latter have served the three purposes listed in the mandate given by the President of the European Commission to the European Fiscal Board (EFB) (Annex A), viz. to ensure the long-term sustainability of public finances; to stabilise economic activity in a counter-cyclical fashion; and to improve the quality of public finances. Our key findings are listed in some detail at the opening of each of the three chapters. At this point we simply refer to them briefly before turning to the forward-looking part of our mandate: to outline possible improvements in the design and implementation of the rules and in the governance framework within which they operate. Given the complexity of the current version of the rules, we have been specifically asked to look for simplifications.

The mandate presents significant challenges. In the absence of any well-defined counterfactual scenario of what might have happened in the absence of fiscal rules - or under the pre-crisis version of them - conclusions about their impact are necessarily tentative. Furthermore, with three major criteria, potentially in mutual conflict, to observe any overall evaluation becomes subjective, in particular since policy preferences are far from identical throughout the EU. We have relied largely on the original motivations for the rules, i.e. to strengthen sustainability as a primary objective. Finally, there are no easily identifiable links between the gradual modifications in the implementation of the rules over the past decade and the specific degree of attainment of the three main purposes. The complications introduced have, in our view, been well-intended and designed to achieve outcomes reflecting all three objectives. It is not surprising that they have not been fully successful.

The EFB, in trying to meet our challenging mandate, starts from the premise that well-designed fiscal rules can provide major positive contributions to national budgetary outcomes. This applies, a fortiori, when countries join a monetary union. On the one hand, in Economic and Monetary Union (EMU) public finance imbalances can no longer trigger the currency tensions which before EMU helped to incentivise fiscal and other policy adjustments. On the other hand, the tasks of stabilisation become more difficult, as spillovers of

national fiscal policies through demand effects and, particularly, through financial market linkages intensify. The potential tension between national political incentives and the union-wide interest in monitoring the coherence of national fiscal policies provides a constant challenge to the fiscal rules. Deeper integration, which could take the form of either extended coordination of national policies beyond the monetary area or some central fiscal capacity would, in an ideal world, be superior to a purely rules-based framework. But steps to deepen integration were not politically feasible nor were they generally regarded at Maastricht as economically essential to underpin EMU.

Despite our recognition of the potential importance of fiscal rules, the EFB does see clear limits to what they can achieve and the risk that they have become overloaded in recent years. We also note that the implementation of the rules has become a source of tension among groups of Member States as well as between them and the Commission. It is therefore high time to consider how they could be simplified and made more effective. Simplification is not, however, a panacea. It should be seen in the broader context of EU fiscal governance and of the largely unforeseen evolution of the general economic environment in recent years, marked by slow growth and extraordinarily low interest rates.

Looking at the first of the three criteria for evaluation suggests that on average the sustainability of public finances has improved since the six and two-pack reforms and against the backdrop of a protracted period of economic growth. It is a notable achievement that without exception EU national governments have by now complied with the excessive deficit procedure (EDP), that (headline) deficits have been reduced sharply from over 6% to below 1% of GDP on average since their peak of 2010, and that public debt ratios have on average edged downwards since 2014. 'Gross errors' in the evolution of public finances in the sense of the Treaty have been largely absent. Since we shall also argue below that the pace of debt reduction has been slower than desirable - and recommended - particularly in a few countries with very high debt, the view of improved sustainability as the overriding achievement of the reformed rules requires justification.

The six-pack reform was agreed in 2010 at a moment when the EU economies were beginning

to recover from crisis. Despite the relatively good times in the immediate pre-crisis years, most Member States had failed to build up fiscal buffers, while public debt ratios had stabilised around 60% of GDP as an average for the euro area. The downturn and the European Economic Recovery Plan of 2008-09 which - in an appropriate counter-cyclical way, but with too limited differentiation between weaker and stronger economies - had succeeded temporarily in mitigating its impact. But the average public debt ratio was approaching 90% of GDP, and, by 2010, the obvious vulnerabilities of public finances focused the minds of governments on giving priority to sustainability. The risk of a repetition of the perceived causes of the crisis and the need to dampen financial market concerns about the state of public finances fostered a rare degree of agreement among Member States to tighten the fiscal rules. The rapid deterioration of Greek public finances, as well as the prospect that private creditors might have to participate in the losses on sovereign debt, provided additional impulses to prudence, but also to strengthen the crisis-management tools through the set-up of the European Stability Mechanism (ESM). At the same time, the six-pack reform also introduced new elements of flexibility, such as the unusual events clause, an escape clause for severe economic downturns, as well as additional elements to be included under other relevant factors when deciding whether to open an EDP or not. For reasons that one may understand, these elements received less attention in the communication around the reform but formed the basis for subsequent reinterpretations of flexibility under the Stability and Growth Pact (SGP).

The reinforcement of sustainability in the early years after the reforms came, however, at a significant cost in terms of pro-cyclical fiscal policies in most Member States in 2011-13, failing to prevent what turned out to be the second - and uniquely European - dip into recession. As explained in Chapter 2, there were other causes as well: overly cautious monetary policies until mid-2012, and an underestimation of the impact of consolidation simultaneously in most Member States. Since 2014 the aggregate fiscal stance has been broadly neutral. While that has not been inappropriate for the period as a whole, the counter-cyclical measures that would have been advisable after economies had entered a more robust recovery by 2017-18 have been absent, risking a repeat of the years prior to the crisis of a

decade ago with reluctance to build up fiscal buffers.

On the basis of this very summary review of our analysis in Chapters 3 and 4, it is clear that improving sustainability and conducting counter-cyclical fiscal policies have at times been in conflict or priority was given to the first over the other. That was the case in 2011-13 when consolidation efforts were impressive - most of the longer-run improvements in sustainability date back to these years - but with high costs of pro-cyclicality. Less dramatically, the two objectives have been in conflict more recently; neither sustainability nor stabilisation was well served by the policies pursued, as pro-cyclical policies in countries with high debt weakened both objectives at the same time.

In view of the priority given to the sustainability objective, it is not surprising that pro-cyclical fiscal policies continued as before the reform. The latter delivered an outcome broadly in line with what was then aimed for. But, in retrospect, ways of simplifying the rules and addressing the trade-off between the objectives of sustainability and stabilisation would have been preferable.

The third criterion which we have been asked to apply in our assessment of the rules - whether they have improved the quality of public finances - is ambiguous and imprecise, particularly in view of different political preferences as to priorities in expenditure and tax policies between the Member States. EU fiscal rules have focused almost entirely on aggregates - public deficits and debt - leaving the allocative and distributional aspects of fiscal policies, central to national policy-making, in the hands of the Member States. The country-specific recommendations (CSRs) do address detailed proposals in these areas, but the CSRs do not have the force of commitments, ultimately backed up by the possibility of sanctions. Compliance has been disappointing - and increasingly so in recent years - despite the relevance of the CSRs for long-term economic performance.

Nevertheless, the fiscal rules have since 2015 aimed to offer some limited incentives to Member States to engage in structural reforms and public investment by linking the introduction of flexibility to structural reforms and the associated improvements in sustainability as well as to additional public investment to raise potential growth. Both elements have proved difficult to

apply *ex ante* and to monitor *ex post*; and both have been subject to a cap. The investment clause has been applicable only to countries with a sizeable negative output gap, currently not observed anywhere on the basis of the methodology agreed by the Council and the Commission. Neither the investment nor the structural reform clause has been much invoked. Instead, national governments have slowed down structural reform initiatives and postponed public investment. Statements by national policymakers have suggested the latter actions were to be at least partly attributable to the stringency of fiscal rules. This is hard to verify, but - at a minimum - one may conclude that the fiscal rules have not provided a visible protection for public investment over the past decade. It remains an open question - to which we return below in Section 6.4 - whether the rules could be made more suitable for that purpose.

Criteria for improving the functioning of the rules follow from the above review. Ideally the rules should retain the primary focus on sustainability for which they were designed, be directed at problem cases of very high debt, while allowing for counter-cyclical policies, and making a contribution to improving the quality of public finances. We are well aware that these general criteria give only limited guidance to efforts to reform and simplify them. We also recognise that they do not look very different from the motives that have guided the architects of the six and two-pack reforms, and subsequently the Commission's and implementation of the rules.

Yet reform and simplification of the fiscal rules have become highly controversial topics. We attribute this disaffection to two sets of factors. The first relates to a process of simplification, the outcome of which is difficult to predict; since the costs of living with an unreformed system currently remain manageable both to those Member States that argue for more laxity and those that want to apply the rules more strictly, there seems to be a propensity to defer reforms. The second factor, reinforcing the first, is that changes in the economic environment, and particularly in the perceptions of these changes, should be taken into account before embarking on the difficult process of not only simplifying, but also of updating the rules.

Although we have sympathy for this more encompassing view, we shall try to separate the two

perspectives, not only because our mandate refers specifically to simplification, but also because we believe that there is currently room for eliminating several of the complications introduced over the past decade. Simplification would be helpful even in the absence of other reforms of the EU fiscal framework.

The following sections of this chapter will first look at four sources of complexity in the rules that we propose to reduce in order to simplify and refocus them (6.2). We then present our main reform proposal of simplification: to move to a rules-based framework with one long-term anchor, one policy indicator and a general escape clause, the latter to be parsimoniously applied following a demarcation of the underlying independent economic analysis, the policy recommendation by the Commission and the ultimate decision by the Council (6.3). We also review the role of the national independent fiscal institutions (IFIs) in such a process. Our extension beyond a strict focus on simplification is made to consider a restrictive variant of the Golden Rule to protect growth-enhancing spending in areas of priority indicated by EU initiatives (6.4). In this context we underline the possible use of the special incentive to invest from the prospect of a more persistent low-interest rate environment in most Member States in the euro area. In a final Section (6.5) we look beyond the changes in secondary legislation, which would be sufficient to accommodate our earlier proposals, to the longer-run role of the Treaty-based reference values of 3% and 60% of GDP for public deficits and debt and the desirability of moving to a set of norms less uniform across Member States. We also look for an enhanced role of the currently less operational concepts in macroeconomic policy-making of the macroeconomic imbalance procedure (MIP) and of the euro area fiscal stance.

## **6.2. FOUR SOURCES OF UNNECESSARY COMPLEXITY IN THE CURRENT IMPLEMENTATION OF THE RULES**

The current implementation of the rules leaves an impression of precision and refinement, which goes well beyond what can be justified in view of the uncertain estimation methods and data on which it relies. We see four dimensions in an excessive pretension of completeness in country surveillance; though these dimensions interact and sometimes reinforce each other, they do have

separate characteristics. First, a prominent role for unobservable indicators and data subject to major revisions. Second, too much emphasis on annual, rather than longer-term, indicators of performance. Third, difficulties of getting the timing of flexibility and discretion right. Fourth, an increasingly bilateral process of surveillance, discouraging multilateral peer review. These weaknesses reflect ambitions to move beyond an initially oversimplified set of rules and applied as uniformly as possible in order to take into account implicitly or explicitly other objectives than the adjustments required to make public finances more sustainable and to build some country-specific features into the recommendations.

The first source of complexity is the reliance on unobservable indicators of fiscal performance. It was recognised already in the SGP reform of 2005 that there are solid economic arguments for preferring the use of the cyclically-adjusted, or structural, government deficit rather than the more readily observable headline deficit (see Chapter 2). Relying on the latter, which is cyclically sensitive, does not provide a measure of current policy efforts. Since some Member States from the start had become used to regarding the 3% of GDP reference value in the Treaty not as a ceiling, but as a target, the risk of more pro-cyclical policies by staying below the ceiling came to the fore. The potential inability to deal with adverse shocks in a regime focusing on the headline deficit achieved prominence. However, the estimation of the analytically superior structural deficit requires an assessment of the degree of resource utilisation in any given year, summarised in the output gap and budgetary elasticities. Meticulous work on estimating the output gap has been going on for two decades in the Commission and among national experts, refining the ‘commonly agreed methodology’ adopted already in 2002. Nevertheless, significant revisions continue to be made, and major errors of judgement have been observed in policy recommendations in either direction, particularly for smaller open economies for which capacity limits and full employment are relatively hard to define. Member States have seized upon the ambiguities of the output gap, taking the technical subject of individual adjustments onto the agenda of Ministers and other high-level officials.

The six and two-pack reforms already internalised the implication of these difficulties of relying on the structural deficit as the main policy indicator.

The six-pack reform proposed an expenditure benchmark as an alternative, which was at the same time closer to capturing the input into fiscal policy making and with fewer ambiguities of measurement. Unfortunately, with both indicators being in use, the expenditure benchmark has been used alongside the structural deficit, effectively allowing cherry-picking by Member States of the measure less unfavourable to the country concerned. We reviewed the relative stringency of the two indicators in Chapter 3. Although the expenditure benchmark also entails some measurement problems, we believe that moving to a single and better-defined indicator would reduce the risk of making wrong policy calls, while providing at the same time a more easily communicable message on the policy stance. Outside Ministries of Finance, in national parliaments and in the general public, the structural deficit has not become a familiar notion; a possible exception is Germany which pioneered its use in policy design. Even financial market analysts who devote considerable resources to evaluating euro area economic policies and performance, have not found guidance in the structural deficit in adjusting their expectations, as was one intention with the reform of the fiscal rules.

One may note, as an additional argument for downgrading the structural deficit as a major policy indicator that the link from the output gap to changes in the inflation rate appears to have considerably weakened over the past decade. Inflation in the euro area, as in other industrial countries, has remained very low despite the output gap apparently moving into positive territory in the course of 2017-18. Central banks have drawn the conclusion that the size - and even the sign - of the output gap has become less relevant to the monetary policy stance than earlier assumed; the focus in monetary targeting is now more firmly on the inflation rate. The role of the output gap in monetary and fiscal policy may not necessarily be the same; yet this observation tends to further undermine the role of the output gap and of indicators based on it in shaping policy recommendations.

Along with the downgrading of the structural deficit for the implementation of the fiscal rules the matrix of requirements introduced by the Commission in 2015 as an element of flexibility should also be disposed of. Depending on the size of the output gap and the debt level the approach varies the required speed of adjustment of Member

States to their respective medium-term objectives (MTO). As shown in Chapter 3 the approach has failed to carry through a careful differentiation of recommendations to better reconcile sustainability and stabilisation objectives, which was the main intention of the approach. Hence, the consequences of eliminating the matrix of requirements would be modest.

The second source of complexity is associated with the reliance on annual, rather than longer-term indicators. There is an understandable attachment to the annual headline budget deficit in the fiscal rules; it is easily observable and the national government can be seen as directly accountable for it, even though the headline deficit is subject to cyclical fluctuations beyond its control. Even for those who want to put the main emphasis on the evolution of public debt, the annual budget balance is arguably essential for steering the debt. However, focus on medium-term budget plans would be more appropriate and less subject to revisions and efforts at intrusive management as the economic outlook changes. But we recognise that extending the focus to medium-term budget plans meets the objection that national budgetary practice is concentrated on the annual finance bill; medium-term plans are likely to be overridden. The annual stability and convergence programmes (SCP) of Member States do contain data for the fiscal outlook for three years ahead, typically illustrating a propensity to backload a major part of fiscal adjustments to later years in the outlook, e.g. 2021-22 in the 2019 Commission SCP reports. Figures for the outer years do not seem to be taken very seriously by most national authorities.

We see another argument in favour of downgrading the annual headline deficit. In the most recent years with all countries below the 3% of GDP reference value, the latter has become a soft, almost irrelevant indicator. The reasons for not suggesting doing away with it altogether are partly that it has the high status of a Treaty objective and that it has become the most familiar feature in the fiscal rulebook, having played an important historical role in the policy adjustments after the crisis. National policy makers tell us that it has been a significant element, easily communicable to the general public. While we see the case for more differentiated reference values for deficits and debt in the Treaty Protocol and return to it in our long-run scenario in Section 6.5, we believe that while the 3% of GDP reference value may continue to be less relevant than in the

past, there is no point in trying to eliminate it in the single-anchor framework we propose in Section 6.3.

A third source of complexity is that the Commission - and the Council - have had difficulties in getting the timing of the flexibility introduced from 2015 right. The intention, as analysed in the EFB annual report 2017, was to reconcile continuing consolidation better with stabilisation objectives than had been the case in the pro-cyclical contraction of 2011-13, while also making some limited allowance for improving the quality of public finances. These intentions were entirely appropriate, but flexibility came rather late in the recovery, encouraging some pro-cyclical policies. The departures from broadly neutral policies in the aggregate for the euro area were modest, but they created more leeway for vulnerable Member States to pursue expansionary policies than seems appropriate not only in retrospect, but also on the basis of the information available in real time.

In 2017 the Commission proposed an additional element of flexibility, the margin of discretion. The basic criterion was whether the recovery of a Member State could be considered still 'fragile' or not. The intuition was sound, namely, to address more explicitly the needs to consolidate in high-debt countries and to underpin the continuation of the recovery. However, the approach did not win favour with Member States, and the Commission chose to apply it only for 2018. One reason was that the initiative of the margin of discretion came on top of an existing, already substantial, scope for flexible implementation rather than as a substitute for it. In 2018 the Commission even applied additional discretion beyond the margins discussed with the Member States.

The criterion of fragility introduced an element of economic judgement, which in the current context opened the door to more political discretion. The EFB regarded the approach as promising; if appropriately underpinned by independent economic analysis, it could form the basis for designing the general escape clause proposed in Section 6.3.

This experience provides a lead into the complications, which have crept into the fiscal rules: increasing bilateral implementation with the associated weakening of the transparency and the multilateral peer pressure element in the rules,

supplied by other Member States. We regard this source of complication as both a consequence of and as the most serious concern in the current implementation of the fiscal rules.

In our reviews of the detailed experience in recent years in the EFB annual report 2017 and 2018 we have tried to understand how the rules were applied. The available documentation is very rich, yet it leaves several questions as to how particular recommendations were justified by the Commission and approved by the Council. Cumulatively they have amounted to a shift towards increasing the weight of sustaining the recovery in a trade-off with sustainability. Some Member States have begun to incorporate the notion of ‘broad compliance’ as a well-established right to be used in budgeting, rather as a possibility to be asked for ex post. The Commission has added to its scope for discretion in taking particular national circumstances into account. The accumulation of the increasingly specific decisions has been codified into an extended rule book in an effort by the Commission, and encouraged by Member States, in itself laudable, to document all precedents for the future and create a comprehensive catalogue for all circumstances that have arisen in the past.

Surveillance of compliance and of the need to codify the fiscal rules further has, however, become increasingly based on negotiations between the Commission and the Member States concerned and correspondingly harder to follow with the time and attention required by the Eurogroup and the committees preparing its meetings. Discussion of the Commission's recommendations in the Eurogroup itself have reportedly become more perfunctory than was the case in the first decade and a half of the euro. The members of the EFB have, obviously not been able to personally observe this tendency, reported to us while collecting oral evidence from a number of present and past officials who were attending the meetings.

The Commission has correctly underlined that there have so far been no examples of the Eurogroup not endorsing recommendations to implement the fiscal rules. Nevertheless, critical statements by national officials after Eurogroup meetings have often left the impression that the decisions taken were controversial. This divergence reflects, in our view, that the decision-making process has, for both practical and formal reasons,

become stacked in favour of adopting the Commission's proposals.

As to the practical reason, with the growing complexity it has become more than difficult for national Finance Ministers, who also today typically serve for shorter periods than in the past - and therefore do not have the long experience and the collegial relationships of their predecessors – to invest the time to challenge the outcome of the Commission's bilateral negotiations with a government. The focus of Eurogroup participants and of their advisers has tended to shift towards the potential implications any single recommendation might have for their own country, rather than remaining on the specific decision itself and on the rules as such.

As to the more formal reason, the change in voting introduced with the six-pack reform appears to have modified attitudes to the decision-making process, particularly in the Commission. In the light of earlier difficulties of reaching decisions on policy recommendations in the Council – the failure to adopt the Commission's recommended policy actions for Germany and France in 2003 – the six-pack reform introduced the principle of reverse qualified majority voting (RQMV). Henceforth it would require a qualified majority of voting Member States to overturn a Commission recommendation. Most observers expected this to lead to quasi-automatic adoption of proposals to implement the stricter rules of the six-pack, with the Commission acting in the classical role of ‘guardian of the Treaty’. While RQMV only applies to the decision to impose sanctions, which have yet to be experienced – the intention was to introduce a more decisive role for the Commission throughout the preventive and corrective arm of the SGP. That expectation has been met, but in a different way from what was foreseen. The Commission has increasingly emphasised its role as primarily a political body, accountable to the European Parliament in the implementation of the fiscal rules, rather than the role as straightforward guardian of the Treaty.

This evolution of the Commission into a more political body may not be regarded as controversial in itself, but it does raise two important concerns. The first is that the distinction between the economic analysis and the policy recommendations on the fiscal adjustment, on the one hand, and, on the other hand, the considerations which the Commission and the Council as political bodies

apply in supplementing and overriding the economic analysis, has become blurred. The second concern is that the only body where the political considerations are really debated seems to have become the College of Commissioners with the Council/Eurogroup largely endorsing recommendations. The Commission has absorbed space on either side of its necessary – and perfectly legitimate – role in formulating recommendations that take into account both the economic and the political inputs into decision-making. There is insufficient distinction between the more independent economic analysis which is available through the Commission's expert staff, mainly in the Directorate-General for Economic and Financial Affairs (DG ECFIN), and deliberations in the College of Commissioners; and the Eurogroup has for practical and formal reasons become less inclined to become involved in peer review and in decisions on the implementation of the fiscal rules.

Two steps that would redraw the balance between the Commission and the Eurogroup would be to abandon the RQMV and to nominate a full-time President of the Eurogroup who is neither a national Finance Minister nor a member of the Commission. A demarcation among economic analysis, policy advice based on it, and potential broader political considerations would also be of great importance. A necessary condition could be met by according more autonomy to the Commission's expert staff in DG ECFIN in secondary legislation. Concretely, DG ECFIN would conduct a fully independent analysis accompanied by policy conclusions that would be made public. The College of Commissioners would use this as an input to its recommendations to the Council.

The EFB believes that there have been important interactions between the governance framework and the increasing complexity analysed earlier. We try to address the sources of complexity first in Section 6.3 by a minimalist proposal, primarily to address more efficiently and transparently the sustainability-stabilisation trade-off. We then extend the proposal by reviewing the implications of the changing economic environment – inadequate growth of the capital stock and monetary accommodation – in the Sections 6.4 and 6.5.

### 6.3. A CEILING ON NET PUBLIC EXPENDITURES

An earlier version of our main proposal was first presented in the EFB annual report 2018. We envisage a single fiscal anchor – a debt ratio objective and a declining path towards it – a single indicator of fiscal performance – a ceiling on the growth rate of net primary expenditures for countries with debt in excess of 60% of GDP – and a general escape clause, parsimoniously applied and triggered on the basis of an advice based on an independent economic analysis, provided both by the IFI of the country concerned and a more autonomous Commission staff. These general ideas are close to proposals made by a number of independent economists as well as by international institutions (IMF, OECD and ECB)<sup>(129)</sup>, indicating some convergence of ideas as to how the fiscal rules could be reformed. Concretely, 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 range of its long-run objective within a given maximum number of years. Member States with a debt ratio below 60% of GDP would not be subject to a net expenditure ceiling, but would still have to observe the 3% deficit.

The proposed reform would significantly reduce most of the sources of complexity outlined in the previous section. As regards unobservability, both debt and net primary expenditure growth are largely observable. The latter is under the control of the government, recalling that debt servicing costs and unemployment benefit payments (at unchanged rates) are excluded. Expenditure growth is further adjusted for the impact of discretionary changes in public revenues, i.e. in direct and indirect tax rates, a correction that does involve estimates rather than firm data. The trend growth rate of potential output moves slowly and is not subject to the revisions of annual estimates of the level of potential output (and the distance to actual GDP)<sup>(130)</sup>. As regards the short-termism implied by the present reliance on annual data, we propose to correct that by setting the ceiling of net expenditure growth for a period of three years, after which the ceiling is calculated anew. Though

<sup>(129)</sup> Other contributions have also proposed a net expenditure growth rule, usually in combination with a long-run debt target. Examples are Bénassy-Quéré et al. (2018, 2019), Darvas et al. (2018), Eyraud et al. (2018), EFB (2018b), Feld et al. (2018), Heinemann (2018), and Kopits (2018).

<sup>(130)</sup> See Darvas, Martin, and Ragot (2018), p.6 and footnote 15; also see Darvas and Simon (2015).

monitoring would continue to be annual, the medium-term horizon would provide incentives to governments to look beyond the coming year.

Our proposal should also reduce the need for the flexibility of implementation the Commission has developed with increasing difficulties of getting the timing right. The net primary expenditure ceiling has a built-in automatic stabilising property: when actual output grows more slowly than at the trend rate of potential output, net primary expenditure growth will exceed the latter, while a rising expenditure to GDP ratio will help to stabilise the economy; vice versa, when actual GDP grows faster than trend, net expenditures will shrink as a share of GDP. These smoothing effects may be enlarged when the impact on inflation is taken into account. We also envisage a compensation account in which deviations from planned net primary expenditure growth are accumulated and which is subject to some maximum and a requirement to de-cumulate in the case of windfall gain. Increases in the compensation account can only occur as a result of unexpectedly adverse developments and should not be planned in advance.

Finally, our proposed reform should reduce the lack of transparency which has come to mark recent implementation. The simplicity of the policy indicator relative to the structural and less observable ones currently used will help in this regard. It will become more difficult for policy-makers to turn a blind eye to required adjustments by referring to uncertainties and by raising technical measurement issues.

We recognise one objection to our proposal: reducing the expenditure ceiling to bring about a convergence to the 60% of GDP debt norm in the Treaty over a relatively short time span of, say, 15 or 20 years (as envisaged in the current rule) during a period of modest growth would represent an adjustment effort larger than observed internationally in the past<sup>(131)</sup>. The simulations in the EFB 2018 annual report suggest e.g. that Italy and Portugal would have to run primary budget surpluses – the metric usually chosen in adjustment programmes - in the order of 4-5% of GDP over a decade or more to follow the debt reduction path outlined. This estimate may be regarded as too pessimistic in the sense that it regards the average debt servicing costs of highly-indebted countries as

<sup>(131)</sup> In fact, Eichengreen and Panizza (2014) show that historical episodes of extended periods of such high primary surpluses are rare.

independent of the path of their respective debt ratios, while a gradual decline of these costs could be expected when a country embarks on a credible debt reduction path. Nevertheless, the question whether the proposed debt path is economically and politically feasible must be addressed, and subjected to an independent economic evaluation taking into account the trade-off of the expected gains in output and the risks attached to slower improvements in sustainability that would follow the application of the clause (see Section 6.2). Independent analysis, both by the national IFI concerned and by the Commission staff with the assurance of better demarcation vis-à-vis political considerations, would be required, though our proposal for an expenditure rule should in itself reduce the need for the clause relative to the present system.

In the present context, sanctions have been very difficult to enforce. One proposal that the EFB made in the 2017 annual report, is to substitute financial sanctions by providing countries with an incentive to maintain or obtain access to joint facilities. This has already been done with respect to the precautionary facilities of the ESM. In our proposal, conditionality could also refer to accession of an eventual common fiscal capacity built as a result of a rainy day fund.

#### 6.4. PROTECTING PUBLIC INVESTMENT

Chapter 5 reviewed whether the fiscal rules could be shown to have improved the quality of public finance, concluding that (gross) public investment had been cut disproportionately relative to other categories of expenditure – public consumption and wages as well transfers - during the crisis and that it was only just recovering towards pre-crisis levels. Measuring the value of the stock of public assets is highly uncertain, but it is clear that not only has new investment been postponed; the maintenance of parts of the public capital stock has also lagged. This is a major concern at a time when trend growth of GDP in the euro area and, in particular, the contribution to it of rising productivity, remain modest. Furthermore, in addition to its role in raising the longer-term growth prospects, most public investment can also be shown to have a larger impact - multiplier effect - on demand than other categories of public expenditures. The incentives to encourage investment through the flexibility provisions of the fiscal rules have been little used and too modest.

Could more be done and, if so, without recreating complexities of the kind that have eroded respect for the rules?

Extraordinary and unforeseen changes in the economic environment, notably in the shape of the prospect of a longer period with very low interest rates, have added urgency to finding a response to this question. The low cost of debt servicing has provided direct support to the strengthening of public finances; if a country with a public debt roughly the size of its GDP experiences a reduction of its average debt serving costs of, say, 2 percentage points, that translates into a cut of 2% of GDP in the deficit and debt ratio. At the margin, where the interest rate on newly-issued sovereign debt is currently slightly negative for maturities up to 10 years for several euro area countries, the outlook offers strong incentives for a reallocation of expenditures in favour of investment that can be presumed to yield a higher return. The financing conditions also raise questions as to the relevance of historical notions of what constitutes a sustainable level of public debt. There is little evidence that this reasoning has had an impact on the composition of public expenditures. However, listening to the debate of policy officials and in the general public we are keenly aware that there is a new readiness to look at the fiscal rules also from this recent, but at a minimum more than temporary, change in the economic environment. Accordingly, the issue whether introducing some version of the Golden Rule into the fiscal rulebook to encourage public investment beyond what the market conditions already provide might now have become justified.

There are two important arguments to warn against the positive answer that seems intuitively right. The first, and most significant, is that getting involved into the allocation of public expenditures in individual Member States would mark a step beyond the focus on aggregates – deficits and debt – which have been a basic premise in the respect for national sovereignty in the EU integration process. However well-intentioned, more micromanagement from the EU could be seen as unduly paternalistic by national authorities and the public. The second argument is that a Golden Rule would provide incentives for national governments to try to modify their accounts to bring additional expenditures into the favoured investment category, hence enhancing sustainability concerns without generating future returns to alleviate them.

We fully recognise these arguments, but solutions could be found to mitigate their strength. The EU budget contains provisions for encouraging investment and other growth-enhancing spending in well-defined areas which could be relied on for demarcating more specifically the categories of expenditures which would qualify under a Golden Rule, be open to monitoring, and presumably have the potential to enhance growth. The fear that national governments would have an informational advantage over EU institutions - the Commission, Eurostat and the European Court of Auditors - in designing their fiscal accounts to suit purposes beyond investment could be further mitigated by giving also the independent fiscal institutions (IFIs), which are familiar with the public accounts in their respective countries, a mandate to express an opinion on a governmental request.

More specifically, the EU budget has already identified national investment projects that are considered growth-enhancing and adding pan-European value added. These projects include investments in physical and digital infrastructure, mitigation of climate change etc. National co-financing for these projects is already excluded in the current rules in the calculation of the investment clause. Our proposal is to allow countries that voluntarily top up expenditures on projects thus identified beyond their co-financing commitments - and agree to subject themselves to enhanced scrutiny by the Commission - to deduct such additional spending from the calculation of the net primary expenditures we have outlined in the previous section.

A crucial element in evaluating whether to add the above version of a Golden Rule to our simplified proposal in the previous section is the expected duration of the extraordinary environment of low interest rates. EMU was presented from the start as the road to an investment-friendly regime of low and stable interest rates - with the proviso that prudent fiscal policies would be required to underpin the regime. The first part of the promised package is currently being delivered in increasing abundance, but public investment has been barely sufficient to sustain a trend rate of growth of more than about 1.5% per annum for the euro area as an average. This is clearly a much wider problem than can be addressed through adding elements of incentives to raise public investment through modifications of the fiscal rules. Not least, if the reformed rules were adopted and worked as hoped for, they would benefit primarily the currently

seven countries in the euro area with debt (well) above the 60% of GDP norm. Discussing the possible application of a Golden Rule inevitably raises the issue that applying flexibility does not directly affect the majority of Member States that do not have fiscal sustainability concerns. The countries for which the current low-interest environment offers substantial budgetary relief are those that need a Golden Rule the least.

Like the rules themselves, suggested modifications to them, including those here presented, carry an in-built asymmetry through their focus on sustainability. Nominal interest rates are well below the modest growth rates in the countries with the most solid fiscal positions – Germany and the Netherlands – and far below recent nominal growth in a number of euro area Member States. This situation would offer an opportunity especially to lower debt countries to improve public finances by increasing public investment. But the main beneficiaries of this so-called ‘snowball effect’ have so far not responded to the additional fiscal space created. We return to this subject of (a)symmetry in the next section where we speculate more freely on how a revised rules-based framework could look after the deepening of EMU.

## 6.5. GOING BEYOND UNIFORM RULES

We have maintained the focus of the fiscal rules as outlined in our mandate - to strengthen sustainability, while allowing for a stabilising role for national fiscal policies and trying to improve the quality of public finances - throughout the previous sections, including in our proposal for a reform of the rules. This has proved to be an ambitious task. Yet we want, in this final section of our policy recommendations, to engage in a few reflections on how the rules and the parameters in the Stability and Growth Pact might be modified in a deepened EMU.

We see a mutual relationship between the fiscal rules and the less formal commitment to coordinate and monitor policies in other areas than fiscal policies and, of course, the already fully joint monetary policy, the main achievement of EMU. Arguably, because these other policy areas are subject to only more informal efforts at coordination, effectively to mutual persuasion and peer review, an inclination to do as much as possible through the current fiscal rules is

understandable. But that also risks to overload the rules when they are put at the service of objectives as well as national preferences that are both difficult to reconcile. Effective attainment of multiple objectives is, in principle, limited to the set of policy instruments available. This is aggravated if these instruments are constrained by rules and suffer from the double challenge of on the one hand trying to sustain as much uniformity of rules across national borders as possible and on the other hand of reconciling the sum of national policy recommendations with an appropriate aggregate performance of the euro area.

Attaching operational meaning to aggregate concepts for a heterogeneous euro area will remain more than difficult. The macroeconomic imbalance procedure (MIP) and the euro area fiscal stance were both introduced as important and innovative elements of the six-pack reform, but both have remained largely dormant in shaping policy, which is why we have hardly referred to them in our assessment of the reforms. The MIP appears to have helped to make structural deficiencies in the economies of Member States more transparent, but the basic idea that it would be useful to consider the (im)balance between private savings and investment and hence the current external account when discussing fiscal issues and the associated sanctions for excessive imbalances has not been followed up. Furthermore, the implementation of the fiscal rules remains separate, also in organisation, from the MIP.

Raising the question of the appropriateness of the sum of national recommendations from the viewpoint of an aggregate fiscal stance, suitable also in the policy mix with the single monetary policy, has retained an abstract air due to the heterogeneity of the euro area. No doubt for that reason, it has been difficult to avoid the bland conclusion in the Council that a broadly neutral stance is appropriate, adding that it has to be suitably differentiated between Member States. When the Maastricht Treaty was signed, a primary concern was that the Commission and the Council should focus entirely on national economic performance and policy recommendations, and the ECB only on the euro area aggregates. Such a division of labour would minimise the risk of fiscal dominance through policy coordination between the monetary and the political authorities. Perceptions have changed; since 2014 the ECB, which is protected by the division of authority, has been asking for more support from fiscal policy to

correct internal divergence and to stabilise the euro area as a whole.

Could this combined challenge be met by going further in revising fiscal rules and governance than we have discussed so far? We take note of recent decisions not to move in any nearer-term future towards an EU budget with a sizeable central fiscal capacity for stabilisation, subject to appropriate conditionality for participation. Such a capacity would, in our view, have been desirable for both sharing and reducing risk, alleviating the problems of sustainability in vulnerable Member States and sparing others from considering other crisis management measures under duress in case of a significant downturn. A temporary slowdown of activity could still be handled primarily by national fiscal stabilisers. But in the absence of more centralised initiatives, and keeping in mind the tendency for the application of fiscal rules to be overloaded, the only way forward appears to be to give more concrete meaning to the notion of coordination beyond the current fiscal rules and to focus on more symmetry in reactions than on uniformity of rules, including the Treaty reference values for deficits and debt.

We have argued that the 3% of GDP deficit value should be regarded as a ceiling and not as a target. Its role as a debt stabilising indicator however has gradually become less important. This is because the rule mirrors the economic circumstances prevailing at the time of its creation. Against the backdrop of a changed economic environment, the 3% of GDP reference value for the deficit is effectively no longer a constraint on debt developments. Despite its diminished relevance, the 3% of GDP deficit rule has turned into a focal point for policy-makers and the public at large. This trade-off should be taken into account when discussing potential reform proposals.

The 60% of GDP debt reference value requires more discussion. This norm is, indeed, to a large degree arbitrary, although not obviously unreasonable in the light of both economic analysis and documented experience. But it, too, suffers from the risk of lapsing into irrelevance, directly for those who are well below it and likely to drop even further, indirectly for the seven high, or very high-debt countries for whom it looks unattainable over even a long time span. Their focus has to be not the level of the objective, but the pace of approaching it – the ‘satisfactory pace’ in the language of the Treaty. The six-pack reform aimed

to operationalise it and it is today the main constraint on national policies in several countries. Our main proposal is an effort to improve the current implementation of such a debt-reduction strategy.

However, and more radically as an extension of our analysis of the sustainability and investment-capacity of Member States, the adjustment of public debt could be made country-specific, either by changing the reference values of the Treaty protocol, or by differentiating the speed of adjustment towards the current debt reference value<sup>(132)</sup>. Such differentiation would rely on demographic factors underlying differences in saving, pension systems etc., already central components in the Commission's assessment of sustainability and of the reports of the Economic Policy Committee. Crucially, the countries currently not subject to any debt reduction rule would also go through this procedure, making it fully symmetric. Building on our proposal in Section 6.4 to provide for more incentives for investment, the benefits of particularly low borrowing costs enjoyed by the fiscally soundest countries, there would be a commitment by them to undertake additional net public investment, prioritised also at the EU level. The prominence of new commonly agreed national debt targets should be raised above that of the MTO into EU law to minimise the risk of any perceptions of laxity. The challenge is to make the differentiated national targets credible as an undertaking, raising public ownership and facilitating communication with national parliaments and public opinion. The targets should be truly multilateral agreements, prepared obviously by the Commission and the government, the latter incorporating the views of its IFI, and adopted after careful review by the Council. The process would in some ways resemble the negotiations of the multiannual financial framework (MFF). It could also be carried out in a similar seven-year cycle, and in the middle of the MFF span, to avoid interference in the EU budget negotiations.

The symmetry in the process would be met by a commitment of high-debt countries to a net public expenditure path for the coming seven years,

<sup>(132)</sup> The modification of the reference values for the debt and the deficit can be done without going through the involved procedure foreseen for Treaty changes. The deficit and debt reference value of the SGP are defined in Protocol 12 of the Treaty on the Functioning of the European Union, which can be amended with a unanimous decision of the Council, still demanding but less than a full Treaty change.

matched by commitments by Member States in strong fiscal positions to a binding net expenditure path, which includes growth-enhancing public investments with cross border effects. A period of seven years for fixing net expenditure growth paths may seem rather long, as the economic outlook may fundamentally change over such a long period. However, flexibility is provided by the escape clause in response to unforeseen economic developments. In addition, debt targets could be revised by mutual agreement after a midterm review. As already mentioned, the MIP and the assessment of the appropriateness of the euro area fiscal stance would fit very meaningfully into such a pattern of negotiations and commitment. Countries with high current account deficits would limit their expenditure targets more, while countries with an excessive external surplus would be presumed to step up the rate of expenditure growth. This proposed closer integration of the fiscal with the macroeconomic considerations would be difficult to achieve, but would constitute a significant step towards a truly coordinated policy approach in the euro area. It could also take into account longer macroeconomic cycles and the prospects of continued monetary accommodation and interest rates near the zero lower bound.

## GLOSSARY

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

**Budget semi-elasticity:** The change of the *budget balance-to-GDP ratio* to a cyclical change of GDP. The estimates of the budget semi-elasticity used for EU fiscal surveillance purposes are derived from an agreed methodology developed by the OECD. The average semi-elasticity for the EU as a whole is 0.5.

**Constrained judgement:** A two-step approach that allows the Commission — under specific circumstances — to depart from the *output gap* estimates of the commonly agreed method in its assessment of the cyclical position of a Member State. The plausibility of the commonly agreed method is first checked against the indications of an alternative tool. If the difference between the two exceeds a given threshold, the Commission may apply a constrained degree of discretion in choosing the appropriate output gap estimate for surveillance purposes.

**Corrective arm of the Stability and Growth Pact:** The part of the *Stability and Growth Pact* that deals with preventing the risk of and/or correcting an excessive budgetary imbalance. Under the SGP an excessive budgetary imbalance is (i) a government deficit exceeding 3% of GDP and (ii) government debt in excess of 60% of GDP that is not approaching 60% at a satisfactory pace (see also *debt reduction benchmark*).

**Country-specific recommendations (CSRs):** Policy guidance tailored to each EU Member State based on the provisions of the SGP and the MIP. The recommendations are put forward by the European Commission in May of each year, then discussed among Member States in the Council, endorsed by EU leaders at a summit in June, and formally adopted by the finance ministers in July.

**Debt reduction benchmark:** The reduction of a country's government debt above 60% of GDP by 1/20<sup>th</sup> per year on average. This is the criterion used to assess whether excessive government debt

is sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The pace of reduction is assessed over both the past 3 years and the next 3 years, and after correcting for the cycle. Compliance in at least one of the three cases is sufficient to ensure compliance with the debt criterion (see *corrective arm of the SGP*).

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

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

**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:** a 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 missions 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 at boosting demand and stimulating confidence. The plan called for a fiscal stimulus of EUR 200 billion, equivalent to 1.5% of EU GDP: EUR 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 (i) corrected for certain non-discretionary items, such as interest expenditure, (ii) including a smoothed measure of public investment, and (iii) adjusted for discretionary revenue measures. The growth rate may not exceed *potential GDP* growth over the medium term and is further constrained for Member States that have not yet achieved their *medium-term budgetary objective*.

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

**Fiscal stance:** A measure of the direction and extent of *discretionary fiscal policy*. In this report, it is defined as the annual change in the *structural primary*

*balance*. When the change is positive, the fiscal stance is said to be restrictive. When it is negative, the fiscal stance is said to be expansionary.

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

**Flexibility clauses:** Provisions under the preventive arm of the SGP allowing for a temporary and limited deviation from the *MTO*, or the adjustment path towards it. Flexibility clauses can be granted, subject to pre-defined eligibility conditions, to accommodate the budgetary impact of major structural reforms or government investment.

**Maastricht Treaty:** The Treaty on European Union was signed in Maastricht (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):** According to the *Stability and Growth Pact*, EU Member States are required to specify a medium-term objective for their budgetary position in the *stability and convergence programmes*. The MTO is country-specific, in order to take into account the diversity of economic and budgetary developments and the diversity of fiscal risks to the sustainability of public finances. It is defined in structural terms (see *structural balance*).

**Minimum benchmark:** The lowest value of the structural balance that provides a sufficient margin against the risk of breaching the Treaty threshold of 3% of GDP for the deficit during normal cyclical fluctuations. For each Member State, the Commission provides an annual update of the *minimum benchmark*, by taking into account past output volatility and the budgetary responses to output fluctuations. A Member State with a greater output volatility and a larger budgetary semi-elasticity will need a more demanding structural balance in order to ensure compliance with the threshold of 3% of GDP.

**Output gap:** The difference between actual output and estimated potential output at any particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see *potential GDP*). A standard business cycle usually lasts up to 8 years, suggesting that the

output gap is normally expected to close roughly every four years.

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

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

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

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

**Reverse qualified majority voting:** an EU decision system according to which a Commission's 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 5 years to bring the general government debt-to-GDP ratio to 60% in 15 years' time, including financing for any future additional expenditure arising from an ageing population.

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

**Safety margin:** The difference between the 3%-of-GDP threshold of the deficit and the *minimum benchmark*.

**Significant deviation procedure (SDP):** A procedure under the preventive arm of the SGP to correct a significant deviation from the MTO or the adjustment path towards it.

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

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

**Stability and convergence programmes (SCPs):** Every year in April, EU Member States are required to set out their fiscal plans for the next 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 Member States under severe financial pressure.

**Unusual event clause:** A provision under the preventive arm of the SGP allowing for a temporary deviation from the MTO or the adjustment towards it, in the case of an unusual event outside government control with a major impact on the financial position of the general government. To be granted, the deviation must not endanger fiscal sustainability in the medium term.

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

## ANNEX A

### Request for the ad hoc advice and terms of reference



**Jean-Claude JUNCKER**  
President of the European Commission

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Brussels, 28/1/2019  
Ares (2019)400219

*Dear Professor Thygesen,*

*It was a pleasure to have you at the College meeting of 10 October 2018. The annual report that you presented that day, together with the earlier publications of the European Fiscal Board, are very valuable contributions to the work of the European Commission in applying the EU fiscal framework and seeking to improve it further.*

*In your presentation, you rightly stressed the importance of commonly agreed fiscal rules at the EU level, as they contribute to stable and inclusive economic growth across EU Member States and to a smooth functioning of the euro area as a whole.*

*The need to capture the diversity of economic circumstances, which was particularly pronounced during the crisis years, has brought more sophisticated but also more complex fiscal rules at the EU level over time. This assessment is shared by many observers, including the European Fiscal Board.*

*As part of its work on deepening Europe's Economic and Monetary Union, the Commission has acknowledged the need to review and simplify the current set of EU fiscal rules in several important policy documents. The issue was raised in the Five Presidents' Report of June 2015 and further discussed in the Reflection Paper of May 2017, as well as in the roadmap for deepening Europe's Economic and Monetary Union published in December of the same year.*

.../..

*Prof. Niels Thygesen*  
*Chair of the European Fiscal Board*

*On top of the legislative reforms of 2011 and 2013, practical steps have been taken in recent years to facilitate and improve the implementation of the Stability and Growth Pact and make sure the rules are fit for purpose. As indicated in the documents mentioned above, the Commission is of the view that ongoing efforts to strengthen economic, fiscal and financial integration within Europe should eventually pave the way towards simpler EU fiscal rules.*

*In order to prepare the ground for such a simplification, and in line with the provisions of the Commission's decision establishing the European Fiscal Board, I would like to invite the Board to carry out an assessment of the current EU fiscal rules. The broad terms of reference of the assessment are attached in the annex. I would be grateful if this work could be completed by end July this year.*

*I am looking forward to receiving the results of your assessment.*

*Yours sincerely,*

A handwritten signature in black ink, consisting of a stylized 'J' followed by a horizontal line.

***Annex - Terms of reference of the request to the European Fiscal Board for an ad hoc advice: assessment of the EU fiscal rules***

Further to Article 2(2d) of Commission Decision 1937/2015 establishing the European Fiscal Board (henceforth the Board), the President of the European Commission hereby asks the Board to carry out an assessment of the EU fiscal rules (“the Stability and Growth Pact”), in light notably of the so-called ‘six-pack’ and the ‘two-pack’ reforms.

The objective of the assessment should be: (i) to evaluate the impact of the most important innovations introduced by the recent reforms of the EU fiscal rules; (ii) to assess whether these rules remain fit-for-purpose in the light of changing circumstances and possible future developments; and (iii) to provide indications on whether and how the relevant pieces of EU legislation underpinning the EU fiscal rules can be simplified further.

**Background to the requested assessment**

The post-2007 economic and financial crisis has triggered important reforms of the Stability and Growth Pact, notably the so-called “six-pack” and “two-pack” reforms of, respectively, 2011 and 2013. The two reform packages encompass the following pieces of EU legislation.

*‘Six-pack’ reform*

Regulation (EU) No 1176/2011 “On the prevention and correction of macroeconomic imbalances” lays out the details of the macroeconomic imbalance surveillance procedure for all Member States;

Regulation (EU) No 1174/2011 “On enforcement action to correct excessive macroeconomic imbalances in the euro area” focuses on possible sanctions and other corrective procedures for euro-area Member States;

Regulation (EU) No 1175/2011 amending Regulation (EC) No 1466/97 “On the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies” introduces changes to the preventive arm of the Stability and Growth Pact (SGP);

Regulation (EU) No 1177/2011 amending Regulation (EC) No 1467/97 “On speeding up and clarifying the implementation of the excessive deficit procedure” introduces changes to the corrective arm of the SGP;

Regulation (EU) No 1173/2011 “On the effective enforcement of budgetary surveillance in the euro area” details possible sanctions; and

Council Directive 2011/85/EU “On requirements for budgetary frameworks of the Member States” aims to strengthen national budgetary frameworks.

*‘Two-pack’ reform*

Regulation (EU) No 473/2013 “On common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area” applies to all euro-area Member States, with special provisions for those subject to an excessive deficit procedure (EDP); and

Regulation (EU) No 472/2013 “On the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability” provides a surveillance framework beyond the SGP for euro-area Member States under financial stress.

The following table presents an indicative list of the main innovations introduced by the eight pieces of EU legislation.

	<b>Source</b>	<b>Innovation</b>
<b>Calendar</b>	Reg. 1175/2011	European Semester
	Reg. 473/2013	For euro-area Member States: submission of draft budgetary plans in autumn
	Reg. 472/2013	Separate surveillance calendar for Member States subject to enhanced surveillance or to a macroeconomic adjustment programme
<b>Adjustment requirements</b>	Reg. 1175/2011	Allowed deviations from the recommended adjustment path towards the medium-term budgetary objective under certain conditions
	Reg. 1177/2011	Possibility to revise EDP recommendations and notices following a severe economic downturn in the euro area or the Union as a whole
<b>Monitoring</b>	Reg. 1176/2011	Surveillance of non-fiscal developments to detect macroeconomic imbalances
	Reg. 472/2013	Additional reporting requirements for Member States completing a macroeconomic adjustment programme
	Reg. 473/2013	Economic partnership programmes for Member States in the corrective arm, describing the policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit
	Reg. 473/2013	Enhanced reporting requirements for Member States in EDP
<b>Assessment of compliance</b>	Reg. 1175/2011	Introduction of the expenditure benchmark as an additional indicator of compliance in the preventive arm of the SGP, as part of an overall assessment with the structural balance as the reference
	Reg. 1175/2011	Definition of a significant deviation from the adjustment path
	Reg. 1177/2011	Introduction of a numerical benchmark for assessing compliance with the government debt criterion of the Treaty
	Reg. 1177/2011	Additional specification of relevant factors to be taken into account when assessing the existence of an excessive deficit and compliance in the corrective arm of the SGP
	Reg. 1176/2011	Definition of macroeconomic imbalances

<b>Enforcement</b>	Reg. 1175/2011	Possibility for the Commission to address a warning to a Member State in case of a significant deviation
	Reg. 1173/2011	Possibility to apply sanctions at an earlier stage in the surveillance process and with a gradual increase in intensity. Higher degree of automaticity: sanctions subject to reverse qualified majority voting in the Council
	Reg. 1176/2011	Introduction of an excessive imbalance procedure
	Reg. 1174/2011	Possible sanctions in the event of non-compliance with recommendations to correct excessive macroeconomic imbalances
	Reg. 473/2013	Possibility for the Commission to address a recommendation to a Member State at risk of non-compliance with its obligations under an EDP
	Reg. 473/2013	Possibility for the Commission to issue a negative opinion on a draft budgetary plan (DBP) and request a revised DBP
<b>Governance</b>	Directive 2011/85	Minimum requirements for national budgetary frameworks in terms of accounting and statistics, forecasts (budgetary planning to be based on the most likely scenario or a more prudent scenario), numerical fiscal rules, medium-term budgetary frameworks and transparency
	Reg. 1175/2011, 1177/2011, 1173/2011	Economic dialogue: possibility for the European Parliament to invite the Presidents of the Commission, the Council, the European Council or the Eurogroup to discuss multilateral surveillance
	Reg. 1177/2011	Introduction of a 'comply-or-explain' principle for the Council vis-à-vis Commission recommendations and proposals under the corrective arm
	Reg. 473/2013	National budgetary plans to be based on independent macroeconomic forecasts, indicating whether the budgetary forecasts have been produced or endorsed by an independent body
	Reg. 473/2013	Member States to have in place independent bodies monitoring compliance with national numerical fiscal rules
	Reg. 472/2013	Dialogue: possibility for the European Parliament to invite representatives of the Council and the Commission to discuss the application of the Regulation

In addition to the legislative changes brought about by the abovementioned reforms of 2011 and 2013, there have also been important developments in terms of practice over the years.

Examples include the use of flexibility within the existing rules of the Stability and Growth Pact, the creation of the European Semester of economic policy coordination as well as the use of new benchmarks and indicators to guide policies.

#### **Scope and timetable of the requested assessment**

Building on its past work and taking into account reviews done or planned by the European Commission, the Board is requested to assess the effectiveness of the EU fiscal rules in achieving the overarching goals of EU fiscal surveillance, namely (i) ensuring the long-term sustainability of public finances, (ii) stabilising economic activity in a counter-cyclical fashion; and (iii) improving the quality of public finances.

For the purpose of assessing the EU fiscal rules, it may also be useful to look at other relevant processes at EU level, such as the articulation with the fiscal aspects of the Macroeconomic Imbalances Procedure, as well as relevant national practices, including those arising from the intergovernmental Fiscal Compact.

A particular point of interest for that assessment is the balance to be found between the need to capture complex, diverse and changing economic circumstances and the quest for readability, predictability and transparency of the rules.

The findings of the Board should be shared with the President of the European Commission by end July 2019.

When carrying out its assessment, the Board may consult relevant stakeholders such as representatives of the European Parliament, the Member States and national independent fiscal institutions. The Board is also invited to work in close cooperation with the European Commission at all levels.

The results of this assessment shall be made public in due course.

## ANNEX B

### List of interviewees

List of ‘architects’ of the six and two-pack reforms of EU economic surveillance, and current officials interviewed for the purpose of the assessment of the EU fiscal rules commissioned by President Jean-Claude Juncker. The European Fiscal Board would like to thank all interviewees for their time and insightful input.

Name	Current and past affiliation(s)
Marco Buti	Director-General, Economic and Financial Affairs, European Commission (since 2008)
Antonio José Cabral	Retired; senior economic advisor to the President of the European Commission José Manuel Durão Barroso (2004-2009, 2009-2014)
Mario Centeno	President of the Eurogroup (since 2017), Portuguese Minister of Finance (since 2015)
Lorenzo Codogno	Macro Advisors Ltd, and Visiting Professor at the LSE; Chair of the Economic Policy Committee of the Council of the European Union (January 2010 – December 2011)
Servaas Deroose	Retired; Deputy Director-General, Economic and Financial Affairs, European Commission (2010 – 2018)
José Luis Escrivá Belmonte	Chairman of AIREF, the independent fiscal council in Spain, and of the Network of EU Independent Fiscal Institutions (IFIs)
Ramon Fernandez	Deputy Chief Executive Officer of Orange; Director-General of the French Treasury (2009-14)
Luis de Guindos	Vice President of the European Central Bank (since 2018); Spanish Minister of Economy and Competitiveness (2011-16), Minister of Economy, Industry and Competitiveness (2016-18)
Reza Moghadam	Director of the European Department at the IMF (2011-2014); Vice Chairman for Global Capital markets at Morgan Stanley (since 2014)
Pierre Moscovici	Commissioner for Economic and Financial Affairs, Taxation and Customs, European Commission (2014-2019); French Minister of Finance (2012 to 2014)
Lucio Pench	Director for Fiscal Policy (Directorate C) in the Directorate-General for Economic and Financial Affairs, European Commission (since 2011)
Carsten Pillath	Director-General, Economic and Social Affairs, General Secretariat of the Council of the European Union (since 2008)
Klaus Regling	Managing Director of the European Stability Mechanism (ESM) (since 2010)

Olli Rehn	Governor Bank of Finland (since July 2018); Commissioner for Economic and Monetary Affairs (2010-14)
Odile Renaud-Basso	Director-General of the French Treasury (since 2016), and member of the Economic and Financial Committee at the Council of the European Union; Deputy Head of Cabinet of the President of the European Council (2010-2012)
Herman van Rompuy	President of the Strategic Council of the Brussels-based think tank European Policy Centre (EPC); President Emeritus of the European Council (2009 – 2014); Finance Minister of Belgium (1993-99); Prime Minister (2008-09)
Ludger Schuknecht	OECD Deputy Secretary-General (since 2018); Chief Economist at the German Ministry of Finance (2011-18)
Rolf Strauch	Chief Economist and Management Board Member in charge of Economics, Policy Strategy, and Banking of the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) (since July 2010)
Margrethe Vestager	Commissioner for Competition (2014-2019); Danish Minister for Economic Affairs (2011-14); President of ECOFIN (2012)
Hans Vijlbrief	Chair of the Economic and Financial Committee/Euro Working Group at the Council of the European Union (since 2018)
Thomas Wieser	Non-resident fellow at the Brussels-based think tank Bruegel; Chair of the Economic and Financial Committee/Euro Working Group at the Council of the European Union (2012 –2018, 2009 – March), Vice-Chair of the Economic and Financial Committee (2005 –2009)

## ANNEX C

### Statistical annex to Box 4.1

The tables below summarise the estimation results underpinning the analysis presented in Box 4.1 of Chapter 4 of the report. The list of variables and sources is reported in Table C.6.

Table C.1: Estimation results for the cyclical policy

Cyclical indicator	Δ Output gap			Δ Unemployment rate			Δ CLI		
	LSDVc	IV-2SLS	IV-GMM	LSDVc	IV-2SLS	IV-GMM	LSDVc	IV-2SLS	IV-GMM
Estimator	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Δ CAPB (t-1)	-0.160*** (0.032)	0.107 (0.113)	-0.123* (0.057)	-0.150*** (0.032)	0.184 (0.096)	-0.118** (0.043)	-0.132*** (0.039)	0.188 (0.121)	-0.087 (0.059)
Δ Output gap (t)	-0.250*** (0.034)	-0.340* (0.153)	-0.211* (0.091)						
Δ Unemployment rate (t)				0.168*** (0.050)	0.119 (0.114)	0.157 (0.129)			
Δ CLI (t-1)							-0.113 (0.065)	-0.221 (0.158)	-0.280 (0.201)
Current account balance (t-1)	0.021 (0.020)	0.017 (0.037)	-0.025 (0.041)	0.008 (0.020)	0.005 (0.028)	0.009 (0.046)	0.010 (0.019)	-0.015 (0.030)	0.033 (0.036)
Public debt-to-GDP (t-1)	0.018*** (0.005)	0.024*** (0.006)	0.021** (0.008)	0.021*** (0.005)	0.021*** (0.006)	0.021* (0.008)	0.022*** (0.005)	0.022*** (0.006)	0.032** (0.011)
Age dependency ratio (t-1)	-0.153* (0.069)	-0.196* (0.081)	-0.098 (0.054)	-0.167** (0.065)	-0.160* (0.077)	-0.097 (0.062)	-0.191* (0.076)	-0.201* (0.081)	-0.157* (0.069)
Election year dummy (t-1)	0.398* (0.181)	0.479** (0.185)	0.434* (0.200)	0.318* (0.156)	0.441* (0.191)	0.323 (0.206)	0.332 (0.174)	0.384 (0.197)	0.384 (0.232)
Nr. changes in government (t-1)	-0.242* (0.119)	-0.189 (0.135)	-0.201 (0.107)	-0.176 (0.125)	-0.160 (0.146)	-0.103 (0.123)	-0.137 (0.151)	-0.135 (0.155)	-0.142 (0.135)
Financial stress index (t-1)	-0.369 (0.633)	-1.393* (0.636)	0.003 (0.008)	-0.311 (0.430)	0.596 (24.52)	-0.002 (0.008)	-0.790 (1.019)	-1.176 (1.046)	0.017 (0.012)
Sovereign debt crisis (t-1)	-5.984*** (1.462)	-5.681*** (1.388)	-8.615** (2.734)	-6.363*** (1.570)	-5.894*** (1.547)	-8.832** (2.738)	-6.483*** (1.935)	-5.343** (2.065)	-11.99 (7.263)
Systemic banking crisis (t-1)	-1.014* (0.428)	-0.778 (0.472)	-0.965 (0.566)	-0.553 (0.451)	-0.282 (0.521)	-0.556 (0.608)	-1.060* (0.455)	-1.103* (0.547)	-1.301 (0.782)
Currency crisis (t-1)	-0.170 (0.701)	0.595 (0.877)	-0.133 (0.609)	1.759** (0.631)	3.477*** (0.872)	1.711 (0.989)	0.629 (0.938)	0.911 (1.030)	0.490 (1.052)
Crisis dummy: 2008-2009	-1.642* (0.663)		-1.761 (0.878)	-0.861 (0.598)	-2.078 (57.47)	-1.305 (0.836)	-1.714 (0.989)	0.234 (0.787)	-2.525*** (0.519)
EU programme dummy (t-1)	1.693*** (0.435)	0.558 (0.525)	1.087 (0.680)	1.580*** (0.457)	0.408 (0.567)	1.085 (0.651)	1.651** (0.549)	0.024 (0.810)	0.122 (1.046)
Run-up to euro dummy (t-1)	-0.058 (0.254)	-0.173 (0.291)	-0.072 (0.415)	-0.028 (0.274)	-0.104 (0.312)	0.039 (0.387)	-0.146 (0.305)	-0.148 (0.337)	-0.060 (0.389)
SGP dummy (t-1)	-0.371 (0.340)	-0.185 (0.335)	-0.309 (0.394)	-0.203 (0.308)	-0.060 (0.348)	-0.146 (0.369)	-0.330 (0.351)	-0.312 (0.367)	-0.304 (0.479)
SGP 2005 revision dummy (t-1)	0.812 (0.469)	0.793 (0.443)	0.934 (0.471)	0.587 (0.443)	0.602 (0.452)	0.847 (0.438)	0.782 (0.434)	0.816 (0.483)	1.356* (0.563)
6P onwards dummy (t-1)	-1.100 (0.595)	-0.907 (0.583)	-0.653 (0.479)	-0.771 (0.527)	-0.665 (0.576)	-0.648 (0.523)	-1.219* (0.511)	-1.101 (0.624)	-1.235* (0.569)
Time FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R-square	0.193	0.141	0.179	0.145	0.087	0.149	0.143	0.095	0.114
Observations	980	883	980	1062	959	1062	867	786	867
Countries	33	33	33	35	35	35	27	27	27
Instruments		79	127		77	128		76	121
Model F		3.39	19.17		3.00	17.12		2.79	8.12
Model F: p-value		0.000	0.000		0.000	0.000		0.000	0.000

Notes: The dependent variable used is the change in the cyclically adjusted primary balance as a percentage of GDP. The results are based on an unbalanced panel spanning the period 1970-2017 for the EU Member States and a set of non-EU countries (Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the USA). The estimators are (i) LSDVc: Nickell bias-corrected least-squares dummy variable estimator as operationalized by Bruno (2005); (ii) IV-2SLS: two-stage least squares fixed-effects estimator; and (iii) IV-GMM: two-step system generalized method of moments developed by Blundell and Bond (1998). The instruments included are the lags of the lagged dependent variable, the cyclical variable, and the lagged current account. The number of lags is collapsed and restricted to the third order and earlier, as advised by Roodman (2009a, 2009b). Standard errors are reported in parentheses, with \*, \*\* and \*\*\* denoting statistical significance at the 10%, 5% and 1% level, respectively.

Source: European Fiscal Board and the Commission's Joint Research Centre.

Table C.2: Estimation results for the cyclicity of fiscal policy – EU only

Cyclical indicator	Δ Output gap			Δ Unemployment rate			Δ CLI		
	LSDVc	IV-2SLS	IV-GMM	LSDVc	IV-2SLS	IV-GMM	LSDVc	IV-2SLS	IV-GMM
Estimator	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Δ CAPB (t-1)	-0.190*** (0.039)	-0.017 (0.135)	-0.153* (0.068)	-0.176*** (0.041)	0.223 (0.145)	-0.128* (0.062)	-0.164*** (0.048)	0.126 (0.135)	-0.119 (0.069)
Δ Output gap (t)	-0.411*** (0.049)	-0.505** (0.186)	-0.410*** (0.101)						
Δ Unemployment rate (t)				0.330*** (0.084)	0.157 (0.153)	0.264 (0.159)			
Δ CLI (t-1)							-0.229* (0.097)	-0.338 (0.243)	-0.376 (0.228)
Current account balance (t-1)	0.062* (0.030)	0.054 (0.053)	0.008 (0.026)	0.051 (0.032)	-0.030 (0.042)	-0.004 (0.024)	0.013 (0.008)	-0.035 (0.008)	-0.003 (0.031)
Public debt-to-GDP (t-1)	0.029*** (0.007)	0.030** (0.009)	0.017** (0.006)	0.026*** (0.007)	0.017 (0.009)	0.017* (0.006)	0.024** (0.008)	0.020* (0.008)	0.034*** (0.009)
Age dependency ratio (t-1)	-0.155 (0.095)	-0.195 (0.120)	-0.040 (0.050)	-0.078 (0.099)	-0.071 (0.123)	-0.038 (0.050)	-0.119 (0.124)	-0.149 (0.136)	-0.077 (0.087)
Election year dummy (t-1)	0.347 (0.232)	0.352 (0.269)	0.398 (0.308)	0.446 (0.243)	0.592* (0.284)	0.520 (0.315)	0.364 (0.280)	0.351 (0.312)	0.374 (0.413)
Nr. changes in government (t-1)	-0.139 (0.167)	-0.160 (0.186)	-0.141 (0.165)	-0.165 (0.174)	-0.242 (0.204)	-0.162 (0.157)	-0.116 (0.205)	-0.133 (0.234)	-0.102 (0.240)
Financial stress index (t-1)	0.599 (0.557)	-1.803 (23.13)	0.006 (0.012)	1.039 (0.569)	-0.275 (25.83)	0.003 (0.014)	0.647 (0.612)	-0.623 (1.581)	0.007 (0.019)
Sovereign debt crisis (t-1)	-6.025*** (1.199)	-5.646*** (1.465)	-7.487*** (1.820)	-6.633*** (1.241)	-5.727*** (1.658)	-8.267** (2.291)	-6.668** (2.075)	-5.546* (2.319)	-10.02* (3.971)
Systemic banking crisis (t-1)	0.558 (0.696)	0.769 (0.723)	0.698 (0.540)	-0.008 (0.725)	0.192 (0.772)	0.021 (0.749)	-0.691 (0.781)	-0.677 (0.971)	-0.979 (1.476)
Currency crisis (t-1)	0.670 (1.443)	0.828 (1.479)	0.411 (0.812)	0.993 (1.505)	1.024 (1.652)	0.307 (0.989)	0.608 (1.383)	0.631 (1.655)	0.917 (1.049)
Crisis dummy: 2008-2009	-5.682*** (0.777)	-0.805 (54.27)		-3.305*** (0.810)	0.794 (60.59)	-2.522 (1.648)	-0.260 (0.904)	-1.027 (2.386)	0.322 (1.760)
EU programme dummy (t-1)	1.353** (0.489)	0.647 (0.577)	1.532 (0.769)	1.507** (0.511)	0.373 (0.685)	1.316 (0.768)	1.619* (0.786)	0.230 (0.920)	0.233 (1.096)
Run-up to euro dummy (t-1)	0.159 (0.331)	0.171 (0.361)	0.325 (0.484)	0.080 (0.343)	0.038 (0.400)	0.203 (0.437)	0.068 (0.410)	0.137 (0.463)	0.089 (0.510)
SGP dummy (t-1)	-1.237 (0.679)	-1.093 (0.852)	-2.163** (0.734)	-1.160 (0.704)	-0.793 (0.942)	-1.750* (0.779)	-1.476 (0.826)	-1.174 (1.109)	-2.390** (0.818)
SGP 2005 revision dummy (t-1)	2.647*** (0.666)	2.718 (1.709)	2.600** (0.935)	1.924** (0.681)	1.899 (1.883)	1.841* (0.852)	-0.755 (0.872)	0.567 (0.816)	-0.516 (0.928)
6P onwards dummy (t-1)	-0.755 (1.382)	-0.604 (2.665)	-1.047 (1.501)	0.659 (1.381)	1.007 (2.936)	-0.289 (1.614)	2.197 (2.566)	0.018 (2.778)	2.395* (1.014)
Time FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R-square	0.220	0.194	0.276	0.183	0.117	0.219	0.200	0.142	0.174
Observations	633	606	633	633	606	633	537	507	537
Countries	27	27	27	27	27	27	20	20	20
Instruments		74	126		75	126		74	113
Model F		2.96	54.51		2.30	18.55		2.07	2.59
Model F: p-value		0.000	0.000		0.000	0.000		0.000	0.011

Notes: The dependent variable used is the change in the cyclically adjusted primary balance as a percentage of GDP. The results are based on an unbalanced panel spanning the period 1970-2017 for the EU Member States. The estimators are (i) LSDVc: Nickell bias-corrected least-squares dummy variable estimator as operationalized by Bruno (2005); (ii) IV-2SLS: two-stage least squares fixed-effects estimator; and (iii) IV-GMM: two-step system generalized method of moments developed by Blundell and Bond (1998). The instruments included are the lags of the lagged dependent variable, the cyclical variable, and the lagged current account. The number of lags is collapsed and restricted to the third order and earlier, as advised by Roodman (2009a, 2009b). Standard errors are reported in parentheses, with \*, \*\* and \*\*\* denoting statistical significance at the 10%, 5% and 1% level, respectively.

Source: European Fiscal Board and the Commission's Joint Research Centre.

Table C.3: Robustness checks for IV estimates on the cyclicity of fiscal policy

Cyclical indicator	Δ Output gap			Δ Unemployment rate			Δ CLI		
	FD	SYS I	SYS II	FD	SYS I	SYS II	FD	SYS I	SYS II
Estimator	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Δ CAPB (t-1)	-0.093 (0.073)	-0.076 (0.056)	-0.645 (0.470)	-0.092 (0.051)	-0.074 (0.043)	0.269 (0.384)	-0.079 (0.071)	-0.061 (0.056)	-0.638 (0.310)
Δ Output gap (t)	-0.277* (0.108)	-0.169 (0.138)	-0.462 (0.293)						
Δ Unemployment rate (t)				0.180 (0.172)	-0.015 (0.139)	0.425 (0.529)			
Δ CLI (t-1)							-0.230 (0.255)	-0.467 (0.320)	0.019 (0.154)
Current account balance (t-1)	-0.021 (0.084)	0.014 (0.041)		-0.012 (0.130)	0.047 (0.059)		-0.066 (0.145)	0.085 (0.043)	
Public debt-to-GDP (t-1)	-0.006 (0.034)	0.005*** (0.001)	0.009** (0.003)	0.024 (0.036)	0.005** (0.002)	0.005 (0.003)	0.072* (0.034)	0.006* (0.003)	0.012* (0.004)
Age dependency ratio (t-1)	-0.214 (0.328)	-0.025 (0.016)	-0.052 (0.028)	-0.434 (0.323)	-0.034 (0.029)	-0.016 (0.019)	-0.272 (0.280)	-0.045 (0.031)	-0.050 (0.029)
Election year dummy (t-1)	0.518* (0.208)	0.412* (0.178)	0.124 (0.286)	0.384 (0.210)	0.343 (0.180)	0.286 (0.228)	0.324 (0.253)	0.391 (0.213)	0.069 (0.181)
Nr. changes in government (t-1)	-0.378* (0.151)	-0.228* (0.091)	-0.157 (0.119)	-0.245 (0.150)	-0.184* (0.085)		-0.093 (0.198)	-0.196 (0.119)	
Financial stress index (t-1)	-2.220*** (0.489)	0.0004 (0.007)		1.310 (1.000)	-0.002 (0.005)		-0.792 (0.970)	0.021* (0.008)	
Sovereign debt crisis (t-1)	-7.316*** (1.046)	-5.595*** (0.457)	-5.106*** (1.020)	-7.697*** (1.294)	-5.495*** (0.535)	-5.959** (2.035)	-17.01 (14.21)	-5.582*** (0.870)	-3.615** (1.085)
Systemic banking crisis (t-1)	-1.204* (0.586)	-0.973 (0.551)	-2.476* (1.176)	-0.505 (0.601)	-0.464 (0.595)		-1.167 (0.889)	-1.330 (0.700)	-1.126 (0.625)
Currency crisis (t-1)	-0.236 (0.712)	0.389 (0.728)		1.501 (1.176)	2.381 (1.234)	2.394 (1.404)	0.559 (0.982)	1.078 (1.112)	
Crisis dummy: 2008-2009		-1.472 (0.777)		-2.027 (1.827)	-0.297 (0.905)		-3.139 (2.812)	-2.929*** (0.592)	0.290 (0.656)
EU programme dummy (t-1)	2.766* (1.183)	1.545** (0.444)	1.136 (1.380)	2.254 (1.251)	1.596*** (0.422)	-0.516 (0.858)	-0.336 (1.459)	1.816* (0.753)	-1.273 (0.750)
Run-up to euro dummy (t-1)	0.430 (0.701)	-0.057 (0.269)		0.170 (0.820)	-0.117 (0.235)		0.750 (1.738)	-0.051 (0.288)	0.011 (0.426)
SGP dummy (t-1)	0.844 (1.045)	-0.447 (0.307)		0.581 (1.395)	-0.460 (0.250)		1.756 (2.947)	-0.511 (0.308)	-0.310 (0.274)
SGP 2005 revision dummy (t-1)	1.462 (1.089)	0.912* (0.396)		1.335 (1.158)	0.875** (0.318)		2.972 (2.816)	1.312** (0.445)	0.762* (0.330)
6P onwards dummy (t-1)	-0.491 (1.111)	-0.906* (0.444)		-1.249 (1.364)	-0.732 (0.434)		-0.575 (1.075)	-1.540* (0.619)	-0.432 (0.613)
Time FE	Yes	Yes	3y groups	Yes	Yes	3y groups	Yes	Yes	3y groups
Country FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R-square	0.121	0.221	0.106	0.089	0.158	0.035	0.046	0.135	0.058
Observations	947	980	989	1027	1062	1071	840	867	876
Countries	33	33	33	35	35	35	27	27	27
Instruments	89	77	32	89	77	31	84	76	35
Model F	743.05	31.91	28.62	1.05e+08	70.95	116.16	1.62	13.78	11707.49
Model F: p-value	0.000	0.000	0.000	0.000	0.000	0.000	0.080	0.000	0.000

Notes: The dependent variable used is the change in the cyclically adjusted primary balance as a percentage of GDP. The results are based on an unbalanced panel spanning the period 1970-2017 for the EU Member States and a set of non-EU countries (Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the USA). The IV-GMM estimators used, are (i) the two-step system GMM (denoted SYS) developed by Blundell and Bond (1998); and (ii) the difference GMM (denoted FD) developed by Arellano and Bond (1991). To assess instrument proliferation, the SYS estimates only employ the time dummies and up to three lags of the endogenous variables as instruments. Moreover, the SYS II estimates employ 3y average time dummies. Standard errors are reported in parentheses, with \*, \*\* and \*\*\* denoting statistical significance at the 10%, 5% and 1% level, respectively.

Source: European Fiscal Board and the Commission's Joint Research Centre.

Table C.4: Estimation results on the drivers of cyclicity

Estimator	FE	LSDVc	IV-2SLS	IV-GMM
	(1)	(2)	(3)	(4)
$\Delta$ CAPB (t-1)	-0.191** (0.059)	-0.164*** (0.032)	0.078 (0.113)	-0.127* (0.059)
$\Delta$ Output gap (t)	-0.181* (0.075)	-0.181** (0.055)	-0.521 (0.341)	-0.196 (0.137)
Positive $\Delta$ OG dummy (t)	0.094 (0.176)	0.096 (0.187)	0.232 (0.350)	0.328 (0.552)
$\Delta$ Output gap (t)   pos. $\Delta$ OG	-0.235 (0.124)	-0.234* (0.102)	0.206 (0.389)	-0.189 (0.274)
Current account (t-1)	0.025 (0.018)	0.024 (0.020)	0.029 (0.037)	-0.021 (0.038)
Public debt-to-GDP (t-1)	0.020** (0.007)	0.020*** (0.005)	0.024*** (0.006)	0.022** (0.008)
Age dependency ratio (t-1)	-0.164* (0.071)	-0.161* (0.070)	-0.204* (0.079)	-0.104 (0.054)
Election year dummy (t-1)	0.387* (0.182)	0.391* (0.183)	0.461* (0.185)	0.411 (0.203)
Nr. changes in government (t-1)	-0.236* (0.097)	-0.239* (0.119)	-0.194 (0.136)	-0.187 (0.102)
Financial stress index (t-1)	-6.796 (10.97)	-0.442 (0.631)	-0.373 (0.570)	0.003 (0.008)
Sovereign debt crisis (t-1)	-6.175*** (0.533)	-6.184*** (1.451)	-5.495*** (1.431)	-8.709** (2.688)
Systemic banking crisis (t-1)	-0.973* (0.441)	-0.975* (0.431)	-0.762 (0.472)	-0.976 (0.565)
Currency crisis (t-1)	0.014 (0.602)	0.031 (0.712)	0.570 (0.875)	-0.069 (0.678)
Crisis dummy: 2008-2009	12.97 (25.45)	-1.144* (0.534)	-3.195 (1.735)	-2.435* (1.186)
EU programme dummy (t-1)	1.832*** (0.498)	1.807*** (0.434)	0.471 (0.548)	1.193 (0.714)
Run-up to euro dummy (t-1)	-0.067 (0.330)	-0.073 (0.253)	-0.180 (0.290)	-0.041 (0.428)
SGP dummy (t-1)	-0.312 (0.263)	-0.308 (0.343)	-0.204 (0.337)	-0.213 (0.387)
SGP 2005 revision dummy (t-1)	0.883** (0.305)	0.872 (0.473)	0.715 (0.454)	0.910 (0.478)
6P onwards dummy (t-1)	-1.221** (0.439)	-1.212* (0.599)	-0.837 (0.588)	-0.687 (0.502)
Time FE	Yes	Yes	Yes	Yes
Country FE	Yes	Yes	Yes	Yes
R-square	0.184	0.184	0.147	0.177
Observations	980	980	883	980
Countries	33	33	33	33
Instruments			81	127
Model F			3.73	10.69
Model F: p-value			0.000	0.000

Notes: The dependent variable used is the change in the cyclically-adjusted primary balance as a percentage of GDP. The results are based on an unbalanced panel spanning the period 1970-2017 for the EU Member States and a set of non-EU countries (Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the USA). The estimators are (i) FE: within fixed effects estimator, with county-clustered standard errors; (ii) LSDVc: Nickell bias-corrected least-squares dummy variable estimator as operationalized by Bruno (2005); (iii) IV-2SLS: two-stage least squares fixed-effects estimator; and (iv) IV-GMM: two-step system generalized method of moments developed by Blundell and Bond (1998). The instruments included are the lags of the lagged dependent variable, the cyclical variable, and the lagged current account. The number of lags is collapsed and restricted to the third order and earlier, as advised by Roodman (2009a, 2009b). Standard errors are reported in parentheses, with \*, \*\* and \*\*\* denoting statistical significance at the 10%, 5% and 1% level, respectively.

Source: European Fiscal Board and the Commission's Joint Research Centre.

Table C.5: Estimation results on fiscal performance

Estimator	FE	LSDVc	IV-2SLS	IV-GMM
	(1)	(2)	(3)	(4)
4y-average $\Delta$ Debt-to-GDP (t-1)	0.629*** (0.140)	0.655*** (0.0150)	0.705*** (0.0230)	0.601*** (0.154)
4y-average debt-to-GDP ratio (t)	-0.0228** (0.00739)	-0.0232*** (0.00409)	-0.0339*** (0.00473)	-0.00191 (0.0203)
4y-average nom. GDP growth (t)	-0.0395* (0.0161)	-0.0387*** (0.00464)	-0.0241*** (0.00628)	-0.0811*** (0.0154)
4y-average unemployment rate (t)	0.109 (0.0761)	0.106** (0.0341)	0.0896** (0.0344)	0.129 (0.113)
Current account balance (t)	-0.116*** (0.0273)	-0.110*** (0.0188)	-0.0770** (0.0240)	-0.125* (0.0552)
Age dependency ratio (t)	0.207 (0.124)	0.216*** (0.0618)	0.313*** (0.0705)	0.0226 (0.116)
Election year dummy (t)	-0.326 (0.163)	-0.333* (0.159)	-0.407* (0.167)	-0.352* (0.145)
Nr. changes in government (t)	0.168 (0.109)	0.166 (0.116)	0.243 (0.128)	0.234* (0.107)
Federal dummy (t)	-0.567* (0.221)	-0.527 (0.314)	-0.681* (0.342)	-0.161 (0.207)
EU programme dummy (t-1)	-2.527*** (0.688)	-2.507*** (0.504)	-2.247*** (0.490)	-3.628* (1.374)
Run-up to euro dummy (t-1)	-0.781 (0.398)	-0.767* (0.304)	-0.461 (0.289)	-1.736** (0.576)
SGP dummy (t-1)	-0.164 (0.373)	-0.163 (0.355)	-0.185 (0.329)	-0.262 (0.386)
SGP 2005 revision dummy (t-1)	0.382 (0.528)	0.356 (0.449)	0.414 (0.448)	0.158 (0.733)
6P onwards dummy (t-1)	-0.252 (0.979)	-0.238 (0.555)	-0.341 (0.580)	-0.303 (1.375)
Time FE	Yes	Yes	Yes	Yes
Country FE	Yes	Yes	Yes	Yes
R-square	0.686	0.691	0.656	0.715
Observations	1296	1296	1196	1296
Countries	36	36	36	36
Instruments			73	124
Model F			43.92	16.22
Model F: p-value			0.000	0.000

Notes: The dependent variable is the 4-year average change in the debt-to-GDP ratio. The results are based on an unbalanced panel spanning the period 1970–2017 for the EU Member States and a set of non-EU countries (Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the USA). The estimators are (i) FE: within fixed effects estimator, with county-clustered standard errors; (ii) LSDVc: Nickell bias-corrected least-squares dummy variable estimator as operationalized by Bruno (2005); (iii) IV-2SLS: two-stage least squares fixed-effects estimator; and (iv) IV-GMM: two-step system generalized method of moments developed by Blundell and Bond (1998). The instruments included are the lags of the lagged dependent variable and the 4-year average control variables. The number of lags is collapsed and restricted to the third order and earlier, as advised by Roodman (2009a, 2009b). Standard errors are reported in parentheses, with \*, \*\* and \*\*\* denoting statistical significance at the 10%, 5% and 1% level, respectively.

Source: European Fiscal Board and the Commission's Joint Research Centre.

Table C.6: Variables and sources

Variable	Description	Source
CAPB	Cyclically-adjusted primary balance (% of GDP)	Merged (where consistent) from the Commission 2018 autumn forecast, the IMF World Economic Outlook (October 2018), the IMF Global Debt Database and the OECD balance of payment database
Output gap	(% of potential GDP)	
Unemployment rate	(% of active population)	
Current account balance	(% of GDP)	
Public debt-to-GDP	Gross debt of general government (% of GDP)	
Age dependency ratio	Percentage of the population over 65 years of age	
4y-average nom. GDP growth	4-year average of nominal GDP growth	
CLI	Composite Leading Indicator	OECD
Election year dummy	Dummy for election years	Comparative Political Data Set
Nr. changes in government	Number of changes in government	Comparative Political Data Set
Federal dummy	Dummy for states with a federal structure	Comparative Political Data Set
Financial stress index	Newspaper-based financial indicator for the US developed by Lukas Püttman	The EPU webpage of Baker, Bloom & Davis
Sovereign debt crisis	Dummy variable for years of sovereign debt crisis	Laeven & Valencia (2013 and 2018)
Systemic banking crisis	Dummy variable for years of systemic banking crisis	Laeven & Valencia (2013 and 2018)
Currency crisis	Dummy variable for years of currency crisis	Laeven & Valencia (2013 and 2018)
Crisis dummy 2008-2009	Dummy for 2008 and 2009	Own calculations
EU programme dummy	Dummy for EU Member States under an EU financial assistance programme	Own calculations
Run-up to euro dummy	Dummy for the three years preceding the adoption of the euro	Own calculations
SGP dummy	Dummy for EU Member States as of 1999 or when they joined the EU, if later	Own calculations
SGP 2005 revision dummy	Dummy for EU Member States as of 2005 or when they joined the EU, if later	Own calculations
6P onwards dummy	Dummy for EU Member States as of 2012 or when they joined the EU, if later	Own calculations
Positive $\Delta$ OG dummy	Dummy for years when the change in the output gap is positive	Own calculations
$\Delta$ Output gap   pos. $\Delta$ OG	Change in the output gap restricted to years of positive change in the output gap	Own calculations

*Source:* European Fiscal Board and the Commission's Joint Research Centre.

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