EN 2018

NO 18

Special Report

Is the main objective of the preventive arm of the Stability and Growth Pact delivered?

(pursuant to Article 287(4), second subparagraph, TFEU)

EUROPEAN
COURT
OF AUDITORS

AUDIT TEAM

The ECA's special reports set out the results of its audits of EU policies and programmes, or of management-related topics from specific budgetary areas. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was carried out by Audit Chamber IV Regulation of markets and competitive economy. Mr Neven Mates, Dean of this Chamber, is the reporting Member. He was supported by Georgios Karakatsanis, Head of Private Office and Marko Mrkalj, Private Office Attaché; Zacharias Kolias, Director; Jacques Sciberras, Head of Task; Albano Martins Dias da Silva, Isabel Quintela, Adrian Savin and Marion Schiefele, Auditors; Aykut Efe, Trainee.

From left to right: Marion Schiefele, Albano Martins Dias da Silva, Jacques Sciberras, Georgios Karakatsanis, Neven Mates, Marko Mrkalj, Isabel Quintela, Adrian Savin, Zacharias Kolias.

CONTENTS

ABBREVIATIONS AND ACRONYMS

AMECO	Annual macro-economic database of DG ECFIN
CoC	Code of Conduct
CSR	Country-specific recommendation
DBP	Draft Budgetary Plan
DG ECFIN	Directorate General for Economic and Financial Affairs
EB	Expenditure benchmark
ECA	European Court of Auditors
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EFC	Economic and Financial Committee
ESA	European System of Integrated Economic Accounts
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
MS	Member State(s)
MTO	Medium Term Objective
OECD	Organisation for Economic Co-operation and Development
OG	Output gap
pp	Percentage points
SCP	Stability and Convergence Programmes
SB	Structural balance
SGP	Stability and Growth Pact

SPB	Structural primary balance
SWD	Staff working document
TSCG	Treaty on Stability, Co-ordination and Governance in the Economic and Monetary union

GLOSSARY

Code of Conduct: Policy document with guidelines for the implementation of the Stability and Growth Pact and the format and content of stability and convergence programmes.

Corrective arm of the Stability and Growth Pact: Officially known as Excessive Deficit Procedure (EDP) – a mechanism which should be initiated against Member State in which the reference values for deficit and debt are exceeded.

Country-specific recommendations: Policy guidance formulated annually by Commission to Member States on how to maintain sound public finances. The Commission then submits them to the Council for endorsement in July in the context of the European Semester.

Draft Budgetary Plans: Documents that the governments of the euro area Member States are required by European economic governance rules to submit to the Commission by October 15 of each year in order to ensure the coordination of their fiscal policies.

Economic and Financial Committee: Formerly the Monetary Committee, the EFC is a Committee of the Council of the European Union set up by Article 134 of the Treaty on the Functioning of the European Union. Its main task is to prepare and discuss Economic and Financial Affairs Council (ECOFIN) decisions with regard to economic and financial matters.

ESA (ESA 95 and ESA 2010): The European system of national and regional accounts is the EU's internationally compatible accounting framework for the systematic and detailed description of the economies of the EU Member States and regions. For most of the audited period the relevant system was ESA 95, which was upgraded in September 2014 to ESA 2010, reflecting developments in measuring modern economies, advances in methodological research and the needs of users.

While the ESA is broadly consistent with the definitions, accounting rules and classifications applied by the comparable United Nations system, it also has some specific features which are more in line with EU practices.

European Exchange Rate Mechanism 2 (ERM II): The European Exchange rate mechanism (ERM) was set up in order to stabilise exchange rates and help Europe to become an area of

monetary stability before the introduction of the single currency, the euro. After the euro's introduction on 1 January 1999, the original ERM was replaced by ERM II at the start of Stage Three of economic and monetary union. This began with the irrevocable and definitive fixing of exchange rates, the transfer of monetary competence to the European Central Bank, and the introduction of the euro as the single currency. ERM II provides a framework for exchange rate policy co-operation between the Eurosystem (the central banking system of the euro area) and European Union Member States that are preparing to adopt the euro.

European Fiscal Board: An independent advisory body to the Commission established in 2015. The board's main task is to evaluate the implementation of the EU fiscal rules.

European Semester: The annual EU cycle of economic policy coordination. The Semester covers fiscal policies as determined by the Stability and Growth Pact, the prevention of excessive macroeconomic imbalances (under the Macroeconomic Imbalances Procedure) and structural reforms in the context of the Europe 2020 strategy. It results in country-specific recommendations to Member States.

Excessive deficit procedure: A procedure launched by the Council upon recommendation by the European Commission against any European Union Member State that exceeds the budgetary deficit ceiling imposed by the EU's Stability and Growth Pact legislation. The procedure entails several steps, potentially culminating in sanctions, to encourage a Member State to get its budget deficit under control, and is a requirement for the smooth functioning of Economic and monetary union.

Expenditure benchmark: Rule that contains the net growth rate of government spending at or below a country's medium-term potential economic growth rate, depending on the country's position in relation to its medium-term budgetary objectives (MTOs). Under the expenditure benchmark, spending increases, which go beyond a country's medium-term potential economic growth rate, must be matched by additional discretionary revenue measures. The expenditure benchmark complements the MTO by putting growth in net expenditure on a sustainable path and therefore helping to move towards or maintain the MTO itself.

Fiscal Compact: Fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

Government debt: The total gross debt at nominal value outstanding at the end of the year of the general government sector as defined in ESA 95 and ESA 2010.

Government budget balance (deficit): The difference between revenue and expenditure of the general government sector. When negative, usually referred to as a deficit. Also referred to as the headline balance/deficit.

Matrix of required adjustments: A table that sets the required annual fiscal effort required from Member States in relation to the economic cycle, taking into account their fiscal consolidation needs including their level of public debt. The commission first used one version of the matrix internally, and then published a revised version in January 2015. It was endorsed by the ECOFIN Council of 12 February 2016 in the "Commonly agreed position on flexibility within the SGP".

Medium-term budgetary objective: The level of structural balance each Member State is expected to converge to. For most Member States it is -1 % of gross domestic product (GDP), and for euro zone Member States somewhat tighter, -0.5% of GDP, unless they have a low debt ratio. The level for each Member State is determined on the basis of various country-specific fiscal risks.

One-off and temporary measures: Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also Structural (budget) balance.

Output gap: The difference between actual output (i.e. GDP) and estimated potential output at a given point in time.

Potential GDP: The level of GDP that an economy can produce in a given year which is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity will start to bite and inflationary pressure will build; if output falls below the potential level, resources are lying idle and inflationary pressure will abate. The level and growth of potential output are continuously re-estimated, which might lead to ex-

post revisions in their estimated values. For the purposes of the preventive arm, the potential output estimates are produced by the Commission based on the EU commonly agreed methodology (for more on methodology see: "The production function methodology for calculating potential growth rates and output gaps", European Economy, Economic Papers No. 535, November 2014).

Primary balance/deficit: Government balance/deficit increased/reduced by interest payments.

Public debt: See *Government debt*.

QUEST model: The global macroeconomic model that the Directorate General for Economic and Financial Affairs (DG ECFIN) uses for macroeconomic policy analysis and research.

Significant deviation procedure: The Commission may trigger a significant deviation procedure when a sizeable deviation is detected in the structural balance and expenditure relative to the adjustment path. Under the significant deviation procedure, Member State is expected to implement measures for correcting the deviation.

Stability and Growth Pact: An agreement binding on all the EU Member States since 1997 (reformed in 2005 and 2011) concerning implementation of the Maastricht Treaty provisions addressing the sustainability of Member State fiscal policies, essentially by maintaining public deficit and debt at acceptable levels.

Stability and Convergence Programme: A document produced annually by Member States which presents the Member State's policies and measures to ensure sustainable fiscal policies, to maintain their fiscal positions at or above their medium term objectives, or follow a path towards the MTO, whilst simultaneously ensuring adequate debt reduction efforts to comply with the debt rule and the treaty reference value of 60 %.

Structural (budget) balance: The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance (see also government budget balance/deficit).

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG): Intergovernmental treaty agreed at the EU summit of 30 January 2012 and signed on 2 March by the Heads of State or Government of all EU countries, with the exception of the United Kingdom and the Czech Republic. It includes provisions to foster economic policy coordination and convergence and specific chapter – Fiscal Compact - to strengthen the fiscal governance framework of the euro area.

Vintage of data: A set of estimated and forecasted data for several years at a given point of time. As the time passes, forecasts for a year (for example 2018) change, i.e. they are different in different vintages of data (for example, in projections from 2014, 2016, etc).

EXECUTIVE SUMMARY

Is the main objective of the preventive arm delivered?

I. The preventive arm of the Stability and Growth Pact (SGP) was introduced to strengthen fiscal discipline in Member States. The main rationale for the European Union to safeguard discipline and stability is that a fiscal crisis in one Member States might cause problems to others.

II. The Regulation on preventive arm from 1997 (No 1466/97) after being amended in 2005 and 2011 now requires that Member States improve their structural balances, i.e. headline balances adjusted for cyclical factors and one-offs toward country specific targets called Medium Term Objective (MTO), which for most countries are set between 0.5 % and -1 % of gross domestic product (GDP). This should ensure that the Member States headline deficit does not breach the 3 % of GDP ceiling set in the Treaty. More importantly, it would also ensure convergence within a reasonable time, of public debt ratios in heavily indebted Member States, towards the limit of 60 % of GDP set in the Treaty.

What we audited

III. We audited whether the European Commission had used the authority that it was granted by the Regulation to ensure an adequate implementation of the preventive arm. We also addressed the issue of interaction between the preventive and corrective arm of the SGP to the extent that it is relevant for the former. The Commission was the auditee.

What we found

IV. The Regulation has set a reasonable benchmark for annual convergence towards the MTO of 0.5 percentage points of GDP per year. However, it has allowed deviations from that requirement, and authorised the Commission to grant various flexibility clauses. The effectiveness of the preventive arm therefore depends very much on the way in which the Commission implements it (***Part I***).

V. The implementation rules decided by the Commission and its operational decisions do not ensure that the main objective of the Regulation is met - i.e. that Member States

converge toward MTOs in a reasonable period. (Some of the main implementation rules after announced by the Commission were later endorsed by the Council.)

VI. Implementation rules on flexibility stem from 2005 reforms of the regulation but were not formally operationalised until 2015 when they reflected considerations prompted by the Great recession. Some flexibility in crisis periods was appropriate in principle, but specific provisions were not time–bound and effectively went too far in practice particularly when implemented during more normal times. Moreover, the rules set by the Commission do not distinguish enough between those Member States that do have a high level of debt and others. Instead of tightening the framework as the recovery was progressing, the Commission further weakened it in 2017 by introducing the new "margin of discretion".

VII. The structural reform allowance is no longer linked to the actual budget costs of the reform, but it is used as an "incentivizing instrument". All allowances (except for the pension reform) increase spending not only in the particular year for which they are granted, but also in the following years. The cumulative effect of all these allowances have resulted in multi-year delays in effective deadlines for reaching MTOs (***Part II***).

VIII. The credibility of the preventive arm has been further eroded by the developments in the corrective arm. The Commission considers that the requirements of the corrective arm can be fully met just by cyclical recovery, which is also facilitated by the Commission's practice of proposing to Council granting multi-year extensions for exiting excessive deficit procedures (EDP). As a result, Member States under EDP do not have to fulfil the requirements for improving their structural balances they would otherwise have to observe if they were under the preventive arm.

IX. Of particular concern is that the weakened SGP framework is unable to ensure progress towards the MTOs in several highly indebted Member States. In the period of recovery and expansion in 2014-2018, their structural balances have either diverged from their MTOs or converged to them at such slow pace that substantial improvement ahead of the next recession is far from being assured. Despite the fact that the weakened framework is not ensuring progress towards MTOs, the Commission has decided that compliance with it is essential for justifying a non-activation of the debt-based EDP (***Part III***).

X. At the technical level, we found weaknesses and information gaps in the Stability and Convergence Programmes (SCP) submitted by Member States that are not flagged in the Commission's staff working documents (SWD). In addition, the Commission does not explain clearly the differences between its own assumptions and those of Member States with respect to fiscal measures included in the respective forecasts. Moreover, the methodology used in its assessments is not always in line with the Regulation and may delay preventive warnings (***Part IV***).

XI. Finally, we found that fiscal country-specific recommendations (CSRs) adopted by Council are based upon the Commission recommendations and reflect the conclusions of underlying technical assessments. However, they do not explain sufficiently the rational for recommended adjustments nor the risks if Member States fail to meet the requirements (***Part V***).

What we recommend

XII. The framework needs to be tightened in its important components in a coordinated way. First the Commission should address the issue of persistent cumulative deviations from the required adjustment by introducing ex-poste corrections, i.e. additional requirements in the following years. Second, it should review the parameters in the table that sets requirements for adjustment (the so-called "matrix") so as to ensure that MTOs are reached within a reasonable period of time. Higher requirements should be set for heavily indebted Member States. Third, flexibility clauses should cover only direct costs related to the reforms and unusual events in a particular year.

XIII. We consider that these changes can be achieved with the existing legal framework.

XIV. Commission should explore ways within the legal framework to ensure that the level of structural adjustment required under the preventive arm is also delivered by Member States under the corrective arm.

XV. The Code of Conduct (CoC) should be updated to improve the quality of information required in SCPs on planned fiscal measures. The Commission's documents should report all differences between forecasts and present assessment conclusions in line with the criteria

set in the Regulation. Indicators used should also ensure they provide the earliest possible warnings of deterioration rather than based on most favourable data taken from a mix of past vintages.

XVI. CSRs should contain clear and explicit adjustment requirements in the enacting part of the recommendations and recitals should provide a clearer explanation of the rationale for such adjustments and the risks if these are not implemented.

INTRODUCTION

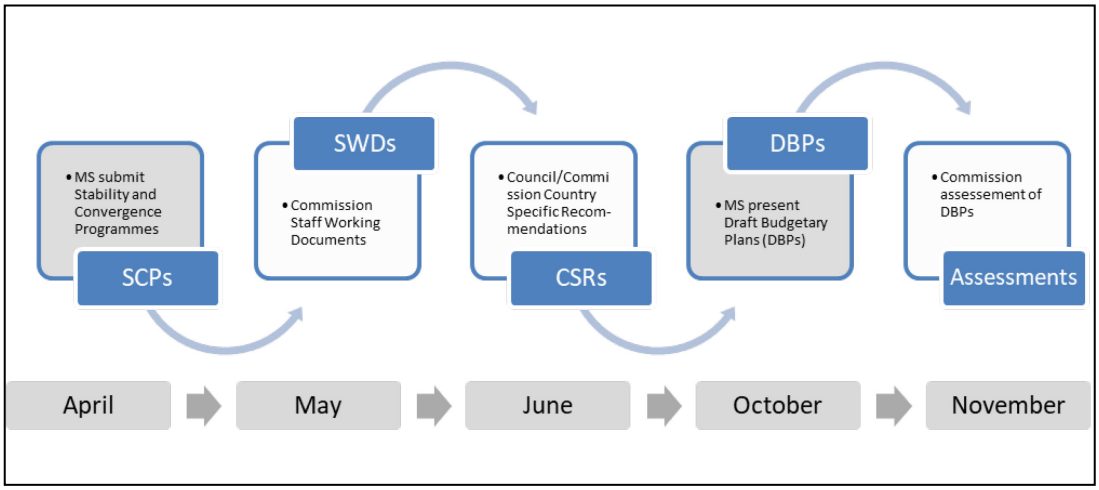
The preventive arm of the Stability and Growth Pact

1. The Stability and Growth Pact (SGP) has established a system of multilateral surveillance over fiscal policies in Member States. It is implemented by the European Commission and Council of the European Union with the objective of ensuring fiscal discipline in Member States. The rationale for the surveillance is that one country's fiscal policies can adversely affect others. This phenomenon is particularly pronounced in monetary unions. The SGP has a preventive and a corrective arm[1].

2. The surveillance is co-ordinated within the European Semester process, which requires Member States to submit their Stability and Convergence Programmes (SCPs) in spring. SCPs are then assessed by the Commission, and the results of these assessments are published in Commission Staff Working Documents (SWDs). The Council on the basis of Commission's recommendations issues country specific recommendations (CSRs) in June every year. Member states in the euro area are also required to present Draft Budgetary Plans (DBP) in October which are assessed by the Commission in November (see ***Figure 1***).

[1] The SGP is based on Articles 121 and 126 of the Treaty on the Functioning of the European Union (the "Treaty") and Protocol No 12 annexed to it, while Article 136 is the basis for measures specific to euro area Member States. The preventive arm was established by Council Regulation No 1466/97 of 7 July 1997 (further amended in 2005 and 2011).

Figure 1 – Milestones of preventive arm surveillance process under the European Semester



Source: ECA.

3. The main objective of the preventive arm, as set in Council Regulation No 1466/97 was to ensure that Member States rapidly converged towards a close-to-balance or surplus budget position, which would then allow them to deal with normal cyclical fluctuations without breaching the 3 % limit on headline deficit[2]. In 2005, the target position for each Member State was recast in terms of a structural balance (SB)[3] which has to converge towards their country-specific medium-term objective (MTO). According to the Regulation, the MTO cannot be below -1 % of the gross domestic product (GDP) for euro area and European Exchange Rate Mechanism 2 Member States. Signatories of the Treaty for Stability Co-ordination and Governance (TSCG) have committed to MTOs of at least -0.5 % of GDP – unless their debt is below 60 % of GDP, in which case the limit remains -1 %[4]. ***Figure 2*** outlines the key steps under the current preventive arm framework.

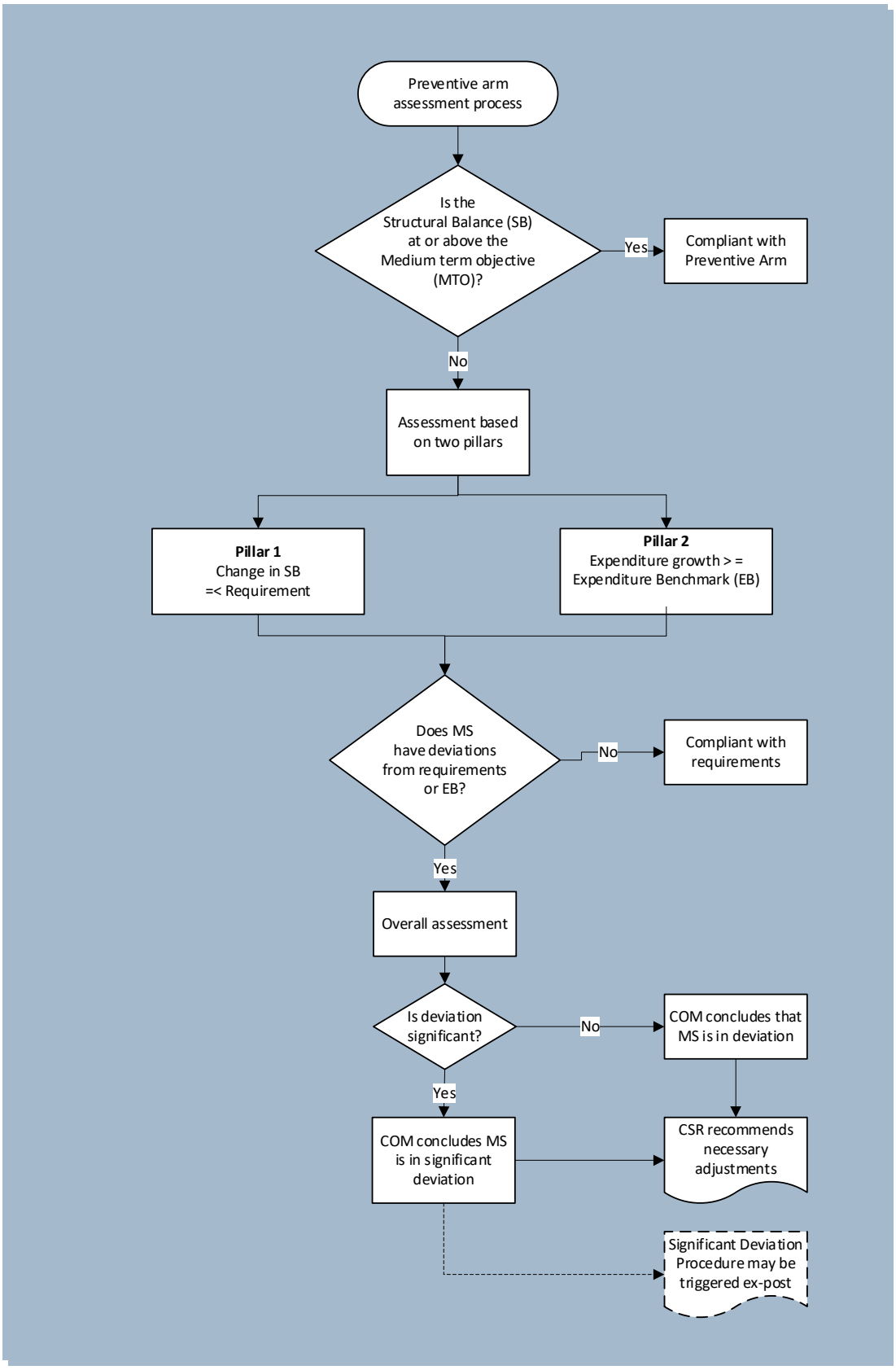
---

[2] A breach of this limit would trigger an excessive deficit procedure (the SGP corrective arm).

[3] Budget balance and the deficit are equal in absolute value, but have opposite sign. The deficit of 3 % equals balance of - 3 %.

[4] Twenty-two out of the 25 signatories of the TSCG are formally bound by the Fiscal Compact (the 19 euro area Member States plus Bulgaria, Denmark and Romania).

<u>Figure 2</u> – Preventive arm rules



Source: European Court of Auditors (ECA).

4. With growth of the EU economies having slowed since 2007 and public debt ratios having increased sharply in many Member States, the preventive arm has gained importance beyond the need to create fiscal space for operation of automatic stabilizers and for discretionary anticyclical fiscal policy[5]. Fast convergence towards the MTOs has become crucial to reduce excessive debt ratios. Even the most indebted Member States would quickly put their debt ratios on a declining path as soon as they reached their MTOs. This prompted the Commission to acknowledge that compliance with the preventive arm is an essential condition for not triggering the debt-based excessive deficit procedure (EDP)[6].

Audit scope and approach

5. The main audit question was whether the Commission had effectively coordinated the Member State fiscal policies needed for achieving the objectives of the preventive arm of the SGP under its assigned responsibilities for the European Semester.

6. More specifically, we examined:

(a) the clarity of the objectives and conditions set in Regulation No 1466/97 to ensure that the Member States with deficits and/or high debt levels (above 60 % of GDP) progressed rapidly towards their MTOs (***Part I***);

(b) the Commission's implementation of the Regulation, whether it is compliant with the rules and whether operational decisions are effective in relation to preventive arm rules (***Part II***);

---

[5] Fiscal policy acts as an automatic stabilizer when it lets the headline deficit increase in a time of recession, but does not implement additional measures that would worsen the structural deficit. In a boom period, it allows the headline deficit to decline in a similar way.

Discretionary anticyclical fiscal policy is the one that takes additional measures to stimulate the economy at the time of a recession. This leads to an increase in the structural deficit (i.e. decline in the structural balance). At the time of a boom, anticyclical fiscal policy would try to cool the economy, and reduce the structural deficit (i.e. improve the structural balance). The opposite is a pro-cyclical policy.

[6] For example see Report prepared in accordance with Article 126(3) of the Treaty on Italy, Commission 2016, Brussels, 22.2.2017 COM(2017) 106 final.

(c) the overall rate of progress, particularly of high-debt Member States, towards their MTOs (***Part III***);

(d) the Commission's work to ensure the submission of comprehensive and adequate SCPs, and to assess their plausibility and compliance with the regulations and the Code of Conduct (CoC) of the SGP, the quality of the Commission's SWDs and other related country assessments (for example, the DBPs for euro area Member States submitted in the autumn) in terms of whether they report, in a timely and consistent manner, on the most important risks and appropriate policy responses (***Part IV***);

(e) the basis for and relevance of CSRs as well as their monitoring, and level of implementation (***Part V***);

7. We assessed the effectiveness of the Commission's implementation of the preventive arm in the period 2011 to 2016 (including the analysis of the spring 2017 SWDs in relation to 2016) and followed the most important developments in 2017 and 2018.

8. We examined the preventive arm in detail for a sample of six Member States (Austria, Belgium, Finland, Hungary, Italy, and the Netherlands). However, for some of the aspects analysed, we also considered other Member States. The six Member States selected included five from the euro area and one from non-euro area. Member States that were already covered under similar audits were excluded (with the exception of Italy[7]) and from the remaining Member States, we selected those that had: the highest level and persistence of SB deficits and debt; or the longest durations under EDP; as well as the highest distance from their MTO (see ***Annex I***).

---

[7] Italy exited EDP in June 2013, and the period before was partially covered under Court's EDP audit. It was included in the sample given the extensive application of flexibility clauses under the preventive arm and its overall importance for macroeconomic developments in the EU.

9. Our audit criteria came from:

(a) the requirements of the legal framework, in particular Regulation 1466/97 related to the European Semester;

(b) the CoC for the content of the SCPs;

(c) the Commission's rules and procedures, e.g. vade mecums, and other guidelines issued to Member States or internally to the Commission Directorate General for Economic and Financial Affairs' (DG EFCIN) staff;

(d) documents issued by a number of EU institutions and other international organisations [in particular the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the European Central Bank (ECB)] or resulting from research to identify best practice.

10. We visited DG ECFIN for an introduction to the rules framework, the rationale behind various operational decisions, and the internal processes involved in assessing Member States' fiscal plans and ultimately producing CSRs.

11. We interviewed staff from the country desks at DG ECFIN for the six Member States in the sample and reviewed a range of Commission documents, both texts in the public domain and internal records. We also carried out information visits to the six Member States in the sample, where we met the Commission's counterparts in the respective ministries of finance and economy, representatives from fiscal councils and European Semester Officers at EU representations.

12. We organised an advisory panel of independent experts from academic and research institutions and think tanks, and invited a number of Member States fiscal councils to an internal seminar to share their views on the framework and the various developments they had observed in Member States.

13. We performed analytical tests on the compliance assessment models used by the Commission. We tested whether the models had been structured to reflect the conditions in

the regulations, and whether the models were accurate and consistent across Member States and over time.

14. We also tested the impact of certain operational approaches by comparing the outcomes to simulations of alternative interpretations, and re-performed various analyses carried out by country desks, reviewing Member State SCPs, Commission SWDs, internal working papers and other available information to determine whether there was a sound basis for certain observations and recommendations the Commission had made.

OBSERVATIONS

Part I — the regulation set an appropriate pace for converging towards the MTO but included ambiguous provisions

15. To achieve fast convergence towards the MTOs, the Regulation set an average annual SB adjustment benchmark of 0.5 % of GDP, and stated that the benchmark should be higher for Member States with debt exceeding 60 % of GDP[8].

16. Somewhat contradictorily, the Regulation allows for a relatively large margin of deviation from the benchmark before a Member State is considered non-compliant. Some margin of deviation could be considered appropriate given the uncertainties involved in forecasting and budget execution. But the envisaged margin is large: in one year, the permitted deviation can be 0.5 %, i.e. the same size as the as the benchmark. Over two years, it can be again 0.5 % of GDP in total (i.e. 0.25 % on average in each year). Such a relatively large margin of permitted deviation has created ambiguity about what is actually expected from Member States. Even more importantly, the Regulation does not explicitly set a cumulative limit for such deviations over several years, which could be interpreted to imply that the deviation of little less than 0.25 % can continue indefinitely[9]. This has an important impact

---

[8] Article 5(1), paragraph 2 and Article 9(1), paragraph 2 of Regulation No 1466/97.

[9] See similar observations from the European Fiscal Board, Brussels, p. 55 of the European Fiscal Board's 2017 Annual Report, Section 5.1.3.

on the time it takes a Member State to reach its MTO and, therefore, on the effectiveness of the preventive arm.

17. Furthermore, the Regulation contains a number of conditions and flexibilities which could have an additional impact on the preventive arm's effectiveness, depending on how they are implemented by the Commission.

18. The Regulation introduced the notion that the SB adjustment should be cycle-dependent, although it implies that some adjustment would still be required in bad times. It requires the Commission and the Council to consider "whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times"[10].

19. Furthermore, the Regulation allows "room for budgetary manoeuvre, considering in particular the need for public investment"[11].

20. The Regulation provides for flexibility by requiring the Council and the Commission to "take into account the implementation of major structural reforms which have long-term positive budgetary effects, including by raising potential growth, and therefore a verifiable impact on the long-term sustainability of public finances"[12]. To use this flexibility, Member States are required to present "a cost-benefit analysis of major structural reforms which have direct long-term positive budgetary effects" in their SCPs[13]. Requests for flexibility are eligible if the Member State has respected the safety margin to the 3 % reference value and is expected to return to the medium-term budgetary objective "within the programming

---

[10] Regulation No 1466/97 Article 5(1), paragraph 2 and Article 9(1), paragraph 2.

[11] Idem, Article 2a, paragraph 1.

[12] Idem, Articles 5(1) and 9(1).

[13] Idem, Articles 3(2)(c) and 8(2)(c).

period"[14]. The programme period for the SCPs is, in general, four years, with some countries including a 5th year in the programme period.

21. The Regulation also specifically allows for deviations due to the direct incremental costs of pension reforms[15]. The eligible deviation is strictly linked to budget costs in the first year following the introduction of the reform and any annual incremental costs in subsequent years. Given positive long-term effects of the pension reforms on the fiscal sustainability, this clause is not detrimental for the effectiveness of the Regulation.

22. Finally, the Regulation also provides for deviations resulting from unusual events, beyond the Member State's control, which have a major impact on their financial position, and from a severe economic downturn in the euro area or the Union as a whole, provided that these deviations do not endanger medium-term fiscal sustainability.

23. While the basic requirements in the Regulation were formulated in terms of improvements to the budget balance and structural balance, the reforms in 2011 introduced in addition an expenditure benchmark (EB). This benchmark requires that the growth path of annual expenditure as defined in Article 5(1)(b) of the Regulation[16] does not exceed a medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. Additionally, if a Member State is not at its MTO, then annual expenditure growth should be lower than the medium-term rate of potential GDP growth, with the aim of achieving the targeted improvement in the SB.

24. While the two benchmarks (EB and SB benchmark requirement) could, in theory, produce the same results, different compliance results may stem from certain differences, such as the use of a different potential growth rate from the one used for the SB, or the

---

[14] Idem, Articles 5(1) and 9(1), sub-paragraph 10.

[15] Idem, Articles 5(1) and 9(1).

[16] "The expenditure aggregate shall exclude interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure."

exclusion of interest spending. The expenditure rule does, however, offer some advantages in the ex post assessment of performance[17].

Part II — the Commission has extensively exercised the discretion granted but has not focused on the main objective

Cyclicaly adjusted requirements combined with margin for deviation and margin for discretion do not deliver the benchmark rate of adjustment

25. To differentiate the adjustment according to the position of the economy in the business cycle (referred to as "bad versus good times" in the Regulation), the Commission published a matrix of required adjustments (hereafter referred to as "matrix") in 2015 that stipulated the required adjustments (see ***Figure 3***). The main criterion for determining good or bad times is the output gap (OG), which has been split into five categories: exceptionally bad times, very bad times, bad times, normal times and good times. The matrix does not envisage any adjustment during "exceptionally bad times", a concept not mentioned in the Regulation. Member States with debt of less than 60 % of GDP are not required to make any adjustment in "very bad" times and unless growth is above potential even in "bad" times. Although not required by the Regulation, the Commission subsequently reached agreement on the matrix (and other flexibilities, see below) with Member States via the Economic and Financial Affairs Council (ECOFIN)[18].

---

[17] Focus on the expenditure benchmark places a stronger emphasis on those policy levers directly controlled by government and it is more predictable than the SB indicator.

[18] Commonly Agreed position on Flexibility in the Stability and Growth Pact; ECOFIN Council of the EU; 14345/15; Brussels, 30 November 2015, p. 8; OUTCOME OF THE COUNCIL MEETING, 3445th Council meeting Economic and Financial Affairs Brussels, 12 February 2016.

Figure 3 - Matrix for determining the annual fiscal adjustment towards the MTO under the preventive arm of the pact

	Condition	Required annual fiscal adjustment*	
		Debt below 60 % and no sustainability risk	Debt above 60 % or sustainability risk
Exceptionally bad times	Real growth <0 or output gap <-4	No adjustment needed	
Very bad times	-4 <= output gap <-3	0	0.25
Bad times	-3 <= output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 <= output gap < 1.5	0.5	> 0.5
Good times	output gap >= 1.5%	> 0.5 if growth below potential. >= 0.75 if growth above potential	>= 0.75 if growth below potential. >= 1 if growth above potential

* All figures are in percentage points of GDP.

Source: COM (2015) 12 final, Annex 2.

26. For situations of negative growth rates and an output gap lower than - 4 %, the matrix uses the words "no adjustment needed", instead of "zero adjustment". This might suggest that the different terms were used to allow for a decline in the SB during sharp recessions, although the Commission stated during the audit that they would require a zero adjustment in both cases[19]. The large number of different categories relating to "bad times" reflects the fact that the matrix was introduced during a period of deep recession, which might have also affected the values of its parameters.

27. The Commission has made a small and not consistent differentiation in the adjustment requirements for Member States with higher debt ratio (i.e. above the 60 % limit) and other

[19] Regardless of the rules and their interpretation, it is very difficult to prevent a worsening in the structural balance during recessions. For example, during the relatively mild recession in 2000, the structural balances in euro area countries declined on average by 1.2 pp of GDP between 2000 and 2002. During the great recession, structural balances declined by 2.5 pp of GDP between 2007 and 2010 (Based on IMF data, World Economic Outlook, October 2017).

Member States. The requirement for the former is set higher by a quarter of a percentage point in bad and good times, but surprisingly not in normal times. For them, the Commission has simply specified that the requirement should be higher than 0.5 % of GDP. The 2016 Vade Mecum explains that higher than 0.5 % of GDP is "conventionally understood to be 0.6 % of GDP at least"[20]. While an adjustment of 0.6 % of GDP has been required in normal times, there is no evidence that a requirement higher than this amount has been recommended in normal times for MS with higher debt levels.

28. The matrix draws a distinction depending on whether growth outpaces potential, or not. However, this is done in an inconsistent manner as the requirements are higher by a quarter of a percentage point more in bad and good times if growth is above potential, but in normal times there is no such additional adjustment for low-debt countries, while it is unspecified for high-debt countries. Although it should be easier to implement reforms when growth is fast, i.e. higher than the average or potential growth rate, the Commission argued that they had considered the feasibility of larger adjustments, including their political viability (see also ***paragraph 50***).

29. Before setting the matrix values, the Commission did not analyse how the set parameters, combined with the "significant deviation" defined in the Regulation, could ensure that the Member States reached their MTO in a reasonable time. The matrix was not based on a simulation of whether, under reasonable macroeconomic assumptions, its values would produce an average improvement in the SB of 0.5 pp of GDP over a reasonable period of time. The only analysis done was on the distribution of output gaps, without looking at implications for reaching the MTO.

30. The European Fiscal Board warned that, in the absence of restrictions on cumulative deviation in the Regulation, Member States had an incentive to systematically deviate from

[20] Vade Mecum on the Stability and Growth Pact 2016, paragraph 5, Box 1.6, p. 38.

the required adjustment towards the MTO, and that some may have planned to do so within the permitted margins[21].

31. Weakening the framework further, in May 2017 the Commission introduced a "margin of appreciation", also referred to as the "margin of discretion"[22]. It announced that it intended to use this margin in cases where the impact of a large fiscal adjustment on growth and employment would be particularly significant[23].

32. In its proposed country-specific recommendations for Italy in May 2017, the Commission stated that the required adjustment would need to be "at least 0.6 % of GDP", but then added: "As recalled in the Commission Communication accompanying these country-specific recommendations, the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal to achieve a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of Italy's public finances. *In that context, the Commission intends to make use of the applicable margin of appreciation in the light of the cyclical situation of Italy."*[24]

33. In this way, the Commission announced ex ante that a significant deviation from the adjustment set in the CSRs might not trigger a non-compliance assessment. This has reduced the relevance and credibility of the set requirement.

34. Further explaining this new flexibility later in the year, the Commission stated that it could exercise a degree of discretion when assessing compliance with the SGP[25]. Therefore, even if a Member State was significantly deviating from its required adjustment, the

---

[21] See p. 55 of the European Fiscal Board 2017 Annual Report.

[22] COM(2017) 500 final "2017 European Semester: Country-specific recommendations".

[23] In its 2017 Annual Report, the European Fiscal Board stated in this context: "While flexibility is desirable, the growing number of flexibility provisions under the SGP is increasingly perceived as lacking transparency and, at times, to be determined in an ad hoc manner including in response to political considerations".

[24] COM(2017) 511 final.

[25] COM(2017) 800 final "2018 Draft Budgetary Plans: Overall Assessment".

Commission "might eventually conclude" that a significant deviation procedure was not warranted. In this context, the Commission refers to Article 6(3) of 1466/97, claiming that although the overall assessment was linked to precise quantitative criteria, it was not limited to such criteria, allowing the Commission to take other elements into account.

35. Further explanations for using additional relaxation appeared in the Commission's 2018 overall assessment report on the DBPs. The justification for relaxation is given on the grounds that the recovery still appears fragile or could be jeopardised by a too large fiscal tightening. It is stated that Member States with a debt-to-GDP ratio above 60 % should ensure effective delivery of a "reasonable fiscal adjustment", which is described by the Commission as roughly half of the requirement from the matrix. The same document sets this reasonable adjustment as the essential criterion for avoiding the debt-based EDP.

36. It should be noted that the latest weakening of requirements has been introduced at a time when the EU and euro area economy has been continuously growing for four years, with growth rates higher than those of potential output. In one case the Commission has justified reducing the adjustment required based on its assessment that recovery is insufficiently robust, but it did not take into account that growth over the past four years (2015-2018), which might appear low, is estimated to have been 1 pp higher than the potential growth rate.

Commission implementation of flexibility, on which it later reached agreement with Member States, leads to long delays in reaching the MTOs and allows for an increase in unrelated expenditure

37. In 2015 the Commission took the position to limit the structural reform clause to 0.5 % of GDP and not to set a limit on the investment clause[26]. Subsequently ECOFIN[27], in agreement

---

[26] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"; Strasbourg, 13.1.2015; COM(2015) 12 final.

[27] Commonly Agreed position on Flexibility in the Stability and Growth Pact; ECOFIN Council of the EU; 14345/15; Brussels, 30 November 2015, p. 8.

with the Commission, set a cumulative limit on combined structural reform and investment allowances at 0.75 % of GDP until a Member State has reached its MTO. No cap has been imposed on the pension reform clause (which is, however, limited to actual costs). No such restriction applies either to the unusual event clause.

38. The investment clause can only be used in a budget year when GDP growth is negative or the negative output gap is greater than 1.5 % of GDP. No such restriction applies to the structural reform clauses (including the pension reform clause). No such restriction applies either to the unusual event clauses.

39. The investment and structural reform allowance can only be granted if a Member State's structural balance is at a distance to the MTO of at most 1.5 pp of GDP. This restriction does not apply to the pension reform clause. It also does not apply to the unusual event clauses.

40. ***Table 1*** provides an overview of all the approved flexibility clauses in 2013-2017.

Table 1 – List of flexibility clauses granted in 2013-2017, in percentage of GDP

MS	Sum of allowed deviation 2013-2017	2013		2014		2015		2016					2017					
		Pension	Investment	Pension	Investment	Pension	Refugee	Structural reform	Pension	Investment	Refugee	Security	Structural reform	Pension	Investment	Refugee	Security	Earthquake
LV	1,20	0,50				0,30			0,30				0,10					
IT	1,20						0,03	0,50		0,21	0,06	0,06				0,16		0,18
BG	0,70		0,60		0,10													
FI	0,67						0,05				0,17		0,50		0,10	-0,15		
SK	0,40				0,40													
AT	0,39						0,09				0,25	0,04					0,01	
HU	0,22						0,04					0,04					0,14	
BE	0,17						0,03				0,08	0,05					0,01	
LT	0,10								0,10				0.4*					
SL	0,08										0,07					0,01		

Sources: 2013 - 2017 Commission.

Granted Ex post
Granted
To be granted ex-post SF 2018

* 0.40 granted fully however conditoinal to respecting the Minimum Benchmark. This meant the allowed deviation for LT was of 0.1 in 2017.

Source: Commission.

Implementation of the investment clause

41. In January 2015 the Commission[28] took the position that the allowance under the investment clause could be granted when Member States intend to incur national spending

[28] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the

on eligible growth-enhancing EU programmes[29]. Nominal expenditure is then calculated as a percentage of GDP, and the adjustment requirement is reduced by the same percentage of GDP. A condition was imposed that euro value of spending on gross fixed capital formation in the corresponding year should not decline. This was subsequently confirmed by ECOFIN in a "Commonly agreed position on Flexibility the Stability and Growth Pact"[30].

42. The current design of the investment clause makes it neither a condition nor an explicit objective for the investment ratio as a share of GDP to increase. In the case of Italy, the Commission reported that, even with the granted investment allowance, the country's budget spending on gross fixed capital formation would, in fact, remain broadly stable relative to GDP[31].

43. As the expenditure relating to the approved investment clause will reduce the SB in the year for which the allowance has been approved, this will affect the path of structural balances in the following years, and the time for converging to the MTO will therefore be extended, all else being equal. As a result, the investment allowance in one year will increase overall permitted spending in the following years, independently of the level of investment spending in those years. There is no condition requiring that levels of increased investment are sustained in subsequent years. This can also be seen in the Commission's description of the effects of the investment clause[32] (see ***Figure 4***).

European Investment Bank on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"; Strasbourg, 13.1.2015; COM(2015) 12 final.

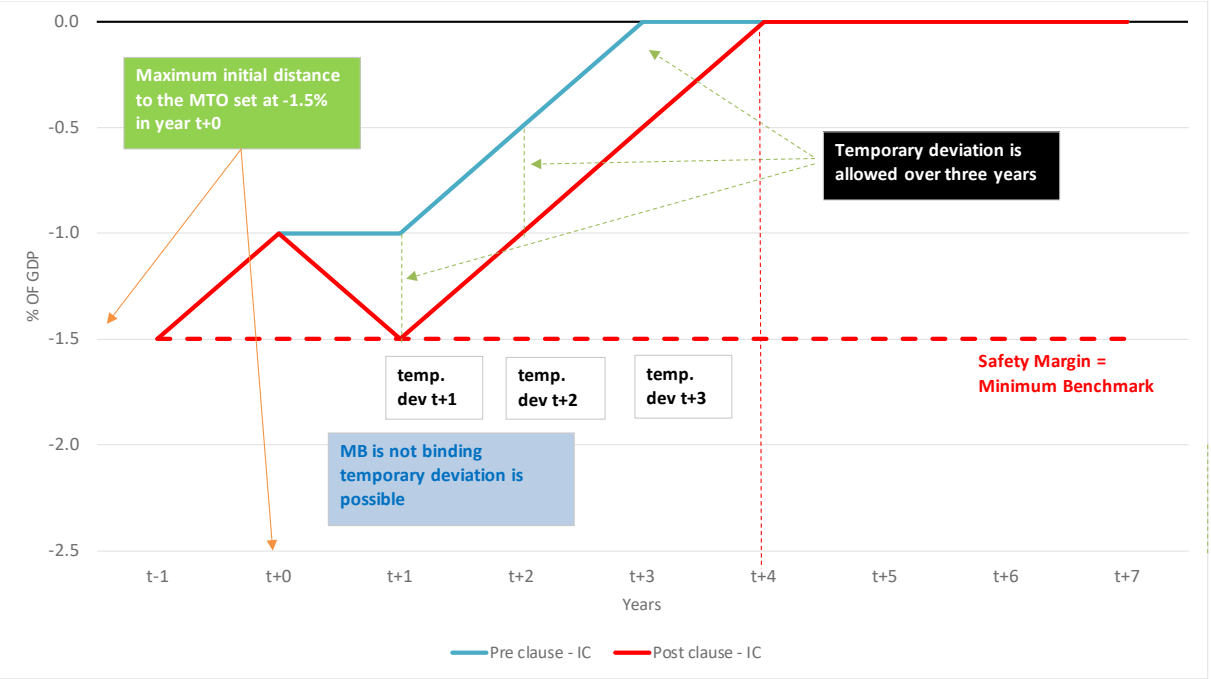
[29] The Commission occasionally refers to the investment allowance as a sub-category of the reform clause.

[30] ECOFIN 888, UEM 422, 14345/15.

[31] Assessment of the 2016 Stability Programme for Italy (May 2016): "Italy's government gross fixed capital formation is forecast by the Commission to increase further in nominal terms in 2016 and 2017 (by 0.9 % and 0.6 %, respectively). As a result, public investment is expected to remain broadly stable as a share of GDP (at around 2.3 %)".

[32] 2017 Vade Mecum, Annex 14, simulation 2, p. 176.

Figure 4 – Simulation of investment clause by Commission



Source: Commission SGP Vade Mecum 2017, Annex 14, Simulation 2, p. 176.

44. To avoid lengthening the convergence time, in the years that follow the Commission would need to increase the adjustment from the matrix by a full or pro-rated amount of the approved investment allowance (and the same applies to structural reform and unusual event allowances, see below). However, the Commission is not applying this approach. It explained during the audit that additional adjustments relative to the matrix would create a stop-start adjustment pattern and could lead to large adjustments which might be considered punitive or deter Member States from implementing structural reforms.

45. In its description of the effects of the investment clause[33], the Commission shows that the convergence time will increase, but claims that the effect of the allowances will have been eliminated by the last year of the programme period. Its calculation is based on the assumption that the average adjustment will amount to 0.5 pp of GDP per year, and that the Member State's initial distance to the MTO is 1.5 % of GDP. Without the investment allowance, the MTO would be reached in 3 years at that pace. With the investment

[33] See various simulations of clauses in the Commission SGP Vade Mecum 2017, Annex 14.

allowance of 0.5 % of GDP another year would be needed. On this basis, the Commission claims that even without compensatory measures in the following years, the effects of clauses will have been eliminated by the end of the programme period (see ***Figure 4***).

46. However, in reality the average 0.5 % adjustment is not achieved owing, among other factors, to the significant deviation margin. The extension in the convergence time will therefore be much longer. It will be further extended when the effects of other allowances (reform and unusual events) are taken into account. In the case of one country, the cumulative non-pension allowances for all purposes reached 1.2 % of GDP in 2015-17 (see ***Table 1***).

47. The effect is that the approved investment allowance leads to increased overall spending in the subsequent years, regardless of what happens to the level of investment spending. The total increase in current spending can therefore surpass the approved investment allowance several times over, until the MTO is finally reached[34].

Implementation of the structural reform clause

48. As with the investment clause, the structural reform allowance results in an increase in permitted spending not only in the year for which it is approved but also in subsequent years (when compared to the original path), and therefore lengthens the convergence time for reaching the MTO.

49. The Commission decided that the structural reform allowance does not need to correspond to the actual budgetary costs of implementing the reform[35]. The Regulation on the other hand clearly requires that a cost-benefit analysis is needed for reform to qualify for

---

[34] See Commission SGP Vade Mecum 2017, Annex 14, simulation 2, p. 176.

[35] It explains that one of the reasons why this is not feasible is that direct costs are considered to be difficult to measure. The Commission also argues that "there may be other costs associated with introducing such a reform that go beyond the direct fiscal costs, for example economic and political costs".

the allowance[36]. For major pension system reforms, it clearly indicates that the allowance should be limited to actual costs.

50. Instead, the Commission exercises discretion in setting the level of the allowance (within the limits approved by ECOFIN), as long as the reform is expected to have a long-term impact on growth and therefore positive budget impacts, despite such effects being much more difficult to measure than the actual budget costs of the reform. In this way, the "standard reform allowance" acts as an incentive for reforms rather than an instrument to cover their costs[37].

51. However, the Commission has many other policy instruments to encourage Member States to implement structural reforms, including its budgetary resources.

52. The Commission will apply the clause in the ex post assessment if the planned reforms are fully implemented[38]. When clauses are granted ex ante, the CSR states that if the planned reform is fully implemented, the ex post assessment of compliance deducts the clause from the fiscal requirement[39]. In the case of Italy in spring 2017, the Commission granted the permitted deviation but did not transparently assess whether all reforms presented in Italy's National Reform Programme of 2015, for which flexibility had been asked, were fully implemented. In the Country Report 2017 some reforms are reported as not implemented (e.g. of the 2015 competition law bill was not adopted).

---

[36] Regulation No 1466/97, Article 3(2)(c) requires that SCPs contain a cost-benefit analysis of major structural reforms which will have direct long-term positive budget effects, including raising potential sustainable growth.

[37] The Commission explained that: "given the acknowledged difficulty surrounding accurately quantifying the impact of structural reforms, a political decision was taken to follow a more generic approach, which carries the benefits of being more efficient, communicable and speedy in terms of delivery. This approach involves the provision of a standard allowance based on a reform or package of reforms being assessed (or verified) as suitably significant. The main focus of the Commission's assessment of an application for the structural reform clause is therefore the sustainability-enhancing nature of the reform package."

[38] Commonly Agreed position on Flexibility in the Stability and Growth Pact; ECOFIN Council of the EU; 14345/15; Brussels, 30 November 2015, Section 3.1., p. 6.

[39] Commonly Agreed position on Flexibility in the Stability and Growth Pact; Section 3.3.(iv.).

53. We found a lack of sufficient information and assessment (both ex ante and ex post) by the Commission of the direct fiscal costs and the long-term benefits underpinning certain clauses. For example, Italy was granted two structural reform clauses for a total of 0.5 % of GDP in 2016; however, the deviation did not correspond to verifiable direct and indirect fiscal costs for the reforms as estimated by Italy. In 2016 the deviation was twice as large as the costs and no costs were forecast in the adjustment period (2017-2019).

54. We further found that the Commission had insufficiently estimated the economic impact related to the clauses. Examples of simulations using the QUEST model[40] do exist but, in some cases, the Commission should have requested more analysis and justification from Member States where they had provided insufficient information. In the case of Italy's structural reform clause of 0.4 % of GDP from 2016, the national authorities estimated the long-term positive GDP impacts of the reforms and provided them to the Commission. In spring 2015 the Commission assessed that the authorities' forecasted positive impacts on GDP to be 'plausible'. However, we did not obtain sufficient evidence to substantiate the Commission's checks. Afterwards, the Commission produced its own impact estimates in December 2015 and revised them in April 2016, in part due the long-term nature of the projections and the related uncertainties of certain assumptions. No estimates were produced at the time of the ex post assessment of the clause (i.e. in Spring 2017). These estimates are indicative at best and generally uncertain, making them inadequate to serve as a criterion for assessing ex post the eligibility of clauses. As regards the investment clause granted to Italy (0.25 % of GDP), the impact on GDP had not been estimated.

<u>The implementation of the unusual events clause</u>

55. Flexibility is allowed for deviations due to unusual events such as a refugee influx, natural disasters or security threats[41]. The Commission must assess whether such events justify flexibility or not. The related clauses do not have a ceiling.

---

[40] The global macroeconomic model that the Directorate General for Economic and Financial Affairs (DG ECFIN) uses for macroeconomic policy analysis and research.

[41] Article 5(1), paragraph 13 and Article 9(1), paragraph 13 of Regulation No 1466/97.

56. As with investment and structural reform clauses, the Commission does not increase adjustment requirements in the years after granting the clause, so as to offset the increase in spending due to the unusual event. The time for achieving the MTO is therefore further prolonged.

57. When assessing the expenditure allowed under the clauses, we found that certain preventive expenditure had been allowed ex ante (for example, preventive action on public buildings in Italy in 2017), despite deviating from the principle in the Vade Mecum requiring that it relate directly to the event[42]. In its replies, the Commission argues that if this expenditure were not incurred, it would be excluded ex post. We believe that, in this particular event, it should have been considered ineligible since it was not directly linked to the actual event.

Selection of the most favourable indicators from several vintages

58. Another relaxation of the framework stems from the use of the most favourable data from several vintages for making decisions at various points of the procedure, instead of the latest available, which are the most reliable. The most favourable in this context means indicators requiring the smallest adjustment. Selection of the most favourable vintages occurs: when calculating the distance of the SB from the MTO and when the adjustment requirement is set and subsequently frozen.

59. The Commission measures the distance to the MTO in a given year by comparing the MTO with the SB of the previous year, doing so by using the most favourable of different vintages, instead of comparing it with the SB of that year. For Member States at their MTO yet with a worsening SB, a delay of one year may occur when assessing a Member State using this approach.

Use of one-sided freezing

60. Once set in the spring of the previous year, requirements are frozen, i.e. never revised upwards, even when data revisions indicate an improvement in economic conditions. For

---

[42] Commission SGP Vade Mecum 2017, paragraph 4, p. 46.

example, in assessing the DBPs in November 2017, the Commission could have taken into account the improved macroeconomic prospects. By contrast, they are revised downwards if an economic situation deteriorates into very bad times.

61. Furthermore, in the assessments of spring 2014, spring 2015 and spring 2016, the Commission selected the most favourable indicators from a mix of vintages that were not comparable since they were based on the European System of Integrated Economic Accounts (ESA) 95 and 2010. During this transitional phase, the mixing of such vintages may have led to diverging positions from those that would have emerged had the indicators used been based on a common standard.

The cumulative effect of clauses and the significant deviation margin prevents attainment of the MTO in a reasonable time

62. When the benchmark for annual convergence of 0.5 pp of GDP was set, the average SB of Member States with a deficit was 2.9 % of GDP[43], and their average MTO was -0.5 % of GDP. This implied that the MTO would be reached in about five years, assuming average macroeconomic conditions in that period. This would be also roughly the convergence time for Member States exiting the EDP, assuming that the headline balance and SB coincide at that point (see ***Box 1***).

Box 1 - What is a reasonable time frame for reaching the MTO under the preventive arm?

The preventive arm regulation does not clearly specify the timeframe for reaching the MTO, although it mentions an "adjustment path sufficient to achieve the medium-term budgetary objective *over the cycle*" (Article 5(1) of the Regulation No 1466/97).

The same article, when explaining the requirements of the structural reform clause, states "that the budgetary position is expected to return to the medium-term budgetary objective *within the programme period*."

[43] Economic Forecast Spring 2006; European Commission, table 2.9, p. 43.

The Commission used far more precise language, relating to the conditions for an investment clause, in its 2015 flexibility communication: "MTO must be reached *within the four-year horizon of the current Stability or Convergence programme*."

The following considerations suggest that a reasonable deadline for achieving the MTO should be no longer than 4-5 years:

- At the time when the preventive arm regulation was adopted and introduced (1997-1999), the average structural balance deficit for euro area countries was below 2 % of GDP. With the defined benchmark for annual adjustment at 0.5 % of GDP, the structural budget deficit would have been eliminated (i.e. be "close to balance or in surplus") within 4 years.

- The purpose of the preventive arm is to create scope for automatic stabilisers to operate freely while keeping the headline budget deficit below the 3 % ceiling. Any period longer than 4 years for achieving the MTO increases the probability of entering the next recession period before the target is achieved. For example, in the euro area, there were only 4 years with growth higher than 1 % between the 2001-2002 recession and the next crisis.

- The debt rule under the SGP requires that the debt-to-GDP ratio fall by an average over three years of 1/20 of the excess between the actual debt ratio and 60 % of GDP. For highly indebted countries, reaching the MTO would deliver such debt reduction. In other words, fast progress towards the MTO within the period of 3 years is crucial for highly indebted Member States to ensuring compliance with the debt rule. Moreover, for countries exiting the EDP, the regulation envisages a transition period of 3 years until the 1/20 debt reduction requirement has been reached.

63. However, taking into account the average significant deviation of 0.25 % of GDP over two consecutive years, a Member State could double its convergence time while still being considered compliant.

64. Flexibility clauses for investment and structural reforms have been limited to 0.75 pp of GDP. With an average fiscal effort of 0.25pp per year[44], the convergence time would lengthen by another three years[45].

65. Flexibility clauses relating to unusual events are not limited; in the case of Italy, they have reached 0.5 pp of GDP. This will lengthen the convergence time by another two years, assuming the same conditions as above.

66. Finally, as experience has shown, any recession would set the clock back. Within the long time frame for achieving the MTO permitted in the framework, a recession is quite likely. The relatively shallow recession in 2000-2002 (average growth rates in the euro area did not turn negative), for example, led to a decline in the euro area structural balance of about 1.2 % of GDP. Such recessions would further prolong the period for reaching the MTO. With the time for reaching the MTO extended, more than one recession might become possible.

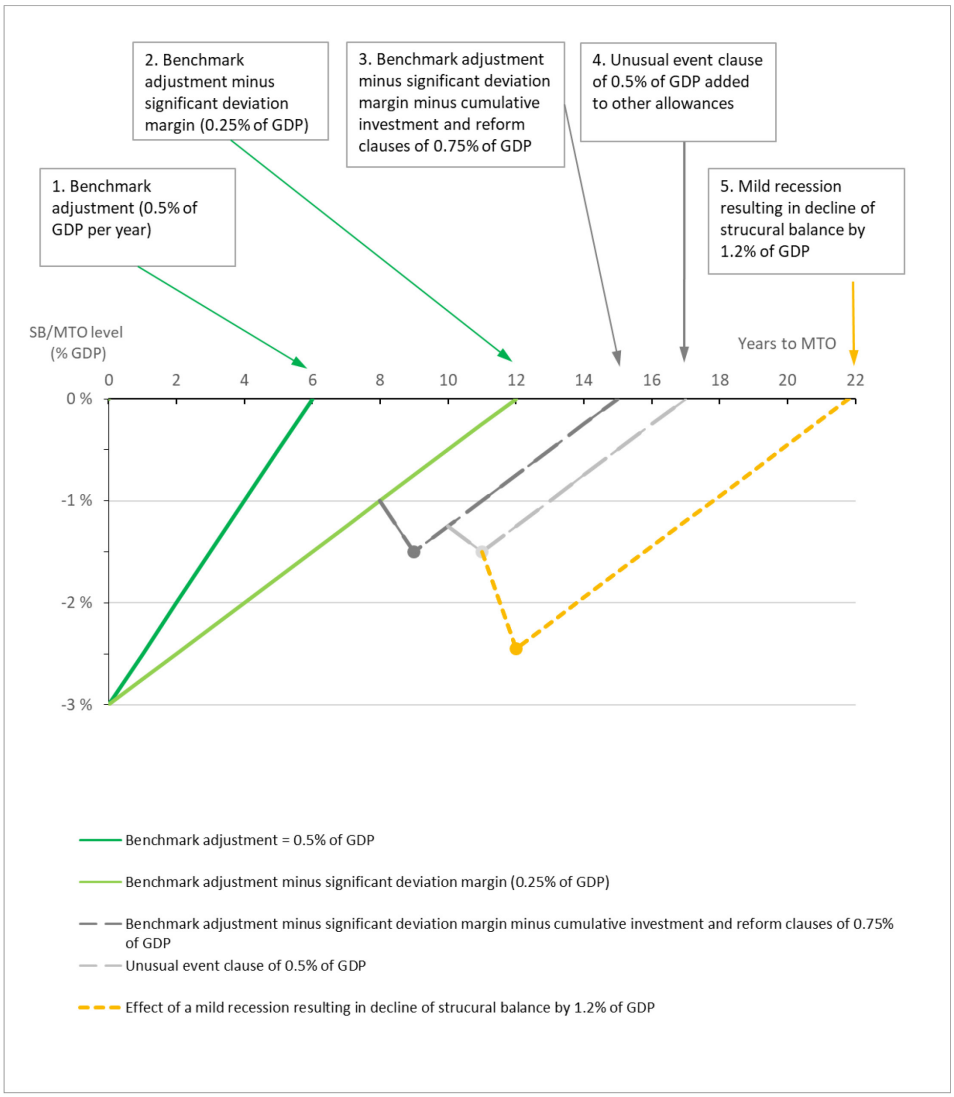
67. ***Chart 1*** illustrates the cumulative effect of the matrix, significant deviation margin, all clauses (except the pension reform clause) and a possible recession on the time for achieving the MTO. Except for the effects of recession, other effects shown in the ***Chart 1*** broadly correspond to those already incurred in practice.

---

[44] The benchmark of 0.5pp of GDP minus the significant deviation margin of 0.25pp of GDP.

[45] Italy received investment and reform allowances of close to that limit.

<u>Chart 1</u> - Cumulative impact on time to reach the MTO of the significant deviation margin, maximum investment and structural reforms, unusual event clauses and a mild recession



Note: (1) We assume that all clauses are granted before the time of recession and when SB is above -1.5 %. This, however, does not affect the result. (2) The average of Member States' current MTO is -0.5 pp of GDP. 3. The cumulative investment and reform clauses are a statutory maximum. The largest amount approved so far was 0.71 %. The unusual event amount is the largest cumulative so far approved.
Source: ECA.

68. Finally, the latest introduction of the new "margin of discretion" has opened a new window to reduce requirements by halving the matrix requirement. A Member State with a debt exceeding 60 % of GDP in normal times would see its requirement in the matrix reduced from 0.6 % to 0.3 %. Moreover, unless it had applied a significant deviation margin of more than 0.25 % of GDP in the previous year, the Member State would then be able to

further reduce this requirement by 0.24 % of GDP, practically avoiding any adjustment despite being in "normal times".

69. When defining the matrix, introducing all these allowances and approving them for specific Member States, the Commission did not analyse the effects of the allowances on a Member State's prospects for reaching the MTO in a reasonable time (see ***Box 1***), which is the main objective of the Regulation. The Commission stated that it had intentionally focused on annual changes in the SB because of uncertainties in forecasting macroeconomic developments. Simulations provided by the Commission and annexed in the Vade Mecum, are not realistic as they assume convergence at the benchmark rate of 0.5 % annually when in reality this changes in accordance to the Matrix and is further reduced by the allowed deviation margin. This short-sighted approach prevents proper assessment of the effects of allowances on achieving the main objective of the Regulation.

70. Altogether the matrix, the significant deviation margin, the various flexibility clauses and the latest margin of discretion have led to a much weaker framework. Specifically, convergence towards the MTOs for Member States that apply all the flexibility clauses could be extended to an extremely long period. This would put Member States with high debt in a precarious position in the next recession, and would also postpone reduction in their debt ratio.

Information value of outer year projections in SCPs

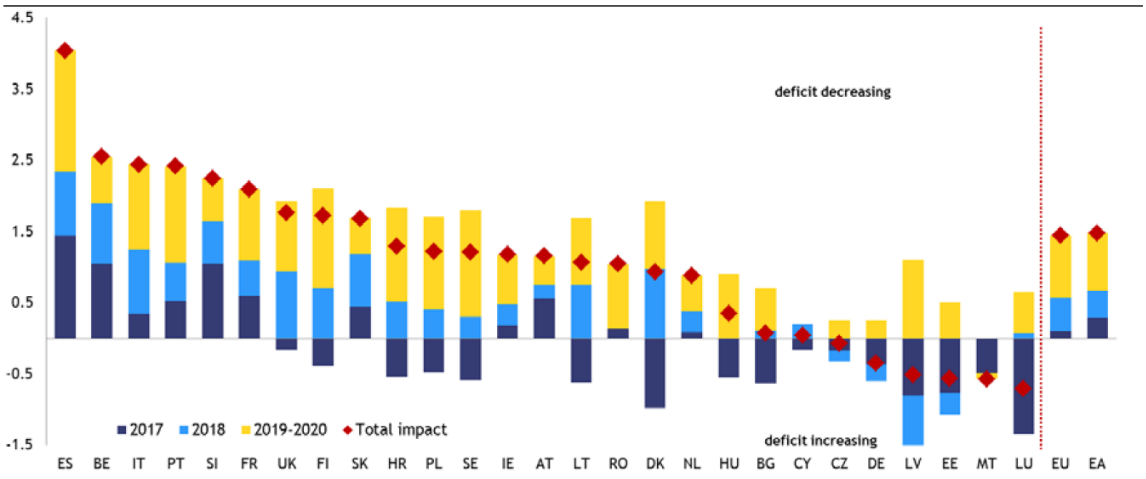
71. Most of the Member States under the preventive arm show in their SCPs that they would reach the MTO by the fourth year, or at least make considerable progress towards it[46]. This is in line with expectations expressed by the Commission in its document "The best use of

[46] See, for example, Box 2.1 in "An Overview of the 2017 Stability and Convergence Programmes and an Assessment of the Euro Area Fiscal Stance for 2018", Institutional paper 059, July 2017.

flexibility…"[47]. However, most progress is projected to be achieved in the last two years of the programme period (see ***Chart 2***)[48].

Chart 2 – Time profile of fiscal developments 2017-2020 as presented in the 2017 SCPs

Graph 2.1: **Time profile of fiscal developments: planned change in headline budget balance (pp of GDP, cumulative) in EU Member States for 2017-2020, as presented in 2017 SCPs**



The graph shows the change in the headline balance over the period 2017-2020 according to 2017 SCPs. Countries are ordered from largest to smallest cumulative change in the headline budget balance in the period 2017-2020.
Source: 2017 Stability and Convergence Programmes.

Source: Institutional Paper 059, July 2017, European Commission, referring to SCPs 2017, p. 17.

72. SB projections are revised every year. For example, most early projections for SB in 2018, made in 2014 and 2015, are far more optimistic than those made in later years, i.e. 2016 and 2017 (see ***Table 2***). Such downward revisions cannot be attributed to worsening macroeconomic prospects since these have actually improved.

---

[47] COM(2015) 12 final, Strasbourg 13.1. 2015.

[48] Graph 2.1 in the same document.

Table 2 - Targeted SB for 2018 in the 2014-2017 SCPs for a sample of Member States, in percentage of GDP

	AT	BE	FI	IT	HU	NL	ES	FR	PT
SCP 2014	-0.3 %		0.3 %	0.0 %					-0.2 %
SCP 2015	-0.5 %	0.0 %	-2.6 %	0.1 %	-1.6 %	-0.5 %	-0.2 %	-0.1 %	-0.4 %
SCP 2016	-0.5 %	0.0 %	-1.4 %	-0.8 %	-1.7 %	-0.6 %	-1.9 %	-0.3 %	-0.8 %
SCP 2017	-0.8 %	-0.4 %	-1.1 %	-0.7 %	-2.4 %	0.3 %	-2.0 %	-0.5 %	-1.1 %

Source: SCPs 2014-2017 for AT, BE, FI, IT, HU, NL, ES, FR, PT.

73. In its 2015 communication on flexibility, the Commission stated that "the Member State must compensate for any temporary deviations and the MTO must be reached within the four-year horizon of its current Stability or Convergence Programme"[49]. This sentence appears in the section dealing with the effects of the flexibility clauses, but seems to suggest that all Member States have to reach the MTO by the end of the SCP programme period.

74. A similar sentence appears in the same context in Article 5(1), which says that "the budgetary position is expected to return to the medium-term budgetary objective within the programme period".

75. However, the Commission does not hold Member States accountable for such revisions, nor does it try to enforce the original target. It has also not designed the matrix in such a way that all Member States, regardless of where they are relative to the MTO, would reach it in the fourth year of the programme period. The persistent overestimates of the structural balances 2-3 years ahead show that the outer year projections in the SCPs have limited information value (see ***Table 2***).

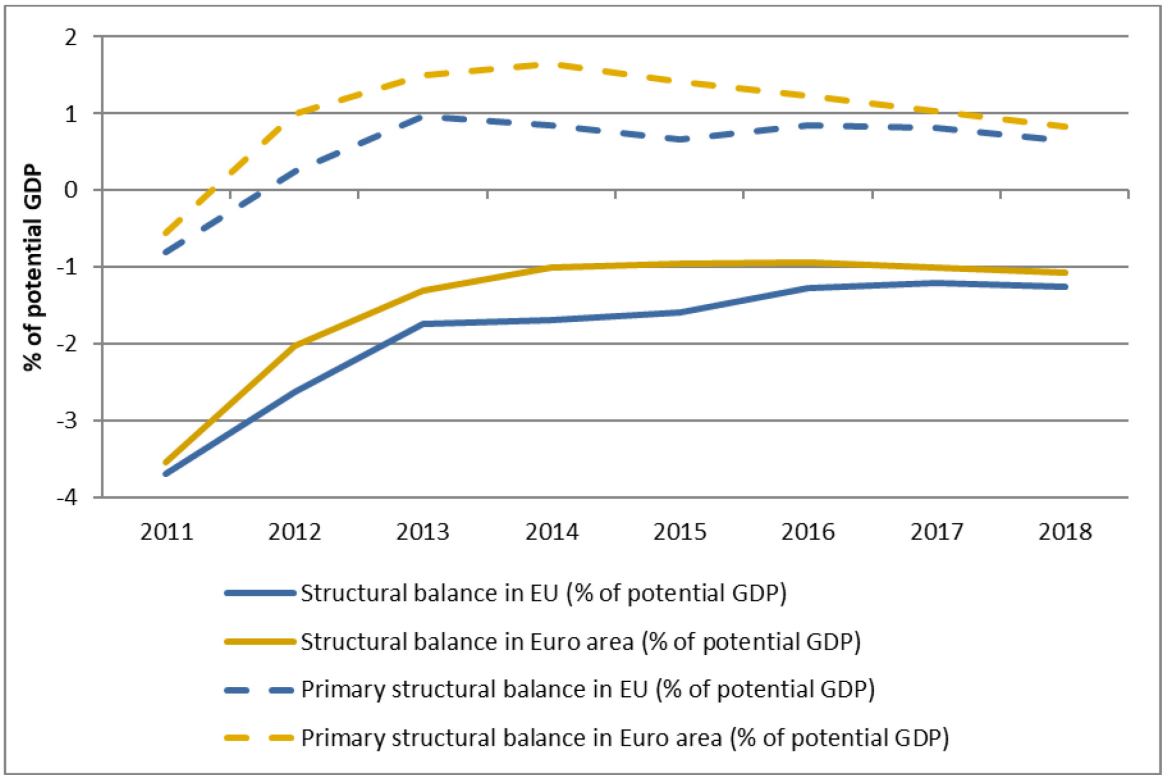
[49] COM(2015) 12 final, section 2.2, Strasbourg, 13.1.2015. It was later approved by the ECOFIN under the title "Commonly agreed position on Flexibility in the Stability and Growth Pact", ECOFIN 14345/15.

Part III — progress towards the MTOs came to a halt as soon as market pressure subsided and several indebted countries are not on the path to achieve the MTO in a reasonable time

No progress towards the MTOs on average in recent years

76. Between 2011 and 2014 fiscal consolidation in Member States was driven by market pressures. Once these pressures subsided and GDP growth returned in 2014, the SGP framework weakened by implementation acts was not capable of ensuring further improvement in the structural balances, particularly among Member States in weak fiscal position. In the Eurozone, after 2014 structural balance remained basically unchanged, while the structural primary balance on average worsened by about 1pp of GDP. Member States spent all the savings coming from lower interest rates (see ***Chart 3***).

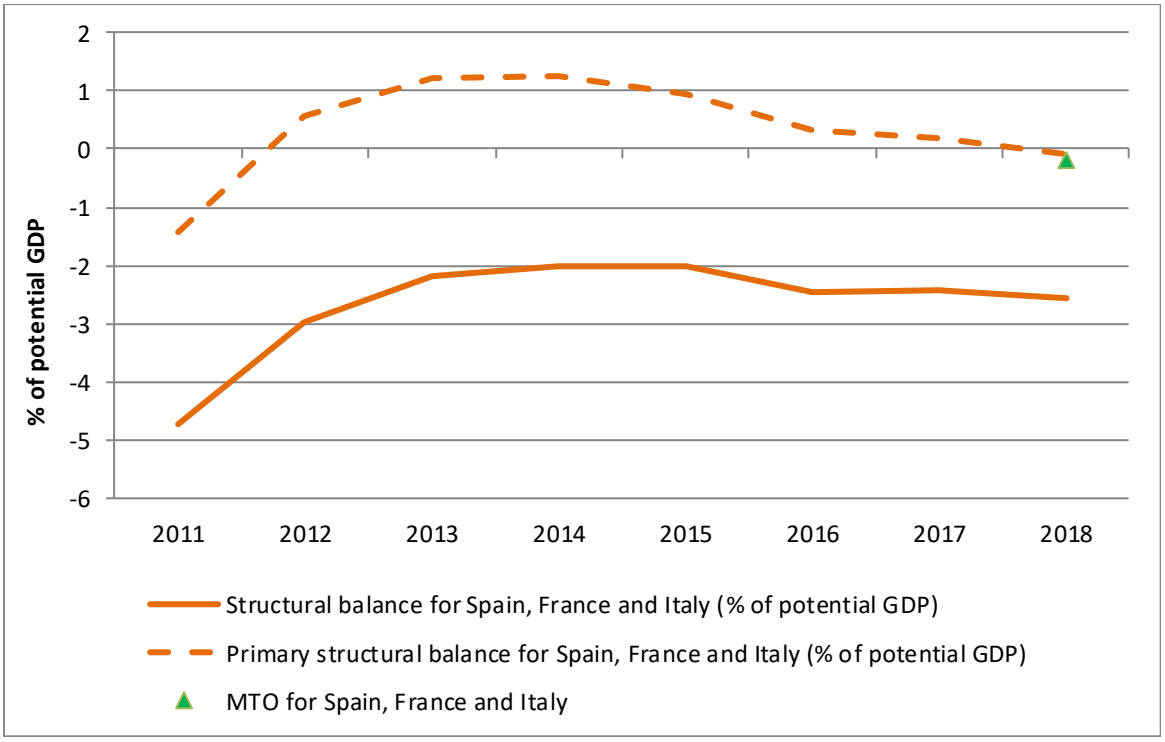
Chart 3 - Structural balance and primary structural balance in EU and Euro area (Percentage of potential GDP for 2011 – 2018)



Source: Annual macro-economic database of DG ECFIN (AMECO), March 2018.

77. In several large euro zone countries (Spain, Italy and France), which are far from their MTOs, the structural balance and even more the structural primary balance worsened substantially (see ***Chart 4***).

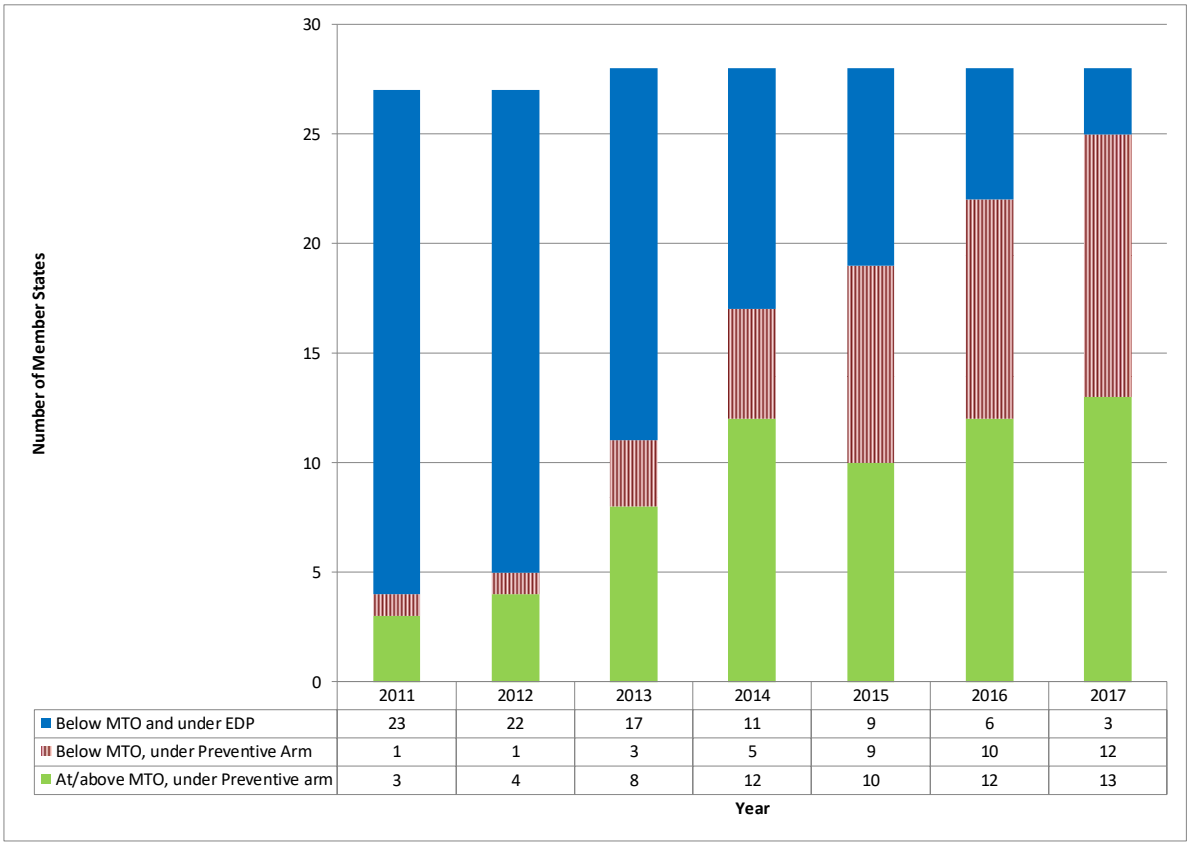
Chart 4 – Fiscal developments in selected EU Member States (average, percentage of potential GDP for 2011 – 2018)



Note: The structural balance for Spain, Italy and France is based on a weighted average of their respective nominal GDP; MTOs based on 2017 Stability Programmes.
Source: AMECO, March 2018.

78. The number of Member States that have achieved their MTO, increased from 3 in 2011 to 12 in 2014 under market pressures despite the adverse economic conditions at that time. After that, progress in that respect also came to a halt, despite the fact that growth returned (see ***Chart 5***). Only about half of Member States are currently at their MTO.

<u>Chart 5</u> - Number of Member States at their MTO (2011 – 2017)



	2011	2012	2013	2014	2015	2016	2017
Below MTO and under EDP	23	22	17	11	9	6	3
Below MTO, under Preventive Arm	1	1	3	5	9	10	12
At/above MTO, under Preventive arm	3	4	8	12	10	12	13

Source: Commission Spring Forecast 2016 for 2013-2015, Commission Spring Forecast 2017 for 2016-2017.

79. ***<u>Figure 5</u>*** presents the rate of progress in structural balance for Members States not at their MTO based on the Autumn forecast data 2017. On average, these 13 countries do not show progress over the four years between 2014 and their latest forecast for 2018. Seven in fact reported a deterioration in their structural balance and only six member states registered improvement. The average worsening was somewhat higher than the average improvement.

Figure 5 – Convergence or divergence of Member States towards their MTO from 2014 to 2018

Member States not at MTO	MTO	Distance to MTO	Structural Balance (% of PGDP)		ΔSB	SB Deteriorating	SB Improving
	2017 SCPs	(SB 2017 - MTO)	2014	2018	(2018-2014)		
Romania	-1.0	**-2.3**	-0.4	-4.3	-3.9		
Estonia	-0.5	**-0.6**	0.0	-1.4	-1.4		
Hungary	-1.5	**-1.7**	-2.2	-3.6	-1.4		
Italy	0.0	**-2.1**	-1.0	-2.0	-1.0		
Latvia	-1.0	**-0.8**	-1.0	-1.8	-0.8		
Austria	-0.5	**-0.4**	-0.8	-1.0	-0.2		
Portugal	0.25	**-2.1**	-1.7	-1.8	-0.1		
Finland	-0.5	**-0.5**	-1.5	-1.4	0.1		
Poland	-1.0	**-1.1**	-2.8	-2.3	0.5		
Slovenia	0.25	**-1.9**	-2.2	-1.6	0.6		
Slovakia	-0.5	**-1.1**	-2.2	-1.2	1.0		
Belgium	0.0	**-1.5**	-2.9	-1.5	1.4		
Ireland	-0.5	**-0.8**	-4.0	-0.5	3.5		
Number of MS.						7	6
Share of total MS which are not at their MTO.						54%	46%

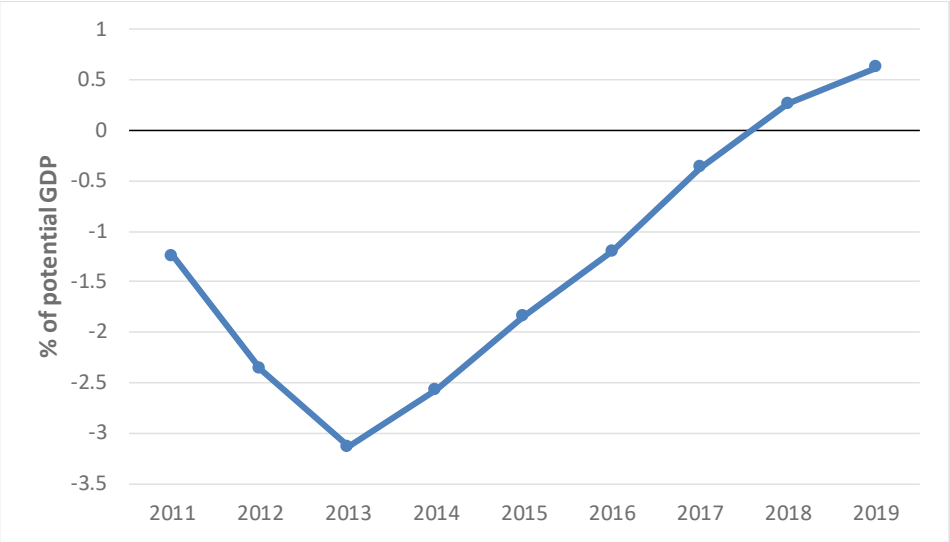
Source: Commission Autumn Forecast 2017, SCPs 2017, Assessment of the DBPs for 2018.

80. Moreover, in 2016 the Commission's position papers on the euro area fiscal stance began recommending fiscal expansion[50], despite the fact that the output gap started to close rapidly after 2013 and will turn positive in 2018 (see ***Chart 6***)[51]. Such recommendations could have weakened the case for fiscal consolidation in Member States not at MTO.

[50] Commission communication "Towards a positive fiscal stance for the euro area", p. 7, COM(2016) 727 final, 16.11.2016, Brussels.

[51] A classical critique of discretionary fiscal policy is that its effects always come too late and then act pro-cyclically.

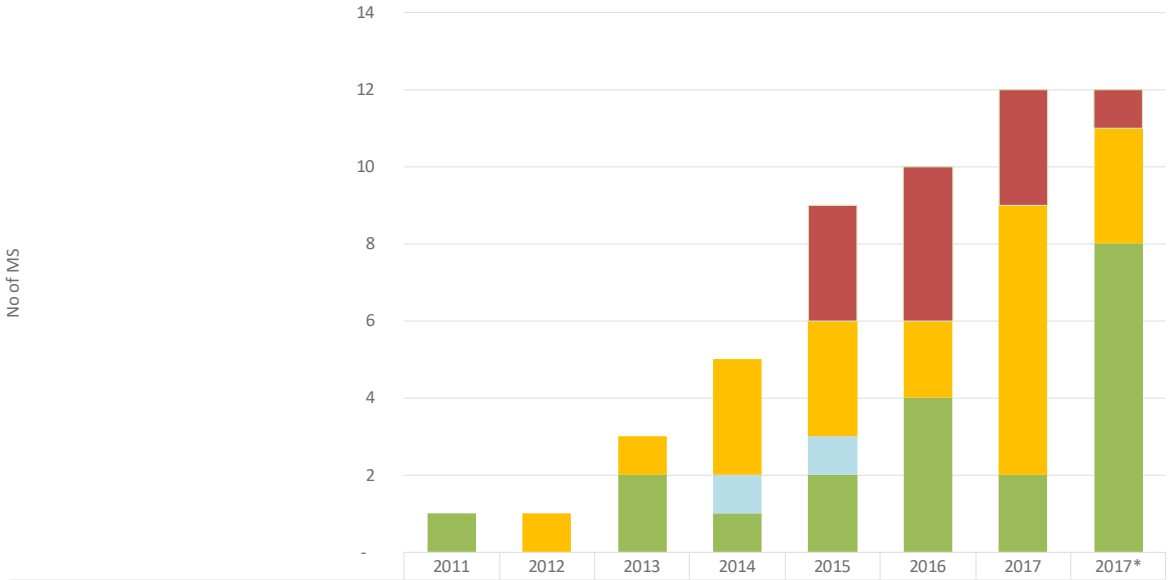
<u>Chart 6</u> - Output gap (OG) in the euro area (2011-2019)



Source: AMECO, March 2018.

81. The poor adjustment effort made by Member States under the preventive arm and not yet at MTO can also be seen by comparing the requirements for the adjustment in SB set in the matrix with the actual adjustment. ***<u>Chart 7</u>*** shows the rate of progress in the structural balance for those Member States which are not at their MTO. Very few countries meet the requirements from the matrix, and the majority does not. On the basis of preliminary data, in 2017 only two Member States seem to have been compliant with the matrix, whereas after taking into consideration the most recent updates of structural balance indicators from the Spring 2018 forecast, it seems that in view of the growth registered in a number of Member States during 2017, more than half of the same Member States will be compliant to their MTO ex post.

<u>Chart 7</u> – Number of Member States under the preventive arm and below the MTO which are or are not making adjustments in accordance with the SGP matrix requirements



	2011	2012	2013	2014	2015	2016	2017	2017*
Not compliant with matrix even after allowance			-	-	3	4	3	1
Not compliant with matrix and with no allowance		1	1	3	3	2	7	3
Not compliant with matrix but compliant after allowance			-	1	1	-	-	-
Compliance with requirement from Matrix	1		2	1	2	4	2	8

**Note*: Based on Spring forecast 2018 updates of structural balance for the same Member State.

Source: Commission SWDs for 2011-2012; Spring Forecast 2017 for years 2013-2017; Spring Forecast 2016 for years 2013-2015 for distance to MTO.

82. The effectiveness of the preventive arm has also been undermined by developments in the corrective arm since 2014. Spain under the corrective arm experienced a large deterioration in its structural balance in period after 2014, while France and Portugal achieved only very slow progress (see ***<u>Table 3</u>***)[52].

[52] The EDP for Portugal was abrogated in June 2017.

<u>Table 3</u> - Measuring the number of years needed to reach the MTO for Euro area MS with high levels of debt to GDP in 2017

Member State	Average change in SB (2014-2018)	**MTO**	Distance to MTO	Number of years needed to reach the MTO
		(SPs 2017)	(SB 2017-MTO2017)	(based on SB for 2017 and average adjustment for 2014-2018)
Belgium	0.3	0.0	-1.5	5.0
Ireland	0.8	-0.5	-0.8	0.9
Spain	-0.3	0.0	-3.1	No convergence
France	0.1	-0.4	-2.0	14.9
Italy	-0.2	0.0	-2.1	No convergence
Portugal	0.2	0.25	-2.1	8.7

Note: The outcome of the structural balance for Portugal and France in 2017 and the projection for 2018 have been revised upwards significantly in the Spring 2018 forecast.
Source: SB - AMECO 2017; MTO set by Member States using Spring Forecast 2017 revised in 2016 to be applied in 17-19; Distance from MTO and Years to MTO based on ECA calculations.

83. Moreover, the Commission does not apply the preventive arm requirements to Member States under the corrective arm, although there is no clear legal stipulation to that effect. The Commission's interpretation is that the corrective arm allows the headline deficit to be brought below 3 % by cyclical recovery alone, with no obligatory improvement in the structural balance. At the same time, for several Member States the Commission has recommended repeated multi-year extensions of deadlines for exiting the excessive deficit procedure (EDP), much longer than envisaged in the Treaties. As a result, Member States under the corrective arm do not have to fulfil the requirements they would otherwise have to observe if they were under the preventive arm. The Commission at one point sought consent of Member States to address these inconsistencies, but the issue has not been resolved.

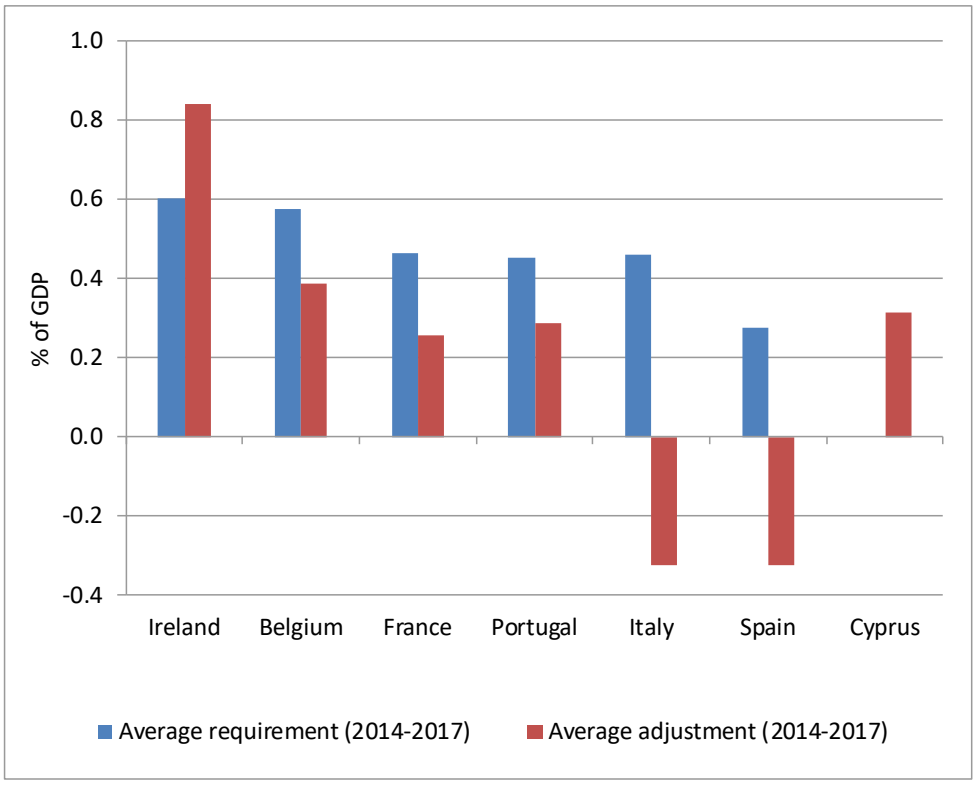
Particularly weak results seen in the most highly indebted Member States

84. Movements in budgetary balances and debt ratios in the individual Member States of a monetary union are much more important than those in aggregate or average indicators[53]. This is because incentives for fiscal discipline are weaker in a monetary union, as countries do not have to watch their own balance of payment positions, yet the negative external effects of their fiscal policies on related countries are larger.

85. For this reason, the most important developments are in the highly indebted EU countries (which we consider as those with a debt ratio above 90 %). Moreover, it is important to also look at Member States under the corrective SGP arm in this period (2014-2018). It is logical to assume that the criteria for the preventive arm should provide a floor for the adjustment requirements under the corrective arm. In that sense the former are relevant for the latter. The picture that arises is a cause for concern (see ***Chart 8***).

[53] In this context, comparing the EU aggregates with the United States and Japan has very limited value. The EU has neither extensive public debt nor taxation powers.

<u>Chart 8</u> - Average requirement (based on matrix[54]) and average adjustment (change in SB) 2014-2017



Source: SB from AMECO, March 2018, Requirements from Commission Spring assessments 2015, 2016, 2017.

86. The success story is Ireland, which has improved its SB by substantially more than required by the matrix. It is also set to reach its MTO in 2018 and its debt-to-GDP ratio is declining fast[55]. Cyprus is at its MTO in 2018.This, combined with the recovery, set its debt ratio on a downward trajectory, albeit a slow one[56] (see ***<u>Chart 9</u>***).

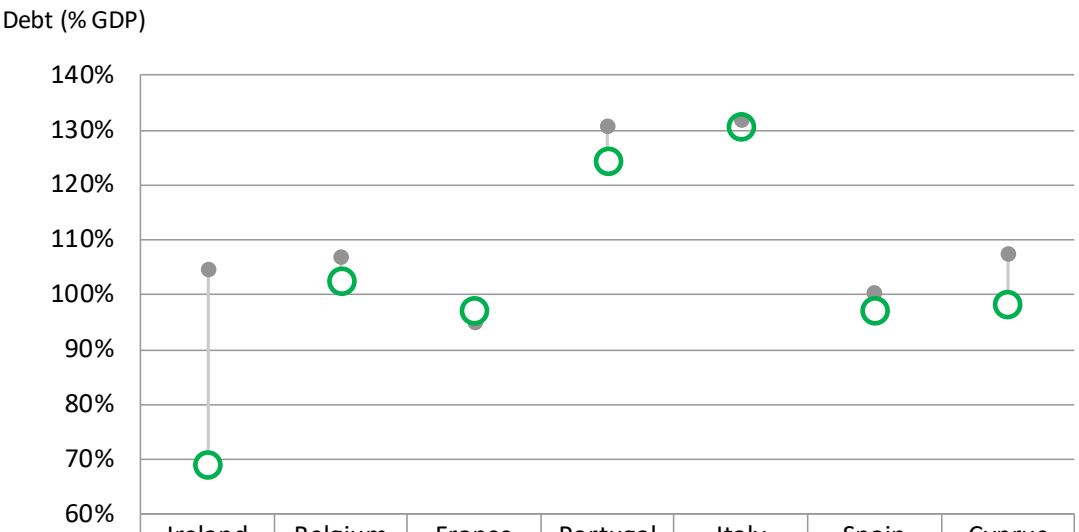
---

[54] The average requirement for Member States under the EDP, assuming the matrix of the preventive arm is applied.

[55] The observation remains valid also when comparing debt to disposable national income, although the decline is somewhat smaller.

[56] Cyprus structural balance was strongly positive in 2014, far above its MTO, meaning it has approached its MTO in 2017 from above.

Chart 9 - Public debt relative to GDP in 2014 and 2018



	Ireland	Belgium	France	Portugal	Italy	Spain	Cyprus
2014	105%	107%	95%	131%	132%	100%	107%
2018	69%	103%	97%	124%	131%	97%	98%

Source: AMECO, March 2018.

87. Belgium has made some progress towards its MTO, but much less than required by the matrix. By end-2018, it is forecast to be still approximately 1.5 pp away from the MTO, which has recently been revised down. Assuming that in the coming years it continues to adjust at the average rate for 2014-2018, it will need 5 years to reach the MTO (see also ***Table 3***).

88. Portugal's SB has, on average, improved only slightly in this period, and remains some 2 pp of GDP away from MTO, although the latest Spring Forecast 2018 update indicates a significant improvement in Structural balance for 2017. If 2017 was an exception year and the previous years are indicative of the average speed of adjustment, it would need almost 9 years to reach the MTO. If the more recent structural balance improvements reported in the Spring 2018 forecast can be sustained and continue to exceed the matrix requirements, it would reach its MTO within a more reasonable time frame.

89. But of concern are the developments in three large countries: Italy, France and Spain. Here the adjustments were substantially below the requirements of the matrix, and at that pace it will not facilitate convergence towards MTOs in a reasonable time. In our view, large

deviations of adjustment in fiscal balances for Member States under the corrective arm, differently from those under the preventive arm, are of material importance for the credibility of the overall SGP framework.

90. France, under the corrective arm, has hardly improved its SB in 2014-2018 (***Table 3***). With a distance to the MTO of 2.7 pp of GDP at end-2018, and assuming the average adjustment speed from 2014-2018, it will need 15 years to reach the MTO. France's debt to GDP continued to increase in this period.

91. Italy (under the preventive arm) and Spain (under the corrective arm) experienced a large deterioration in their structural balances in the same period, and are now far from the MTO: Italy by 2 pp and Spain by more than 3 pp. They have not achieved progress in debt reduction, despite the expansion of their economies.

92. In the case of France and Spain – both under the EDP, the Commission had extended the deadline for exiting the EDP several times[57], while the taking position that "an EDP cannot be stepped up if the Member State achieves its intermediate headline deficit targets, even if the policy commitments have not been delivered"[58].As a result, in 2014-2017 the structural balance in Spain worsened by 1.7 pp of GDP, the one in France improved very little.

93. In that period, in all three large countries, growth was outpacing potential and the output gap closing. The latter is projected to be positive in Italy and Spain in 2018, and only slightly negative in France (see ***Chart 10***, ***11*** and ***12***). The three countries have additionally issued more than half of total euro area public debt.

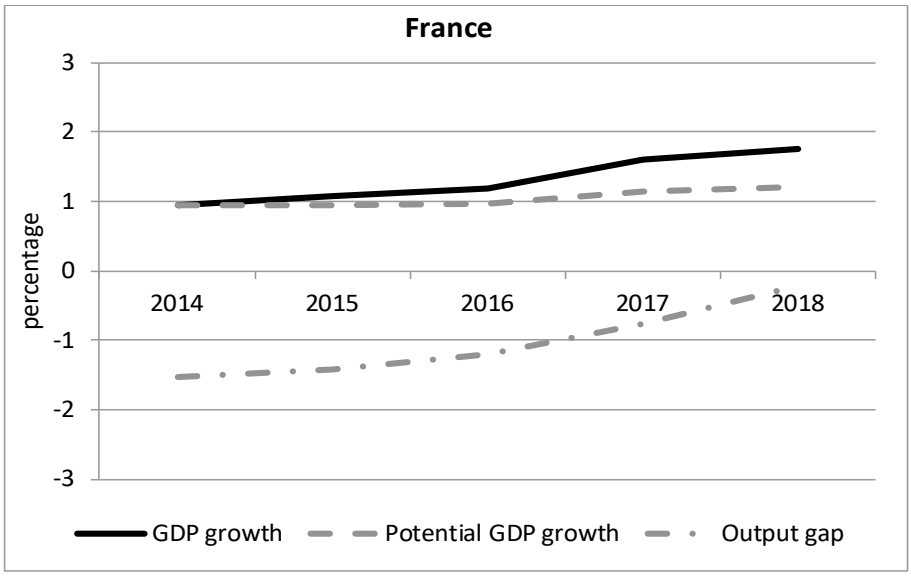
---

[57] In the case of France, EDP was opened in 2009, and the original deadline for exiting it was 2012. Already at the end of 2009 it was extended to 2013. In 2013 it was extended by two years to 2015. In 2015 it was extended by another two years to 2017. France experienced negative growth rate only in 2009.

In the case of Spain the deadline was extended four times, twice by one year and twice by two years, with the last deadline set for 2018.

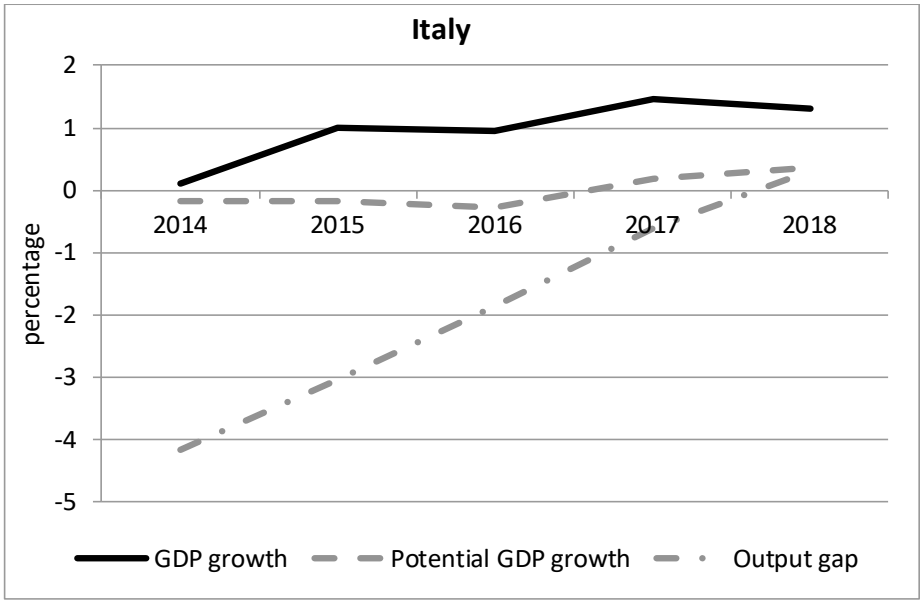
[58] See Commission SGP Vade Mecum (2017 edition), section 2.3.2.1.

<u>Chart 10</u> – GDP, potential GDP and output gap evolution in France (2014-2018)



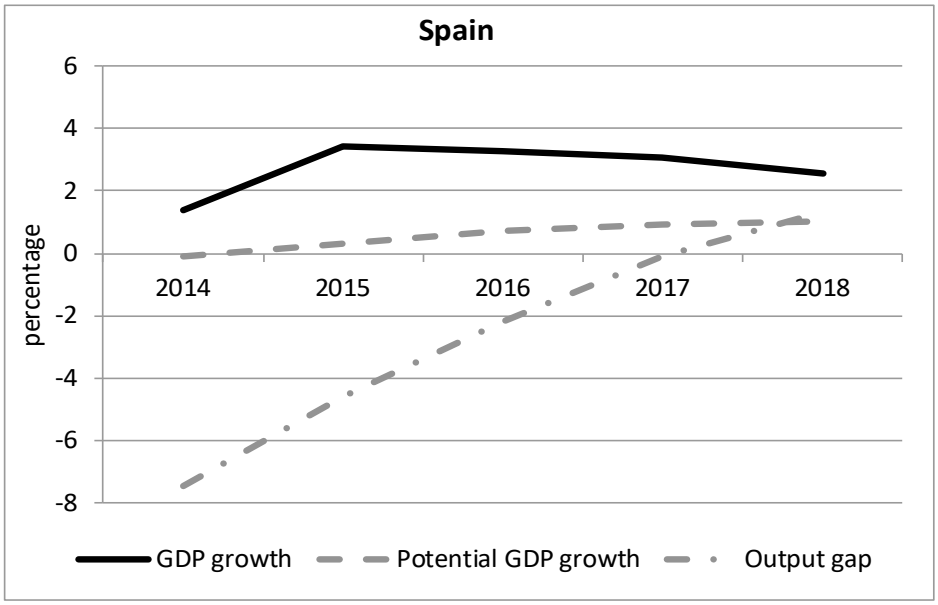
Source: AMECO, March 2018.

<u>Chart 11</u> – GDP, potential GDP and output gap evolution in Italy (2014-2018)



Source: AMECO, March 2018.

Chart 12 – GDP, potential GDP and output gap evolution in Spain (2014-2018)



Source: AMECO, March 2018.

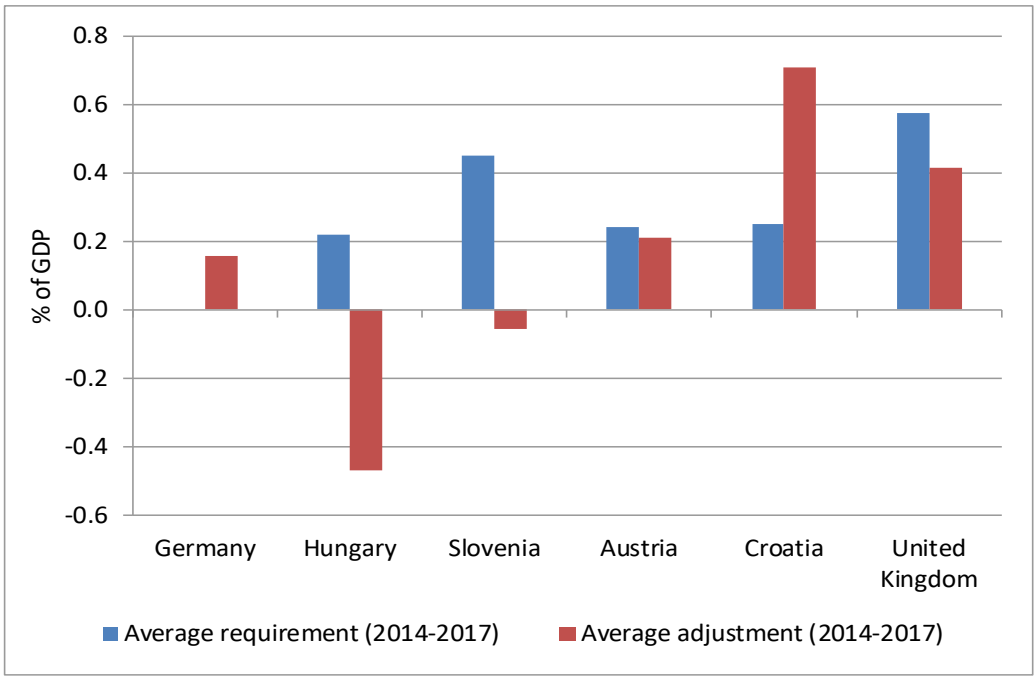
94. The ECB recently noted the absence of progress in fiscal consolidation in indebted euro area countries. In its 2017 Financial Stability Review, it observed: "…improving headline balances mask underlying fiscal vulnerabilities and an overall slight loosening in the fiscal stance for the euro area over the 2017-19 horizon. Fiscal efforts continue to fall short of commitments under the Stability and Growth Pact in several euro area countries (see ***Chart 8***). The projected deterioration of structural balances in 2017-19 in a number of countries may further challenge compliance with the medium-term objectives"[59].

Mixed performance in Member States with debt levels between 70-90 % in 2014-2018

95. In this group, two countries surpassed the requirements from the matrix: Germany and Croatia. Austria and, to a lesser extent, the United Kingdom have come close to meeting their requirements. Slovenia did not adjust on average, while Hungary has implemented a highly expansionary fiscal policy (see ***Chart 13***).

[59] ECB, Financial Stability Review, November 2017, p. 29.

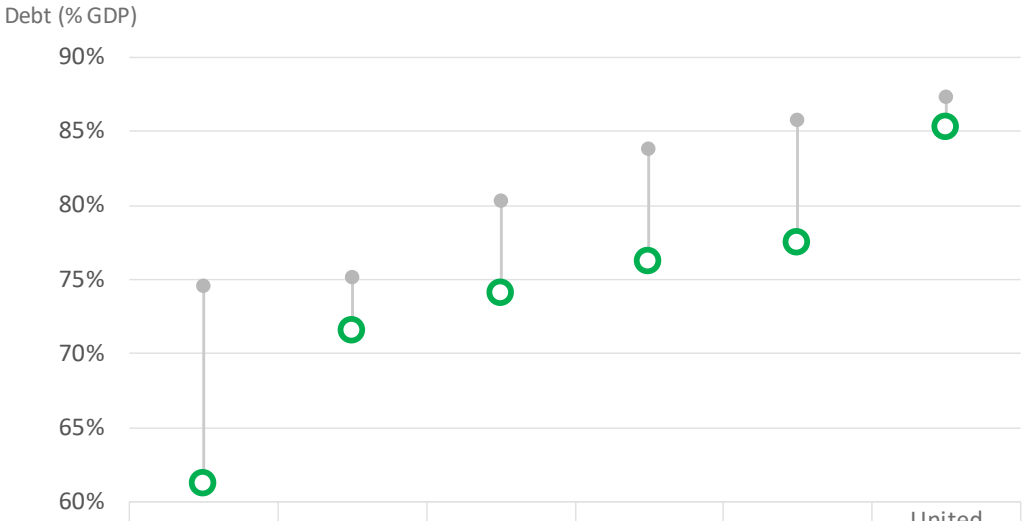
<u>Chart 13</u> - Average requirement (based on matrix) and average adjustment (change in SB) 2014-2017 in countries with moderately higher public debt



Source: AMECO, March 2018. Note: Croatia average requirements based on three years - 2015-2017.

96. The Member States that adjusted their structural balances have also seen a substantial reduction in their debt ratios: Germany's debt dropped by 14 pp of GDP, Austria's by 8 pp and Croatia's by 9 pp. The reduction in the debt level was small in the United Kingdom, reflecting the high starting structural deficit, although it improved substantially in this period. On average, debt reduction in this group was substantially higher than in the group of highly indebted Member States (with exception of Ireland in that group) (see ***<u>Chart 14</u>***).

Chart 14 - Public debt to GDP in countries with moderately higher debt 2014-2018



	Germany	Hungary	Slovenia	Austria	Croatia	United Kingdom
2014	75%	75%	80%	84%	86%	87%
2018	61%	72%	74%	76%	77%	85%

Source: AMECO, March 2018.

A sharp worsening in two Member States with low debt

97. Romania, with a low debt level of 39.4 % of GDP was above its MTO in 2014, but is now heading towards an exceptional worsening in SB by about 4 pp of GDP from 2014 to 2018. For the first time, the Commission launched a significant deviation procedure in May 2017, and stepped it up in November 2017.

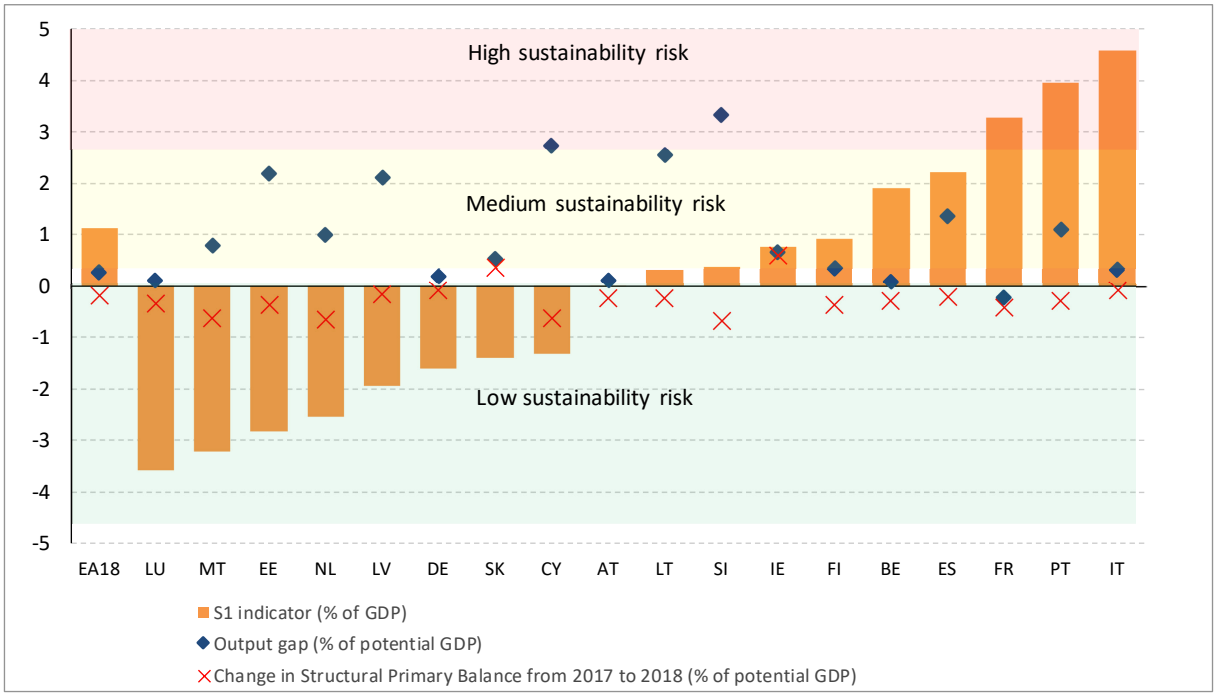
98. Estonia, with a debt level of only 10.7 % of GDP in 2014, was above its MTO in 2014. It has seen its SB decline by 1.4 pp of GDP from 2014 to 2018, mostly in 2017. The Commission considers the factors contribution to this decline to be very different in nature from those of Romania given the overall fiscal situation in both Member States including the exceptionally low level of public debt (9.1 % of GDP in 2018) in Estonia.

An imbalance between sustainability and cyclical considerations

99. In its recent communications on the newly introduced margin of appreciation, the Commission has stressed the importance of balancing fiscal sustainability and anticyclical

considerations in setting fiscal targets[60]. However, a recent analysis by the Commission itself showed that this is not being done in highly indebted Member States (those with sustainability risk on the right side of the ***Chart 15***). In these countries the output gap is effectively closed or is even positive, but fiscal effort to improve fiscal sustainability is missing[61].

Chart 15 - Forecast change in Structural Primary Balance between 2017 and 2018 for euro area MS in relation to fiscal sustainability risk (S1 indicator) and the output gap



Note: The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to GDP ratio to 60 % by the target date. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively. For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.

---

60 In 2016 the Commission pointed to such a trade-off: "The general definition of an appropriate fiscal stance has to take into account stabilisation and sustainability needs. As discussed below, sometimes, the existence of trade-offs between these two dimensions can require a balancing act between the need to provide direct support to the economy while not ignoring the sustainability of public finances in the medium run." (p. 116, 'Report on Public Finance in the EMU 2016' of European Commission).

61 COM(2017) 800 final "2018 Draft Budgetary Plans: Overall Assessment".

Source: This is a simplified chart from Commission Communication titled "2018 DBPs: Overall assessment", European Commission, 2017. Output Gap - AMECO March 2018;
Change in Structural Primary Balance - COM autumn forecast 2017; S1 indicator from "2018 DBPs: Overall assessment", European Commission, 2017.

Part IV - the Commission could improve certain technical aspects of assessments

Optimistic bias in Commission forecasts for real GDP growth and investment for year t and t+1

100. The Commission regularly carries out statistical checks on the accuracy of its own forecasts, having done so in 2007, 2012 and 2016. Its analysis shows that its forecasts are generally accurate and comparable to those from other international institutions, such as the IMF and OECD.

101. However, the 2016 study[62] found that the Commission had, on average, overestimated year-ahead real GDP forecasts in the 2000-2014 period by +0.54 pp. This type of bias is also confirmed in the extended sample for 1969-2014 (i.e. +0.33 pp).

102. At Member State level, the bias for Italy is statistically significant, at 1 % level for both current-year and year-ahead GDP forecasts, while the biases for Denmark, France and Portugal are significant at 5 % level for year-ahead forecasts. This relatively large bias appears in spring current-year forecasts and autumn year-ahead forecasts. It substantially affects, for example, the projection for debt dynamics; in the case of one country, the average optimistic bias of 1.1 % resulted in an underestimate of the debt-to-GDP ratio of the year ahead forecasts by 1.4 pp of GDP.

103. Despite the identified biases, we have not been able to identify what corrective action the Commission has taken to prevent the bias from recurring in future.

---

[62] https://ec.europa.eu/info/publications/economy-finance/european-commissions-forecasts-accuracy-revisited-statistical-properties-and-possible-causes-forecast-errors_en

Assessment of the information included in SCPs

104. The information included in the SCPs of the sampled Member States generally followed the requirements of the Code of Conduct (CoC) and the Regulation. In particular, they contained information on the fiscal targets for the entire programme horizon and on the fiscal measures to achieve them. However, in certain cases, requirements were not followed. We found that the Commission assessments of the sampled SCPs were not systematic in presenting these information gaps (see ***Box 2***).

Box 2 – Missing information

Two SCPs do not show the full fiscal path towards achieving the MTO, and three SCPs do not disclose revenue and expenditure targets for the year t+1.

Five SCPs do not present public expenditure by function, and three omit the financial sector risks for public debt.

Five SCPs fail to include cost-benefit analyses of the reforms and three failed to include risks assessments of GDP forecasts.

Two SCPs did not show which fiscal measures were envisaged or enacted.

105. The Commission assessments flag deficiencies in the specification of fiscal measures in the SCPs (see results of sample in ***Annex I***). Before 2011, the Commission produced a specific assessment of the quality of the SCPs based on the requirements of the CoC (see, for example, the annex to the SWDs in 2009 and 2010). From 2011 onwards there is, however, no similar annex.

Reporting the level of deviation by the Commission correct but confusing

106. We found that the deviation calculations had been correctly estimated in the assessments. The significant deviation assessments are also correct and mainly documented in SWDs. However, in its SWDs, the Commission presents a table showing conclusions on the level of deviation based on comparisons of the two pillars (for 1-year and 2-year average estimates). Although the table compares conclusions from the two pillars, it is confusing in the way it presents the results on compliance for each respective pillar.

Our technical testing where no major issues were identified

107. We tested technical aspects of the preventive arm procedures. No major issues were identified for most of these aspects. The Commission in agreement with Members States issued the CoC in 2012 and 2016 in order to "stipulate the exact nature of the SCP information" required by the Regulation (in particular Articles 3.2 and 7.2). We found it in line with the requirements of the Regulation.

108. The Commission issued a Vade Mecum for the SGP in 2012, 2016 and 2017. We reviewed whether the approaches described in the editions for 2016 and 2017 reflected the requirements in the Regulation. We identified a number of exceptions, as explained below.

- The Regulation asks for the most up-to-date economic data and the Commission uses the most favourable data from mixed vintages to determine the position with respect to the MTO. This in turn determines whether an adjustment is required in a given year. Additionally asymmetric freezing is applied in setting the adjustment requirements from the matrix when the distance of the structural balance to the MTO exceeds the requirement derived from the matrix. Similarly, the reference rate in the EB in year t is based on the spring forecast projections of year t-1 and it is not updated for subsequent forecast. Such approaches lead to delayed warnings during periods of SB worsening (see ***paragraph 59***) or changes in factors underlying the composition of the reference rate. Moreover, the Commission measures the distance to the MTO in a given year by comparing it with the SB of the previous, and not with current year (see ***paragraph 60***).

- The Commission deducts "smoothing of investments netted out of EU funds for investments" in computing the government expenditure in the EB. As a result, the expenditure estimate of a specific year does not accurately capture a government's capital investment in a given year. Such smoothing is not foreseen in the Regulation.

109. We tested whether the internal guidelines provided to country desks and spreadsheets used for assessments were in line with the approaches described in the Vade Mecum. We found Commission assessment workings to be in line with the Vade Mecum, with the

exception of its testing of the position relative to the MTO using the most favourable SB from past vintages.

110. We tested whether the SCPs in the audit sample had information gaps as regards the requirements of the CoC. We found that the Commission's SCP assessments were not systematic in presenting these gaps.

111. SWDs provide relevant information on Member States' fiscal commitments, their respective measures, and compliance with the preventive arm rules. We identified room for improvement in describing the measures taken and the impact considered in the Commission's forecast (aside from that planned by the Member States in their SCPs). A table in the SWDs which explains differences more clearly would be useful.

112. Member States agreed to a common EU method for estimating the potential output. However, certain Member States also produce their own estimates based on methodologies which differ from the common EU method which is used as the basis for the preventive arm assessments. Different methodology leads at times to different estimates which in turn may also lead to a different structural balance estimate. Having reviewed various studies comparing the Commission's potential output estimates with those prepared by others, we found that the EU approach performs well compared to similar estimates (e.g. OECD or IMF).

113. Moreover, in 2016 the Commission introduced a plausibility tool to assess situations where estimated output gaps of specific years are subject to a large degree of uncertainty. This is a pilot project being carried out over the next two years to take into account any factors which Member States consider relevant to their potential output estimates. This approach of maintaining an open dialogue on addressing issues of plausibility within the context of a common approach is appropriate.

114. We tested the spreadsheets and formulas used, and re-performed a number of assessments to test the accuracy of the workings. We also reviewed a sample of the data used by the Commission in its assessments and found that it matched corresponding sources, such as data from AMECO, the Statistical Office of the EU (EUROSTAT) or the SCPs. No issues emerged, except for the way the transition from ESA 95 to ESA 2010 had been

addressed and the manner in which vintages of data had been used in the assessment (see ***paragraph 62***).

115. We found that the minimum MTOs were calculated according to the approach described in the Vade Mecum. We also verified whether all Member State MTOs were at or above the minimum MTO and found them all to be compliant, with the exception of Slovenia in 2016-2017 (for the years 2017-2019). This had no impact on the Commission's assessment outcome.

116. We tested the sensitivity of the minimum MTOs to underlying variables and found that they were mostly sensitive to large changes in semi-elasticity, large debt shocks and ageing costs. We observed, however, that the minimum MTOs did not take into account other factors affecting debt, such as stock flow adjustments.

117. We also tested the assessment workings to check that the parameters from the matrix had been correctly applied. During the transition to the new matrix, parameters from the old matrix were retained for the spring 2015 assessment and only applied for Member States of which the SB had deteriorated, instead of making adjustments for all Member States. The Commission did not manage transitions between the rules in a consistent manner.

Part V - CSRs reflect underlying assessment conclusions but require more clarity

CSRs reflect the results of the assessments carried out, but their relevance may change if conditions alter

118. The final fiscal CSRs adopted by the Council are based on the Commission's recommendations. Written in a legal form, they call on Member States to address identified risks of significant deviation, and specify the adjustment required for the SB and expenditure growth.

119. We found that fiscal CRS relating to the preventive arm were in line with the assessment conclusions contained in the SWDs.

120. In our opinion the recommendations are published early enough in the year (July) to give Member States the chance to respond in their annual budgetary process. Most Member

States discuss, fine-tune and adopt the budgets for the subsequent year in the autumn. Up to that point, macroeconomic and budgetary conditions may change, whereas the CSR in force remains that set earlier in the year. Significant changes in conditions may affect the relevance of the CSRs.

CSR formulations published in 2017 became less clear and enforceable

121. The relevance of CSRs also depends on their clarity and credibility in terms of whether they can be monitored and enforced on an ex post basis. During the audit, the Commission proposed the CSRs for 2018 with the numerical requirements in the recitals rather than in the enacting part. The Commission considers both the recitals and the enacting part to be equally binding and enforceable, which is not being generally understood by public.

122. The ECB in this context recently pointed out: "The Commission's fiscal policy recommendations depart from those in the past in two respects. First, only the recitals of the recommendations, rather than the enacting parts, specify the size of the structural adjustment that the Council recommends governments make to ensure full compliance with the SGP. It is usually the enacting parts that should provide clear ex ante guidance to governments on how to conduct public finances over the next 12-18 months. They also serve as a guide to parliaments and the public and as a reference for transparent ex post assessments of compliance with the SGP. It is therefore important that the fiscal guidance is fully incorporated, including in governments' draft budgetary plans for 2018, in order to ensure sufficient progress towards sound public finances"[63].

123. The ECB also pointed out that "…for all countries with structural adjustment requirements of 0.5 % of GDP and above in 2018, irrespective of their level of government debt, the recitals state that "the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal to achieve a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of [the respective Member State's] public finances". This could imply reductions in structural adjustment requirements over and above those granted under

---

[63] ECB Economic Bulletin 4/2017.

the existing flexibility provisions in the SGP (as communicated by the Commission in January 2015). Going forward, it is important that a consistent implementation of the rules-based SGP is ensured"[64].

124. Such guidance communicated by the Commission may lead to a situation where the two objectives, of strengthening the on-going recovery on the one hand and ensuring the sustainability of public finances on the other hand, lead to very asymmetric conclusions: one prompting a Member State to spend more on growth-enhancing measures and the other restricting such increases in expenditure. It could also imply lower requirements than those determined by the SGP rules framework (the combination of matrix and clauses).

125. To better convey the logic of the proposed recommendations, the Commission should provide a summary of the underlying assessment and explain the importance of implementing the recommendations, as well as point out risks if they are not implemented. In the past, each CSR was supported by one recital setting out the underlying rationale. However, after the latest changes, the recitals have ceased to explain the rationale behind the CSRs.

Commission sufficiently monitors the implementation of fiscal CSRs

126. The Commission monitors the implementation of the CSRs on the basis of a variety of inputs, with more focus on monitoring activity in the last quarter of the year. Given the extensive analysis, available data, and number of information visits and exchanges between Member States and the Commission, we consider this as sufficient monitoring and follow up of developments in Member States.

CONCLUSIONS AND RECOMMENDATIONS

The main objective of the preventive arm has not been delivered

127. The preventive arm is intended to ensure that EU Member States maintain their fiscal position at their respective medium-term objectives (MTOs) to ensure a sustainable fiscal

---

[64] Ibid.

position and provide fiscal space in cases of recession. Moreover, by reaching their MTOs, Member States with high debt would ensure that their debt ratios started declining in line with the requirements under the debt-based corrective arm of the SGP. This is all crucial for avoiding a disruptive fiscal crisis in the EU and, even more importantly, in the monetary union (***paragraphs 4 to 5***).

128. The Regulation set a reasonable benchmark for annual convergence towards the MTO of 0.5 pp of GDP per year; but it also introduced the concept of significant deviation which is interpreted as an allowed deviation margin. Furthermore, it granted wide discretionary powers to the Commission to adjust the requirements (***paragraphs 16 to 17, 32 to 37***).

129. The Commission has exercised these discretionary powers very extensively with a view to reduce adjustment requirements, both in setting the implementation rules and in individual decisions. However, as a result, the Commission has not ensured meeting of the Regulation's main objective: convergence towards the MTOs in a reasonable period of time (***paragraphs 63 to 71***).

130. The adjustment requirements and parameters, as specified in the so-called matrix, and the numerous flexibility clauses were set when the main concern was the EU's second recession in 2012. Flexibility in such a situation was appropriate in principle, but has gone too far in practice (***paragraphs 26 to 71***). In particular, it did not distinguish enough between those Member States with debt problems and others (***paragraphs 85 to 97, 100***). Furthermore, the approved matrix parameters and the various flexibility clauses were not time-bound to these specific circumstances (***paragraphs 77 to 82***).

131. Instead of tightening the framework, the Commission has recently weakened it further for example by introducing the new margin of discretion in 2017 (***paragraphs 32 to 37, 69 and 79***).

132. As a result, the current framework does not ensure convergence towards the MTOs at a reasonable pace during normal times. On average, it has not facilitated progress towards the MTOs in the recent recovery period, despite the fact that growth has surpassed the potential growth rate and the output gap has been closing (***paragraphs 79 to 82***).

133. Of particular concern is the inability of the weakened SGP framework, as set in the Commission's implementation rules, to ensure progress towards the MTO in several highly indebted Member States. Their structural balances in 2014-2018 have either diverged from their MTOs, or are converging towards them at such a slow pace that substantial improvement ahead of the next recession is far from assured (***paragraphs 85 to 97, 100***).

134. The credibility of the SGP's is undermined by inconsistencies between the preventive and corrective arms. The Commission does not apply the preventive arm requirements to Member States under the corrective arm, and it has repeatedly proposed multi-year extensions of deadlines for exiting the excessive deficit procedure (EDP) meaning that Member States under an EDP do not have to fulfil the requirements they would otherwise have to observe if they were under the preventive arm (***paragraph 84***).

135. Although not required by the Regulation, the Commission has sought and reached agreement with Member States through the ECOFIN Council of ministers on many implementation rules. Such precedents might now make necessary corrections in the framework more difficult (***paragraphs 26, 38, 42 and 51***).

136. Nevertheless, the current framework as set in the Commission's implementation rules needs to be modified. We recommend the following measures in the context of the review of the preventive arm framework scheduled for 2018.

The Commission should address the issue of cumulative deviations and parameters in the matrix of required adjustments

137. The current combination of the matrix specifying adjustment requirements depending on the business cycle, flexibility clauses and the permitted deviations do not ensure that MTOs are reached within a reasonable time under reasonable macroeconomic scenarios. We consider that the issue of cumulative deviations can be addressed within the current regulation, given that its main objective should be given preponderance relative to the granted flexibility options. Given the interconnectedness of these issues the scale of necessary revision in the matrix will depend on whether and how the issues of the cumulative deviations and flexibility clauses are addressed and resolved. Regardless of this, there is a strong case for tightening requirements for Member States with debt ratios above

90 % of GDP and, to a lesser extent, for those with debt above 60 % but less than 90 % of GDP (***paragraphs 26 to 71, 85 to 97 and 100***).

Recommendation 1

(a) To address the cumulative effects of the permitted deviations, the Commission should include in the revised matrix a provision increasing the adjustment requirement for the following year to compensate for the average deviation of the MS in the two preceding years and the expected deviation in the current year[65].

(b) The Commission should increase the adjustment requirements for Member States with debt ratio above 60 % of GDP, with a view to bringing the requirements in line with the provisions of the debt rule. The scale of the increase should depend on the distance from the 60 % threshold, either in steps (for example higher requirements for those with the debt ratio above 90 %), or gradually.

(c) The Commission should review other provisions in the matrix of required adjustments and consider modifying them with a view of achieving convergence toward MTO in all MS in a reasonable time, taking the effects of revisions in all other provisions into account including those related to permitted deviations and allowances.

This recommendation should be implemented in the review of the matrix and flexibility clauses as foreseen for 2018 in the commonly agreed position, or at the latest for the application in Spring 2019.

Flexibility clauses should be reformed to reflect the original role envisaged in the Regulation

138. The Commission is using the structural reform clause far beyond its objective in the Regulation of ensuring that budget constraints do not hamper the implementation of important reforms. The Regulation does not speak about flexibility clauses serving as an

[65] See a similar recommendation in the 2017 report from the European Fiscal Board.

incentive for reforms. Allowances under SGP should be used for the intended purpose, while other instruments can be used to promote reforms (***paragraphs 50 to 52***).

139. The Commission allows increased spending under various clauses to continue beyond the years for which they had been approved. The overall spending is permanently increased until the MTO is finally reached. This leads to prolongations in the convergence period that adversely affects the achievement of the basic objective of the Regulation (***paragraphs 44 to 48, 54***).

140. The investment clause does not ensure an increase in the public investment-to-GDP ratio and allows non-investment-related spending to continue in the years ahead (***paragraph 43***).

141. The unusual event clause also leads to increase in non-related expenditure in the years following the granting of the clause, and applies broad interpretation of eligible expenditures (***paragraph 57***).

Recommendation 2

(a) The Commission should amend the implementation rules for the structural reform clause and limit the clause to directly identified budget costs in the first few years of implementation. The approved increase in spending should be treated as a one-time event, and not lead to an increase in unrelated expenditure in the following years.

(b) The Commission should discontinue the use of the investment clause in its current form. Any possible successor clause should ensure an increase in public investment relative to GDP.

(c) The Commission should approve the unusual event clause only for expenditure directly linked to the events that have occurred.

This recommendation should be implemented in time for application in Spring 2019.

The adjustment requirements under the corrective and preventive arm should be synchronised and the step-up procedures used more effectively

142. Inconsistencies exist between the deficit-based corrective arm and the preventive arm. Discontinuing the practice of excessive and multiyear prolongations in the deadlines for exiting EDP would be an important step in that direction. Moreover, requirements under the preventive arm should be the minimum under the corrective arm. We do not see legal grounds to exempt Member States under the corrective arm from meeting the requirements of the preventive arm and be subject to the preventive arm step-up procedures (***paragraph 84 to 94***).

Recommendation 3

The Commission should explore ways within the legal framework to ensure that the level of structural adjustment required under the preventive arm is also delivered by Member States under the corrective arm. The Commission should submit a note to the EFC explaining how it plans to achieve this.

This recommendation should be implemented in time for application in Spring 2019, and by that time the Commission should submit such a note to the EFC.

Improve the quality of information required in Stability and Convergence Programmes and in the Commission's assessment reports

143. There is a need to improve the quality of information presented in Stability and Convergence Programmes (SCP). Furthermore, given that the Commission's assessment is underpinned by a comparison of its own forecasts with those of Member States, more transparency on the different measures included in the Commission's forecasts is necessary to determine the credibility of the plans and the corresponding assessment. A clearer presentation of compliance results, based on criteria set in the recommendations, and an explanation of factors taken into account in the overall assessment, are also necessary in the Commission's staff working documents (SWD) (***paragraphs 104 to 106, 111 to 112***).

Recommendation 4

(a) The Commission should propose and seek agreement with Member States for revisions in the Code of Conduct (CoC) to ensure that Member States' SCPs include a summary table including the revenue and expenditure estimates along with the main revenue and expenditure measures and their timing.

(b) The Commission should, in its SWDs, better explain the differences between its own estimates of fiscal measures and those in Member States forecasts. It should also be more explicit in all cases on the level of compliance of an SCP with the requirements of the CoC.

(c) The Commission should introduce a table presenting, separately for each pillar, assessment conclusions in its SWDs on the level of deviations. It should also explain in detail the conclusion of the overall assessment, pointing to all the factors taken into consideration if the overall assessment conclusion is not in line with the criteria stipulated in the Regulation.

(d) The Commission should also present data on cumulative deviations of at least the preceding five years.

This recommendation should be implemented in time for application in Spring 2019.

Use of vintages and freezing should be reviewed

144. Certain technical approaches, such as the use of freezing or of the most favourable indicators from a mix of vintages, or the use of smoothing of investments in the expenditure benchmark do not stem from the Regulation and may lead to delays in detecting significant deviations (***paragraphs 59 to 60, 108 to 109***).

145. The practice of unfreezing adjustment requirements is asymmetrical. It prevents a larger adjustment from being sought when assessing draft budgetary plans (DBP), when perhaps justified by updated information (***paragraph 61***).

Recommendation 5

(a) The Commission should base its requirements on the most up-to-date data rather than the most favourable data from a selection of past vintages.

(b) In the expenditure benchmark, it should apply the concept of aggregate expenditure as required by the Regulation, without "smoothing of investments".

(c) Where prospects improve substantially between the assessment of SCPs and DBPs, the Commission should be ready to request a larger adjustment effort.

This recommendation should be implemented in time for application in Spring 2019.

The clarity of explanations in country-specific recommendations should be improved

146. Current recitals are legalistic and do not provide detailed reasoning for the recommendations. More could be done to explain the rationale behind recommended adjustments and the risks that would ensue if such requirements were not met (***paragraphs 122 to 126***).

Recommendation 6

(a) Recitals should explain in detail the rationale for the recommended adjustment and related risks.

(b) The required adjustment should be specified in the enacting part of the CSRs to indicate their obligatory character and not in the recitals.

This recommendation should be implemented in time for application in Spring 2019.

This Report was adopted by Chamber IV, headed by Mr Neven MATES, Member of the Court of Auditors, in Luxembourg at its meeting of 13 June 2018.

For the Court of Auditors

Klaus-Heiner LEHNE

President

ANNEX I

SELECTION OF MEMBER STATES FOR THE AUDIT SAMPLE

1. The audit of the preventive arm procedures focused on six Member States (5 from euro area and 1 from non-euro area).

2. Member States that were under an EDP or an adjustment programme throughout, or covered already under EDP, Greece, or Macroeconomic Imbalance Procedure (MIP) audits, were excluded (with the exception of Italy[66]). From the remaining Member States, we selected those that had been longer under the corrective arm, showed recent worsening in the structural balance, or had and the highest distance from MTO (see ***Table 1***).

[66] Italy exited EDP in June 2013, and the period before was partially covered under Court's EDP audit. It was included in the sample given the extensive application of flexibility clauses under the preventive arm and its overall importance for macroeconomic developments in the EU.

Table 1 - Selection of Member States for the audit sample

Analysis of criteria and choice of MS sample for preventive arm audit														
EMU	MS	Structural balance (SB)						Comments	Distance from the MTO (SB_{t-1}-MTO_t)*					
		2011	2012	2013	2014	2015	2016		2011	2012	2013	2014	2015	2016**
Euro area	Belgium	-4,03	-3,42	-2,73	-2,85	-2,48	-2,10	ES audit	-4,61	-4,78	-4,17	-3,48	-3,60	-3,23
	Estonia	0,27	-0,10	-0,40	0,31	0,31	0,18	At MTO throughout	0,17	0,27	-0,10	-0,40	0,31	0,31
	Ireland	-7,52	-6,45	-4,32	-3,22	-2,99	-2,15	Under PA only in 2016	-8,83	-7,52	-6,45	-4,32	-3,22	-2,99
	Latvia	-1,26	-0,03	-0,94	-1,76	-2,09	-1,85	AT MTO in 2013-14	-1,19	-0,26	0,97	0,06	-0,76	-1,09
	Lithuania	-3,59	-2,60	-2,27	-1,42	-1,20	-1,43	AT MTO in 2015-16	-2,29	-2,59	-1,60	-1,27	-0,42	-0,20
	Luxembourg	1,38	2,47	2,06	2,15	0,71	0,90	At MTO throughout	0,00	0,88	1,97	1,56	1,65	0,21
	Netherlands	-3,58	-2,26	-0,94	-0,53	-1,07	-1,40	ES audit (1 year more under EDP than LT, LV)	-3,03	-3,08	-1,76	-0,44	-0,03	-0,57
	Austria	-2,53	-1,82	-1,24	-0,67	-0,59	-1,01	ES audit (1 year more under EDP than LT, LV)	-2,76	-2,08	-1,37	-0,79	-0,22	-0,14
	Portugal	-6,22	-3,09	-2,50	-1,37	-1,82	-2,33	Under EDP throughout	-7,60	-5,72	-2,59	-2,00	-0,87	-1,32
	Slovakia	-4,11	-3,56	-1,69	-2,05	-2,06	-2,04	Debt < 60% of GDP throughout	-6,65	-3,61	-3,06	-1,19	-1,55	-1,56
	Finland	-0,85	-1,14	-0,98	-1,75	-1,75	-1,52	ES audit	-0,61	-0,35	-0,64	-0,48	-1,25	-1,25
Non euro area	Denmark	-0,50	0,04	-0,18	0,56	-2,26	-1,36	Less persistent and lower deficit/debt than HU	-0,22	0,00	0,54	0,32	1,06	-1,76
	Croatia	n/a	n/a	-3,57	-3,85	-3,49	-3,84	Under EDP in 2013-2016	n/a	n/a	-4,08	-3,57	-3,85	-3,49
	Hungary	-4,52	-1,44	-1,47	-2,50	-2,35	-2,63	ES audit	-1,88	-2,82	0,26	0,23	-0,80	-0,65
	Poland	-6,07	-4,04	-3,44	-2,65	-3,01	-2,65	Less persistent and lower deficit/debt than HU	-7,26	-5,07	-3,04	-2,44	-1,65	-2,01
	Romania	-2,98	-2,01	-1,07	-0,63	-0,78	-2,74	Less persistent and lower deficit/debt than HU	-4,59	-1,98	-1,01	-0,07	0,37	0,22
	Sweden	0,00	0,10	-0,19	-0,82	-1,04	-0,96	At MTO throughout	1,77	1,00	1,10	0,81	0,18	-0,04
	United Kingdom	-5,84	-6,56	-4,55	-5,15	-4,48	-3,30	Under EDP throughout	-6,00	-4,59	-5,31	-3,30	-3,90	-3,23
								Other ECA audits						
Alread audited	Germany	-1,34	-0,12	0,27	0,82	0,92	0,71	EDP	-1,68	-0,84	0,38	0,77	1,32	1,42
	Greece	-6,40	-0,43	1,98	0,57	-1,13	-0,27	Greek audit	-9,65	-5,90	0,07	2,48	1,07	-0,63
	Spain	-6,17	-3,35	-1,90	-1,80	-2,53	-2,61	MIP	-7,04	-6,17	-3,35	-1,90	-1,80	-2,53
	France	-5,09	-4,26	-3,53	-2,79	-2,74	-2,39	EDP/MIP	-5,50	-4,69	-3,86	-3,13	-2,39	-2,34
	Italy	-3,27	-1,28	-0,87	-1,06	-0,98	-1,50	EDP/ES audit	-3,27	-3,27	-1,28	-0,87	-1,06	-0,98
	Cyprus	-5,50	-5,14	-1,69	2,02	0,35	0,22	EDP	-5,06	-5,50	-5,14	-1,69	2,02	0,35
	Malta	-2,78	-3,65	-2,47	-2,39	-2,09	-1,65	EDP	-4,02	-2,78	-3,65	-2,47	-2,39	-2,09
	Slovenia	-4,79	-2,13	-2,16	-2,75	-2,69	-2,48	MIP	-4,55	-4,79	-2,13	-2,16	-2,75	-2,69
	Bulgaria	-1,87	-0,48	-0,76	-2,48	-2,56	-2,43	MIP	-1,51	-0,87	0,52	0,24	-1,48	-1,56
	Czech Republic	-2,63	-1,48	0,08	-0,78	-1,96	-1,42	EDP	-3,06	-1,63	-0,48	1,08	0,22	-0,96

Source: Commission data (Preventive arm - autumn forecast 2015)
* Distance from MTO (Negative = SB below MTO, Positive = SB above MTO)
** Based on forecast data
Under Preventive arm
Not at MTO according to Commission assessments of Dec 2015

ANNEX II

RESULTS ON MEMBER STATES IN AUDIT SAMPLE

1. We audited a sample of six Member States, reviewing the Commission's assessment of the SCPs, the Commission's SWDs, the CSRs, and various related working papers. We also carried out information visits to the Member States in the sample to gather feedback on the process, the framework of rules, and the coordinated EU surveillance of fiscal policies.

Member States' submissions (SCPs)

2. We found that, overall, the SCPs address most of the requirements of the Regulation and CoC in terms of the information provided. They included information on the budgetary objectives and the measures to achieve them, as well as information on measures to enhance the quality of public finances and achieve long-term sustainability. However, fiscal measures are not always presented in a sufficiently well-structured way to allow for a clear understanding of their details (e.g. estimated budgetary impact, typology, status, etc.). This has been remarked repeatedly in the recitals of the Council recommendations (see ***Table 1***).

Table 1 – Recitals in Council recommendations on the quality and level of information on measures contained in SCPs submitted by Member States in sample

	Recitals in the Council Recommendations		
	2015	2016	2017
AT	(8) … measures to support the planned deficit targets from 2016 onwards have not been sufficiently specified …	(6) … the measures needed to support the planned deficit targets from 2017 onwards have not been sufficiently specified …	
BE	(8) …the measures needed to support the planned deficit targets from 2016 onwards have not been sufficiently specified …	(6) …the measures needed to support the planned deficit targets from 2017 onwards have not been sufficiently specified …	(6) … the measures needed to support the planned deficit targets from 2018 onwards have not been specified …
HU	(8) … Measures to support the planned deficit targets from 2016 onwards have not been	(6) … The measures needed to support the planned deficit targets from 2017 onwards have	

	sufficiently specified, in particular beyond 2016 …	not been sufficiently specified, in particular for after 2017	
FI		(6) … The measures needed to reach the medium-term budgetary objective by 2019 have not been sufficiently specified.	
IT	(12)…The government has yet to specify the additional expenditure cuts that will allow it to avoid implementing the legislated VAT increase in 2016.		

Source: Council recommendations 2015-2017.

COM assessments of Member States' submissions

3. We found that Member States generally submit their SCPs within the stipulated timeframes, and that country desks in DG ECFIN have a relatively short period of time to review the SCPs received in depth (see ***Table 2***).

Table 2 - SCP submissions and SWD publication dates (2015-2017) for Member States in sample

	2015			2016			2017		
	SCP submission date	COM assessment document date	Time elapsed (calendar days)	SCP submission date	COM assessment document date	Time elapsed (calendar days)	SCP submission date	COM assessment document date	Time elapsed (calendar days)
AT	21/04	27/05	*36*	27/04	26/05	*29*	02/05	23/05	*21*
BE	30/04		*27*	29/04		*27*	28/04		*25*
FI	02/04		*55*	14/04		*42*	28/04		*25*
HU	30/04		*27*	29/04		*27*	02/05		*21*
IT	28/04		*29*	28/04		*28*	27/04		*26*
NL	30/04		*27*	28/04		*28*	26/04		*27*

Source: ECA review of SCPs and SWDs.

4. The preparation of the Commission's assessment depends, however, on a process of exchange of information, which starts earlier in the annual cycle, including information exchanges in bilateral meetings held well in advance of the submission of SCPs. The work of country desks is complemented by European Semester Officers working in EU representations in Member States. These Officers liaise with the representatives of the relevant national authorities and monitor closely the main fiscal and budgetary developments in each Member State.

Relevance of country-specific recommendations

5. We assessed whether CSRs are consistent with the conclusions the Commission derives in its assessments. Overall, the fiscal CSRs are in line with the results of the Commission's assessment (see ***Table 3***).

<u>Table 3</u> – Consistency check between CSRs and underlying Commission assessments for sample Member States (2015-2017)

Member State	Year t		COM assessment Required adjustment corrected (years t / t+1)	Recital / Recommendation	
AT	2015		0.3 %	Recital	(8) … 0.3 % of GDP structural adjustment required in order to reach the medium-term objective
	2016		0.3 %	Recommendation	(1) … achieve an annual fiscal adjustment of 0.3 % of GDP in 2017
	2017		0.3 %	Recital	(8) …achieve an annual fiscal adjustment of 0.3 % of GDP in 2017
BE	2015		2015: 0.6 % 2016: 0.6 %	Recommendation	(1) Achieve a fiscal adjustment of at least 0.6 % of GDP towards the medium-term budgetary objective in 2015 and in 2016
	2016		0.6 %	Recommendation	(1) … to achieve an annual fiscal adjustment of at least 0.6 % of GDP
	2017		0.6 %	Recital	(10) …that adjustment … would correspond to an annual structural adjustment of at least 0.6 % of GDP
FI	2015		2015: 0.1 % 2016: 0.5 %	Recommendation	(1) Achieve a fiscal adjustment of at least 0.1 % of GDP towards the medium-term budgetary objective in 2015 and of 0.5 % of GDP in 2016
	2016		2016: 0.5 %	Recommendation	(1) Achieve an annual fiscal adjustment of at least 0.5 % of GDP

Member State	Year t		COM assessment Required adjustment corrected (years t / t+1)	Recital / Recommendation	
			2017: 0.6 %		towards the medium-term budgetary objective in 2016 and 0.6 % in 2017
	2017		0.1 %	Recital	(12) … corresponding to an annual structural adjustment of 0.1 % of GDP
HU	2015		2015: 0.5 % 2016: 0.6 %	Recommendation	(1) Achieve a fiscal adjustment of 0..5 % of GDP towards the medium-term budgetary objective in 2015 and of 0.6 % of GDP in 2016
	2016		2016: 0.3 % 2017: 0.6 %	Recommendation	(1) … achieve an annual fiscal adjustment of 0.3 % of GDP towards the medium-term budgetary objective in 2016 and of 0.6 % of GDP in 2017
	2017		1.0 %	Recital	(8) …that adjustment … would correspond to a structural adjustment of 1.0 % of GDP
IT	2015		2015: 0.3 % 2016: 0.1 %	Recommendation	(1) Achieve a fiscal adjustment of at least 0.25 % of GDP towards the medium-term budgetary objective in 2015 and of 0..1 % of GDP in 2016
	2016		2016: 0.25 % 2017: 0.6 %	Recommendation	(1) … to achieve an annual fiscal adjustment of 0.6 % or more of GDP
	2017		0.6 %	Recital	(10) …that adjustment … would correspond to an annual structural adjustment of at least 0.6 % of GDP

Member State	Year t		COM assessment Required adjustment corrected (years t / t+1)	Recital / Recommendation	
NL	2015		2015: -0.3 % 2016: -0.2 %	Nil	
	2016		0.6 %	Recommendation	(1) … achieve an annual fiscal adjustment of 0.6 % of GDP in 2017
	2017		Compliant	Nil	

Source: SWDs and CSRs for sample Member States (2015-2017).

REPLIES OF THE COMMISSION TO THE SPECIAL REPORT OF THE EUROPEAN COURT OF AUDITORS[1]

"IS THE MAIN OBJECTIVE OF THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT DELIVERED?"

EXECUTIVE SUMMARY

I. The role of the preventive arm is to achieve fiscal sustainability, while foreseeing the possibility for a modulation of fiscal policies in view of economic conditions. At the heart of the preventive arm, the Medium-term Budgetary Objective (MTO) operationalises this need to balance prudent fiscal policy based on the medium to long-term while facilitating the operation of the automatic stabilisers. As the MTO is set in structural terms, it allows for the regular movements in the fiscal balance caused by the economic cycle. Ensuring that Member States continue to make steady progress towards their MTO is therefore a critical function of the Commission and the Council in delivering the necessary improvements in debt sustainability and macro-stabilisation.

Article 6(3) of the Regulation rightly recognises that a wider range of elements determine the sustainability of public finances in the medium-term, including, for instance, the need to avoid counter-productive fiscal adjustment when the cyclical position of the economy is weak, the role of structural reforms and investment in raising potential growth and the need to allow for events outside the control of government. All of these factors are specifically provided for in the Regulation.

The regulation also foresees for an allowable level of deviation from the annual requirements, which recognises the inherent uncertainty in budgetary policy planning and implementation that may lead to a Member State missing their target due to matters outside of the control of government. While the ECA appears to have concerns that this margin is being persistently exploited by some Member States, see paragraph XII and Recommendation 1(a), its stipulation in the Regulation nevertheless requires the Commission to allow such deviation.

While the SGP frames the conduct of fiscal policy for Member States under the preventive arm, it is important to reiterate that budgetary policy is ultimately within the competence of Member States. The Commission obviously plays a key role in the enforcement of the SGP, in particular through its assessment of whether Member States' policies are being conducted in compliance with their obligations under the Regulation. The legislation cannot realistically codify every possible aspect of macroeconomic and budgetary policy-making which may be relevant to the application of the fiscal rules and therefore leaves room for the Commission and the Council to deal with specific situations.

In order to facilitate its assessments, the Commission has developed a large body of procedures and methodologies. These are necessary both to provide predictability to Member States as to how the Commission will assess compliance and to ensure horizontal consistency in these assessments. In such instances where the Commission exercises its discretion in making its assessments, it endeavours to do so in a transparent and orderly manner, in full consultation with the Member States (through the relevant committees, e.g. ECOFIN, EFC).

Ultimately, while the Commission is responsible for assessing Member States' compliance with the preventive arm, the enforcement of the rules is a shared competence between the Commission and the Council, with the setting of Member States' fiscal requirements and any subsequent procedural

[1] The Commission replies reflect discussions with the ECA up to 22 May 2018

consequences requiring the Council's adoption of a Commission recommendation. Since the entry into force of the Six Pack, the Council has endorsed the Commission's recommendations under the preventive arm without substantive modifications.

The Commission considers that the use of the flexibility built into the preventive arm has been proportionate, appropriate and economically justified in view of the unique nature of the crisis, which led to a deep deterioration of public finances across the board. Indeed, while it is now widely recognised that the European economy is recovering strongly, it was only relatively recently that the unusual features of the recovery argued for caution in applying fiscal consolidation. In particular, the Commission and others, including the President of the ECB, pointed to the lack of inflationary pressures, large current account surplus for the euro area and persistently high levels of unemployment in some Member States as evidence for the a continuing degree of slack in the economy. These concerns, along with increased geo-political uncertainty, made the Commission believe that a prudent application of the fiscal rules would seek to ensure that overly large fiscal adjustments did not endanger what was a still fragile recovery in many Member States.

To this end, the Commission's 2015 Communication on Making the Best Use of the Flexibility in the Existing Rules of the Stability and Growth Pact provided further detail on how the Commission would conduct its assessment in three main areas; the modulation of fiscal requirements in light of cyclical conditions, making allowance for the implementation of structural reforms that improve long-term sustainability and making allowance for growth-enhancing public investment. The provisions of the Regulation under which the Commission applies this flexibility are long-standing, mainly dating back to the reform of the legislation in 2005. Again, the approach which the Commission has taken was extensively discussed with Member States, resulting in the publication in early 2016 of a Commonly Agreed Position on Flexibility in the Stability and Growth Pact. Recent Commission simulations confirm that an average requirement of close to the benchmark rate of 0.5% of GDP results from the application of the so-called matrix of requirements. The improvements to sustainability linked to the application of the structural reform and investment clauses will take longer to assess, as the very nature of these clauses recognises that there may be short-term costs to implementing policies that will have a long-term pay-off. In this regard, it is by design that the application of a temporary deviation from the adjustment path for Member States implementing major structural reforms or growth-enhancing investments may lead to a delay in MTO convergence. However, in order to ensure that this effect is temporary and ultimately leads to a long-term improvement in fiscal sustainability, a number of important safeguards have been put in place. In particular, there are stringent eligibility criteria which a Member State must meet in order for the clause to be granted, including remaining in the preventive arm, preserving a safety margin to the 3% of GDP threshold, being within 1.5% of GDP from the MTO when applying for the clause and a number of implementation requirements specific to each clause.

The Commission therefore rejects the ECA's conclusion that the Commission has not ensured that the Regulation's main objective is met. In all cases, the Commission applies the provisions of the Regulation in conjunction with the Council. The Commission has a degree of discretion in its implementation of the provisions of the preventive arm when making its assessments. In such circumstances, the Commission has considered that, in a very limited number of exceptional cases, it is more prudent to err on the side of caution when considering the impact of a large fiscal consolidation on economic growth. The Commission is of the view that a more mechanical application of the rules, which does not take account of the prevailing risks to economic recovery, may ultimately prove counter-productive. In this regard, it is notable that the Commission's approach was broadly endorsed by the European Fiscal Board in its 2017 Annual Report, which found that a rigid application of the rules could have undermined the continuation of a still fragile recovery.

Overall, the fiscal position has steadily improved over recent years, with the number of Member States under the corrective arm significantly reduced and debt now on a downward path in both the EU and the euro area. Of course, the fiscal rules are not perfect, with the increased complexity of the preventive arm being a legitimate concern. The Commission is therefore committed to continuing to attempt to improve the functioning of the preventive arm and is open to considering any proposals that are warranted and take into account both the economic context and the appropriate medium-term perspective.

III. The Commission notes that the corrective arm of the SGP is governed by a separate Regulation to the preventive arm. In this regard, the Commission highlights that the ECA recently conducted a full separate audit of the corrective arm, with the report on the Excessive Deficit Procedure published in April 2016.

IV. The Commission applies the legal framework which has been agreed by the co-legislators. The Regulation does not and cannot provide the level of detail necessary to implement every aspect of the framework and the Commission must decide how to operationalise the legislative provisions. In such instances where the Commission exercises its discretion, it endeavours to do so in a transparent and orderly manner, in full consultation with the Member States through the relevant committees, e.g. ECOFIN, EFC etc. Indeed, the enforcement of the preventive arm is a shared competence between the Commission and the Council, which has endorsed all of the Commission's country-specific recommendations, including those containing allowances granted under so-called flexibility clauses.

V. The Commission rejects the ECA's conclusion that "the Commission and its operational decisions do not ensure that the main objective of the Regulation is met". Firstly, the enforcement of the SGP is a shared competence between the Commission and the Council, which has endorsed all of the Commission's country-specific recommendations. Secondly, the main objective of the Regulation is that Member States pursue prudent fiscal policies over the medium-term, which is operationalised through the achievement of or adjustment towards the MTO. However, the Regulation recognises the wider context of sustainability in the medium-term, including, for instance, the need to avoid counter-productive fiscal adjustment when the cyclical position of the economy is weak, the role of structural reforms and investment in raising potential growth and the need to allow for events outside the control of government. All of these factors are specifically provided for in the Regulation. The results of the ECA's analysis need to be assessed against the specific economic conditions that existed over recent years, including important legacies from the crisis.

VI. The Commission considers that the use of the flexibility built into the preventive arm has been proportionate, appropriate and economically justified. While it is now widely recognised that the European economy is recovering strongly, it was only relatively recently that the unusual features of the recovery argued for caution in applying fiscal consolidation due to the evidence of continuing slack in the economy. These concerns made the Commission believe that a prudent application of the fiscal rules would seek to ensure that overly large fiscal adjustments did not endanger what was a still fragile recovery in many Member States. At the same time, the Commission has consistently stressed the need for high-debt Member States to take measures to improve their sustainability, and a number of the flexibility provisions operationalised by the Commission in its January 2015 Communication are designed to do just that.

The Commission therefore rejects the ECA's conclusion that it further weakened the framework though the application of its discretion. In a very limited number of exceptional cases, the Commission has considered that it is more prudent to err on the side of caution when considering the impact of a large fiscal consolidation on economic growth. It is the Commission's view that a

more mechanical application of the rules, which does not take account of the prevailing risks to economic recovery, may have proven counter-productive.

VII. The temporary deviation under the structural reform clause was never linked to the actual budgetary costs of the reform and the Regulation also does not foresee such a link, particularly because those costs may be difficult to measure and/or have limited direct fiscal impact. Indeed, there may be very beneficial structural reforms that do not create significant direct budgetary costs but nonetheless carry substantial economic or political costs, for example labour market or judicial reforms.

The technical design of the temporary deviation from the MTO or adjustment path means that spending is increased relative to the baseline (i.e. the path of expenditure in the absence of the temporary deviation) in each year until the MTO is reached. This design of the deviation was agreed with the Council, in order to avoid creating a stop-start pattern of fiscal adjustment and to ensure equality of treatment across Member States depending on their distance to MTO. Unless the associated costs are of a one-off nature, the necessary compensation to return spending to the original trajectory in the year after application of the clause would imply an additional fiscal adjustment on top of the Member State's standard requirement in that year which would significantly reduce the incentive for structural reforms that the clause is meant to provide.

The ECA's conclusion that the cumulative impact of all the potential allowances is long delays in reaching the MTO represents a generalisation that relates only to an isolated specific Member State example. In the benchmark case, where a Member State is on the adjustment path to MTO, the ultimate impact is simply to delay achievement of the MTO by one year.

VIII. The Commission believes that the corrective arm has overall performed well in recent years, as evidenced by the fact that the number of Member States under an excessive deficit procedure fell from 24 in 2011 to just three in 2017. Nevertheless, it is correct that Member States who meet their headline deficit targets under the corrective arm will not face procedural consequences if they miss their structural targets. This reflects the inherently nominal nature of the corrective arm, where an EDP is ultimately abrogated based on bringing the headline deficit below 3% of GDP, notwithstanding the structural position.

The Commission put forward options to rectify this anomaly through allowing for a shortening of EDP deadlines when cyclical conditions improve, but this suggestion was not supported by Member States. The Commission is open to the possibility to revisit this issue and build support for proposals among the Member States.

IX. The Commission does not share the ECA's concern "that the weakened SGP framework is unable to ensure progress towards the MTOs in several highly indebted Member States." as a number of the Member States which the ECA is referring to have been under the corrective arm during the period in question. The focus of the EDP is on the achievement of the 3% headline deficit threshold specified in the Treaty. The Commission and Council's enforcement of the corrective arm has therefore been in line with the Treaty and, moreover, has led to a steady reduction in the number of Member States under an excessive deficit procedure since 2014.

Finally, the ECA's focus on these Member States is also selective, ignoring both the large number of Member States at or approaching their MTO under the preventive arm and the highly indebted Member States, such as Cyprus and Ireland, that have made good progress.

X. The Commission conducts a thorough analysis of all Member States' Stability and Convergence Programmes (SCPs) and publishes its findings in the SCP assessments.

As regards fiscal measures, the Commission carries out an independent and thorough assessment of the yields of any fiscal measures. Further transparency and hence potential scrutiny is provided

through the Commission making available for each country the impact of discretionary measures (current/capital revenue as well as current/capital expenditure) and the level of one-offs in the AMECO database since spring 2014. While an element of judgement is unavoidable in a given instance, the Commission believes that the wide-ranging assembly of information provides a check against any systematic biases or inaccuracies.

Nevertheless, the Commission accepts that there has been room for improvement in terms of transparency over the estimation of fiscal measures and, to that end, engaged in intensive discussions with Member States during the course of 2017 to improve the accuracy and transparency of the assessments of such measures.

XI. The Commission is constantly seeking to improve the communication of the rationale underlying its recommendations and will consider specific proposals from the ECA. The Commission will also consider these alongside any relevant recommendations made by the ECA at the conclusion of its European Semester audit.

XII. The Commission disagrees that the design of the framework needs to be tightened. Specifically, the Commission does not accept the first recommendation as Regulation 1466/97 explicitly provides for the 0.25% of GDP allowable margin of deviation and the Commission cannot impose restrictions, i.e. on the accumulation of non-significant deviations, that conflict with the Regulation. Moreover, the 0.25% deviation is prescribed by the Regulation in order to take account of the difficulty of the structural balance computations and the inherent uncertainty in budgetary policy-making and execution. These factors can lead to a Member State deviating from their target due to matters outside of the control of government.

As regards the matrix, the categorisation of parameters already sets higher requirements for more heavily indebted Member States. This notwithstanding, as part of a wider review of the use of flexibility required under the Commonly Agreed Position with Member States, the Commission is currently examining the efficacy of the matrix, including the various requirements.

While the Commission agrees that the unusual events clause provisions should only apply to costs directly related to the events in question, it does not accept the recommendation that the temporary deviation under the structural reform clause should be directly linked to costs as it considers that the required adjustment would weaken the effectiveness of the structural reform clause. The temporary deviation under the structural reform clause is not directly linked to the actual budgetary costs of the reform because some very beneficial structural reforms do not always create significant direct budgetary costs, while such reforms carry substantial economic or political costs.

XIII. The Commission does not agree that the accumulation by Member States of the 0.25% of GDP allowable margin for deviation can be tackled within the existing legal framework, since this provision is specifically provided for in Article 6(3) of Regulation 1466/97. The Commission is therefore concerned that any systematic re-design of the matrix in this manner could be seen as circumventing the margin provided for in the Regulation.

XIV. The inherently nominal nature of the EDP, with its focus upon the 3% headline deficit threshold, limits the Commission's capacity to enforce structural targets under the corrective arm. The Commission has in the past put forward options for seeking to ensure that structural adjustment requirements are delivered under the corrective arm, specifically by envisaging revision of the EDP recommendation in cases of positive economic surprises relative to the scenario underlying the initial recommendation, but Member States have not supported this suggestion.

However, the Commission is open to the possibility to revisit this issue and build support for such proposals among the Member States.

Please see reply to paragraph VIII.

XV. The Commission has since 2017 been engaged with Member States in developing a process seeking to improve the accuracy and transparency of the estimation of fiscal measures. The Commission is open to amending the Code of Conduct to reflect any necessary changes from this process, if Member States agree. However, it will be important that any such changes distinguish between the differing nature of revenue and expenditure measures. The indicators used in the Commission's assessments of compliance are based upon the most recent Commission forecast and the latest validated Eurostat data.

The fiscal requirements are set a year in advance in order to allow the Member State to formulate their budgetary policy. The requirements are based upon the most favourable vintage only as far as the calculation of the distance to the MTO is concerned, whereas the matrix requirements are updated only in a limited number of well-justified circumstances based on the unfreezing principles.

XVI. The Commission accepts this recommendation.

OBSERVATIONS

25. While the concept of exceptionally bad times does not appear in the Regulation, nor do several of the other categories. In fact, the Regulation only mentions good times and bad times, not even referring to the possibility of normal times. This reflects the reality that the Regulation does not and cannot provide the level of detail necessary to implement every aspect of the framework and the Commission must decide how to operationalise the legislative provisions. The reason why no adjustment is sought in such circumstances is that the imposition of fiscal consolidation measures when cyclical conditions are so weak could end up being counter-productive, i.e. the negative impact on activity could result in an even worse budgetary outcome.

26. The matrix is not meant to allow a decline in the structural balance during sharp recessions. While for situations of negative growth rates, the matrix uses words "no adjustment needed," in practice this means that the structural balance requirement is set to 0.

27. The ECA does not indicate how a more consistent differentiation of the matrix categorisations could be implemented. However, the requirement for an adjustment greater than 0.5% of GDP has always been implemented as 0.6% of GDP, with no adjustments higher than this recommended under normal times. Again, it should be noted that the categorisation of cyclical conditions contained in the matrix was proposed by the Commission but fully agreed with Member States through the Commonly Agreed Position on Flexibility.

28. The Commission considers that the differentiation in the matrix pointed out by ECA is not inconsistent.

With the exception of the categories of very bad and exceptionally bad times, the adjustments are clustered around the 0.5% benchmark in order that the matrix does not distance itself too far from the Regulation. The design of the level of adjustment within the categories reflects two further practical factors. Firstly, if the minimum level of granularity is accepted to be 0.1% of GDP, there is a limited degree of differentiation that can be achieved while staying within reasonable parameters of the benchmark. Secondly, the Commission wanted to avoid creating overly large threshold effects, in order to avoid a situation where small revisions to what is ultimately an unobservable variable, i.e. the output gap, lead to large changes in the prescription for Member State's budgetary strategy. Thirdly, the observation appears to confuse the Commission's replies in relation to the potential political costs associated with structural reforms with the reasoning underlying the matrix outlined above.

Finally, as regards the assertion that growth being faster than potential is the ideal time to implement reforms, it should be noted that under the bad times category, the level of the output gap

could remain as low as -3%, indicating that although the output gap is closing (i.e. growth exceeds potential) the economy is still in a challenging cyclical position.

29. The Commission did conduct analysis when setting the parameters for the matrix. The matrix is based on the pooled distribution of output gaps for 28 EU Member States, between 1986 and 2014, according to the Commission 2014 autumn forecasts. It excludes the largest (negative) output gap from either 2009 or 2010, on the basis that these years reflect the most unusual circumstances experienced in the medium-term past and cannot therefore be thought to constitute part of a typical economic cycle. The historical distribution indicates the frequency with which each category of matrix adjustment will be required, which has obvious implications for reaching the MTO. Recent internal Commission simulations being conducted as part of a formal review of flexibility as required by the Commonly Agreed Position confirm an average matrix adjustment based on the cyclical conditions of just under 0.5% of GDP since 2000.

30. The 0.25% margin is contained in the Regulation and the Commission cannot impose restrictions, i.e. on the accumulation of non-significant deviations that conflict with the Regulation.

Indeed, the language in the EFB report is notably ambiguous regarding the need for a change in the legislation in order to introduce its proposals to limit the effect of multiple deviations.

31. The Commission does not agree that the application of its discretion in making its assessments, specifically to apply economic judgement, in any way weakens the framework.

Firstly, under Article 6(3) of Regulation 1466/97, the Commission has a margin of discretion when considering departures from the fiscal adjustments implied by the matrix. In this regard, there is no automaticity in the Regulation in reaching the conclusion of a significant deviation.

Secondly, the SGP, including the preventive arm, should not be understood as merely a static set of individual rules to be mechanically applied to any given event. Rather it represents a system of economic and fiscal governance, designed to help ensure prudent macroeconomic and fiscal policy-making over the medium to long-term. The nature of macroeconomic policy-making ensures that unanticipated events will arise and the economic governance framework needs to be flexible enough to be able to respond to and accommodate such developments. In fact, were the framework unable to do so, the credibility of the SGP as a viable tool for economic governance and policy-making would be undermined.

At all times therefore, it is important for the Commission to use its economic judgement to ensure a sensible application of the rules, rather than engaging in a purely mechanical approach that is divorced from the prevailing macroeconomic circumstances.

<u>Common reply to paragraphs 32 and 33.</u>

The 2017 CSRs were intended to achieve the two objectives of strengthening the ongoing recovery and ensuring fiscal sustainability, while remaining short and simple. This translated into the fiscal CSRs not including recommendations for the required adjustment for 2018, in contrast to past practice. This was ultimately a political decision which took into account a number of considerations.

Firstly, although the so-called ‘matrix’ approach remains the basis for the CSRs for 2018, the 2017 Commission proposals for recommendations brought a qualification regarding Member States for which the matrix implies a fiscal adjustment of, or above, 0.5% of GDP (the margin of discretion). The CSR was not deemed to be the right place to provide the details balancing the matrix requirements and the need to take into account the impact of consolidation on growth and employment through the margin of appreciation.

Secondly, the accompanying recitals are very explicit on what has to be done in 2018; in particular they mention (i) the quantified requirement, (ii) an assessment of compliance, and (iii) a conclusion as to whether additional measures are needed.

Thirdly, the recitals and CSR proper maintain an equal footing as regards their legal strength.

The Commission therefore does not see evidence at this stage that the use of its margin of discretion has reduced the relevance or credibility of the fiscal requirement in the CSR.

34. In the phase of assessing compliance, the Commission has a margin of discretion when considering departures from the fiscal adjustments implied by the matrix. These margins of discretion result from the specific terms of Article 6(3) of Council Regulation no. 1466/97. According to Article 6(3), the establishment of a significant deviation from the MTO or the adjustment path towards it, is, on the one hand, linked to precise quantitative criteria, without being limited to those criteria, and, on the other hand, allows for other elements to be taken into account. There is therefore no automaticity in the Regulation in reaching the conclusion of a significant deviation.

35. In its assessments, the Commission recognises that there can be a tension between sustainability and stabilisation needs in individual Member States, though it also true that this may not necessarily be the case as demonstrated by the analysis published by the Commission in part IV of the Public Finances Report 2016. Where a tension does exist, it is the Commission's role to analyse the competing demands and reach a balanced assessment, factoring in all relevant considerations. Commission discretion consists of an intelligent reading of the set of available indicators, especially in light of the uncertainty surrounding the business cycle and the risks of strong fiscal retrenchment for the on-going recovery in specific Member States.

36. Firstly, the aggregate growth rates do not necessarily capture the potentially fragile nature of the recovery in individual Member States, nor do they take consideration of the potentially counter-productive impact of an overly large fiscal consolidation upon such an economy. These are obviously important factors which the Commission sought to take account of when using its margin of discretion in determining the appropriate fiscal policy setting for individual economies.

Secondly, the fact that actual growth is higher than potential growth does not say much regarding the strength of the recovery. For instance, Italy's potential growth was estimated at around 0 in those years.

37. The limits on the structural reform and investment clauses were agreed in discussions between the Commission and Member States.

41. To complete the picture, the Commission wishes to add an explanation for the rationale underlying the conditions of the investment clause. The clause is intended to cater for public investments which can be considered economically equivalent to structural reforms in having a positive impact on potential growth and the sustainability of public finances and is therefore linked to certain projects co-funded by the EU. The eligibility condition that public investment should not decline is intended to ensure that EU funded investments are not used to substitute for nationally funded investment.

42. A key eligibility criterion in order to qualify for use of the investment clause is that the Member State’s output gap must be more negative than -1.5% of GDP. In other words, the Member State must be in bad economic times. Research shows that when countries face sustainability challenges in such circumstances, public investment is very often cut, with a detrimental impact on potential growth. The investment clause seeks to ensure this does not happen, by requiring that the level of public investment does not decrease in the reference year for the application of the clause. A decrease in the nominal level of investment could still lead to an increase in the investment-to-GDP

ratio if the decrease in GDP growth (outside the control of the government) is starker than that in investment.

43. The intention of the investment clause is to lead to sustained levels of increased investment. In such cases, requiring a Member State to return to their original path a year after the granting of the clause would not be warranted.

44. See reply to paragraphs VII and 43.

45. Since the introduction of the matrix, it is not possible to assess in advance whether a Member State will achieve their MTO within the four-year timeframe (as this will be a function of, amongst other things, the requirements of the matrix for individual years). Consequently, the Commission proposed to Member States a simplifying assumption to meet the MTO convergence criterion, instead assessing whether a Member State applying for use of the clause is within a maximum initial distance of 1.5% of GDP from the MTO. Based on the benchmark adjustment of 0.5% of GDP per year and a maximum temporary deviation of this amount, this distance would deliver a return to the MTO within four years.

46. The non-significant deviation margin is contained in the Regulation and the Commission does not have a choice regarding its implementation. However, it is not necessarily the case that the significant deviation margin will unavoidably be exhausted in every year, i.e. "the extension in the convergence time *will* therefore be much longer." For instance, according to the Commission's Spring Forecast 2018, Finland is not projected to do so.

47. The application of the investment clause will, other things being equal, lead to an increase in overall spending compared to if the clause had not been applied.

However, the increase in spending is not regardless of what happens to the level of investment spending as a qualifying condition is that the level of public investment should not decline in the reference year for the application of the clause.

48. See replies to observation 43, 45 and 47.

49. While a cost-benefit analysis of major structural reforms is requested in the Stability and Convergence Programme under article 3, this does not mean that the temporary deviation has to be based on the costs. Indeed, the relevant provisions of the so-called structural reform clause in Article 5 make no reference to costs. In addition, the fact that the temporary deviation is not directly based on costs, does not mean that costs are not measured.

50. In assessing whether the reforms have positive budgetary impacts, as required by the Regulation, the Commission considers the direct budgetary costs as well as the long-term impact on growth. The long term impact on growth should ultimately improve the long term sustainability of public finances.

52. The Commission has consistently assessed the impact of all structural reforms in Italy, including those for which flexibility under the structural reforms clause had been asked, as indicated in the assessment of Italy's eligibility for the structural reforms clause (Staff working document on Italy's 2016 Stability Programme – page 18). In particular, Italy's 2017 and 2018 Country Reports provide an in-depth assessment of the state of play in terms of implementation of Italy's structural reforms. In addition, a constant reference to the state of play in terms of implementation, both *ex ante* and *ex post*, was included in the Staff working documents on Italy's 2016 Draft Budgetary Plan (pages 22-23), on 2016 Stability Programme (pages 4 and following), and 2017 Draft Budgetary Plan (page 19), as well as in the 126(3) Report of February 2017 (pages 13-14).

53. As stated in reply to observation 49, the temporary deviation is not based upon the direct budgetary costs of the reforms. Extensive details on the Commission's assessment of the long-term growth impact of the reforms are provided in reply to observation 54.

54. The Commission considers that it estimated the economic impact related to the clause properly.. At the time of Italy's application for the structural reform clause for 2016 (in the 2016 Draft Budgetary Plan and the 2016 Stability Programme) the Commission analysed the impact of Italy's structural reforms through its QUEST model in a note presented to the Economic Policy Committee of December 2015 (later published as "*The Economic Impact of Selected Structural Reform Measures in Italy, France, Spain and Portugal*" in April 2016). Hence, by the time of the 2016 Stability Programme, the Commission's estimates had been amply discussed with the Italian authorities. Moreover, the Commission had openly challenged the initial estimation of the impact of reforms as proposed by the Italian authorities in its 126(3) Report of February 2015. As a result of those exchanges, the 2016 Stability Programme revised downwards the estimated impact of structural reforms for which flexibility had been asked (compared to the 2016 Draft Budgetary Plan), as acknowledged in footnote 26. This shows the relevance of the Commission's work to analyse the impact of reforms and verify the estimates presented by the authorities.

As regards, the reportedly indicative nature of the estimates of the impact of structural reforms upon growth, this reflects the intrinsic limits of macroeconomic modelling. The Regulation requires the Commission to take account of the improvement to sustainability from structural reforms' impact upon potential growth, but this is an inherently uncertain modelling exercise.

56. See replies to paragraphs 45, 47 and 48.

57. The preventive expenditure related to earthquakes in Italy was eligible, due to the reoccurrence of intense earthquakes as well as the integrated nature of emergency management and preventive expenditures. As a result, around EUR 3 billion or 0.18% of GDP earmarked by the Italian government for this purpose in 2017 were considered eligible for the "unusual event clause". The budgetary impact of the investment plan has to be confirmed ex post, based on the relevant ex-ante and ex-post data provided to the Commission by the Italian authorities.

58. The Commission does not consider this to be a relaxation of the framework but rather a practical recognition of the realities of budgetary policy-making and setting at the Member State level.

Member States need to be told in advance how large the required fiscal adjustment is in order to be able to factor it into their budgetary planning. This ex ante medium-term budgetary planning and coordination is in fact the raison d'être of the Stability and Convergence Programme process in the European Semester.

If the structural balance is revised so that the distance to the MTO is reduced to such an extent that the original requirement implies an over-achievement of the MTO, then the requirement is unfrozen and revised. It is true that there is an asymmetry in this approach, as if the structural balance is revised downwards, i.e. to a distance further from the MTO than originally projected, then the Member State's requirement is not increased. This is because it would violate the legitimate expectations that the Member State had regarding the required level of budgetary adjustment which has been requested by the Commission when the Member State was planning and agreeing its budgetary strategy.

59. Calculating the requirement based on the in-year distance to MTO is not only politically unrealistic but practically unworkable.

If in spring of t-1, a Member State is estimated to be at its MTO in t-1, then no further adjustment is necessary in year t, and the requirement for t will be frozen at zero. This provides the Member States with the necessary degree of certainty regarding the required level of adjustment to begin the

very extensive national procedures normally involved in building a budget. If, in spring of t, revisions to the structural balance mean that the Member State is estimated to have been a distance of 0.5% of GDP below its MTO in year t-1, it is in the Commission's view too late to revise the requirement. The Member State will already have enacted the budget for year t based upon the Commission telling it that no adjustment was required. It would therefore breach the Member State's legitimate expectations as to the required level of budgetary adjustment on which it would be assessed if the Commission were to impose a larger requirement. In fact, this level of unpredictability would severely undermine the credibility of the SGP framework in the eyes of national politicians.

It is also problematic to base the requirement on the projected distance to the MTO in the year in which the requirement applies, as this projection is itself a function of the requirement. In any event, in-year revisions based on updated projections will not give the Member States sufficient advance notice when setting their budgetary policy.

60. To complete the picture, Member States' requirements are not revised upwards due to an improvement in the Commission's assessment of the cyclical conditions. As per replies to paragraphs 58 and 59, this is because it would violate the legitimate expectations of the Member State as to the required level of fiscal adjustment when designing and setting their national budgetary policy.

61. The transition from ESA95 to ESA2010 meant that the requirement for a given year may have been calculated using ESA 95 while the assessment of the fiscal effort was made using ESA 2010. This is unavoidable unless Member States' requirements were to potentially all be overhauled based on recalculations under ESA 2010. In any case, given the way the matrix behind the requirement is built, it is unlikely that the computation of the requirements based on ESA2010 would have led to changes.

There is no inconsistency in indicators or measurements made across years. For instance, when the fiscal effort for 2014 was assessed using ESA 2010, the figures for both 2014 and 2015 are calculated under ESA 2010.

66. The Commission considers that the scenario presented by the ECA is only illustrative, as it is naturally difficult to extrapolate future outcomes for individual Member States based on the aggregate impact of a historical recession on the euro area.

67. As per reply to paragraph 66, the simulations are somewhat speculative, relating to a hypothetical case that has not occurred in practice and also do not take into account the possible impact of the country-specific minimum benchmarks, which would not allow the granting of the structural reform and investment clauses in many Member States.

68. See replies to paragraphs 33-35 regarding the Commission's use of its margin of discretion.

69. In the Commission's view, the ECA's observation does not present a complete picture.

Firstly, at a general level, when designing both the matrix and the allowances under the flexibility clauses, the Commission conducted extensive analysis. In the former case, this included examining the historical distribution of output gaps. In the latter case, the Commission provided Member States with a number of illustrative simulated scenarios for the design of the flexibility allowances, based on the benchmark adjustment of 0.5% of GDP being implemented (thus assuming no use of the 0.25% of GDP deviation margin). A number of these illustrative simulations are published in an annex to the Vade mecum.

Secondly, in assessing individual Member States' applications for the flexibility clauses, the Commission assesses their distance to the MTO to ensure that it is reachable by the end of the programme period, assuming the benchmark annual adjustment.

70. See replies to paragraphs 66, 67 and 69.

72. It should be noted that the Commission has consistently flagged this issue of revisions to SB projections through dedicated charts in its assessment of the Stability and Convergence Programmes.

75. While the Commission is not given the power to enforce such targets for convergence to the MTO, the Commission does analyse and comment on Member States' revisions to their expected date of achievement of the MTO, as can be seen in the Staff Working Documents and DBP assessments published in each surveillance round. The Commission thus holds the Member States accountable, but cannot take procedural steps under the current legal framework.

It is unclear how the matrix could be designed in such a way as to ensure ex ante that all Member States, regardless of the distance to the MTO will reach it in the fourth year of the programme, given that the projections for where the structural balance will be after three years are almost certainly likely to be wrong (this is the unavoidable nature of macroeconomic forecasting). In addition, if a Member State was very far from MTO at the time of the programme, this could imply very large fiscal adjustments in order to try and close the gap in the four year period. This could prove counter-productive.

76. The Commission and the Member States have through extensive discussions developed a common agreement to establish the level of detail necessary to implement every aspect of the SGP framework, such as establishing the Commonly Agreed Position on Flexibility. The purpose of such work is not to weaken SGP framework, but rather to make broad objectives of the Regulation operational.

77. This observation is not relevant for assessment of performance of the preventive arm of SGP. The analysed sample includes the structural and primary balance dynamics of Member States which were in the Excessive Deficit Procedure during the analysed period (i.e. Spain and France from 2009 onwards), but the corrective arm has a separate set of rules. The Commission recalls that the ECA has published a separate special report in 2016 on 'Further improvements needed to ensure effective implementation of the excessive deficit procedure', where the Commission provided its formal replies. https://www.eca.europa.eu/Lists/ECADocuments/SR16_10/SR_EDP_EN.pdf

78. The Commission considers that the progress towards achieving MTO has continued in recent years, albeit at a less pronounced scale as in the in the initial recovery stage when twelve Member States exited EDP.

79. The Commission considers that the estimates of structural balances of 2014 and 2018 are not fully comparable to make a judgement on the rate of progress in structural balance for Members States not at their MTO between 2014 and 2018. 2014 estimates of structural balances are based on historical data and incorporates actual fiscal measures taken in 2014. In contrast, 2018 estimates are based on the Commission forecast. The relevant Member States are expected to take fiscal measures within the national budgetary process to ensure that the 2018 budget is compliant with the SGP, therefore ex-post assessment of 2018 data is set to indicate different structural balances to the ones forecasted in autumn 2017.

80. The Commission considers that its positions on the euro area fiscal stance are balanced to reflect the fiscal position of each Member State. The Member States not at MTO are expected to take fiscal measures to comply with the SGP, while some Member States above the MTO are suggested to use fiscal space available to them to support economic growth. This is evidenced in the Commission's

2016 Communication "*Towards a Positive Fiscal Stance for the Euro Area*" which specifically states "Member States in the Excessive Deficit Procedure and others still needing to progress towards their medium-term budgetary objective should continue to do so, as recommended to them."

81. The Commission stresses that the outturn data for 2017, on which the final assessment of compliance is based, show significant improvement in Member States' performance, with the number of compliant countries quadrupling compared to the initial projections based on the Spring Forecast 2017. In addition, the aggregate numbers mask important differences in individual Member States' fiscal positions relative to the MTO.

Finally, the sample of Member States excludes the high-performing Member States, i.e. those that are at the MTO. As Member States who have achieved their MTO are also compliant with the provisions of the preventive arm, this gives a more accurate picture of overall compliance across all countries.

82. The fiscal performance of the Member States under the corrective arm of the SGP does not provide an accurate assessment of performance of the preventive arm of the SGP, since these two SGP arms have separate sets of rules.

See reply to paragraph 77 regarding ECA report on Excessive Deficit Procedure.

83. The corrective arm of the SGP is governed by a separate Regulation to the preventive arm. The inherently nominal nature of the corrective arm of the SGP, with its focus on the 3% of GDP threshold contained in the Treaty, means that although the Commission seeks structural adjustment from the Member States under the EDP recommendations, the Commission is not in a position to step up the procedure once the Member State meets the headline targets.

The Commission gave justification for the extensions of deadlines for exiting the excessive deficit procedure in particular cases in its reply to the special report of the ECA of 2016 on 'Further improvements needed to ensure effective implementation of the excessive deficit procedure'. https://www.eca.europa.eu/Lists/ECADocuments/SR16_10/SR_EDP_EN.pdf

85. The corrective arm makes it possible for Member States to follow a strategy of only achieving the headline targets on the back of improving macroeconomic conditions without delivering the required fiscal effort. It is to be noted that the Commission and Council in the EDP recommendations prescribe fiscal efforts that are consistent with those of the preventive arm in structural terms. However, it is not possible to instigate procedural measures if the Member State meets their headline targets. The overriding nature of the corrective arm is nominal as it is based upon the 3% of GDP headline deficit threshold contained in the Treaty. The Commission considers that averaging efforts from the corrective and preventive arm does not therefore accurately reflect the requirement effectively binding on Member States.

88. The most recent data indicate a significant improvement in Portugal's structural balance in recent years, with an improvement of 2% of GDP recorded between 2013 and 2017, leaving it 1.4% of GDP from the MTO.

89. France and Spain were under the corrective arm for almost all of the period in question, meaning that the matrix requirements were of no procedural consequence.

90. The Commission considers that the adjustment speed under the corrective arm does not inform about the effectiveness of the preventive arm of the SGP, since it is guided by a different set of tools.

92. See reply to paragraph 83 regarding the extension of EDP deadlines.

98. Estonia’s structural balance weakening in 2017 has not breached the requirements of the preventive arm.

99. The Commission considers that its use of flexibility, including the margin of appreciation, has been proportionate, appropriate and economically justified. It was only relatively recently that the unusual features of the recovery of the European economy argued for caution in applying fiscal consolidation. In particular, the lack of inflationary pressures, large current account surplus for the euro area and persistently high levels of unemployment in some Member States pointed to the continuing degree of slack in the economy. Given these concerns, along with a rise in geo-political uncertainty, the Commission believed that a prudent application of the fiscal rules would seek to ensure that overly large fiscal adjustments did not endanger what was a still fragile recovery in many Member States. Thus the Commission, in agreement with the Member States, used flexibility to modulate fiscal requirements in light of cyclical conditions.

102. The Commission agrees that its latest assessment of forecast accuracy finds evidence of a bias in some cases while using a particular methodology. However, it stresses that the assessment also concludes that the Commission’s economic forecasts are more accurate than those of the market and comparable to those of other international institutions. In addition, the accuracy of the Commission’s debt projections will also depend on a number of other factors, such as the projection for the primary balance and stock-flow adjustments.

103. The purpose of the regular assessments of forecast accuracy is institutional learning, and the Commission constantly strives to improve the accuracy of its forecasts. Substantial effort in recent years has been invested in the development of additional quantitative forecasting tools. The recent external evaluation of the forecasting services (paper forthcoming) concludes that the forecasts are of a high quality and the forecast processes are efficient.

108.

First bullet point: The Commission considerations on this point are provided in replies to observations 58 and 59 regarding the need to respect the legitimate expectations of the Member States.

In the former case, when the adjustment requirement is derived from the matrix, this is based on the spring forecast of year t-1’s projection of the output gap in year t and this is only unfrozen if the economy moves into very bad or exceptionally bad economic times. In the latter case, the reference rate for the expenditure benchmark in year t is based on the spring forecast projections of year t-1 and it is not updated for subsequent forecasts.

See reply to paragraph 60 regarding the practical problems of setting the distance to MTO based on the current year forecast.

Second bullet point: The smoothing of investment over four years is not specified in the Regulation. Nevertheless, such smoothing has been fully discussed and agreed with Member States through the ECOFIN committees. Therefore it is described in the Code of Conduct, where it states that "Due to the potentially very high variability of investment expenditure, especially in the case of small Member States, the government expenditure aggregate should be adjusted by averaging investment expenditure over 4 years." That is, the smoothing has been introduced in order to avoid that smaller countries with lower GDP per capita are not penalized for peaks in public investment. This is particularly an issue for some new European Member States for whom EU structural funds comprise a significant component of overall investment, as the drawdown of such funds can see large peaks and troughs in individual years.

117. The Commission considers that the transition between 2014 and 2015 was consistent. The Commission, in full agreement with the Member States, has taken a practical policy decision to

ensure during the transition a consistency between the budgetary targets against which the Member States were being assessed. Such an arrangement ensured that the introduction of the matrix published in the Flexibility Communication of January 2015 would not disadvantage particular Member States by changing the established budgetary requirement for 2015 during the transition.

121. The 2018 CSRs were intended to achieve the two objectives of strengthening the ongoing recovery and ensuring fiscal sustainability, while remaining short and simple and thus better understood by the public. This translated into the fiscal CSRs not including recommendations for the required adjustment for 2018, in contrast to past practice. See reply to paragraph 33 for a detailed explanation. Ultimately, the recitals and CSR proper maintain an equal footing as regards their legal strength.

124. The Commission considers that guidance is clear and properly formulated for each individual Member State depending on its fiscal position.

CONCLUSIONS AND RECOMMENDATIONS

127. The role of the preventive arm is to achieve fiscal sustainability, while foreseeing the possibility for a modulation of fiscal policies in view of economic conditions. The MTO operationalises this need to balance prudent fiscal policy based on the medium to long-term while facilitating the operation of the automatic stabilisers. Ensuring that Member States continue to make steady progress towards their MTO is therefore a critical function of the Commission and the Council in delivering the necessary improvements in debt sustainability and macro-stabilisation.

129. The Commission exercises its discretionary powers fully in line with the legal framework, which has been agreed by the co-legislators, and in a transparent manner, in full consultation with the Member States through the relevant committees. The Commission strongly disagrees with the ECA's conclusion that the Commission used its discretion with a view to reducing adjustment requirements. The discretion was used in line with the Regulation, which recognises the wider context of sustainability in the medium-term, such as the need to avoid counter-productive fiscal adjustment, the role of structural reforms and investment in raising potential growth, and the need to allow for events outside the control of government.

130. The matrix and the operationalisation of the flexibility clauses were set out in the Commission's 2015 Communication. However, the specific provisions in the Regulation stem from the 2005 reform.

Regardless, the adjustment parameters in the matrix and flexibility clauses were set up and applied fully in line with the legal framework and in a transparent manner, as well as in full consultation with the Member States through the relevant committees.

131. The margin of discretion was introduced to establish the appropriate fiscal policy setting in cases where the aggregate growth rates do not necessarily capture the potentially fragile nature of the recovery in individual Member States, also taking into consideration the potentially counter-productive impact of an overly large fiscal consolidation upon such economies.

132. Progress towards achieving the MTO is continuing in current years, albeit at a less pronounced scale then in the initial recovery period.

133. The Commission considers that the current SGP framework implementation rules, which are set up in common agreement with the Member States following extensive discussions, do not weaken the SGP framework, but make broad objectives of the Regulation operational.

134. Firstly, the Commission notes that the corrective arm of the SGP is governed by a separate Regulation to the preventive arm. Secondly, the Commission believes that the corrective arm has

overall performed well in recent years, as evidenced by the fact that the number of Member States under an excessive deficit procedure fell from 24 in 2011 to just three in 2017.

That said, the inherently nominal nature of the corrective arm of the SGP, with its focus on the 3% of GDP threshold contained in the Treaty, means that although the Commission seeks structural adjustment from the Member States under the EDP recommendations, the Commission is not in a position to step up the procedure once the Member State meets the headline targets. The Commission's attempts to address this situation did not receive the support of the Member States.

See reply to paragraph 83 regarding the extension of EDP deadlines.

135. The Commission and the Member States have engaged in extensive discussions in order to develop the common understanding necessary to establish the level of detail required to implement every aspect of the SGP framework. The purpose of such rules is to make broad objectives of the Regulation operational and they do not preclude the Commission and the Member states agreeing on any needed further adjustment in the SGP framework.

While the Commission is responsible for assessing Member States' compliance with the preventive arm, the enforcement of the rules is a shared competence between the Commission and the Council. The Commission does not believe that acting without consultation of Member States would be productive or beneficial to the long-term credibility of the framework. The design of the fiscal framework is inherently multilateral in nature and consultation with Member States is vital to ensuring ownership of the rules, which ultimately contributes to both compliance and enforcement.

Recommendation 1

(a) The Commission does not accept the recommendation as Regulation 1466/97 specifically provides for the 0.25% of GDP allowable margin of deviation and the Commission cannot impose restrictions, i.e. on the accumulation of non-significant deviations, that conflict with the Regulation. The Commission is concerned that a systematic re-design of the matrix in this manner could be seen as circumventing the margin provided for in the Regulation. Moreover, the 0.25% deviation is prescribed by the Regulation in order to take account of the difficulty of the structural balance computations and the inherent uncertainty in budgetary policy-making and execution. These factors can lead to a Member State deviating slightly from their target due to matters outside of the control of government.

(b) The Commission does not accept the recommendation. The categorisation of parameters in the matrix already sets higher requirements for more heavily indebted Member States. However, the legislation does not foresee an alignment of the preventive arm requirements with the debt reduction benchmark. Moreover, the legislation explicitly requires the Commission to assess relevant factors when assessing compliance with the debt reduction benchmark, which, therefore, cannot be thought of as an absolute rule.

(c) The Commission partially accepts the recommendation, specifically, to the extent that it asks to examine the effectiveness of the matrix, as the Commission is currently conducting a wider review of the flexibility arrangements required under the Commonly Agreed Position with Member States. The Commission cannot prejudge the outcome of this process.

138. The Commission strongly rejects the ECA's conclusion that the use of the structural reform clause has gone beyond the objective of the Regulation.

Firstly, the provisions of the Regulation under which the Commission applies this flexibility are long-standing, mainly dating back to the reform of the legislation in 2005.

Secondly, although the temporary deviation under the structural reform clause is not directly linked to the actual budgetary costs of the reform, the Regulation also does not foresee such a link,

particularly because those costs may be difficult to measure and/or have limited direct fiscal impact. Indeed, there may be very beneficial structural reforms that do not create significant direct budgetary costs but nonetheless carry substantial economic or political costs, for example labour market or judicial reforms. In such cases, directly linking the temporary deviation to the budgetary costs would effectively nullify the incentivizing intent of the clause.

It is important to point out that the approach which the Commission has taken was extensively discussed with Member States, resulting in the publication in early 2016 of a Commonly Agreed Position on Flexibility in the Stability and Growth Pact.

139. The technical design of the temporary deviation from the MTO or adjustment path means that spending is increased relative to the baseline (i.e. the path of expenditure in the absence of the temporary deviation) in each year until the MTO is reached. This design of the deviation was agreed with the Council, in order to avoid creating a stop-start pattern of fiscal adjustment and to ensure equality of treatment across Member States depending on their distance to MTO. Unless the clause is linked to direct costs related to the reform, the necessary compensation to return spending to the original trajectory in the year after application of the clause would imply an additional fiscal adjustment on top of the Member State's standard requirement in that year. This would significantly reduce the incentive for structural reforms which do not carry substantial fiscal costs but nevertheless require an incentive which the use of the clause can provide.

140. There is a strong rationale for the approach agreed by the Commission and the Council and set out in the Commonly Agreed Position on Flexibility. The clause is intended to cater for public investments which can be considered economically equivalent to structural reforms in having a positive impact on potential growth and the sustainability of public finances and is therefore linked to certain projects co-funded by the EU. The eligibility condition that nominal investment should not decline is intended to ensure that EU funded investments are not used to substitute for nationally funded investment.

141. The Commission considers that it does ensure that only expenditures directly related to the unusual events clause are eligible. An extensive example from a particular case is provided in the Commission's reply to paragraph 57.

Recommendation 2

(a) The Commission does not accept the recommendation as it considers that the required adjustment would weaken the effectiveness of the structural reform clause. The temporary deviation under the structural reform clause is not directly linked to the actual budgetary costs of the reform, because some very beneficial structural reforms do not always create significant direct budgetary costs, while such reforms carry substantial economic or political costs. In such cases, directly linking the temporary deviation to the budgetary costs would effectively nullify the incentivizing intent of the clause.

In addition, as the allowance is not based on once-off costs, the recommended requirement to return spending to the original trajectory in the year after application of the clause would imply an additional fiscal adjustment on top of the Member State's standard requirement in that year. The design of the deviation was agreed with the Council, in order to avoid creating a stop-start pattern of fiscal adjustment.

(b) The Commission does not accept the recommendation to discontinue the clause in its current form as it considers the investment clause to be an important element of the flexibility package introduced in 2015 in order to support growth in the EU in a fiscally sustainable manner, namely by encouraging growth-enhancing public investment. That said, the clause is currently being reviewed as part of a wider review of the flexibility arrangements required under the Commonly Agreed

Position. The Commission will report on the results of its review to the Economic and Financial Committee in June 2018 but cannot prejudge the outcome of that work.

(c) The Commission accepts the recommendation.

142. The Commission provided formal replies on extensions of the EDP deadlines in particular cases in in the context of the special report of the ECA of 2016 on 'Further improvements needed to ensure effective implementation of the excessive deficit procedure'.

The Commission and the Council recommend Member States under EDP to achieve structural adjustments in line with the requirements of the preventive arm. However, the regulation does not provide the Commission and the Council with tools to enforce structural adjustment requirements for the Members States in the corrective arm of the SGP in circumstances where the recommended headline deficit targets are achieved on the back of economic growth and without the achievement of those recommended structural adjustment targets.

Recommendation 3

The Commission partially accepts the recommendation.

The Commission has in the past put forward options seeking to ensure that structural adjustment requirements are delivered under the corrective arm, specifically by envisaging revision of the EDP recommendation in cases of positive economic surprises relative to the scenario underlying the initial recommendation but the Member States have not supported this suggestion. The Commission is open to the possibility to revisit this issue and build support for such proposals among the Member States. The Commission cannot, however, commit at this stage to submitting a note to the EFC.

143. The Commission is constantly seeking to improve the readability and transparency of all SGP-related material and is open to discussing possible improvements to the SCP templates with Member States.

The Commission agrees that there has been room for improvement in terms of transparency over the estimation of fiscal measures and, to that end, engaged in intensive discussions with Member States during the course of 2017 to improve the accuracy and transparency of the assessments of such measures.

Regarding the presentation of the results of its assessments, the Commission is always seeking to improve the communication of the rationale underlying its recommendations and will consider specific proposals from the ECA.

Recommendation 4

(a) The Commission accepts the recommendation. The Commission has since 2017 been engaged with Member States in developing a process to improve the accuracy and transparency of the estimation of fiscal measures and is open to amending the Code of Conduct to reflect any necessary changes from this process, if Member States agree. However, it will be important that any such changes distinguish between the differing nature of revenue and expenditure measures.

(b) The Commission accepts the recommendation.

(c) The Commission accepts the recommendation.

(d) The Commission accepts the recommendation.

144. The Commission considers that the use of freezing reflects the need to anchor *ex ante* the required level of budgetary adjustment to facilitate medium-term budgetary planning by the Member States and to respect their legitimate expectations in this regard.

While not specified in the Regulation, the smoothing of investment over four years has been fully discussed and agreed with Member State through the ECOFIN committees. Therefore, it is clearly described in the Code of Conduct, where it states that "Due to the potentially very high variability of investment expenditure, especially in the case of small Member States, the government expenditure aggregate should be adjusted by averaging investment expenditure over 4 years."

145. The Commission considers that symmetrical unfreezing of the adjustment requirement would fail to respect the legitimate expectations of the Member States to be evaluated against the required level of budgetary adjustment which has been prescribed by the Commission at the time when the Member State was planning and agreeing its budgetary strategy.

Recommendation 5

(a) The Commission does not accept the recommendation as its implementation would violate the legitimate expectations of the Member States to be evaluated against a fiscal adjustment target set at the time of the budgetary planning process. In any case, the requirements are based upon the most favourable vintage only as far as the calculation of the distance to the MTO is concerned, whereas the matrix requirements are updated only in a limited number of well-justified circumstances based on the unfreezing principles.

(b) The Commission does not accept the recommendation as smoothing of investment was established to address pressing problem of public investment fluctuation in some Member States due to exogenous factors. This concept has been discussed and agreed with Member States through the ECOFIN committees and is therefore clearly described in the Code of Conduct.

(c) The Commission does not accept the recommendation as its implementation would violate the legitimate expectations of the Member States to be evaluated against fiscal adjustment target set at the time of the budgetary planning.

Recommendation 6

(a) The Commission accepts the recommendation.

(b) The Commission accepts the recommendation.

Event	Date
Adoption of Audit Planning Memorandum (APM) / Start of audit	20.9.2016
Official sending of draft report to Commission (or other auditee)	11.4.2018
Adoption of the final report after the adversarial procedure	13.6.2018
Commission's (or other auditee's) official replies received in all languages	English: 28.6.2018 Other languages: 19.7.2018

ISBN 978-92-847-0271-8
doi:10.2865/5141
QJ-AB-18-015-EN-N

The European Commission has exercised discretionary powers granted by the preventive arm regulation very extensively with a view to reduce the adjustment requirements, both by setting the implementation rules and in individual decisions.
We consider that the combination of the current matrix parameters, allowed deviations and flexibility clauses cumulatively erode the target set in the Regulation which is to achieve an average annual adjustment of 0.5 % of GDP over the cycle. This prevents that the Medium Term Objectives of member states are reached within a reasonable period. Particularly worrisome is very slow, or even absent adjustment in several member states with high public debt ratio.
The implementation rules and Commission's practice therefore need to be reviewed and strengthened.

EUROPEAN COURT OF AUDITORS

Publications Office

EUROPEAN COURT OF AUDITORS
12, rue Alcide De Gasperi
1615 Luxembourg
LUXEMBOURG

Tel. +352 4398-1

Enquiries: eca.europa.eu/en/Pages/ContactForm.aspx
Website: eca.europa.eu
Twitter: @EUAuditors