5 An assessment of the review of draft budgetary plans based on the 2018 exercise

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On 22 November 2017 the European Commission released its opinions on the draft budgetary plans of euro area governments for 2018, together with an analysis of the budgetary situation in the euro area as a whole. Each opinion includes an assessment of the compliance of the relevant plan with the Stability and Growth Pact (SGP). It also follows up on the guidance provided in the country-specific recommendations for fiscal policies under the 2017 European Semester, as adopted by the Economic and Financial Affairs Council on 11 July 2017.[14]

In general, the draft budgetary plans envisage broadly neutral support of the euro area economy by fiscal policies, but with considerable divergence between countries. Some member countries have reached their medium-term budgetary objectives (MTOs) and several of them are using their room for manoeuvre under the EU's fiscal rules. In contrast, structural efforts in a considerable number of member countries are falling short of SGP commitments, despite the solid and broad-based economic expansion in the euro area. In its statement on 4 December 2017 on the draft budgetary plans for 2018, the Eurogroup concluded that "a broadly neutral fiscal stance appears still appropriate at the aggregate euro area level in 2018".[15] This is also in keeping with the view that when the output gap is small, fine-tuning of support of the macroeconomy by fiscal policies is not warranted.[16] The Eurogroup also noted that "at the same time, the improving economic conditions call for the need to rebuild fiscal buffers, while continuing to strengthen the economies' growth potential".

Based on its 2017 autumn economic forecast, the Commission finds that only six of the eighteen draft budgetary plans are fully compliant with the SGP.[17] This refers to the plans of Germany, Latvia, Lithuania, Luxembourg, the Netherlands and Finland (all under the SGP's preventive arm), and is one more than the number of countries whose plans were found to be fully compliant last year. The Commission considers that the draft budgetary plans of a further six countries are only "broadly

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14 For background and further detail, see the box entitled "Country-specific recommendations for fiscal policies under the 2017 European Semester", *Economic Bulletin*, Issue 4, ECB, June 2017.

15 See Eurogroup statement on the Draft Budgetary Plans for 2018.

16 The concept of the aggregate fiscal stance for the euro area is important in the context of Economic and Monetary Union, where a single monetary policy is complemented by fiscal policies that are conducted at the national level. It is, however, not a legally binding concept. For a discussion of the difficulties surrounding the assessment of the fiscal stance, see the article entitled "The euro area fiscal stance", *Economic Bulletin*, Issue 4, ECB, June 2016.

17 Greece is not included in the exercise.

compliant" with the SGP.[18] This refers to the plans of Estonia, Ireland, Cyprus, Malta and Slovakia under the preventive arm, and Spain under the corrective arm. While the headline deficit of Spain, which had submitted a draft budgetary plan on a no-policy-change basis, is forecast to fall below the 3% of GDP deficit reference value by the 2018 deadline under the excessive deficit procedure (EDP), this is associated with cumulated shortfalls in structural efforts relative to commitments under the SGP.[19] The draft budgetary plans of the six remaining countries are considered to pose a "risk of non-compliance with the SGP".[20] This refers to the plans of France – with an EDP deadline in 2017 – under the SGP's corrective arm, and, under its preventive arm, to Belgium, Italy, Austria, Portugal and Slovenia (Austria having submitted its plan on a no-policy-change basis in the absence of a sworn-in government).

Debt ratios are falling only slowly in countries with high government debt. Among the group of the six countries whose draft budgetary plans pose risks of non-compliance with the SGP, Belgium, France, Italy and Portugal are projected to record high government debt ratios of above 90% of GDP in 2018 (see the chart). With the exception of Portugal, these countries are not expected to reduce government debt towards the reference value of 60% of GDP in line with the SGP's debt rule. In its statement on 4 December 2017, the Eurogroup noted that "a slow pace of debt reduction from high levels in a number of Member States remains a matter for concern". In the case of Italy, the letter sent by the Commission on 22 November 2017 states that "insufficient progress towards compliance with the debt criterion" has been made, and that "Italy's public debt remains a key vulnerability".[21] At the same time, the Commission has still not issued a report under Article 126(3) of the Treaty on the Functioning of the European Union (TFEU) based on notified data for 2016.

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18 For countries subject to the SGP's preventive arm, draft budgetary plans are "broadly compliant" if, according to the Commission's forecast, the plan may result in some deviation from the MTO or the adjustment path towards it, but the shortfall relative to the requirement would not represent a significant deviation from the required adjustment. Deviations from the fiscal targets under the preventive arm are classified as "significant" if they exceed 0.5% of GDP in one year or, on average, 0.25% of GDP in two consecutive years. For countries subject to the SGP's corrective arm, the Commission assesses draft budgetary plans as being "broadly compliant" if their forecast projects that the headline deficit targets will be achieved but there is a noticeable shortfall in fiscal effort compared with the recommended value, putting at risk compliance with the EDP recommendation.

19 According to the European Commission's 2017 autumn economic forecast, no structural effort is forecast in 2018, whereas a structural effort of 0.5% of GDP is specified in the EDP recommendation that the Council issued to Spain in 2016 under Article 126(9) of the Treaty on the Functioning of the European Union.

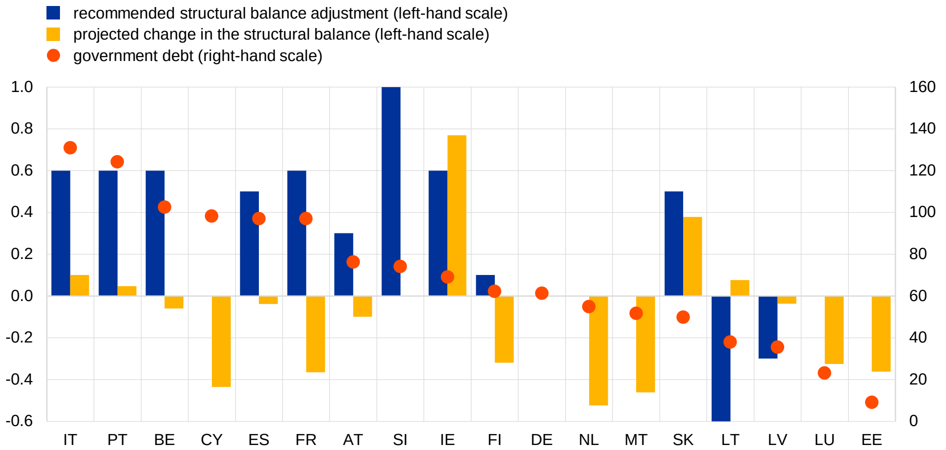
20 For countries subject to the SGP's preventive arm, the Commission assesses a draft budgetary plan as being "at risk of non-compliance with the SGP" if it forecasts a significant deviation from the MTO or the required adjustment path towards the MTO in 2018, and/or non-compliance with the debt reduction benchmark, where that benchmark is applicable. For countries subject to the SGP's corrective arm, the Commission assesses a draft budgetary plan as being "at risk of non-compliance with the SGP" if its forecast for 2018, subject to ex post confirmation, could lead to the stepping up of the EDP, as neither the recommended fiscal effort nor the recommended headline deficit target are forecast to be achieved.

21 See Letter to Italy.

Chart A

Recommended and projected structural balance adjustments for 2018 and government debt in 2018

(percentage of GDP)



Sources: AMECO and country-specific recommendations for fiscal policies as adopted by the Economic and Financial Affairs Council on 11 July 2017.
Notes: Germany, Estonia, Cyprus, Lithuania, Luxembourg, Malta and the Netherlands are recommended to remain at their MTOs. For Austria and Finland, the structural effort requirements are lower than those specified in their respective country-specific recommendations when corrected for flexibility granted under the SGP (notably in the areas of hosting refugees, structural reforms, investment and pensions). For Italy and Slovenia, the structural effort requirements may be reduced by way of applying discretion.

By way of applying discretion, the Commission recommends that the 2018 structural adjustment requirements under the Stability and Growth Pact for Italy and Slovenia be significantly reduced.[22] For countries with structural effort requirements in 2018 of 0.5% of GDP and higher, the recitals to the Council's 2017 recommendations on the member states' economic, employment and fiscal policies issued on 11 July 2017 indicated that upcoming assessments would "take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of […] public finances." On this basis, the Commission recommends a reduction in the structural effort requirements applicable to Italy from 0.6% to 0.3% of GDP, and a reduction in those applicable to Slovenia from 1.0% to 0.6% of GDP.[23] Generally, for the credibility of the SGP, predictability and transparency in the application of its fiscal rules are important.[24] Notwithstanding the reduced requirements, neither country is forecast to comply fully with the SGP's preventive arm next year, according to the Commission's 2017 autumn forecast.

The exercise of reviewing draft budgetary plans appears to have lost effectiveness over time. Introduced in response to the crisis, the review of draft budgetary plans was intended to provide a means of identifying and preventing

[22] For further detail, see the box entitled "The application of discretion in the autumn 2017 fiscal surveillance exercise" in the Commission's communication 2018 Draft Budgetary Plans: Overall assessment.

[23] The Council will make a final assessment in spring 2019 at the latest, when it decides on compliance with the SGP for 2018.

[24] In its staff report on Article IV consultations on the euro area, the International Monetary Fund stated that "… greater discretion for the European Commission in assessing compliance with the rules, weakens the SGP's credibility" and that "steps need[ed] to be taken to restore SGP credibility".

potential deviations from sound fiscal policies early in the budgetary process, i.e. before budgets are finalised. Where a risk of particularly serious non-compliance with the provisions of the SGP is identified – that is, where a plan in fact envisages structural efforts that fall clearly short of requirements – the Commission can ask the relevant member country to provide an updated budgetary plan. The Commission has not made any such requests since the start of the first review exercise in autumn 2013, stating that the "particularly serious non-compliance" criterion has not been satisfied in any particular case.[25] However, the Commission has written to those countries planning considerable shortfalls relative to SGP requirements, requesting that additional measures be taken. Early in the history of the review exercise, particularly in 2014, certain countries publicly committed themselves to following up on such requests.[26] By contrast, in the context of the current review, none of the countries planning for shortfalls in fiscal efforts in 2018 have responded by taking additional measures.[27] Moreover, in previous years, certain countries whose draft budgetary plans had posed risks of non-compliance with the SGP based on the Commission's forecast had committed to "implementing the measures necessary to ensure that the […] budget will be compliant with the SGP", based on a quantification of consolidation gaps relative to SGP commitments.[28] However, this year, in its statement on the draft budgetary plans for 2018, the Eurogroup merely invites the countries concerned "to consider in a timely manner the necessary measures to address the risks identified by the Commission to ensure that their 2018 budgets will be compliant with the SGP provisions." It should also be noted that, unlike in previous years, no follow-up to the current review exercise based on the Commission's winter forecast appears to be envisaged in the Eurogroup in early 2018. Since the start of the draft budgetary plan review exercise in autumn 2013, the proportion of countries that have submitted draft budgetary plans compliant with the SGP has remained unchanged at around one-third, despite the improving economic conditions.[29]

Looking ahead, it is crucial that the draft budgetary plan review exercise is again made more effective. Generally, the extent to which the draft budgetary plan review has incentivised countries to include additional measures in their final budgets is difficult to assess.[30] Governments may take additional measures during the finalisation of the budget or during its implementation throughout the year, without linking them specifically to the outcome of the review exercise. Moreover, the assessment of whether countries have complied with the SGP in a particular year is

[25] This included cases in which the improvement in the structural balance towards the country-specific MTO was forecast to fall significantly short of requirements, i.e. by more than 0.5 percentage point of GDP. This is the threshold for the significant deviation procedure under the SGP's preventive arm.

[26] For example, the Commission sent letters to Italy, Austria and France in October 2014. It had previously requested additional measures from Austria in May 2014, when the Austrian government after the Parliamentary elections had submitted a (non-compliant) updated draft budgetary plan for 2014.

[27] In October 2017 the Commission wrote to Belgium, Spain, France, Italy and Portugal.

[28] See the Eurogroup statement of 5 December 2016 as a reference.

[29] Since the start of the review exercise in autumn 2013, only the plans produced each year by Germany and the Netherlands have all received positive assessments.

[30] See for some information the box entitled "Follow-up to the review of draft budgetary plans for 2015", *Economic Bulletin*, Issue 2, ECB, March 2015.

based on outturn data and is only taken around 18 months or more after the start of the draft budgetary plan review. By that time, changes in the estimates regarding a country's position in the cycle, as well as amendments to the rules, may potentially result in a more favourable assessment of compliance with the SGP.[31] One way in which a country's compliance with the SGP can be improved is by requesting updated plans in all cases where significant deviations from requirements are envisaged. Enhancing the functioning of the draft budgetary plan review exercise is important, particularly in order to address budgetary imbalances in economically favourable times so as to have more fiscal space in a future cyclical downturn.

[31] For example, structural effort requirements have been lowered in exchange for additional structural reforms and investment in 2015.