# Box 5
# Country-specific recommendations for fiscal policies under the 2016 European Semester

**On 18 May 2016 the European Commission announced its proposed country-specific recommendations for economic and fiscal policies for all EU Member States except Greece, including recommendations for implementing the EU's Stability and Growth Pact (SGP).** The country-specific recommendations are scheduled to be approved by economic and finance ministers on 17 June and to be endorsed thereafter by the European Council on 28-29 June.[22] The Council's fiscal policy recommendations aim to ensure that countries comply with the SGP. Hence, they give opinions on the 2016 updates to stability and convergence programmes, which governments had to submit to the European Commission and the Council by mid-April. In terms of follow-up, the country-specific recommendations for fiscal policies issued under the 2016 European Semester will need to be reflected in the draft budgetary plans for 2017 which euro area countries have to submit to the Eurogroup and the European Commission by mid-October. Against this background, this box reviews the recommendations for fiscal policies that were addressed to the 18 non-programme euro area countries.

**According to the European Commission's spring 2016 forecast, the aggregate fiscal stance of the euro area is expected to be slightly expansionary in 2016 and 2017.**[23] On the one hand, this indicates that euro area countries which have achieved their medium-term budgetary objective (MTO), most notably Germany, are using part of their fiscal space. On the other hand, it also reflects the fact that a sizeable number of countries, including those with high government debt levels, are falling short of their structural consolidation commitments under the Pact (see the table).

**Consequently, the Commission's country-specific recommendations identify risks of non-compliance with the structural consolidation requirements of the SGP in many euro area countries.** According to the European Commission's spring 2016 forecast, none of the countries with a deficit above the 3% of GDP reference value in 2015 (i.e. Portugal, Spain and France) is expected to deliver a structural consolidation over the period 2016-17 (i.e. a reduction of the budget deficit through factors other than the impact of the economic cycle and temporary budgetary measures). Moreover, significant shortcomings vis-à-vis structural

22 The adoption of the country-specific recommendations by the Economic and Financial Affairs Council (ECOFIN Council) at the meeting scheduled for 12 July will formally conclude the 2016 European Semester.

23 For a discussion of the concept of the euro area fiscal stance, see the article entitled "The euro area fiscal stance" in this issue of the *Economic Bulletin*.

adjustment requirements are anticipated in countries that are currently under the Pact's preventive arm, even though for some countries these requirements have been lowered markedly. In concrete terms, following a recent agreement on how to operationalise the flexibility that the SGP includes for structural reforms[24], countries that have not achieved their MTOs can progress towards them more slowly by delivering smaller structural consolidation efforts if they implement structural reforms, additional investment and pension reforms.[25] The structural adjustment requirements have for some countries been further reduced to accommodate the costs they incur for hosting refugees and for additional security spending. Overall, the granting of this flexibility has lowered the requirements for progressing towards the MTO from, on average, 0.5% of GDP to -0.1% of GDP in 2016.[26] This notwithstanding, the countries under the SGP's preventive arm which have not yet achieved their MTO are expected to fall short of the reduced requirements by conducting expansionary fiscal policies corresponding, on average, to -0.3% of GDP. This further delays the achievement of MTOs by Member States and thus hinders a return to robust public finances during the unique window of opportunity provided by favourable financial conditions.[27]

**The fiscal policy recommendations for countries therefore vary according to the existing room for budgetary manoeuvre**. They call on Member States whose structural efforts are expected to fall short of their commitments under the SGP to implement further measures to ensure the required compliance. Furthermore, countries that have not yet achieved their MTOs and are expected to maintain general government debt at a level that exceeds the 60% of GDP threshold (Belgium, France, Spain, Italy, Ireland, Portugal and Finland) are recommended to use any so-called windfall gains, i.e. savings from lower than anticipated interest payments, for deficit reductions. At the same time, among the euro area countries that have already reached their MTOs, Germany is recommended to achieve a sustained upward trend in public investment, especially in infrastructure, education, research and innovation. The Netherlands are recommended to prioritise public expenditure towards supporting more investment in research and development.

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[24] For details, see the Economic and Financial Committee's Commonly Agreed Position on Flexibility within the Stability and Growth Pact http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf.

[25] For more details, see the box entitled "Flexibility within the Stability and Growth Pact", *Economic Bulletin*, Issue 1, ECB, 2015.

[26] This excludes countries that have already achieved their MTO.

[27] See the box entitled "The effectiveness of the medium-term budgetary objective as an anchor of fiscal policies", *Economic Bulletin*, Issue 4, ECB, 2015.

**Table**

Structural effort requirements under the SGP for the period 2016-17

(percentage points of GDP)

| | Structural effort 2016 | 2016 structural effort requirement under SGP | memo: 2016 structural effort requirement under SGP (excluding granted flexibility) | Structural effort 2017 | 2017 structural effort requirement under SGP |
|---|---|---|---|---|---|
| **SGP preventive arm** | | | | | |
| Belgium | 0.3 | 0.3 | 0.6 | 0.2 | 0.6 |
| Germany | -0.4 | 0.0 | 0.0 | -0.1 | 0.0 |
| Estonia | -0.5 | 0.0 | 0.0 | -0.3 | 0.0 |
| Ireland | 0.2 | 0.6 | 0.6 | 1.0 | 0.6 |
| Italy | -0.7 | -0.35 | 0.5 | 0.0 | 0.6 |
| Cyprus | -1.3 | 0.0 | 0.0 | -0.9 | 0.0 |
| Latvia | 0.3 | 0.3 | 0.8 | 0.0 | -0.1 |
| Lithuania | -0.8 | -0.7 | 0.0 | 0.4 | 0.1 |
| Luxemburg | -0.3 | 0.0 | 0.0 | -1.1 | 0.0 |
| Malta | 0.7 | 0.6 | 0.6 | 0.4 | 0.6 |
| Netherlands | -0.6 | -0.2 | 0.0 | 0.3 | 0.6 |
| Austria | -0.9 | -0.8 | 0.0 | -0.3 | 0.0 |
| Slovenia | 0.2 | 0.5 | 0.6 | -0.4 | 0.6 |
| Slovakia | 0.2 | 0.25 | 0.25 | 0.6 | 0.5 |
| Finland | -0.2 | 0.3 | 0.5 | 0.1 | 0.6 |
| **SGP corrective arm** | | | | | |
| Portugal (EDP deadline 2015) | -0.2 | 0.6 | 0.6 | -0.3 | 0.6 |
| Spain (EDP deadline 2016) | -0.2 | 1.2 | 1.2 | -0.1 | 0.6 |
| France (EDP deadline 2017) | 0.0 | 0.8 | 0.8 | -0.2 | 0.9 |

Sources: European Commission's spring 2016 forecast and country-specific recommendations.
Notes: In this table, requirements of zero reflect that countries were at the MTO at the beginning of the respective year. Structural effort commitments under SGP (second and last column) reflect the requirements which for some countries have been reduced to account for flexibility granted vis-à-vis the implementation of structural reforms, government investment and pension reforms and for the costs of hosting refugees and additional security spending. EDP refers to excessive deficit procedure.

**On 18 May the European Commission also released recommendations regarding the implementation of the Stability and Growth Pact.** The Commission recommended abrogating the excessive deficit procedures (EDPs) for Ireland and Slovenia by their 2015 deadlines as well as the abrogation of the EDP for Cyprus one year ahead of its 2016 EDP deadline. In reports prepared under Article 126(3) of the Treaty on the Functioning of the European Union (TFEU), the Commission examined the breach of the debt criterion in Belgium, Italy and Finland in 2015 and decided against opening an EDP. In the case of Finland, the breach of the government debt reference value by 3.1% of GDP is explained by mitigating factors, including financial support to other euro area countries to safeguard financial stability and also the negative impact of the economic cycle. As regards Belgium and Italy, the Commission reports accounted for relevant factors, including (i) compliance with the structural effort requirements under the preventive arm of the SGP, (ii) unfavourable economic conditions (i.e. weak growth and low inflation) which make compliance with the debt rule more difficult, and (iii) implementation of growth-enhancing structural reforms. For both countries, the assessment of compliance with the SGP's preventive arm over 2016-17 took account of reduced requirements resulting from the flexibility granted to cope with the costs of hosting refugees and additional security spending. Moreover, in the case of Italy, additional flexibility was granted for structural reforms and investment which – on top of the above-mentioned flexibility – reduced the structural effort requirement in 2016 from 0.5% of GDP to -0.35% of GDP, in the light also of the authorities' commitment to broad compliance with the SGP in 2017. In the autumn the Commission will revisit the resumption of the adjustment path towards the MTO, based on the draft budgetary plan for next year. The assessments of compliance with the debt rule did not consider previous shortfalls in fiscal consolidation as an aggravating factor or quantify the impact of relevant factors in a comprehensive manner to ensure that any discrepancies with the debt rule were explained in full.[28]

Furthermore, the European Commission's country-specific recommendations advised extending the EDP deadlines for Portugal and Spain by one year to 2016 and 2017, respectively, with structural effort requirements of 0.25% of GDP this year. Notably, while the country-specific recommendations are based on Articles 121 and 148 TFEU, the Council has to take decisions under the excessive deficit procedure as laid out under Article 126 TFEU. Moreover, while Article 10(3) of Council Regulation (EC) No 1467/97[29] asks the Council to act immediately in the event that an excessive deficit has not been corrected, the assessment of whether the deadline extensions should be associated with a stepping up of the EDP and possible sanctions was postponed to early July. Apart from this, the recommended structural effort of 0.25% of GDP compares with an adjustment of "at least 0.5% of GDP" envisaged in Article 3(4) of Regulation No 1467/97.

Finally, the Commission did not recommend opening a significant deviation procedure for Malta, which under the SGP's preventive arm was found to have deviated significantly from both the structural effort requirement and the expenditure benchmark in 2015 under the Commission's spring 2016 forecast.

**To ensure credibility, it is important that the governance framework is applied in a legally sound, transparent and consistent manner across time and countries.** Learning the lessons from the crisis, major improvements were made to the EU's fiscal governance framework in 2011 and 2013. The introduction of the debt rule to the corrective arm of the SGP and the establishment of the significant deviation procedure for the preventive arm (to help ensure sufficient progress towards the MTOs) are of particular significance here. The same holds for changes to the decision-making process intended to shield the European Commission from political pressure with the aim of increasing automaticity in the application of rules and sanctions. For these improvements to be effective, the full, transparent and consistent implementation of the SGP is essential. The approach to the implementation of the SGP under the 2016 European Semester has raised a number of questions, which will need to be examined.

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[28] See the article entitled "Government debt reduction strategies in the euro area", *Economic Bulletin*, Issue 3, ECB, 2016.

[29] Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.