Box 7
Review of draft budgetary plans for 2016

On 17 November 2015 the European Commission released its opinions on the draft budgetary plans for 2016 of euro area countries not under a financial assistance programme.[1] These opinions entail an assessment of the extent to which governments' plans meet the requirements of the Stability and Growth Pact (SGP) and follow up on the guidance the European Council provided in its country-specific recommendations for fiscal policies under the 2015 European Semester, as adopted by the Economic and Financial Affairs Council on 14 July 2015.[2]

The Commission's assessment is that only five of the 16 draft budgetary plans are fully compliant with the SGP. In its opinions the Commission assesses the plans of Germany, Estonia, Luxembourg, the Netherlands and Slovakia (all under the preventive arm) as being "compliant" with the provisions of the SGP, noting however that the Netherlands will depart considerably from its medium-term budgetary objective (MTO) in 2015-16 and Slovakia will make little progress towards reducing its still high structural deficit. The Commission regards seven countries' draft budgets as only "broadly compliant"[3]: Belgium, Ireland, Latvia, Malta, Slovenia and Finland under the preventive arm and France under the excessive deficit procedure (EDP). The budgetary plans of four countries run, in the opinion of the Commission, a "risk of non-compliance" with the SGP. This group includes Spain, which is still subject to an excessive deficit procedure with a deadline in 2016. Under the preventive arm it includes Italy, Austria and Lithuania, which exited their excessive deficit procedures in 2012 (Italy) and 2013 (Lithuania and Austria). The Commission calls on those countries whose plans are not fully compliant to take the necessary measures to ensure that their budgets comply with the provisions of the SGP. Risks of non-compliance with the SGP also exist in Portugal, which did not submit a draft budgetary plan by the mid-October deadline in the absence of a new government after general elections. The Eurogroup called for a codification of how to deal with early or late submissions of draft budgetary plans.

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1 The draft budgetary plans had been issued by mid-October 2015 in line with Regulation (EU) No 473/2013 (part of the "Two-Pack"). The Spanish draft budgetary plan was sent to the Commission as early as 11 September 2015.

2 See the box entitled "Country-specific recommendations for fiscal policies under the 2015 European Semester", *Economic Bulletin*, Issue 6, ECB, September 2015.

3 The Commission opinions on countries assessed as being "broadly compliant" with the SGP do not fully reflect the differing degrees of compliance. In fact, for three countries under the preventive arm – Belgium, Malta and Slovenia (which would be under the preventive arm should the EDP be abrogated in a timely manner by the 2015 deadline) – the Commission forecast indicates clear risks of non-compliance, as the expenditure benchmark points to a significant deviation from the requirements and the structural balance pillar points to a deviation that is just below the significance threshold.

This review of draft budgetary plans again revealed the increased complexity and lack of transparency of the fiscal surveillance framework, which led the Eurogroup, in its statement of 23 November 2015, to explicitly call upon the Commission to increase the transparency and predictability of the procedure. The complexity arises from the co-existence of several rules. Under the preventive arm of the SGP, the "Six-Pack" regulations of 2011 introduced – for well-founded reasons – the "expenditure benchmark" as an additional indicator of the fiscal effort. This indicator was designed to ensure that windfall revenues, which improve the structural balance, are not subsumed as fiscal effort but are entirely used for debt reduction. If the structural balance and the expenditure benchmark indicators send conflicting signals on compliance with the structural effort requirements under the SGP, the Commission conducts an "overall assessment" to conclude which of the two fiscal indicators it considers more appropriate for its concluding assessment. However, the manner in which this overall assessment is conducted is still not fully transparent, making it difficult to gauge whether it is applied in a consistent manner. Furthermore, the "freezing" of the adjustment requirements based on previous Commission forecast vintages can potentially distort the assessment of whether fiscal policies are compliant with the SGP.[4] While this method was introduced to ensure reliable ex-ante guidance for governments in light of the volatility of the output gap and structural balance estimates, it can lead to cross-country inconsistencies and even result in a country that is deviating significantly from its MTO being assessed as being at its MTO and fully compliant with the rules (as was the case with the Netherlands in this round of draft budgetary plans; see table).

Furthermore, the structural reform and investment clause, as introduced by the Commission in January 2015, can substantially reduce structural effort requirements even for countries not at their MTO and with very high debt ratios. For example, Italy was granted a reduction in its structural effort requirement for 2016 in the spring of 2015 through the application of the structural reform clause; the draft budgetary plan foresees an application for further leeway in the context of the structural and investment clause.[5] There are thus increasing inconsistencies between the structural effort requirements under the preventive arm and those under the debt rule for several countries, with the Commission forecast indicating significant deviations from the debt rule requirements for Belgium and Italy.[6]

For countries under the excessive deficit procedure, an asymmetry arises from them being assessed as "broadly compliant" with the SGP if they fall short of their structural effort requirements but are nonetheless expected to meet the headline deficit targets. In fact, such budgetary plans are risky as, if the country is identified, ex-post, as having missed the annual headline deficit targets as outlined in the Council recommendation, the Commission would have to recommend stepping up the EDP.

4 Most importantly, the "freezing" methodology foresees that the requirements for year *t* are set based on data from the European Commission's spring forecast in *t-1*. However, the requirements based on the most favourable forecast vintage since *t-1* will prevail over the frozen requirements, for example if they indicate that the country has already achieved its MTO.

5 The Commission has assessed Italy's draft budgetary plan as being at risk of non-compliance with the SGP as a result of its shortfall in structural effort when compared with the Council's recommendation from July 2015, and will review Italy's eligibility for further flexibility under the SGP in the spring of 2016.

6 See the box entitled "Flexibility within the Stability and Growth Pact", *Economic Bulletin*, Issue 1, ECB, 2015.

Table

2016 draft budgetary plans

Commission opinion on compliance of 2016 draft budgetary plan with SGP	Medium-term budgetary objective (MTO)	Structural balance 2016 (European Commission 2015 autumn forecast)	Actual structural effort 2016 (European Commission 2015 autumn forecast)	2016 structural effort commitment under SGP (in percentage points)
"Compliant"				
Estonia *(preventive arm)*	0.0	0.2	*-0.1*	*at MTO*
Germany *(preventive arm)*	-0.5	0.7	*-0.2*	*at MTO*
Luxembourg *(preventive arm)*	0.5	0.9	*0.2*	*at MTO*
Netherlands *(preventive arm)*	-0.5	-1.4	*-0.3*	*-0.2*
Slovakia *(preventive arm)*	-0.5	-2.0	*0.0*	*0.25*
"Broadly compliant"				
Belgium *(preventive arm)*	0.75	-2.1	*0.4*	*0.6*
Finland *(preventive arm)*	-0.5	-1.5	*0.2*	*0.5*
Latvia *(preventive arm)*	-1.0	-1.9	*0.2*	*0.3*
Malta *(preventive arm)*	0.0	-1.7	*0.4*	*0.6*
France *(EDP deadline 2017)*	-0.4	-2.4	*0.3*	*0.8*
Ireland *(EDP deadline 2015)*	0.0	-2.1	*0.8*	*0.6*
Slovenia *(EDP deadline 2015)*	0.0	-2.5	*0.2*	*0.6*
"Risk of non-compliance"				
Austria *(preventive arm)*	-0.45	-1.0	*-0.4*	*0.1*
Italy *(preventive arm)*	0.0	-1.5	*-0.5*	*0.1*
Lithuania *(preventive arm)*	-1.0	-1.4	*-0.2*	*0.1*
Spain *(EDP deadline 2016)*	0.0	-2.6	*-0.1*	*1.2*
Portugal *(EDP deadline 2015)*[1)]	-0.5	-2.3	*-0.5*	*0.6*

Sources: European Commission and AMECO.
Notes: For countries subject to an EDP, the Commission assesses draft budgetary plans as being "broadly compliant" if the Commission's 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. The Commission assesses countries under an EDP as being "at risk of non-compliance" if the Commission's forecast for 2016 (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. As for countries under the SGP's preventive arm, the Commission assesses draft budgetary plans as "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. At the same time, member countries are assessed as being in compliance with the debt reduction benchmark "where applicable". In turn, under the preventive arm, the Commission assesses draft budgetary plans as being "at risk of non-compliance with the SGP" if the Commission's forecast projects a significant deviation from the MTO or the required adjustment path towards the MTO in 2016, and/or non-compliance with the debt reduction benchmark "where applicable".
1) Portugal did not submit a draft budgetary plan for 2016.

The Commission's opinions overall reflect the expectation that the structural effort in 2016 will likely continue to fall short of commitments under the SGP in many euro area countries. On the one hand, this stems from a lack of progress towards countries' MTOs under the preventive arm of the SGP. On the other hand, it relates to insufficient structural efforts under its corrective arm, the excessive deficit procedure. Notably, according to the Commission's 2015 autumn forecast and measured as change in the structural balance, under the preventive arm countries assessed as not yet being at their MTO are forecast to loosen their fiscal stance, on average, by 0.2% of their GDP, even though the preventive arm would require a tightening of 0.3% of GDP.[7] At the same time, countries subject to an EDP are forecast, on average, to consolidate by 0.2% of GDP while their SGP commitments would require a fiscal effort of 0.9% of GDP. Meanwhile, countries that are assessed by the Commission as being at their MTO at the beginning of 2016 are planning to

7 For two countries subject to the preventive arm (Belgium and Italy), the requirements under the debt rule are currently the binding constraint. According to the Commission opinions, the gap in terms of compliance with the debt rule in 2016 amounts to 1.5 percentage points of GDP for Belgium and 3.7 percentage points of GDP for Italy, far above their respective structural adjustment requirements in terms of convergence towards the MTO. For both countries, the Commission will reassess the need to open a debt-based EDP in spring 2016.

loosen their fiscal stance slightly in 2016, on average by 0.2 percentage points of GDP. This partly reflects the fact that Germany is using part of the buffers it has built up to deal with the budgetary costs of the ongoing influx of refugees.[8]

The shortfalls in structural efforts are in line with an aggregate fiscal stance for the euro area that turns slightly expansionary next year. When netting out the impact of the business cycle and the low interest rate environment, the change in the euro area cyclically adjusted primary balance turns negative, by 0.3% of GDP in 2016, according to the European Commission's 2015 autumn forecast.

Finally, the Commission stresses that the composition of government expenditure remains insufficiently supportive of growth. In particular, while the recent moves to reduce the tax burden on labour in a number of euro area countries go in the right direction, the composition of expenditure shows limited progress towards being more growth friendly, with capital expenditure still expected to decline as a share of GDP.

On 23 November 2015 the Eurogroup called on those member countries whose plans run the risk of non-compliance with the rules of the preventive arm to take, in a timely manner, additional measures to address the risks regarding appropriate convergence towards their MTOs and their respect of the debt rule. In turn, countries under the corrective arm of the SGP should ensure a timely correction of their excessive deficits and appropriate convergence towards their MTOs thereafter, as well as respecting the debt rule. In this respect, the Eurogroup reaffirmed the importance of structural efforts and adjustment ("bottom-up") measures in the corrective arm, and recognised that "merely achieving headline targets may not be sufficient to ensure durable corrections of excessive deficits". In line with this guidance on fiscal policies, Italy, Austria and Lithuania under the SGP's preventive arm, and Spain under its corrective arm, committed to take the measures needed to close the gaps identified by the Commission, thereby ensuring compliance with the SGP. Furthermore, the Eurogroup invited member countries whose draft budgetary plans are broadly compliant with the provisions of the SGP to ensure compliance with these provisions within the national budgetary process, and welcomed their commitment to take any necessary measures.

The Eurogroup will assess the follow-up to the review of draft budgetary plans and countries' commitments in April 2016. Notably, it calls on the Commission to increase the transparency and predictability of the review procedure. This is, indeed, required to ensure that the review of draft budgetary plans is an effective early warning mechanism to identify and address fiscal imbalances among euro area countries.

8 The Commission forecast expects these costs to be markedly lower than implied by the German draft budgetary plan.