7 Country-specific recommendations for fiscal policies under the 2017 European Semester

On 22 May the European Commission issued its country-specific recommendations for economic and fiscal policies for all EU Member States except Greece, together with recommendations for implementing the European Union's Stability and Growth Pact (SGP) for individual countries. The country-specific recommendations were finalised and approved by the aforementioned Member States' economics and finance ministers on 16 June. They are scheduled to be endorsed by the European Council on 22-23 June and will be published in mid-July.[27] The Council's fiscal policy recommendations are intended to ensure that EU countries comply with the SGP. To this end, they include assessments of the 2017 updates to stability and convergence programmes, which governments had submitted to the European Commission and the Council in the course of April. In terms of follow-up, the country-specific recommendations for euro area countries' fiscal policies issued under the 2017 European Semester should be reflected in governments' draft budgetary plans for 2018. These plans need to be submitted to the Eurogroup and the European Commission by mid-October 2017. Against this background, this box examines the recommendations for fiscal policies that were addressed to the 18 euro area countries.

According to the European Commission's Spring 2017 Economic Forecast, the improvement in the euro area's budgetary position is accompanied by a split between countries regarding progress towards sustainable public finances. On the one hand, the Commission has assessed eight euro area countries as having achieved their medium-term budgetary objectives (MTOs) in 2016.[28] This favourable development will help bolster the government budgets of these countries and reduce their government debt over the medium term, making their economies more resilient to adverse economic developments. On the other hand, in a number of other countries structural adjustments are falling short of the requirements of the SGP, despite improving economic conditions. This is delaying the achievement of MTOs and the building of fiscal buffers, which is particularly problematic for countries with high levels of government debt. These countries currently record underlying budgetary positions that tend to be farthest from their MTOs (see table). Looking ahead, such countries risk being constrained in using fiscal policy in a stabilising manner during the next downturn and may even need to revert to pro-cyclical tightening of budgetary policies. Possible increases in interest rate levels could exert additional budgetary pressures.

The Commission's country-specific recommendations highlight risks of non-compliance with the structural adjustment requirements of the SGP in several euro area countries. According to the European Commission, neither

---

[27] The adoption of the country-specific recommendations by the Economic and Financial Affairs Council (ECOFIN Council) at the meeting scheduled for 11 July will formally conclude the 2017 European Semester.

[28] For a definition of MTOs, see the box entitled "The effectiveness of the medium-term budgetary objective as an anchor of fiscal policies", *Economic Bulletin*, Issue 4, ECB, 2015.

France nor Spain, the countries with a deficit above the reference value of 3% of GDP in 2016, are expected to deliver a noticeable structural adjustment over the period 2017-18, i.e. a reduction of their budget deficit through factors other than the impact of the economic cycle and temporary budgetary measures. Moreover, significant shortfalls vis-à-vis structural adjustment requirements are anticipated in some countries that are currently under the SGP's preventive arm and have not yet reached their MTOs. This comes at a time when these structural adjustment requirements have been lowered markedly for some countries in order to cater for a number of factors, including structural reforms, additional government investment and pension reforms, as well as costs incurred for hosting refugees and additional security spending. Overall, this flexibility could reduce the requirements for countries to progress towards their MTO from, on average, an adjustment of around ½% of GDP to one of around ¼% of GDP in 2017.[29] Nevertheless, these countries are expected to conduct expansionary fiscal policies of, on average, 0.3% of GDP, i.e. policies that further deteriorate their structural balance.

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 general 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. Second, 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 the existing flexibility provisions in the SGP (as communicated by the Commission in January 2015).[30] Going forward, it is important that a consistent implementation of the rules-based SGP is ensured.

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

[30] See the Commission's Communication on making the best use of the flexibility within the existing rules of the SGP.

Table

Structural adjustment requirements under the SGP for the period 2017-18

	Medium-term budgetary objective	2016	2017		2018	
		Structural balance*	Change in structural balance*	Structural adjustment requirement in CSR	Change in structural balance*	Structural adjustment requirement in CSR
SGP preventive am						
Belgium	0.0	-2.2	0.6	0.6	-0.3	0.6
Germany	-0.5	0.8	-0.2	at MTO	-0.3	at MTO
Estonia	-0.5	0.2	-0.6	at MTO	-0.4	at MTO
Ireland	-0.5	-1.7	0.6	0.6	0.8	0.6
Italy	0.0	-1.7	-0.2	0.6	-0.3	0.6
Cyprus	0.0	0.9	-1.1	at MTO	-0.2	0.2
Latvia	-1.0	-0.8	-0.7	at MTO	-0.9	-0.3
Lithuania	-1.0	-0.2	-0.7	at MTO	-0.2	at MTO
Luxembourg	-0.5	2.0	-1.6	at MTO	-0.2	at MTO
Malta	0.0	0.4	0.0	at MTO	0.2	at MTO
Netherlands	-0.5	0.7	-0.4	at MTO	0.2	at MTO
Austria	-0.5	-1.0	0.0	0.3	0.1	0.3
Portugal	0.25	-2.0	-0.2	0.6	-0.1	0.6
Slovenia	0.25	-1.7	-0.1	0.6	-0.5	1.0
Slovakia	-0.5	-1.5	0.1	0.5	0.5	0.5
Finland	-0.5	-0.9	-0.5	-0.5	0.0	0.1
SGP corrective arm						
Spain (EDP deadline 2018)	0.0	-3.5	0.1	0.5	0.0	0.5
France (EDP deadline 2017)	-0.4	-2.5	0.2	0.9	-0.5	0.6

Source: European Commission's Spring 2017 Economic Forecast (*) and country-specific recommendations.
Notes: In this table, the structural adjustment requirements are those recommended in the country-specific recommendations (CSRs). For some countries under the preventive arm these have been reduced following the granting of flexibility to cater for the implementation of structural reforms, additional government investment, etc. For other countries, these requirements can still be lowered if such flexibility is granted ex post. The expression "at MTO" reflects the fact that, according the European Commission's forecast, countries are at their MTO at the beginning of the year in question. Structural adjustment requirements can be higher for countries subject to the debt rule. EDP refers to excessive deficit procedure.

On 22 May the European Commission also issued recommendations regarding the implementation of the SGP. The Commission recommended abrogating the excessive deficit procedure (EDP) for Portugal by its 2016 deadline, and the Council adopted a corresponding decision on 16 June. Moreover, in reports prepared under Article 126(3) of the Treaty on the Functioning of the European Union, the Commission examined the breach of the debt criterion in Belgium and Finland in 2016 and decided against opening an EDP. In the case of Finland, the breach of the government debt reference value by 3.6% of GDP was explained by mitigating factors, including the provision of financial support to other euro area countries to safeguard financial stability and the negative impact of the economic cycle. As regards Belgium, the Commission concluded that, for 2016 and 2017 taken together, the country was considered to be at risk of non-compliance with the requirements of the preventive arm of the SGP. The analysis nevertheless suggested that the debt criterion should be considered as currently complied with given that the projected deviation could still be corrected in 2017. As regards Italy, the decision on opening a debt-based EDP was postponed. The Commission envisages reassessing Italy's compliance with the debt criterion based on the draft budgetary plan for 2018 and the Commission's Autumn 2017 Economic Forecast. In general, applications of the

SGP's debt rule which are based on compliance with the preventive arm over the medium term and on data validated ex post risk unduly delaying final decisions on whether or not to open debt-based EDPs. In the meantime shortfalls in structural adjustments vis-à-vis the SGP's requirements could further increase debt sustainability risks. Going forward, the assessment of compliance with the debt criterion should be further clarified, based on clearly quantifiable factors, to ensure an effective implementation of the SGP's debt rule.[31]

To conclude, the SGP has seen frequent amendments and interpretations over time and has thus become very complex. This makes the consistent application of the rules across countries and over time more difficult. At the same time, any fiscal framework is as good as its enforcement. In this regard, the full, legally sound and consistent application of the rules of the Stability and Growth Pact is the joint responsibility of the European Commission and the Council. It is of high importance for the credibility of the Pact.

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