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on the review of the flexibility under the Stability and Growth Pact

{COM(2018) 335 final}

INTRODUCTION

This technical annex presents the calculations underpinning the review of the commonly agreed position on flexibility in the Stability and Growth Pact (SGP). On 13 January 2015, the Commission issued a Communication on "making the best use of the flexibility within the existing rules of the Stability and Growth Pact". It provided new guidance on how to apply the existing rules of the Stability and Growth Pact (the "Pact"). Those clarifications by the Commission were discussed with Member States and resulted in the publication of a common position agreed by the Economic and Financial Committee (EFC) in November 2015, which was endorsed by the ECOFIN Council on 12 February 2016.[1] The commonly agreed position on flexibility requests the Commission to review the new approach by the end of June 2018. In November 2017, the European Fiscal Board (EFB) in its first annual report[2] made an assessment of the fiscal framework, including the use of flexibility, pointing to a balanced implementation. The EFB assessment highlighted that the implementation of the Pact succeeded in avoiding on the one hand a major relaxation of the rules, potentially detrimental to sustainability of public finances, and, on the other hand, a rigid application of the rules, which could have undermined the continuation of a still fragile recovery.

The ECOFIN Council asked the Commission to review two key elements of the commonly agreed position (see Box 1 for details). First, the Commission is to review the effectiveness of the so-called flexibility for cyclical conditions, which mainly specifies a modulation of the required fiscal adjustment along the economic cycle and the debt level of Member States, while ensuring an appropriate fiscal adjustment. Second, the Commission is to review the application of the so-called structural reform and investment clauses, which aim at promoting structural reforms and investment through a temporary and limited relaxation of the required fiscal adjustment.[3]

Box 1: Key elements of the review according to the commonly agreed position on flexibility

The commonly agreed position asks the Commission to review the following two elements:

Review of the flexibility for cyclical conditions

"The Commission shall submit a review report to the Council before 30 June 2018 on the effectiveness of the matrix specifying the annual fiscal adjustment towards the Medium-Term budgetary Objective (MTO). In particular, the review will examine the success of the matrix in promoting counter-cyclical fiscal policies and the achievement by the Member States of their MTOs, thereby creating the necessary room to accommodate economic downturns. The review will also assess whether the new matrix has ensured a reduction in government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances, in line with the requirements under the debt rule as specified in Sub-section B(1) of Section I of the Code of Conduct" (see Chapter 2.2. of the commonly agreed position on flexibility in the SGP).

Review of the structural reform and investment clause

[1] http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

[2] European Fiscal Board, Annual Report 2017, 15 November 2017

[3] The Vade mecum on the Stability and Growth Pact – 2018 edition explains how the flexibility clause for cyclical conditions as well as the structural reform and investment clauses were implemented in Chapter 1.3.2.

"By the end of June 2018, the Commission will carry out a review on the application of the structural reform and investment clauses, taking full account of the economic situation at that time and the achievement of its objectives. The review will examine the achievement by the Member States of their MTOs, thereby creating the necessary room to accommodate economic downturns. The review will examine to what extent the projects eligible for the investment clause were co-funded by the EU and whether the investment clause led to new investments. The review will also examine the implications of the continuation of the investment clause. The review may, as appropriate, be accompanied by proposals to the Economic and Financial Committee for a possible modification of the commonly agreed position on flexibility in the Stability and Growth Pact" (see Chapter 5 of the commonly agreed position on flexibility in the Stability and Growth Pact).

The technical annex follows an analytical and evidence-based approach and reviews the use of the flexibility based on past experience. It remains factual, refraining from making policy suggestions. It is structured in two parts. Part I reviews the effectiveness of the flexibility for cyclical conditions. Part II reviews the application of the structural reform and investment clauses.

I. REVIEW OF THE FLEXIBILITY FOR CYCLICAL CONDITIONS

This part reviews the effectiveness of the flexibility for cyclical conditions. In line with the ECOFIN mandate, the technical annex addresses three main questions. It examines whether the flexibility for cyclical conditions (i) promoted counter-cyclical fiscal policies by modulating the fiscal effort along the economic cycle and the debt level of Member State (Chapter I.1), (ii) contributed to the achievement of sound budgetary position over the medium term (Chapter I.1) and (iii) ensured a reduction in government debt at a satisfactory pace (Chapter I.2).[4] The review concentrates on the effectiveness of the design of the matrix, rather than its enforcement, which corresponds to the much broader issue of compliance with the preventive arm of the Pact.

The main element of the flexibility for cyclical conditions is the so-called matrix of requirements (hereafter, simply "matrix") (Table 1). The matrix aims at modulating the required annual fiscal adjustment of Member States in the preventive arm of the Pact according to the position of the Member States in the cycle (measured by the output gap, the real growth rate and the comparison between actual and potential growth) and their debt level. The matrix was designed to ensure an average adjustment requirement of 0.5% of GDP as a benchmark (defined as a change in the structural balance) requested in secondary legislation.[5] The required fiscal adjustment should be higher than the benchmark in good times and more limited in bad times. In addition, it should be higher for Member States with a debt level exceeding 60% of GDP or with pronounced risks to overall debt sustainability.

[4] The review is based on forecast vintages from the European Commission covering the years until 2017.

[5] Article 5(1) of Regulation (EC) No 1466/97 provides: "The Council and the Commission, when assessing the adjustment path toward the medium-term budgetary objective, shall examine if the Member State concerned pursues an appropriate annual improvement of its cyclically-adjusted budget balance, net of one-off and other temporary measures, required to meet its medium-term budgetary objective, with 0.5% of GDP as a benchmark. For Member States faced with a debt level exceeding 60% of GDP or with pronounced risks of overall debt sustainability, the Council and the Commission shall examine whether the annual improvement of the cyclically-adjusted budget balance, net of one-off and other temporary measures is higher than 0.5% of GDP. The Council and the Commission shall take into account whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times. In particular, revenue windfalls and shortfalls shall be taken into account."

Table 1: Matrix of the required annual fiscal adjustment under the preventive arm of the Pact

		Required annual fiscal adjustment (pp of GDP)	
	Condition	Debt ≤ 60% and low/medium sustainability risks	Debt > 60% or high sustainability risks
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

Source: European Commission (2018): Vade Mecum on the SGP, Institutional Paper, 75, March, p. 38.

I.1 Promoting counter-cyclical fiscal policies and supporting the MTO achievement

The methodological approach

This technical annex follows an analytical, evidence-based and backward-looking approach.

- ***Member States' coverage:*** It focuses on Member States in the preventive arm of the SGP, i.e. excluding years when Member States have either achieved or overachieved their Medium-Term budgetary Objective (MTO) or have to comply with budgetary targets under the Excessive Deficit Procedure (EDP).
- ***Time coverage:*** While the matrix of requirements has only been applied since 2015,[6] the technical annex also takes a longer time period into account to assess its impact over several economic cycles. For this purpose, it uses data in real time from Commission forecast vintages from 2000 to 2017 at two crucial points in time of the EU surveillance process, namely (i) when the requirements are set for the first time, i.e. in spring for the year ahead ("*ex ante requirement*") and (ii) when the fiscal outcomes are finally assessed in terms of compliance with the governance framework, i.e. in spring for the previous year ("*ex post requirement*").
- ***Definition of fiscal adjustment requirements:*** This technical annex derives the fiscal adjustment requirements from two options: First, it applies the matrix irrespective of the distance to the MTO, thereby potentially leading to an overachievement of the MTO in certain years (*pure matrix requirement*); Second, it caps the required fiscal effort when Member States have achieved their MTO, preventing an overachievement of the MTO (*matrix requirement not exceeding MTO*). The first option is a theoretical case which has never been applied in practice. However, it serves as the key reference point for assessing

[6] It should be recalled that also the required fiscal adjustments for 2018 were based on the matrix of requirements. At the same time, the Commission decided to make use of its margin of discretion when assessing departures from those required adjustments for Italy and Slovenia (see also Commission Communication of 22 November 2017 on "2018 Draft Budgetary Plans: Overall Assessment").

the effectiveness of the matrix, since the secondary legislation, not the commonly agreed position on flexibility, prescribes the required fiscal adjustment only for Member States on their adjustment path towards the MTO, while asking the remaining Member States to stay at their MTO.[7]

The cyclical modulation

The findings show that the design of the matrix modulates the required fiscal adjustment around the benchmark requirement of 0.5% (Fig. 1a,b, 2). If the matrix had been applied since 2000 irrespective of the distance to the MTO, the benchmark requirement of 0.5% of GDP would have remained the most frequent requirement (43%) (Fig. 1a). However, the matrix would have allowed for lower requirements (15% of the sample) in case of exceptionally bad, very bad or bad times,[8] while it would have led to higher requirements (42% of the sample) in case of normal times for high-debt Member States or in case of good times (Fig. 1a). Member States with public debt-to-GDP ratios exceeding 60% would have received on average requirements exceeding 0.5% (Fig. 1b).

Figure 1a: Distribution of pure matrix requirements (Member States)

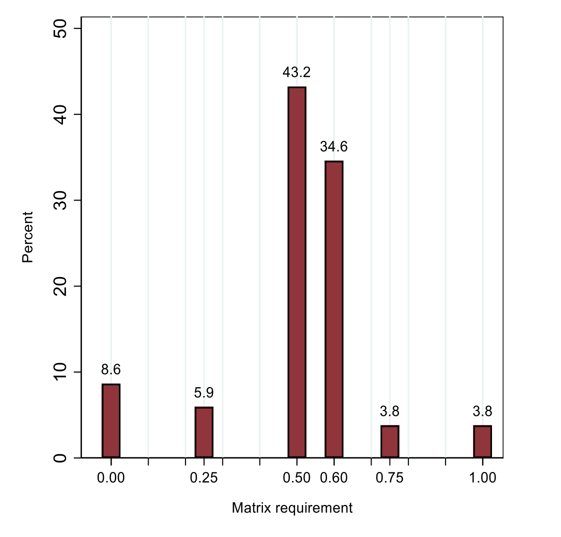
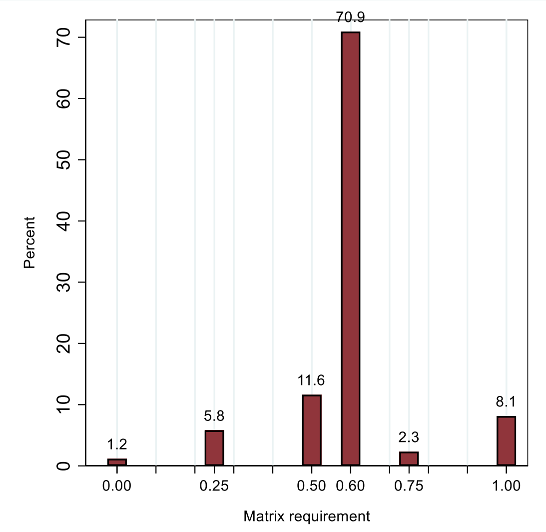


Figure 1b: Distribution of pure matrix requirements (Member States with public debt > 60% GDP)



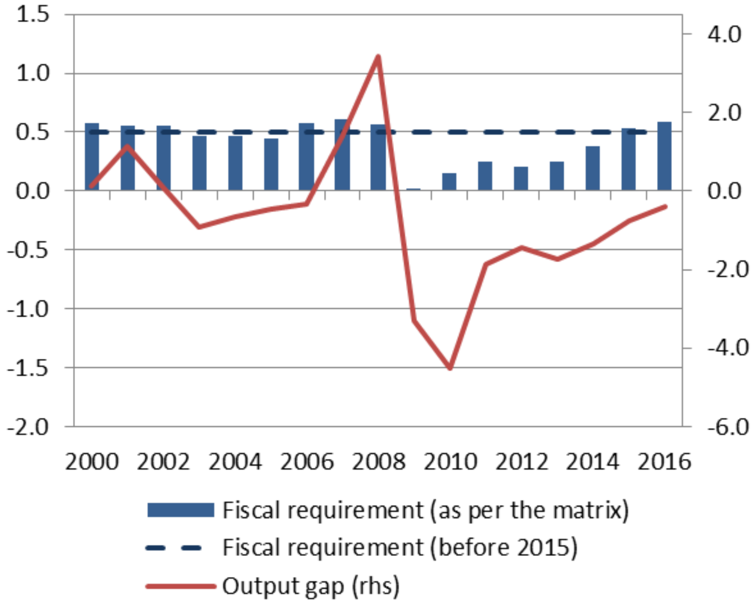
Notes: The figures show frequency distributions of the fiscal adjustment requirements (stemming from an application of the pure matrix) based on unweighted averages for the EU-28 (changing composition) using ex-ante forecasts from COM spring forecast vintages from 2000 to 2017 for the year ahead. The sample focuses on Member States in the preventive arm of the SGP. `Pure matrix requirements' refer to the required fiscal effort derived from a strict application of the matrix irrespective of the distance to the MTO.

7 See footnote 5.

8 In case of bad times, Member States with a debt ratio above 60% of GDP or high sustainability risks and real growth above potential growth are requested to implement an annual fiscal adjustment of 0.5% of GDP.

The design of the matrix allows for a better modulation of the required fiscal adjustment over the cyclical situation of individual Member States (Fig. 2). If the matrix had been applied since 2000, the matrix would have required smaller fiscal adjustments during downturns, compared with a uniform benchmark adjustment of 0.5% per year. This would have contributed to the stabilisation of the economy. Symmetrically, the matrix would have required larger fiscal adjustment in good times, compared with a uniform benchmark adjustment of 0.5% per year. This would have contributed to building up fiscal buffers and ensure sustainability.

Figure 2: Relationship between matrix requirements and economic cycle



Notes: *Fiscal requirements and output gaps are derived from unweighted averages for the EU-28 (changing composition) for the sample of Member States in the preventive arm of the SGP. The fiscal requirements are derived from a strict application of the matrix irrespective of the distance to the MTO. Data stem from vintages from the European Commission spring forecast for the previous year (in real time).*

Promoting the required fiscal benchmark in the medium run

For the EU-28 on average, the matrix would have led to a fiscal adjustment requirement close to the benchmark of 0.5% requested in principle in secondary legislation (Table 2). The application of the pure matrix would have resulted in an average fiscal requirement of 0.5% (using forecast vintages since 2000) and 0.59% (since 2015). The higher requirement since 2015 can be explained by the positive and above-average economic conditions since 2015, on top of the fact that debt-to-GDP ratios had been close to their historical peaks in several Member States and actual growth exceeded on average potential growth. Taking into account that Member States must not exceed their MTO reduces the average matrix requirement by roughly 0.1 percentage point (0.41 since 2000; 0.46 since 2015).

The application of the so-called `freezing principle' results in a somewhat smaller fiscal adjustment requirement on average (Table 2). The required fiscal effort is initially set in spring for the year ahead. To avoid unwarranted consequences of fluctuations in the output gap and the structural balance beyond the control of the governments, the initial requirement is 'unfrozen' if a Member State faces "exceptionally bad" or "very bad times" or if the Member State comes closer to its MTO. That approach is called the `freezing principle', which can only lead to lower (not to higher) requirements if the conditions described above are met (see Box 2 for an application of the freezing principle in the exemplary case of the Netherlands in 2016). To assess the impact of that principle, vintages from three different Commission forecast reports are analysed here, namely spring and autumn reports for the year ahead and spring reports for the previous year.[9] Overall, the application of the freezing principle slightly reduces the average fiscal adjustment requirement by around 0.1 percentage point.

Table 2: Average fiscal adjustment requirements

	Requirement w/o freezing principle		Requirement with freezing principle	
	since 2000	since 2015	since 2000	since 2015
Pure matrix requirement	0.50	0.59	0.39	0.47
Matrix requirement not exceeding MTO	0.41	0.46	0.28	0.25

<u>Notes:</u> The Table shows the requested annual fiscal requirements based on unweighted averages for the EU-28 (changing composition) using COM forecast vintages from 2000 to 2017 for Member States in the preventive arm. `Requirement w/o freezing principle' is based on vintages from COM spring forecasts for the year ahead, `requirement with freezing principle' takes the smallest requirement from three forecast rounds, namely COM spring and autumn forecasts for the year ahead as well as COM spring forecast for the previous year.

<u>Reading example</u>: The average fiscal adjustment requirement since 2000 without freezing principle of the Member States in the preventive arm of the Pact is 0.5pp. Allowing for an unfreezing of that requirement in case of very bad or exceptionally bad economic circumstances reduces the requirement to 0.39 (by ~0.1pp). Taking into account that Member States must not exceed their MTO, further reduces the requirement to 0.28 (by ~0.1pp).

Box 2: The asymmetry of the freezing principle – the case of the Netherlands in 2016

This box examines the freezing principle for the exemplary case of the Netherlands in 2016. It concludes that the freezing principle can lead to a situation in which a Member State is allowed a structural deterioration (based on the frozen requirement), while real-time data indicate that the MTO has not yet been achieved.

In all cases, when setting the requirement, the first step is to assess whether or not the Member State has achieved the MTO. When defining if a Member State is at MTO or has a further adjustment to make to reach MTO, the starting point for year t is the structural balance of year t-1. Therefore, when setting the Netherlands' requirement for 2016, the distance to be covered is the gap between the MTO and the structural balance in 2015.

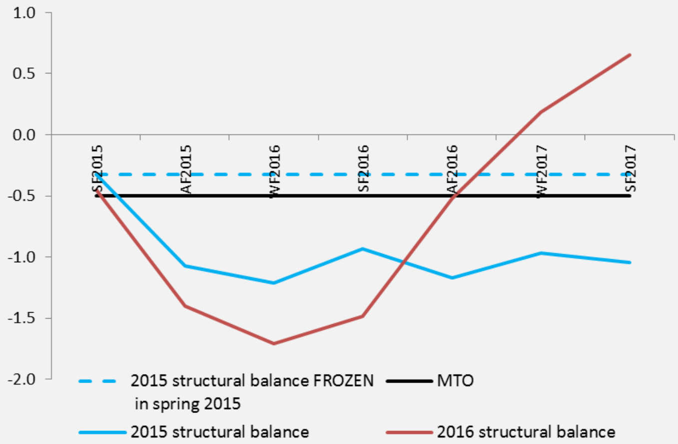
According to the Commission spring forecast 2015, the Netherlands was projected to record a structural balance of -0.3% of GDP in 2015, which implied a 0.2 percentage point overachievement of the MTO, set at -0.5% of GDP. As the Netherlands was expected to continue to overachieve its MTO, no fiscal adjustment was required for 2016.

However, on the basis of the Commission 2015 autumn forecast, due to a worsening of the headline balance and a large upward revision in the output gap (by 0.5 pp of potential GDP),

[9] Following the Opinion of the EFC of 29 November 2016 and the subsequent discussion and endorsement by the Committee, such unfreezing may take place in two occasions: in autumn for the year ahead or in spring for the previous year.

the Commission indicated that the MTO would not be achieved in 2015, which was confirmed by ex post data. However, as the unfreezing is applied asymmetrically (i.e. requirements are not increased if the structural balance is revised down), the assessment of the Netherlands' 2016 Draft Budgetary Plan (DBP) was based on the assumption of MTO overachievement stemming from the spring forecast 2015. Effectively, the 2016 DBP was found to be compliant with the SGP provisions, while at the same time the Member State planned to deviate from the MTO.

Figure A: Evolution of the structural balances for 2015 and 2016 over forecast vintages

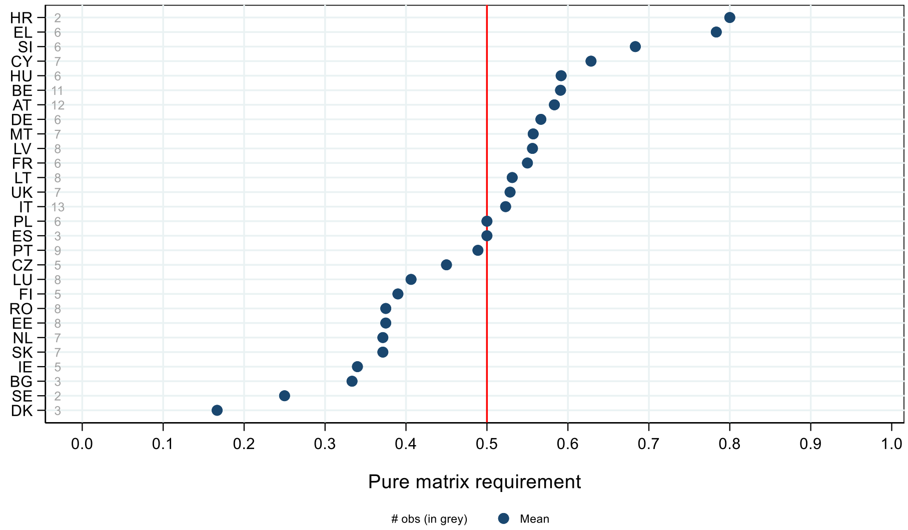


To sum up, the frozen structural position in 2015 from the 2015 spring forecast (-0.3% of GDP) appeared ex post as an outlier among the forecast vintages (Figure A). In other terms, the freezing principle is applied asymmetrically. At the same time, given the relatively large revisions in the structural balance over vintages, the freezing principle provides stability and predictability for policy objectives. In the specific case of the Netherlands, the asymmetric application of the freezing principle did not lead to an expansionary fiscal policy, since the Netherlands did not in fact allow its structural balance to deteriorate in 2016, but largely overachieved the MTO.

Looking at the country-by-country findings reveals that the matrix would have led to an average annual requirement of above 0.5% for around half of the Member States (Fig. 3). Croatia would have been the Member States with the highest, Denmark and Sweden those with the lowest average requirements based on the sample of Member States, which are bound by the matrix (i.e. excluding years when Member States (over-)achieved the MTO and/or had to comply with budgetary targets of the EDP). Since those findings are based for some Member States on a very small number of observations,[10] we also conduct the analysis for an EU-28 sample excluding only those years when Member States (over-)achieved the MTO. For most Member States and with everything else unchanged, it leads to slightly lower requirements, since countries in EDP typically face worse economic conditions, overcompensating the fact that Member States in EDP frequently have higher public debt-to-GDP ratios.

[10] Sweden, for instance, has been bound by the matrix conditions in only two years since 2000, since it (over-)achieved the MTO in the remaining years (based on the COM ex ante forecasts for the year ahead)

Figure 3: Pure matrix requirements by country (EU-28, preventive arm SGP)

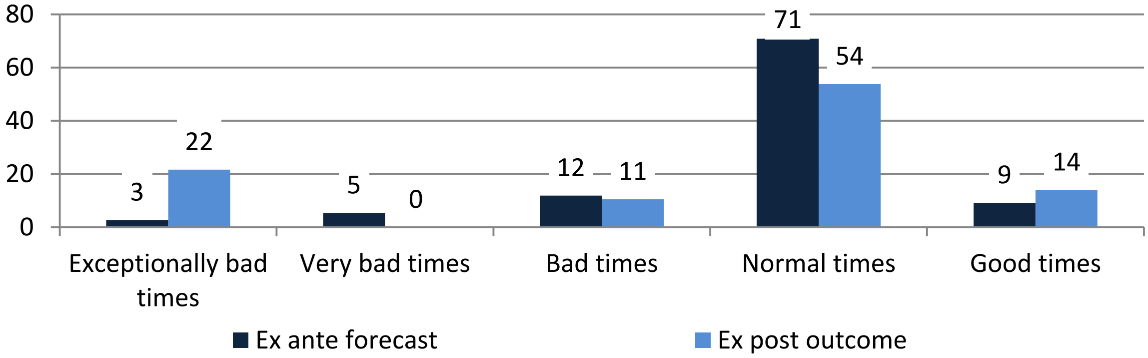


Notes: Ex ante forecasts using vintages from COM spring forecast between 2000 and 2017 for the year ahead for 28 EU Member States. The number of years of a given country under the preventive arm of the Pact is shown next to the country code.

The relevance of the matrix categories

The difference between ex ante and ex post budgetary requirements is mainly related to the gap between the cyclical position as forecast and as actually observed two years later (Fig. 4). For the EU-28 on average, exceptionally bad and good times turn out to be more frequent events based on ex post outcomes (light blue bars in Fig. 4) than on ex ante forecasts (dark blue bars). By contrast, normal times appear to occur less often than projected. A shift in the matrix categories across forecast vintages hampers the predictability of the matrix categories, translating into country-specific forecast error (Table 3). Overall, the total number of forecast errors is however rather limited.

Figure 4: Frequency distribution of matrix categories (in %)



Notes: `Ex ante forecast' based on vintages from COM spring forecasts for the year ahead, `ex post outcome' derived from vintages of COM spring forecasts for the previous year. The sample shows unweighted average for the EU-28 (changing composition) for Member States in the preventive arm of the SGP.

According to our analysis, merging two matrix categories would have greater costs - loss of cyclical modulation - than benefits - improving predictability of matrix categories. Merging two matrix categories can have costs and benefits. On the one hand, costs can occur due to a loss of cyclical modulation in setting the requirements, which is the very raison d'être of the matrix. On the other hand, benefits can emerge from improving the predictability of the matrix categories between forecast and observed data (i.e. reducing the forecast error). We try to quantify the costs and benefits of merging two matrix categories with a cost indicator. That indicator measures in how many percent of the cases the merging of two categories would have implied a loss of cyclical modulation. It varies between 100% (i.e. merging two categories has only costs and no benefits since it does not improve the predictability of the matrix categories) and 0% (i.e. merging two categories has only benefits and no costs, since it does not lead to a loss of cyclical modulation). Our findings show that irrespective of which of the two matrix categories analysed are merged, the costs of merging clearly exceed the benefits (Table 4). We therefore conclude that the matrix categories constitute a good balance between granularity and stability of requirements over forecast vintages.

Table 3: Forecast error of matrix categories by Member States

	Downward revisions *(Ex ante forecast vs. ex post outcome)*	**Upward revisions** *(Ex ante forecast vs. ex post outcome)*
Good times		EE (2)*, LT (2)*
Normal times		SK (2)*
Bad times		**PT (2)***
Very bad times		SK (2)*
Exceptionally bad times	**IT (5)****, FI (5)**, NL (2)**, **PT (3)****, **IE (2)****, LV (2)**	

Notes: To simplify readability, the table reports only forecast revisions if the number of downward/upward revisions (indicated in brackets) exceeds 1. The number of stars shows by how many categories the forecast was revised upwards/downwards on average. The sample covers the Member States excluding Greece in the preventive arm of the SGP. Member States highlighted in bold have debt-to-GDP ratios exceeding 60% according to the COM AF 2017.

Reading example: The forecast for Italy was revised downwards five times, on average by two categories, i.e. from bad to exceptionally bad times.

Table 4: Cost indicator of merging two matrix categories

	e. bad/ v. bad	v. bad/ bad	bad/ normal	normal/ good
Exceptionally bad times	71%			
Very bad times		81%		
Bad times			92%	
Normal times				81%
Good times				

Notes: The cost indicator of merging a couple of adjacent categories (κ) is defined as follows:

$$\kappa = 100 - 100 * \frac{shift_{i\rightarrow i+1}^{SFt-1|t} + shift_{i+1\rightarrow i}^{SFt-1|t}}{obs_i^{SFt+1|t} + obs_{i+1}^{SFt+1|t}}$$

where i corresponds to the respective matrix category, i.e. exceptionally bad times (i=1), … , good time (i=5), SF t-1|t stands for the ex ante forecast, while SF t+1|t refers to the ex post outcome. "shift" refers to the number of cases when the matrix category shifted upwards/downwards by one matrix category between the ex ante forecast and the ex post outcome; "obs" refers to the number of observations in category i according to the ex post outcome.

Comparing the requested with the actual effort: a delicate and inconclusive exercise

The actual fiscal effort needs to be compared with the requested effort under the EU fiscal governance framework, which is determined by the matrix but also other factors. It would be misleading to compare the actual fiscal effort delivered by Member States with the benchmark requirement of 0.5%. The requested effort under the EU fiscal governance framework can be derived from the pure matrix-based required fiscal adjustment. That adjustment may be reduced to avoid that Member States overachieve the MTO and to take into account the freezing principle. Finally, the requirement may be further reduced to take into account the possible application of i) the flexibility clauses to promote structural reforms and public investment, ii) the pension clause found in Regulation (EC) No 1466/97, and iii) the unusual event clause. It leaves us with a requested annual fiscal effort of around 0.27 (since 2000) and 0.2 (since 2015) on average (Table 5).

The actual fiscal effort of Member States falls short of the required one (Table 5). Comparing the requested fiscal effort described above with the actual implemented fiscal effort - measured by the change in the structural balance - points to a significant gap. The sizeable gap for the period since 2000 should be interpreted with caution, since the matrix did not exist before 2015. In addition, it should be recalled that the actual fiscal effort refers only to the average fiscal effort for Member States in the preventive arm of the Pact, i.e. excluding years when Member States (over-)achieved their MTO and/or were under the corrective arm of the Pact, namely the Excessive Deficit Procedure. The average effort for the EU-28 and for Member States in the corrective arm of the Pact is significantly higher (see last two rows of Table 5).

Table 5: Requested requirement vs. actual fiscal effort

	since 2000	since 2015
Requested requirement		
Pure matrix (Tab. 1)	0.50	0.59
Matrixnot exceeding MTO (Tab. 1)	0.41	0.46
Matrix not exceeding MTO with freezing principle (Tab. 1)	0.28	0.25
Matrix not exceeding MTO with freezing principle and clauses		
● with granted structural reform and public investment clause since 2016	0.27	0.22
● with granted structural reform, pub. inv., pension and unusal events clause	0.27	0.20
Actual fiscal effort		
Actual fiscal effort of EU Member States in preventive arm	-0.45	-0.29
Actual fiscal effort of EU Member States in corrective arm	*0.88*	*0.31*
Actual fiscal effort of EU Member States	*0.20*	*0.15*

Note: European Commission vintages using unweighted averages for the EU-28 (changing composition) under the preventive arm. Actual fiscal effort Member States in corrective arm based on EU-28 (changing composition), excluding only years when Member States had to comply with budgetary targets of the SGP.

The implementation gap is driven by numerous factors, outside the remit of the review, but the matrix may have helped to reduce it by improving the design of fiscal surveillance. The review concentrates on the effectiveness of the design of the matrix, rather than its compliance, which corresponds to the much broader issue of ownership by Member States and enforcement at Union level. It is reasonable to assume that the matrix could, by promoting a better design to avoid pro-cyclical policy, improve the credibility of the application of fiscal rules. In particular, the matrix reduces the required effort in bad and very bad times, which may help give further buy-in by national authorities, which are in charge of applying the Union's fiscal rules. In short, good design can contribute to a better enforcement, but cannot ensure it all by itself. As a tentative illustration, the implementation gap appears smaller since the introduction of the matrix.

Cases of departure from the matrix-based approach

The matrix has been the base for setting the fiscal adjustment requirements in the Country-Specific Recommendations proposed by the Commission in the context of the European Semester since 2015. The Commission has departed from the matrix-based approach only in the following limited cases.

In 2015, Romania was allowed to worsen its structural position, instead of keeping it unchanged as per the matrix, in order to encourage the absorption of EU funds. In the case of Romania, under the terms of its 2013-15 balance-of-payments financial assistance programme, it was allowed in 2015 to deviate from the MTO by a maximum of 0.25% of GDP. That allowed deviation was due to the application of the so-called "EU funds adjustor", aiming at accelerating EU funds absorption above past trends[11]. In 2014, Romania had reached its MTO, a deficit of 1.0% of GDP in structural terms, and in the absence of the EU funds adjustor it would have been requested to continue achieving its MTO in 2015 (i.e. a required adjustment of 0% of GDP). The EU funds adjustor was subject to national co-financing of Union funds (net of non-eligible spending and corrections) being in line with or above the allocation in the budget. The outturn data showed that Romania remained within its MTO in 2015, i.e. it did not use the allowed deviation.

In 2017, a smaller fiscal adjustment was required of Slovenia than that implied by the matrix, in light of the uncertainty on the output gap estimates due to its particular economic situation. In the case of Slovenia, the Commission decided that a structural effort in 2017 of 0.6% of GDP, in line with normal times, was more appropriate than the matrix-based adjustment of 1.0% of GDP implied by the projected output gap of X% of GDP. Based on the Commission 2016 spring forecast, Slovenia was assessed to be in "good times" in 2017, requiring a structural adjustment of 1.0% of GDP according to the matrix. The Commission considered the significant uncertainty regarding the calculation of potential growth and the output gap in the specific case of Slovenia because of the peculiar situation of the labour market, the particularly large economic contraction in 2008-2013 and the structural reforms being implemented. Alternative output gap estimations covering a longer time horizon, reflecting the review of the estimation method ongoing at that time, suggested a smoother output gap profile for Slovenia, implying that it would be premature to conclude that the Slovenian economy was in good times in 2017. As such, the Commission concluded that a structural effort in 2017 of 0.6% appeared more appropriate[12].

For 2018, the Commission decided to exercise a degree of discretion when considering departures from the matrix requirements for Italy and Slovenia.[13] The Commission set its recommendations for 2018 Country Specific Recommendations on the basis of the matrix of requirement. However, for the nine Member States with a matrix requirement of 0.5% of GDP or above, the Commission specified that its assessment of compliance would take into account the need to ensure sustainability as well as the need to strengthen the ongoing recovery. Specifically, in its assessment of the 2018 Draft Budgetary Plans, the Commission assessed the cyclical conditions of five Member States, which were initially found at risk of a significant deviation for 2018. As part of its overall assessment, the Commission concluded that the recovery of Belgium, France and Portugal was sufficiently robust and no discretion

[11] See Section 4.2, Assessment of the 2015 Convergence Programme for Romania, DG ECFIN, European Commission - https://ec.europa.eu/info/sites/info/files/file_import/23_ro_scp_en_2.pdf.

[12] See Box 2, Assessment of the 2016 Stability Programme for Slovenia, DG ECFIN, European Commission - https://ec.europa.eu/info/sites/info/files/file_import/24_si_scp_en_4.pdf.

[13] See Commission Communication of 22 November 2017 on "2018 Draft Budgetary Plans: Overall Assessment".

was warranted, confirming the risk of non-compliance with the requirements for 2018. By contrast, for Italy the Commission concluded that the recovery appeared still fragile and for Slovenia that a too large fiscal tightening could jeopardise it, also considering that investment was still below pre-crisis level and that the estimation of the output gap was surrounded by large uncertainty. Therefore, the Commission considered that a fiscal adjustment departing from the matrix requirement could be deemed adequate, provided that Italy and Slovenia ensure such a fiscal adjustment.

I.2 Ensuring a reduction in government debt at a satisfactory pace

As long as the matrix ensures the achievement of the MTO, it also supports fiscal sustainability. The commonly agreed position indicates that the review should also assess whether the matrix has ensured reduction in government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances[14]. Under normal macroeconomic circumstances, achieving the MTO entails compliance with the debt reduction benchmark over the medium term[15]. Indeed, the minimum MTO takes into account, among other things, implicit liabilities related to ageing populations and the level of the debt-to-GDP ratio in order to ensure sustainability or rapid progress towards it. Specifically, for Member States that are not yet at their MTO, compliance with the preventive arm, i.e. an adjustment path towards the MTO of 0.5% of GDP on average per year, allows the debt reduction benchmark to be fulfilled, with some delays in some cases. This is specifically why adherence to the MTO or the adjustment path towards it is considered a key relevant factor when assessing compliance with the debt reduction benchmark.

Member States with debt ratios exceeding 60% or with pronounced risks of overall debt sustainability are required to deliver a structural adjustment higher than the benchmark of 0.5% of GDP in normal or good economic times. As shown in Figure 5 for 2015, those Member States with the highest debt ratios were also typically those with the highest structural deficit, requiring a significant fiscal adjustment. In line with Article 5(1) of Regulation (EC) No 1466/97, the matrix is modulated differently for Member States with debt-to-GDP ratios above 60% (or with pronounced risks of overall debt sustainability), requiring a fiscal adjustment of more than 0.5% of GDP on average. As suggested by the analysis conducted in the previous Chapter, if the matrix had been applied since 2000, Member States with public debt-to-GDP ratios exceeding 60% would have received on average requirements above 0.5%, in line with the provisions of Regulation (EC) No 1466/97.

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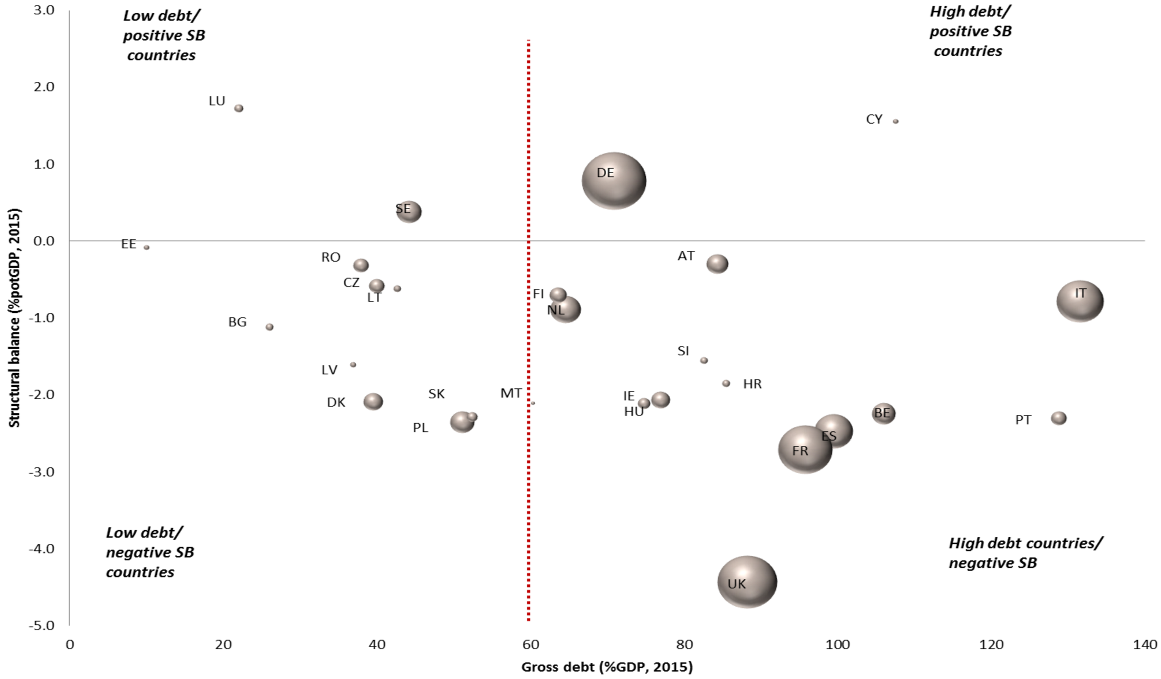
[14] Member States in the preventive arm of the SGP and with debt-to-GDP ratios above 60% should ensure compliance with the debt reduction benchmark. That benchmark requires that the differential of the debt ratio with respect to the reference value of 60% has decreased over the previous three years at an average rate of 1/20th per year as a benchmark.

[15] Note to the EFC-Alternates on "The 2015 update of the minimum medium term objectives", February 2016 (Ref. Ares(2016)936286).

Figure 5: Structural balance and debt ratios across Member States with country sizes

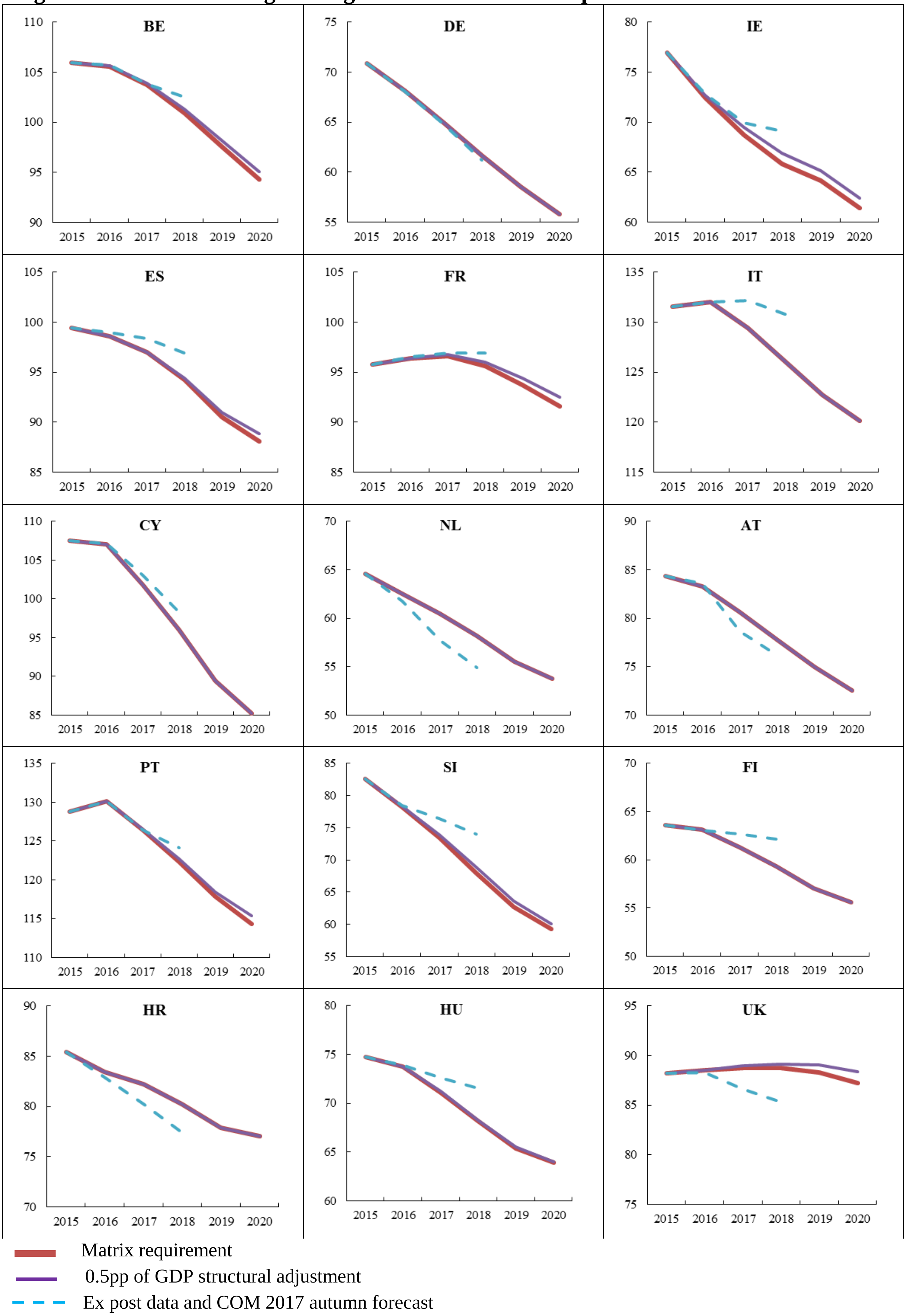


Note: Size of bubbles is proportional to country shares in total EU-28 GDP

For Member States with debt ratios exceeding 60% of GDP, full compliance with the matrix requirements since 2016 would have resulted in a debt trajectory similar to that required by a constant adjustment of 0.5% of GDP (i.e. pre-matrix regime). Figure 6 shows the two debt trajectories, resulting from respectively full compliance with the matrix requirements not exceeding the MTO[16] and a constant structural adjustment of 0.5% of GDP. The two debt trajectories are displayed for those Member States with a debt-to-GDP ratio above 60% in 2015 and they cover a relatively short time period (2015-2020) since the matrix of requirements was introduced only recently. Further details on the simulations are provided in the note to the Table. The charts suggest that full compliance with the matrix requirement implies a debt reduction, which is either marginally faster or equal to the one achieved with a constant requirement of 0.5% of GDP. Such findings can be explained by the fact that the years under analysis are considered by the matrix of requirements to be normal economic times on average. In fact, the output gaps for both the euro area and the Union are between -1.5% and 1.5% for all years after 2016. Under those economic conditions, the matrix of adjustment requires on average an adjustment higher than 0.5% of GDP, which is normally implemented as a required fiscal effort of 0.6% of GDP.

[16] The simulation corresponds to the established SGP debt projection scenario, used and described in the Debt Sustainability Monitor 2017 (Annex A3). The simulations are run on the basis of the 2017 Commission autumn forecast, which incorporates outturn data for the years up to 2016.

Figure 6: Simulations on general government debt developments since 2015



Note: Debt developments resulting from full compliance with the matrix-based requirements are compared with debt developments resulting from a constant adjustment of 0.5% of GDP. A deterministic debt trajectory is simulated assuming full compliance with the matrix-based requirement from 2016, the first year when the matrix was fully implemented. Specifically, in the simulation, the structural balance is supposed to converge towards its MTO according to the requirement prescribed by the matrix, and to remain at its MTO thereafter. The requirements are set on the basis of the cyclical conditions and debt levels as per the ex post data and the Commission 2017 autumn forecast. As a term of comparison, debt developments as implied by a constant adjustment of 0.5% of GDP are simulated. Moreover, those projections are run by taking into account a feedback effect of fiscal consolidation on GDP growth (a 1pp. of GDP structural effort impacting negatively on baseline GDP growth of 0.75pp in the same year). Those debt trajectories correspond to the so-called Stability and Growth Pact scenario run for debt sustainability analysis (see Debt Sustainability Monitor 2017, Institutional Paper 071, European Commission, January 2018).
Source: DG ECFIN calculations based on the 2017 autumn forecast

I.3 Summarising the findings on the cyclical modulation of the required budgetary adjustment

The design of the matrix ensures a modulation of the required fiscal effort over the economic cycle. The findings show that the design of the matrix leads to a modulation of the required fiscal adjustment around the benchmark requirement of 0.5%. In addition, the design of the matrix allows for an effective modulation of the required fiscal adjustment in the preventive arm of the Pact over the cyclical situation of individual Member States. It means that the matrix requires smaller fiscal adjustments during downturns to promote growth and asks Member States to do more in good times to build up fiscal buffers.

The design of the matrix supports the achievement of the MTO inasmuch as it leads to an average requirement close to the benchmark of 0.5% of GDP. Regulation (EC) No 1466/97 requires Member States in the preventive arm of the Pact that are not yet at their MTO to pursue an appropriate structural adjustment towards it, with 0.5% of GDP as a benchmark. Applying the pure matrix requirements since 2000 or 2005 would have resulted in an average requirement of close to the benchmark requirement of 0.5%. Therefore, the application of the matrix seems to support the achievement of the MTO in line with the provisions of the SGP. The average matrix requirement is slightly reduced by fact that Member States already close to their MTO cannot be required to overachieve it. It leads to an average reduction in the budgetary requirement of around 0.1 percentage point. Similarly, applying the freezing principle also leads to somewhat lower fiscal requirements (in the order of 0.1pp) because, according to that principle, the requirement used at the time of the assessment of compliance can be reduced if the country concerned finds itself in very bad or exceptionally bad economic circumstances.

By ensuring the achievement of a sound budgetary position (i.e. the MTO), the design of the matrix also does not weaken debt reduction and supports fiscal sustainability. If the matrix had been applied since 2000, Member States with public debt-to-GDP ratios above 60% would have received on average requirements exceeding 0.5%, in line with the provisions of the Pact. The matrix then supports the achievement of the MTO also –and even more– for Member States with high debt ratios. Under normal macroeconomic circumstances, compliance with the preventive arm, namely achieving the MTO or compliance with the adjustment path towards it, allows to fulfil the debt reduction benchmark. Therefore, by ensuring the achievement of the MTO, the matrix allows to promote debt reduction and ultimately, the long-term sustainability of public finances. From a simulation, the debt trajectories resulting from full compliance with the matrix requirements as of 2016 are similar to those resulting from a constant adjustment of 0.5% of GDP.

The level of granularity of the matrix appears to strike the right balance. When comparing the matrix requirements on the basis of the forecast with those of the ex post outcome, normal economic times occur less often than initially projected. Although merging two rows of the matrix could slightly reduce the forecast error, the benefits of doing so clearly fall short of the costs associated to a loss of cyclical modulation, which is precisely what the matrix tries to achieve. In short, the matrix categories constitute a good balance between granularity and stability of requirements over forecast vintages.

The actual budgetary adjustment made by the Member States falls short of the required one. It is possible to compare the actual fiscal effort made with the required effort. However, the latter differs from the pure matrix requirement since it factors in many other considerations. They are not only the distance to the MTO and the application of the freezing principle, but also the further flexibility granted under the investment and structural reform clauses, and the possible deviation from the path to MTO allowed to cater for unusual events. That comparison exercise points to a significant gap between the actual and requested efforts, the analysis of which stands beyond the scope of this review.

The Commission has only departed from the matrix-based approach in two specific and well-justified cases. When setting the required budgetary adjustment, the Commission departed from the matrix in the cases of Romania in 2015 and Slovenia in 2017 due to country-specific and rather exceptional circumstances. For Romania the departure was made to incentivise the absorption of EU funds, while the departure for Slovenia is explained by the uncertainty of the output gap estimates. When assessing a departure from the matrix requirements for 2018, the Commission applied its discretion in the cases of Italy and Slovenia in light of their particular cyclical conditions.

II. REVIEW OF THE STRUCTURAL REFORM CLAUSE AND INVESTMENT CLAUSE

This second section focuses on the application of the structural reform and investment clauses. The pension reform clause is excluded given the specific provisions reserved to it in Regulation (EC) No 1466/97[17]. As a first step, the technical annex examines the eligibility criteria and the potential coverage of the two clauses, i.e. which Member States were eligible based on some ex ante eligibility criteria. The technical annex then focuses on those Member States that applied for and were granted/rejected use of the clauses, explaining how flexibility was applied in practice.

II.1 The eligibility criteria and potential coverage of the flexibility clauses

The eligibility criteria for the flexibility clauses are designed to safeguard fiscal sustainability, while still supporting Member States in undertaking structural reforms and additional public investment. The spirit of such flexibility is that ambitious structural reforms or well targeted government investment can improve growth potential and therefore improve fiscal sustainability of Member States over the long run.[18] Such reforms or investment can however imply either financial or political costs in the short run. In such cases, a degree of flexibility in the application of the fiscal rules can be warranted. The commonly agreed position on flexibility in the Stability and Growth Pact (SGP) was achieved after detailed discussions between the Council and the Commission over the course of 2015. Those discussions reflected the differing views amongst Member States regarding the correct balance between supporting and encouraging both structural reforms and government investment, while ensuring fiscal responsibility, a concern which led to the inclusion of the review clause in the final commonly agreed position. Key components in ensuring the correct balance between those objectives are the eligibility criteria for accessing the clauses. The safeguards need to be sufficiently tight to ensure that the use of the clauses does not negatively impact upon the Member States' sustainability, while at the same time, not being so severe as to render access to the clauses practically impossible.

There are common eligibility criteria for both the structural reform clause and the investment clause, as well as a few specific safeguards for each clause. There is a relatively high consistency between the criteria that Member States must satisfy when applying for use of the clauses. This is consistent with the fact that the investment clause is, in legal terms, a specification of the structural reform clause: the investment clause concerns government investments aiming at, ancillary to, and economically equivalent to the implementation of major structural reforms. Among the common criteria are that both the 3% of GDP deficit ceiling and a safety margin with respect to the MTO are not breached and that the MTO is reached within the four-year horizon of the Stability and Convergence Programme. Specific requirements also apply for each clause. In the case of the investment clause, there is an additional safeguard placed on the use of that clause: the Member State must be experiencing negative GDP growth or an output gap below -1.5% of GDP, while government investment must not decrease. In the case of the structural reform clause, the

[17] Sustainability-enhancing pension reforms have received specific consideration in the legislation (Articles 5(1) and 9(1) of Regulation (EC) No 1466/97). Specifically, pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar, constitute a specific case of structural reforms which also justify a temporary deviation from the MTO or the adjustment path towards it.

[18] The sustainability effects can stem either from direct budgetary savings from the reforms (such as in pensions or healthcare), or from the increased revenues drawn in the medium to long-run from a more efficient economy with higher potential output (e.g. due to lower structural unemployment or an increased labour force), or from a combination of both kinds of effects.

reforms should be implemented or already adopted by government. All those criteria should be fulfilled in order for the Member State to be granted flexibility. A comprehensive list of the criteria for eligibility of the structural reform and investment clauses are presented in Table 6.

Table 6: Criteria for eligibility to the structural reform clause and investment clause and the timing of their assessment (*in brackets*)

<table>
<tr><th></th><th>Structural Reform Clause</th><th>Investment Clause</th></tr>
<tr><td>Remaining in the preventive arm</td><td colspan="2">▪ Be and remain in the preventive arm in year t+1 (before and after granting)
▪ Safety margin with respect to the 3% of GDP reference value for the deficit (minimum benchmark) (before granting)</td></tr>
<tr><td>Integrity of the MTO</td><td colspan="2">▪ Achievement of the MTO within the four-year horizon of the current SCP should be sought, which operationally means less than 1.5% deviation from MTO in initial year (before granting)
▪ Additional application of the clauses restricted until achievement of the MTO (after granting)</td></tr>
<tr><td rowspan="3">Temporary and limited deviation from the MTO (or adjustment path)</td><td>▪ The deviation cannot exceed 0.5% of GDP, except in the case of pension reforms introducing a mandatory fully-funded pillar (before granting)</td><td>▪ The deviation cannot exceed 0.5% of GDP (before granting)</td></tr>
<tr><td colspan="2">▪ The cumulated deviation for the two clauses cannot exceed 0.75% of GDP (before granting)</td></tr>
<tr><td colspan="2">▪ The temporary deviation remains valid over a period of three years (not applicable)</td></tr>
<tr><td>Cyclical conditions</td><td>Does not apply</td><td>▪ Negative GDP growth or output gap inferior to -1.5% of GDP (before granting)</td></tr>
<tr><td rowspan="3">Objective</td><td>▪ Major structural reform with positive long-term budgetary effects, including by raising potential sustainable growth (before granting)</td><td>▪ Investments aiming at, ancillary to, and economic equivalent to the implementation of a major structural reforms, i.e. with a verifiable major net positive impact on potential growth and on sustainability of public finances (before granting)</td></tr>
<tr><td>▪ The reforms must be fully implemented (or submission of a medium-term structural reform plan including well specified measures and credible timelines) (before and after granting)</td><td>▪ Projects to a large extent co-financed by the Union under Cohesion policy (including the YEI), TEN, CEF, EAFRD, EMFF and the EFSI (before and after granting)</td></tr>
<tr><td></td><td>▪ Total public investments are not reduced, i.e. co-financed expenditure should not substitute for nationally financed investments (before and after granting)</td></tr>
<tr><td>Timing of application</td><td colspan="2">▪ In the SCP (or DBP) submitted in year t for benefitting from the clause in year t+1</td></tr>
<tr><td rowspan="2">Information</td><td>▪ In-depth and transparent documentation with quantitative analysis of short-term cost – if any – and of medium-term budgetary and potential growth impact as well as timetable for implementation of reforms. (before granting)</td><td>▪ Detailed information on the projects co-financed by the Union (e.g. size, key features), specifying how they will contribute to boost potential growth and long-term sustainability of public finances. (before and after granting)</td></tr>
<tr><td colspan="2">▪ Independent evaluation of the information provided or comprehensive independent information to support the estimated impact (and planned timetable). (before granting)</td></tr>
</table>

The Commission services have examined how demanding some eligibility criteria were in practice. While a low number of Member States have made use of the clauses to date, i.e. four of them, it is a policy decision for the national authorities whether they want to apply to use one of the clauses. The more relevant question, in terms of the design of the clauses, would appear to be how many Member States have been eligible for use of the clauses – even if they did not apply for them – since the Commission Communication of January 2015. As part of the review of the clauses, the Commission services have retroactively examined eligibility across all Member States. That exercise is conducted considering only a subset of the eligibility criteria, which are listed hereafter. The other eligibility criteria become relevant only when Member States formally apply for use of the clauses and submit the information needed to assess them (for that reason, they are examined as part of Chapter II.2, which covers the cases of application of the clauses).[19] The exercise is run for the years from 2015 until 2018. In particular, eligibility for the application of the clause in year t is assessed on the basis of the information available in spring of year t-1, when the Member State should normally apply for the clause in its Stability or Convergence Programme (SCP).

Eligibility criteria assessed for the exercise:	**How it is checked in practice:**
A. achievement of the MTO within the four year horizon of the SCP, i.e. the maximum initial distance at which the structural balance of a Member State can be from the MTO is 1.5% of GDP	$SB_{t-1} - MTO_{t-1} \geq -1.5\%$
B. an appropriate safety margin is continuously preserved[20], i.e. the structural balance respects the minimum benchmark	$SB_{t+i} \geq$ Minimum Benchmark $_{t+i}$ with i=0,1,2
C. negative GDP growth or output gap lower than -1.5% of GDP (*only for the investment clause*)	Real GDP growth $_t < 0$ or Output gap $_t \leq -1.5\%$

Over the period 2015-2018, a greater number of Member States could have applied to avail of the structural reform clause compared with the investment clause[21]. Table 7 reports whether each Member State (excluding Greece which has been subject to a macroeconomic adjustment programme) met those three eligibility criteria in the spring for use of the clause in the following year. It is important to highlight that the Table does not consider cases where those eligibility criteria could be met as a result of the constrained judgement approach. The Table clearly shows that there were more Member States potentially eligible for use of the structural reform clause than the investment clause. In particular, the number of Member States potentially eligible for the structural reform clause averages around 12 per year. For the investment clause, only five Member States were eligible in 2015, none of which applied for use of the clause for that year. Out of those five Member States, two would also have been eligible in one of the following years. However, Denmark did not apply for use of the investment clause and only Italy applied to use and benefitted from the clause for 2016.

[19] The presence in Member States of projects co-financed by the Union under Cohesion policy (including the YEI), TEN, CEF, EAFRD, EMFF and the EFSI was not assessed.

[20] It is worth highlighting that the respect of the minimum benchmark is assessed only at the time of the assessment of the application for the use of the clause. That approach is justified by the fact that the clauses are not retracted once granted, if compliance with the minimum benchmark is altered due to future revisions of the minimum benchmark.

[21] It is based on the subsets of eligibility criteria that can be assessed.

Only four countries eventually applied and benefitted from use of the structural reform clause out of the 18 countries that could potentially have applied for it during the assessment period. Table 7 shows that nine Member States have never been eligible for use of the structural reform clause while six have always been eligible over the period assessed, one of which benefitted from it in 2017 (Lithuania). The other three Member States that benefitted from the clause are Italy in 2016, and Latvia and Finland in 2017. Italy and Finland also applied for use of the investment clause respectively in 2016 and 2017. In the case of Finland, the Commission applied "constrained judgement" to the estimate of the output gaps and on that basis concluded on its eligibility for the clauses[22].

Table 7: Fulfilment of some eligibility criteria and scope for flexibility based on real time data

Member State	Structural reform clause				Investment clause				If the MS can apply, how big is the scope for flexibility available (SB_t - MB)?			
	Is the MS satisfying the eligibilty conditions under consideration?											
	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
BE	A,B	A,B	A,B	A,B	A,B	A,B,C	A,B,C	A,B,C				
BG		A,B				A,B,C	C	C	0.5		0.5	0.5
CZ	B				B,C	C	C	C		0.1	0.5	0.5
DK		B				B		C	0.2		0.03	0.5
DE					C	C	C	C	0.5	0.5	0.5	0.5
EE					C	C	C	C	0.5	0.5	0.5	0.5
IE (EDP 2015)		A,B	A			A,B,C	A,C	C				0.5
ES (EDP 2018)												
FR (EDP 2017)				A,B				A,B,C				
HR (EDP 2016)			B	B			B,C	B,C				
IT			A,B	A,B			A,B,C	A,B,C	0.75	0.75		
CY (EDP 2015)						C	C	C		0.5	0.5	0.5
LV	B	B		B	B,C	B,C	C	B,C			0.1	
LT					C	C	C	C	0.5	0.5	0.5	0.0
LU					C	C	C	C	0.4	0.5	0.5	0.5
HU	B	B	B	A,B	B,C	B,C	B,C	A,B,C				
MT	A,B	A	A		A,B,C	A,C	A,C	C				0.5
NL			B			C	B,C	C	0.6	0.5		0.5
AT					C	C	C	C	0.5	0.4	0.4	0.5
PL	A,B	A,B	A,B	A,B	A,B,C	A,B,C	A,B,C	A,B,C				
PT (EDP 2016)			A,B	A,B			A,B,C	A,B,C				
RO		B	A,B	A,B	C	B,C	A,B,C	A,B,C	0.1			
SI (EDP 2015)		A,B	A,B	A,B		A,B,C	A,B,C	A,B,C				
SK	A,B	B	A		A,B	B	A,C	C				0.5
FI		B	B	B		B	B,C	B,C	0.2			
SE					C	C	C	C	0.5	0.05	0.1	0.5
UK (EDP 2016-17)			A,B	A,B			A,B,C	A,B,C				

LEGEND

Member State in EDP Member State is potentially eligibile Member State is not eligible

A means that the condition of max distance of 1.5% of GDP from the MTO is not met

B means that the condition of respecting the minimum benchmark is not met

C means that the condition of negative real GDP growth and output gap below -1.5% are both not met

The respect of the minimum benchmark for both clauses proves to be a more demanding criterion than the maximum allowable distance from the MTO of 1.5% of

[22] The three eligibility criteria were fulfilled as follows:

- achievement of the MTO within the four-year horizon of the SCP: based on the Commission 2017 spring forecast, Finland was expected to remain sufficiently close to its MTO in 2017-2018 and according to the Government plans, Finland would return to its MTO in 2019. In addition, on the basis of the constrained judgement approach, the structural balance in 2016 was estimated at -0.5% (Finland's MTO). Therefore, the eligibility criterion of a maximum initial distance of 1.5% of GDP between the structural balance in 2016 and the MTO was satisfied;
- an appropriate safety margin is continuously preserved: on the basis of the constrained judgement approach, the structural balance was estimated at -1% in 2017 and 2018, above the minimum benchmark of -1.1% (2019 was beyond the Commission 2017 spring forecast horizon);
- negative GDP growth or output gap lower than -1.5% of GDP: on the basis of the constrained judgement approach, the output gap for 2017 was estimated at -2.1% of potential GDP (-1.4% on the basis of the commonly agreed methodology).

GDP. The exercise described above also illustrates which of those ex ante criteria are the most demanding. Over the years assessed, the respect of the minimum benchmark is less frequently met than the maximum distance of 1.5% of GDP from the MTO. In particular, the annual update of the minimum benchmarks has led to marginally stricter benchmarks over time. At the same time, as economic conditions improve, the required fiscal efforts become larger and the Member States' structural balances should converge faster towards their MTO, making the respect of the minimum benchmark easier.

The specific eligibility criteria for the investment clause, which requires a country to be in bad economic times, has become harder to fulfil, as the recovery strengthens. With respect to the eligibility criterion for the investment clause (i.e. negative real GDP growth or negative output gap below 1.5%), all Member States experienced positive GDP growth since 2015 but around half of them showed an output gap below -1.5% in 2015. However, as economic conditions improved and output gaps started to close, by 2018 only Greece still appears to be in bad times.

The scope for flexibility averaged to around 0.4% of GDP in the Member States eligible for use of the clauses. It is possible to determine the scope for flexibility available to those Member States that could have applied for the clauses. That scope for flexibility is computed as the difference between the structural balance in year *t* and the minimum benchmark, under the assumption that the Member State does not benefit already from other clauses, e.g. the pension clause. The commonly agreed position also imposes a cap on the flexibility which can be granted to a Member State, namely 0.5% of GDP for each clause or 0.75% in case of both clauses being granted. That capping is taken into account when computing the available scope. As reported in Table 7, the scope for flexibility for each of the years assessed averages around 0.4% of GDP, with substantial variation by Member State and year.

II.2 The Member States that actually applied for use of the clauses

Four Member States were granted use of the structural reform clause, namely Italy, Latvia, Lithuania and Finland[23]**. Italy and Finland were the only two Member States that were granted use of the investment clause.** Member States can make use (or not) of the granted flexibility, in particular by fulfilling the eligibility criteria. To be eligible, all four Member States were either close to their MTO or, at least, no farther from it by 1.5% of GDP, which limits the possible induced delays in achieving the MTO[24]. Table 8 shows the flexibility applied for and granted to each Member State under the structural reform and

[23] The temporary deviations granted to Latvia and Lithuania for the reform of their pension systems is considered to fall outside the scope of the review, because the pension reform clause was already well detailed and applied before the commonly agreed position on flexibility in the SGP. Latvia implemented a systemic pension reform as from 2013, which entailed a gradual increase in the share of social security contributions diverted to a funded pension scheme. The reform was fully implemented in three steps in 2013, 2015 and 2016, with each step leading to a temporary deviation lasting for three years. The allowed deviation totalled 0.5% of GDP in 2013-14, 0.8% in 2015, 0.6% in 2016-17 and 0.3% in 2018. In the case of Lithuania, in April 2015, at the time of the submission of the 2015 Stability Programme, Lithuania applied for flexibility in 2016 of 0.1% of GDP for its systemic pension reform. The amount requested was 0.1% of GDP. The pension reform clause was demanded in relation to changes to the Lithuanian pension system initiated in 2012, which resulted in three sources being used to fund the second pillar of the pension system, as of 2014. From 2016 contributions paid by the State increased by one percentage point, resulting in an estimated additional spending of EUR 38.7 million (or 0.1% of GDP). According to the 2015 Stability Programme, such modification would allow reducing spending on pensions by 0.1% of GDP by 2040 and 0.2% of GDP by 2050 and 2060.

[24] A slight delay in achieving the MTO cannot be ruled out, as a predictable consequence of the modulation of the required budgetary adjustment, in particular if a Member State cumulates the use of the two clauses and a (temporarily) lower adjustment as per the matrix.

investment clauses[25] up to the spring 2018 forecast. Flexibility was formally granted in spring, as part of the Country Specific Recommendations issued by the Commission for adoption by the Council. As regards the assessment of the implementation of the structural reforms, the Commission performed a continuous monitoring of the progress in the implementation of structural reforms, with detailed assessments published in Member States' annual Country Reports. However, implementation may not be fully achieved already in the year when granting the clause. This is because some applications for use of the clause were based on a package of reform measures rather than on one single reform. As a result, it is unlikely (and would perhaps be unwise in terms of the economic impact) for all of the measures to be introduced at once. Therefore, it may require a number of years before all of the reforms can be effectively implemented.

Table 8: Flexibility under the structural reform and investment clauses

MS	2016							2017							
	Investment			Structural reform				Investment			Structural reform				
	Requested	Granted	Flexibility used	Requested	Granted	Requested (additional)	Granted (additional)	Requested	Granted	Flexibility used	Requested	Granted	Requested	Revised requested	Granted
Timeline	DBP2016	Spring 2016	Spring 2017	SCP2015	Spring 2015	DBP2016	Spring 2016	DBP2017	Spring 2017	Spring 2018	SCP2016	Spring 2016	DBP2017	Updated DBP2017	Spring 2017
IT	0.25	0.25	0.21	0.4	0.4	0.1	0.1								
LV				0.2	-						0.5	0.1*			
LT											0.6	-	0.6	0.5	0.4*
FI								0.1	0.1	0.0			0.5		0.5

* while granting the requested flexibility for structural reforms, the temporary deviation allowed for 2017 is limited in order to respect the minimum benchmark

Section II.2 is structured as follows. First, it provides an assessment of the information provided by each Member State that was granted use of the clauses and the fulfilment of the (ex post) eligibility criteria (sections II.2.1 to II.2.4). Then, Romania is discussed as a case of rejection of an application for flexibility (section II.2.5). Box 3 presents Finland as a case study on the interplay of the clauses for the purpose of determining the required fiscal adjustments.

II.2.1 Italy

A. Application for flexibility

In April 2015, in its 2015 Stability Programme, Italy requested a temporary deviation of 0.4% of GDP from the required adjustment path towards the MTO in 2016 in view of the planned implementation of major structural reforms with a positive impact on the long-term sustainability of public finances. In October 2015, in its 2016 Draft Budgetary Plan, Italy updated the requested temporary deviation in 2016 for structural reforms to 0.5% of GDP and requested an additional temporary deviation for 2016 of 0.3% of GDP under the investment clause.

B. Information provided by Member State

Structural reform clause

The reform areas put forward in the 2015 Stability Programme and the 2016 Draft Budgetary Plan included: (i) public administration and simplification; (ii) product and service markets; (iii) labour market; (iv) civil justice; (v) education; (vi) a tax shift; (vii) spending review as financing measure; and (viii) changes in bankruptcy law and in the tax treatment of banks' nonperforming loans. The 2015 Stability Programme included information on the state of implementation of the reforms (already adopted or about to be completed) as well as a

[25] The unusual event clause is outside the scope of this review.

detailed timeline for delivery (by the end of 2015 most reforms were to have been completed). The positive impact on GDP was estimated at 3% of GDP by 2025, and the national indicator measuring the direct and indirect net gains in debt sustainability was expected to improve by 1.1pps. Although the estimates were produced by the Ministry of Finance without independent evaluations, extensive details on the computations were provided together with a comparison with similar estimates produced by the OECD.

Investment Clause

The amounts presented under the investment clause included EUR 5.1 billion (or 0.3% of GDP) of national expenditure on projects co-financed by the Union, representing 46.6% of the total cost of the projects. The policy areas concerned were: competitiveness of SMEs, research and innovation, sustainable transport, network infrastructures, energy efficiency, employment and labour mobility, education and training, social inclusion, institutional capacity and efficiency of the public administration. The increase in potential GDP was estimated at 0.3% by 2027, corresponding to an improvement in debt sustainability of 1.7 pps, measuring both the direct and indirect net gains.

C. Assessment of fulfilment of conditions

The amount of flexibility granted ex ante and ex post under the structural reform clause amounts to 0.5% of GDP[26]. The Commission assessed the estimated positive impact on growth and the long-term sustainability of public finances as plausible at the time of granting the clause, through their effect on growth and tax-intake. Implementation of the structural reform clause has been monitored by the Commission services based on the information provided by the Italian authorities. The 2017 and 2018 Country Reports acknowledged the progress made in several policy areas, but also pointed out the remaining obstacles and a general slow-down of the reform momentum. In some cases, reforms have been fully implemented, while in others the relevant laws have been adopted but implementation is still ongoing. Italy's economic outcomes also seem to broadly confirm ex ante expectations. Specifically, Italy's output growth accelerated to 1.5% in 2017 (from 0.9% in 2016), supported in particular by exports and investment. That momentum, driven both by domestic and external demand, is expected by the Commission to largely continue in 2018 as well.

The Commission recognised ex ante a temporary deviation of only 0.25% of GDP under the investment clause due to the uncertainty in some planned investment. This also allowed respecting the eligibility criteria according to which the cumulated deviation for the two clauses cannot exceed 0.75% of GDP. Ex post, flexibility was reduced to 0.21% of GDP in light of the actual eligible investment. In terms of the eligibility criteria, Italy's total public investment declined by around EUR 1.6 billion in 2016 compared to 2015. However, when taking into account the sharp fall in the amount of investment financed though Union funds, nationally-financed public investment moderately increased in 2016 by around EUR 1.1 billion, pointing to no substitution between co-financed and nationally-financed investment in line with the commonly agreed position.

[26] That temporary deviation for 2016 was granted in two steps: 0.4% of GDP under the structural reform clause in spring 2015 and a further 0.35% of GDP, of which additional 0.1% of GDP under the structural reform clause and 0.25% of GDP under the investment clause in spring 2016, conditional however on: (i) the existence of credible plans for the resumption of the adjustment path towards the MTO as of 2017; (ii) the effective use of a deviation from the adjustment path for the purpose of increasing investments; and (iii) progress with the structural reform agenda, taking into account the Council recommendations.

II.2.2 Latvia

A. Application for flexibility

Latvia applied for flexibility in 2016 for a major structural reform in the health sector. The first application was made in the 2015 Stability Programme but was rejected because the eligibility criterion of the minimum benchmark was not met based on the Commission forecast. The second application in the 2016 Stability Programme for a temporary deviation of 0.5 % of GDP in 2017 met the eligibility criteria. The carry forward effect[27] of the temporary deviations granted in 2015 and 2016 under the pension reform clause and the respect of the minimum benchmark of 1.7% of GDP constrains the allowed deviation under the structural reform clause to 0.1% of GDP in 2017 0.4% of GDP in 2018 and the full 0.5% of GDP in 2019.

B. Information provided by Member State

The use of structural reform clause for the healthcare sector was based on ongoing implementation of Latvia's Health Strategy for 2014-2020. One of the key objectives of the strategy is to increase public financing for the health sector by around 1% of GDP by 2020, exceeding the amount of flexibility requested under the reform clause. Specific measures under the reform clause are detailed and implemented as part of the annual budgetary process.

The reform was independently evaluated by the University of Latvia. The reform is estimated to reduce the large number of premature deaths due to health problems, thus increasing working-age population and employment. The full implementation of the reform would increase employment by 0.6% and the GDP level by 2.2% by 2023. It in turn will have a positive impact on the sustainability of public finances in the long run.

C. Assessment of fulfilment of conditions

With respect to the structural reform in the health sector, the Commission assessed the estimated positive impact on growth and the long-term sustainability of public finances as plausible at the time of granting the clause. That assessment was based on the information provided in the 2016 stability programme and the evaluation by the University of Latvia.

Implementation of the structural reform clause has been monitored by the Commission services based on the information provided in the Stability Programmes of Latvia. For 2017, the 2017 Stability Programme of Latvia presented a package of three measures totalling 0.1% of GDP: (i) early diagnosis and treatment of oncological patients, (ii) improved access to specialists, examinations, day care, rehabilitation and (iii) improved access to medicine for hepatitis C virus patients. Ex ante assessment of those measures confirmed an estimated positive effect on GDP and public finances in the long run as plausible. The implementation broadly followed the announced plans. For 2018, the measures launched in 2017 are continued and expanded. The 2018 Stability Programme reconfirmed a positive effect of the reform measures on economic growth, employment and public finances in the long run, which the Commission has assessed as plausible.

[27] In line with the commonly agreed position, the temporary deviations under all clauses are applied in such a way as to ensure that a Member State benefiting from the clause experiences the same increase in its debt level as a result of the deviation, regardless of its distance from the MTO. See also Box 3.

II.2.3 Lithuania

A. Application for flexibility

In April 2016, Lithuania requested flexibility for a structural reform (The New Social Model), but the clause was not granted as the reform package had yet to be adopted. In October 2016, Lithuania's caretaker government submitted the (no policy change) 2017 Draft Budgetary Plan containing a request for flexibility in 2017 due to the same structural reform. The amount requested was 0.6% of GDP. It was reduced to 0.5% of GDP in the updated 2017 DBP. The request for flexibility was confirmed in the 2017 Stability Programme.

B. Information provided by Member State

The structural reform package known as 'The New Social Model' aimed at introducing more flexibility in labour relations and a new pension adjustment mechanism. According to the information provided in the updated 2017 DBP, the cost of the reform amounted to EUR 220 million (or 0.5% of GDP). In the medium term, according to an independent group of scientists and experts, that reform should result in 10% higher employment, while pension-related changes should reduce expenditures by 0.8%.

C. Assessment of fulfilment of conditions

The Commission assessed the estimated positive impact of the reform as plausible at the time of granting the clause. The assessment of the 'The New Social Model' structural reform package was performed during the evaluation of the 2017 Stability Programme. By then all the necessary legal acts were adopted, and their provisions came into force in 2017. Lithuania was granted a temporary deviation of 0.4% of GDP for 2017 taking into account the country's MTO, the minimum benchmark and previously granted flexibility under the pension clause.

In 2017 under the New Social Model labour relations were made more flexible, i.e. the new types of contracts were introduced and periods of notice became shorter, while severance allowances for dismissed employees were lowered. On the other hand, the rules for receiving unemployment benefits were adjusted and more persons became eligible to receive such type of financial support and also for a longer period.

Following the amended legislation on the State social insurance pensions, the new pension indexation mechanism was applied for the first time in 2018. As that mechanism links pensions to the wage bill growth, Lithuania’s long-term fiscal sustainability seems to have improved. The 2018 Country Report acknowledged the progress made in that respect, but also pointed out the remaining risks due to uncertainties surrounding the adequacy of pensions.

II.2.4 Finland

A. Application for flexibility

Finland requested flexibility for 2017 on the basis of structural reforms and investment in October 2016 in its 2017 Draft Budgetary Plan. In its application, Finland requested a temporary deviation from the MTO or the adjustment path towards it of 0.5% of GDP under the structural reform clause and of 0.1% of GDP under the investment clause.

B. Information provided by Member State

Structural reform clause

In its 2017 DBP, two major reforms were presented: a pension reform that was implemented as from 2017 and the Competitiveness Pact, a labour market agreement, which came into force in January 2017. The main feature of the pension reform[28] was that the lowest old-age retirement age of the earnings-related pension system would be increased gradually by two years. At the time of submission of the request, the Research Institute of the Finnish Economy estimated the positive impact of the reform on the sustainability of public debt at 1.1 pps of GDP.

The Competitiveness Pact aimed at improving Finland's cost-competitiveness vis-à-vis competitor countries. The pact included a 12-month wage freeze, an increase in annual working time without extra compensation, and a reduction and partial shift of social security contributions from employers towards employees. As a result of the measures of the Pact, Finland's unit labour costs were expected to decrease by 2020 by about 4%. The government decided to lower personal income taxation to compensate employees for the increase in contributions. Therefore, as a short-run cost, general government revenue was projected to decline by 0.55% of GDP in 2017.

Investment Clause

According to the Finnish authorities, Finland's financing contribution in 2017 grant authorisations to Structural Funds, external border cooperation and other cohesion policy programmes totalled EUR 175 million (0.1% of GDP).

C. Assessment of fulfilment of conditions

Structural reform clause

The Commission assessed the estimated positive impact on growth and the long-term sustainability of public finances as plausible at the time of granting the clause. The pension reform was already adopted by the Parliament at the time of submission of the request for the clause. An ex post assessment points to the same direction as ex ante expectations: taking into account the pension reform, the estimates for long-run sustainability of public finances have improved by1.1pps of GDP.

In addition, the Competitiveness Pact was implemented in 2017. The 2018 Country Report acknowledged a positive trend in Finland's cost competitiveness since 2014. That trend was further strengthened by the Competitiveness Pact. The preliminary economic outcomes are also rather close to the ex ante expectations. Specifically, as a result of the Pact and on the basis of preliminary outturn data, Finland's unit labour costs decreased in 2017 by 3.0%. In addition, exports increased significantly so that Finland gained export market share and employment expanded by 1.1%. As for the short-run cost, direct taxes paid by households fell by about 5% (or 0.2% of GDP) and contributions to social security declined by 2.2% (0.3% of GDP) despite a 2.8% increase in the wage bill. The amount of flexibility granted ex ante and ex post amounts to 0.5% of GDP.

Investment Clause

As with the structural reform clause, ex ante the criteria for eligibility (a negative output gap larger than -1.5% of potential GDP, the respect of the minimum benchmark (-1.1% of GDP) with the use of constrained judgement[29], increasing public investment) were met. Therefore, in spring 2017, Finland was granted a temporary deviation of 0.1% of GDP under the investment clause. However, in spring 2018, outturn data for 2017 showed a decline in public

[28] It should be noted that that pension reform was part of the structural reform clause. In fact, to be eligible for the pension reform clause, a reform should qualify as a systemic pension reform according to Eurostat.

[29] See footnote 22.

investment in 2017 compared to the previous year, while investment linked to Union funds is estimated to have remained stable.

Box 3 – Finland: a specific case illustrating the potentially complex interplay of the clauses for the purpose of determining the required fiscal adjustment

This box includes an example on how the interplay of the clauses works in practice when determining the requirements (e.g. updating Finland's fiscal requirements for 2017 and determining those for 2018 in the spring of 2017). It highlights how technical it can be to determine the requirements, mainly because of the carry forward effects of previously granted flexibility.

When applying flexibility, equal treatment of Member States irrespective of their distance to the MTO has to be ensured. In line with the commonly agreed position, the temporary deviations under all clauses are applied in such a way as to ensure that a Member State benefiting from the clause experiences the same increase in its debt level as a result of the deviation, regardless of its distance from the MTO. Concretely, a Member State that is at its MTO is allowed to depart from it for three years and therefore the flexibility granted in a given year is carried forward for the next two years. For Member States not yet at the MTO but likely to reach it before the end of the period during which they have the clause, the matrix-based adjustment path is delayed by one year. Specifically, they are required to adjust towards their MTO until they reach a distance from the MTO that is equal to the allowed temporary deviation[30].

When Finland was granted flexibility under the structural reform and investment clauses, it was already benefiting from flexibility under the unusual event clause. As a case study, Finland was granted temporary deviations in 2017 of 0.5% of GDP for major structural reforms and 0.1% of GDP for Union co-financed investments (see Section II.2.X). Finland had also been granted a temporary deviation related to the exceptional inflow of refugees of 0.05% of GDP in 2015 and 0.17% of GDP in 2016. In its 2017 Stability Programme, Finland also reported an expected decrease by 0.15% of GDP of the budgetary impact stemming from the exceptional inflow of refugees in 2017.

In spring 2017, when the structural reform and investment clauses were formally granted, the fiscal requirement for 2017 was updated accordingly. The following steps were followed:

i. Finland's initial fiscal requirement for 2017 corresponded to a structural effort of 0.36% of GDP[31]. In fact, Finland had an initial structural balance position in 2016 of -0.86% of GDP and a MTO of -0.5% of GDP on the basis of the Commission 2017 spring forecast
ii. Adjusting this requirement for the flexibility granted for 2017 (0.6% of GDP) resulted in an allowed deterioration of the structural balance by 0.24% of GDP (0.36% - 0.6%).
iii. However, in 2017, Finland was allowed to depart from its MTO taking into account

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[30] Algebraically, the adjustment path towards the MTO in year t+1 for a Member State benefitting from the structural reform/investment clause and/or the unusual event clause will be:

SBt+1 – SBt = min[adj_matrixt+1 – deviation increment t+1 , {(MTO – deviation level t+1) – SBt }]

In fact, the Member State would halt the adjustment if, while being entitled to the deviation, the distance between its structural balance and the MTO corresponds to the cumulated allowed deviation (i.e. its MTO minus the cumulated temporary deviation). See also Annex 13 of the Vade mecum on the SGP – 2018 edition.

[31] Applying the freezing principles in Spring 2017, the requirement corresponded to the distance of the structural balance to the MTO, being this lower than the pure matrix-based adjustment (0.6% of GDP). This is to avoid that the matrix-based adjustment leads to an overachievement of the MTO.

not only the newly granted flexibility of 0.6% of GDP but also the carry-over of the temporary deviations under the unusual event clause[32] granted in 2015 and 2016 (0.22% of GDP). Considering also the latter, the fiscal requirement for Finland corresponded to an allowed deterioration of the structural balance by 0.46% of GDP (-0.5% - 0.6% - 0.22% - 0.86%).

iv. If the expected decrease by 0.15% of GDP in the costs related to the exceptional inflow of refugees were also to be considered, the allowed deterioration would have to be reduced by that amount, to 0.31% of GDP.

It is worth noting two further aspects. Firstly, the complexity in determining the requirement for 2017 arises from the interplay of the flexibility granted for 2017 under the structural reform and investment clauses with the carry-over of the flexibility granted in the previous years under the unusual event clause. Secondly, since Finland's initial structural balance position was -0.86% of GDP, the temporary deviation for 2017 (-0.46% of GDP) allows Finland to deteriorate to a structural balance position (-1.32%) below its minimum benchmark (-1.1%).[33]

Such complexity also applied for the 2018 requirement for Finland. On the basis of the Commission 2017 spring forecast, the Commission also set as the fiscal requirement for 2018 a structural effort of 0.1% of GDP. When setting that requirement, the following steps were followed:

i. The structural balance in 2017 (i.e. -1.34% of GDP) was estimated well below the MTO (-0.5% of GDP). Finland being in normal economic times, the matrix-based requirement would have therefore led to a structural effort of 0.6% of GDP.

ii. However, in 2018, Finland was allowed to depart from its MTO (-0.5% of GDP) taking into account the temporary deviations carried forward on the basis of the unusual event clause granted in 2016 (0.17% of GDP), the structural reform clause and the investment clause (0.6% of GDP). Considering all that and Finland's initial structural balance position (-1.34% of GDP), the fiscal requirement for Finland was set at 0.07% of GDP (- 0.5% - 0.6% - 0.17% - 1.34%).

iii. If the expected decrease by 0.15% of GDP in the costs related to the exceptional inflow of refugees in 2017 were also to be considered and carried over, the required effort would have to be increased by that amount, to 0.22% of GDP.

II.2.5 Romania as a case of rejection of application for flexibility

In April 2015, at the time of the submission of the 2015 Convergence Programme, Romania applied for the use of the structural reform clause in 2016. Romania applied for a temporary deviation of 0.5% of GDP under the structural reform clause. The structural reforms included in the 2015 Convergence Programme pertained to research and development, the health care sector and social inclusion. The Convergence Programme stated that detailed documentation would be submitted by June. Hence, it was not possible to provide an assessment of the reforms and their impact on public finances. The Commission concluded that Romania was also not eligible for use of the structural reform clause given that the structural deficit for

[32] The carry-over of deviations due to unusual events results solely from a consistent application of the approach agreed for the structural reform and investment clauses also to the unusual event clause.

[33] This is possible because the minimum benchmark is respected after applying the "constrained judgement approach" to the estimates of the output gaps (see footnote 22). In addition, the temporary deviation related to the unusual event clause is not subject to such condition.

2016, as forecast in the Commission's 2015 spring forecast, significantly exceeded the minimum benchmark (i.e. 3.4% versus 1.8% of GDP).

II.3 Summarising the findings on the structural reform and investment clause

There are common eligibility criteria across the structural reform and investment clause, as well as a number of specific requirements for each clause. The eligibility criteria were designed to safeguard fiscal sustainability while supporting and encouraging both structural reforms and government investment. A comprehensive overview of those eligibility criteria confirms that most of them are common between the two clauses. That commonality is also explained by the fact that the investment clause is, in legal terms, a specification of the structural reform clause. Some specific eligibility criteria were added for each clause, which was justified by their particular nature.

Regarding the common criteria, the respect of the minimum benchmark has proved to be a more demanding criterion than the maximum allowable distance from the MTO. Indeed, over 2015-2018, the respect of the minimum benchmark is less frequently met than the maximum distance of 1.5% of GDP from the MTO. This is in part explained by the fact that the annual update has tightened the minimum benchmarks over the years, as a consequence of the calculation methodology.

Over 2015-2018, the specific eligibility criterion for the investment clause requiring a Member State to be in bad economic times has become increasingly difficult to meet. A greater number of Member States could have applied for the structural reform clause than for the investment clause[34]. This is notably due to the specific eligibility criterion applying to the investment clause, which requires being in bad economic times (i.e. negative real GDP growth or negative output gap below 1.5%). As economic conditions improve (with many countries closing their output gaps), this criterion has prevented most Member States from requesting the investment clause. By 2018 only Greece still appears to be in bad times. Examining the implications of the continuation of the investment clause, the review concludes that, on the basis on the Spring 2018 Commission forecast, all Member States (excluding Greece) will remain in normal or good economic times in 2018 and 2019, with an output gap much higher than -1.5%, and will, therefore, be ineligible to the investment clause.

Few eligible Member States have actually applied for use of the structural reform or the investment clause. Two Member States have applied for use of both clauses at the same time. Out of 18 countries that could have potentially applied for use of the structural reform clause in at least one of the years assessed (2015-2018), only four eventually applied for use of and benefitted from the clause. Regarding the investment clause, only Italy benefitted from the investment clause on top of the structural reform clause in 2016.

For the four Member States that were granted flexibility, the objectives of the clauses, namely strengthening the link between investment, structural reforms and fiscal responsibility, have been reached to some extent. Regarding the structural reform clause, while some structural reforms have been fully implemented in the Member States that were granted the clause, others are still under implementation. Regarding the investment clause, the review confirms that the projects eligible for the investment clause were co-funded by the Union. The analysis is more mixed as to whether the investment clause led to new

[34] This is based on the subsets of eligibility criteria that can be assessed. In addition, cases where those eligibility criteria could be met as a result of the constrained judgement approach were not considered.

investments. While acknowledging that total public investment may be highly dependent on the implementation of Union funding, the public investment financed nationally increased only in the case of Italy while it remained stable in Finland. In addition, public investment did not increase by the same amount as the temporary budgetary deviation allowed by the clause, which suggests that the flexibility was partly used for other purposes than boosting investment. Overall, the flexibility to foster structural reforms and public investment appears to have been economically justified, when looking at the Member States that benefitted from it. Nevertheless, the positive impact of the reforms/investment on sustainability is meant to unfold over time and is only partially captured by this review, which covers only few years.