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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

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

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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"[1]. It provided new guidance on how to apply the existing rules of the Stability and Growth Pact (the "Pact") to strengthen the link between the key priority of the three-pronged economic strategy of the new Commission, namely investment, structural reforms and fiscal responsibility in support of jobs and growth as well as to take better account of changes in the economic situation. The new clarifications by the Commission were extensively discussed with Member States. It resulted in the publication of a common position agreed by the Economic and Financial Committee (EFC), which was endorsed by the ECOFIN Council on 12 February 2016.

Sections 2.2 and 5 of the commonly agreed position on flexibility request the Commission to review the effectiveness of the new clarifications by the end of June 2018. In particular, the review should address two key elements, namely the effectiveness of the modulation of the fiscal effort over the economic cycle as well as the application of the flexibility for structural reforms and investment. A technical annex presents the calculations and necessary details underlying the findings of this review.

1. Recalling the main elements of flexibility under the Stability and Growth Pact

The Communication of January 2015 was adopted at a time when Europe was starting to emerge from the economic recession started in 2008 but was still facing a weak and fragile recovery, with major differences across countries. In particular, unemployment remained persistently high, private and public investment was weak and a number of Member States faced high debt levels as a legacy of the crisis. Inflation remained subdued and well below the target of the European Central Bank.

Against that backdrop, the Commission Communication and the commonly agreed position provided operational guidance on how to apply the existing rules in a responsible, differentiated and growth-friendly manner.

The clarifications concern only the preventive arm of the Pact, whose aim is to guarantee a sound budgetary position in all Member States over the medium run. This fundamental principle of fiscal responsibility was upheld and reasserted by the Commission. At the same time, the Commission allowed the budgetary adjustment requirement recommended to Member States to vary according to i) the fluctuations in the economic environment and ii) the need to promote structural reforms and public investment.

The modulation of budgetary adjustment over the economic cycle was addressed by the so-called "matrix of requirements" (hereafter, simply "matrix). This means that larger fiscal efforts are required for Member States in economic good times and/or with high levels of public debt, while smaller fiscal efforts is required for Member States in economic bad times and/or with low levels of public debt (see Box).

A temporary and limited relaxation of the required fiscal adjustment was identified to support structural reforms and investment. The Pact allows a Member State to depart from its sound

[1] COM(2015)12 final

budgetary position (or the convergence path toward it) to accommodate the short-term costs associated with implementing structural reforms that will bear a long-term pay-off. [2] This corresponds to the so-called "structural reform clause". The fiscal trajectory of a Member State could also cater for significant public investment carried out at national level but co-financed by the Union. This corresponds to the so-called "investment clause". Safeguards for both clauses have been put in place to balance flexibility with the need to preserve fiscal prudence. The Box provides additional information on the functioning of the two clauses.

Box: the main elements of the Communication of January 2015

The 13 January 2015 Communication consists of two main components. It gives orientation for the application of the flexibility in the preventive arm of the Stability and Growth Pact (i) to take into account cyclical fluctuations of the economy, and (ii) to allow for room for the implementation of structural reforms and investment.

Cyclical modulation of required budgetary adjustments

The size of the annual required fiscal adjustment is provided by the so-called "matrix of requirements". The matrix gives a detailed breakdown of the required annual adjustment taking into account the economic cycle, the debt level and sustainability needs of each Member State, and the direction into which the economy is moving.

The economic cycle is mainly captured by the output gap, i.e. the difference between actual output and estimated potential output. The larger the positive (negative) output gap, the greater (lower) the required adjustment effort. Unfavourable overall fiscal positions require a faster fiscal adjustment, specifically in case of fiscal sustainability being at risk or the debt-to-GDP ratio above the 60% of GDP reference value of the Treaty.

Flexibility to promote structural reform and investment

The preventive arm of the Pact provides the necessary flexibility within the rules without compromising fiscal responsibility. With regard to structural reforms and investment, it takes the form of a fiscal allowance (technically, a temporary deviation from the Medium-Term Objective or the path towards it) corresponding to their short-term budgetary impact.

Both structural reforms and investment should have positive budgetary effects in the long term and raise potential growth. Structural reforms must be major and fully implemented. Investment needs to be to a large extent co-funded by the Union, but only the nationally financed part is taken into account.

Both clauses concerning structural reforms and investment are subject to safeguards to preserve fiscal prudence. For instance, they can be applied only once per period of adjustment towards a sound budgetary position. The use of the clauses should not lead to a breach of the 3% of GDP deficit threshold and a safety margin in relation to that threshold should be preserved. Only Member States in bad economic times can apply for investment clause. Furthermore, total public investment should not decrease.

2. The main findings of the review

In line with the mandate given to the Commission, the review answers two main questions. The first one is if the matrix specifying the annual fiscal adjustment has been effective in modulating the required fiscal adjustment over the economic cycle. The second question is whether further flexibility effectively allows for more structural reforms and investment. The key findings of the review (see the Annex for the full analysis) can be summarised as follows.

The cyclical modulation of required budgetary adjustments has been effective. The matrix has been the base for setting and quantifying the budgetary adjustment requirements in the Country-Specific Recommendations proposed by the Commission in the context of the

[2] Article 5(1) and Article 9(1) of EC Regulation (EC) No 1466/97

European Semester since 2015. The design of the matrix promotes a real modulation of the required fiscal effort according to the economic cycle and the level of public debt in Member States. That modulation does not reduce the standard pace of the necessary fiscal adjustment. It therefore supports the achievement of a sound budgetary position over the medium-term and promotes debt reduction at satisfactory pace.

Four Member States have applied to make use of the structural reforms and/or investment clauses since 2015: Italy, Latvia, Lithuania and Finland for structural reform; Italy and Finland for investment. Nearly half of the Member States would have been eligible to apply to make use of the structural reform clause but most did not request to do so. The condition that a Member State must be experiencing bad economic times to benefit from the investment clause limited its use significantly. The need to respect the safety margin vis-à-vis the 3% deficit ceiling for three years has also proven constraining for some Member States.

The positive impact of the reforms and investment on fiscal sustainability unfolds over a longer time span than that covered by this review. It should also be noted that the impact on public investment volumes is complex to assess with precision.

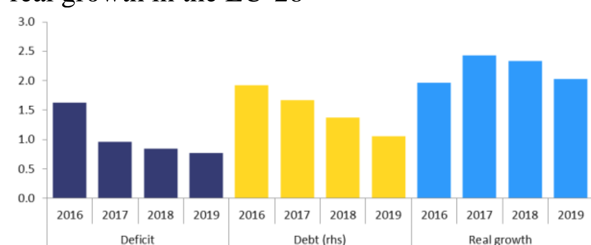
3. Conclusion: the new approach worked and delivered

Overall, the review shows that the key objectives of the Commission Communication and the commonly agreed position on flexibility have been met to a large extent. They provide a predictable and transparent framework that allowed the Commission to apply the existing rules of the Pact in a country-specific and balanced manner. The first annual report[3] issued by the European Fiscal Board also pointed to a balanced implementation of the Pact.

The flexibility allowed under the Pact allowed a good balance to be struck between the objective of ensuring prudent fiscal policy and stabilising the economy. The European Commission spring forecast 2018 shows that public debt and deficits declined, while economic activity has picked up since 2016 (Fig. 1 and 2).

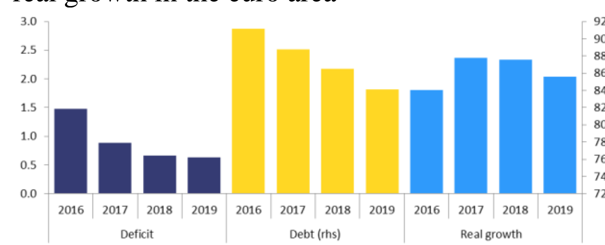
For the future, the cyclical modulation encourages Member States to increase their fiscal effort in good times to make our economies more resilient. With the economic expansion in Europe in its fifth year, the time is ripe to build up fiscal buffers, which would allow automatic stabilisers to fully play their role in the next downturn and mitigate the employment and social impacts. This is urgent, since improvements in the fiscal situations of many Member States have recently been largely driven by the positive business cycle and since public debt levels are still close to their historical peaks in several Member States.

Figure 1: Developments in public finances and real growth in the EU-28



Source: European Commission spring 2018 forecast.

Figure 2: Developments in public finances and real growth in the euro area



Source: European Commission spring 2018 forecast.

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