

Part II

Recent developments in fiscal surveillance

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Contributors: S. Ciobanu (Box II.1.1), A. Mangov (Chapters II.1 and II.2), M. McGann (Chapter II.3), K. McMorrow (Box II.3.1), R. Torre (Chapter II.3).

KEY FINDINGS

The structural balance has a prominent role in defining and assessing compliance with Member States' obligations under the Stability and Growth Pact. However, it contains several features that can raise operational challenges for fiscal policymaking and surveillance. This part describes the two initiatives taken to make surveillance evolve to overcome this difficulty in the present context.

The agreement in the Economic and Financial Committee

- The Commission, together with the Economic and Financial Committee of the Council, has made efforts to increase transparency and predictability in the implementation of the Pact and to reduce complexity within the existing legal framework.
- In this context, a larger role has been given to the expenditure benchmark when setting and assessing fiscal policies under the Pact. The expenditure benchmark sets an upper limit to the rate at which government expenditure can grow in a single year and can therefore be seen as an expenditure ceiling. Governments can spend more than the ceiling provided that they raise the corresponding additional revenues.
- The expenditure benchmark provides, as a rule, a predictable and stable benchmark, as it is relatively easy to measure and focuses more upon those policy levers that are controlled by government.

"Constrained judgement"

- The second initiative focuses upon the estimates of the output gap, which are an essential input to the computation of the structural balance. They are calculated using a methodology decided collectively in the Economic and Financial Committee.
- The Commission may now –under limited and specific circumstances agreed by Member States– depart from the output gap estimates of the commonly agreed methodology in its assessment of the cyclical position of the Member State concerned when conducting its fiscal assessments. That process is referred to as the application of "constrained judgement".
- When the "plausibility tool" indicated an uncertainty surrounding the estimated output gaps, the Commission decided to take this element into account as part of its wider assessment of the cyclical situation of Member States with large fiscal requirements for 2018 and at risk of significant deviation from those requirements. This practice is part of the decision by the Commission to apply its degree of discretion when assessing a departure from the required adjustment for 2018.

1. INTRODUCTION

The Stability and Growth Pact (SGP) has undergone a number of reforms over the last decade, aiming at strengthening its economic underpinning and its adaptability to changing economic conditions. The reforms have allowed for a better understanding and monitoring of Member States' fiscal policy actions. By doing so, they have also addressed a number of shortcomings of the structural balance, a key indicator for fiscal surveillance that may be, and frequently is, affected by non-policy effects. In particular, the reforms have put greater emphasis on aggregate expenditure developments and revenue-increasing (or -decreasing) measures, that is, on what the government can control more directly.

However, there has been a growing perception that the fiscal rules have become too complex and that they face a range of implementation difficulties in relation to the measurement and robustness of key surveillance indicators. Currently, two different sets of budgetary indicators are used to assess compliance with each of the two arms of the SGP. That practice has come as a result of discussion with Member States over the years, to have complementary signals and to improve the measurement of the fiscal effort carried out by the government ("input-based approach"). The multiplicity of indicators has, however, increased the complexity of the framework. This complexity has in turn led to questions about equal treatment over time and across Member States and predictability of policymaking.

Against that background, the Commission has explored ways within the existing legal framework to increase the transparency and predictability of the application of the SGP rules and reduce complexity. The Commission Communication of 21 October 2015 on "Steps towards Completing Economic and Monetary Union" ⁽²⁵⁾ identified a number of pathways towards improving the transparency and predictability of policy-making and reducing complexity. The approach retained by the Communication has been to discuss with the Council the possible concrete adjustments to be brought to the framework, on the basis of technical contributions by Commission staff.

⁽²⁵⁾ European Commission (2015).

As a result of the subsequent discussion in the Economic and Financial Committee (EFC), it has been agreed to introduce a greater focus on the expenditure benchmark and reduce the number of technical indicators used to check compliance with the rules of the SGP. That agreement essentially consists in introducing the preventive arm's expenditure benchmark into the corrective arm of the SGP, in place of the indicators used until now. At the same time, it clarifies the working of the preventive arm in certain aspects. In parallel, the Commission has enhanced transparency, for instance, through an annual update of its Vade mecum on the SGP, the production of detailed country reports and sharing the data and calculations underlying surveillance decisions with the Member States. ⁽²⁶⁾

The Commission, together with the Member States, has also looked into the difficult issue of output gaps and introduced the "constrained judgement" approach. In particular, following repeated requests that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap, two concrete steps were agreed by the EFC in October 2016. First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment would be introduced in the commonly agreed methodology. That change was implemented in the Commission 2016 autumn forecast. Second, it was agreed that a new "plausibility tool" could be used to signal cases where the results of the agreed methodology could be interpreted as being subject to a large degree of uncertainty. Specifically, the EFC approved the use of the "plausibility tool" within the autumn 2016 surveillance exercise as part of a wider approach to considering estimates of the output gap within the fiscal framework. That wider approach has been described as the exercise of "constrained judgement".

Chapter II.2 covers the EFC agreement on the compliance indicators used in the SGP framework and is structured as follows. Section II.2.1. describes the rationale behind the

⁽²⁶⁾ European Commission (2017).

Box II.1.1: The Commission proposal for incorporating into EU law the substance of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) was signed in March 2012 by 25 Contracting Parties (all the current Member States, except the Czech Republic, Croatia and the United Kingdom) and entered into force on 1 January 2013. The cornerstone of the TSCG is its Title III, which sets out the so-called "Fiscal Compact". Its main provision is the obligation to enshrine in binding and permanent national provisions, preferably constitutional, a balanced-budget rule in cyclically-adjusted terms. The rule mirrors the requirement that is at the centre of the preventive arm of the SGP, namely the medium-term budgetary objective. The Fiscal Compact binds 22 Contracting Parties (all euro area Member States and, on a voluntary basis, Bulgaria, Denmark and Romania). As the intergovernmental approach used to adopt the TSCG was understood from the outset as a way to take necessary steps at the height of the economic and financial crisis, the Contracting Parties enshrined in the TSCG the agreement to seek integration of its substance into Union law at most within five years of the date of its entry into force, i.e. by 1 January 2018.

Accordingly, the EMU deepening package put forward by the Commission on 6 December 2017 includes a proposal for a "Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States" ⁽¹⁾. The legal basis of the proposal is the second paragraph of Article 126(14) of the TFEU.

The proposed directive seeks to achieve, along with the existing provisions of the SGP, the underlying objective of the Fiscal Compact, namely convergence to prudent levels of public debt. Indeed, the high levels of public debt still observable today will take time to be absorbed. Further progress therefore remains imperative and requires annual budgetary decisions to follow a steady orientation towards achieving and maintaining medium-term budgetary objectives.

There is a strong rationale for bringing the essence of the Fiscal Compact into the body of the EU fiscal framework. It would ensure more effective and systematic monitoring of implementation and enforcement of fiscal rules at both EU and national level as part of the overall EU economic governance framework, compared to the current intergovernmental set-up. It diminishes the possible risks of duplications and conflicting actions inherent in the co-existence of intergovernmental arrangements alongside the mechanisms foreseen by EU law. A consolidated framework governed by EU law would also facilitate a consistent and coordinated evolution of the EU and national fiscal rules within the wider process of EMU deepening. Above all, as argued in the Five Presidents' Report on Completing Europe's Economic and Monetary Union, the integration into the Union legal framework of all inter-governmental instruments created during the crisis would bring greater democratic accountability and legitimacy across the Union.

Specifically, the legislative proposal lays down an obligation to have in place a national framework of permanent and binding fiscal rules which, while being consistent with the rules of the SGP, increases the national ownership of a sound fiscal policy. That framework must ensure the convergence of public debt-to-GDP ratio towards the 60% Treaty reference value by establishing an anchoring medium-term objective in terms of structural balance and by setting for the whole term of a Member State's legislature a path for expenditure net of discretionary revenue measures that is consistent with that objective or the adjustment path towards it and is binding on annual budgets throughout the period. A correction mechanism must also be automatically triggered in the event of significant observed deviations with a view to compensating deviations from that expenditure path. The proposal brings about a strengthening of the role and independence of national fiscal councils, which should assess ex-ante and ex-post the adequacy of the medium-term objective and the expenditure path and call for the activation of the correction mechanism in case of significant deviations. Not least, the directive gives a legal basis to the principle of "comply-or-justify" in order to boost the reputational costs of non-compliance with the national fiscal rules.

⁽¹⁾ https://ec.europa.eu/info/publications/economy-finance/completing-europes-economic-and-monetary-union-policy-package_en

(Continued on the next page)

Box (continued)

As the EMU and its completion must remain open to all Member States, the proposed directive should apply to both the euro area countries and other Member States wishing to be bound by it. According to the proposal, Member States would have until 30 June 2019 to bring into force the national provisions necessary to comply with it.

EFC agreement. Section II.2.2. recalls the logic behind, and the precise definition of, the expenditure benchmark. Section II.2.3. describes how the expenditure benchmark will be used in the corrective arm of the SGP. Section II.2.4. lists the clarifications brought by the EFC agreement as to the working of the preventive arm.

Chapter II.3 covers the "constrained judgement" approach in relation to the estimation of output gaps and is structured as follows. Section II.3.1. provides an overview of the "plausibility tool", including a detailed box on the underlying statistical methodology. Section II.3.2 explains in greater detail how the "constrained judgement" approach can be derived from the "plausibility tool". Section II.3.3 explains how "constrained judgement" affects the assessments of compliance within the fiscal framework. Finally, the fiscal surveillance implications of the application of "constrained judgement" in the autumn of 2016, the spring and the autumn of the 2017 are set out in Section II.3.4. Reference is also made to how the uncertainty surrounding the estimated output gaps, as indicated by the results of the "plausibility tool", was factored in when assessing a departure from the fiscal adjustment for 2018.

On 6 December 2017, the Commission made a proposal to integrate the substance of the Treaty on Stability, Coordination and Governance into the Union legal framework. The proposal takes into account the appropriate flexibility built into the Stability and Growth Pact. Box II.1.1 provides an overview of that proposal.

2. THE RECENT AGREEMENT OF THE ECONOMIC AND FINANCIAL COMMITTEE ON A GREATER FOCUS ON THE EXPENDITURE BENCHMARK

2.1. THE RATIONALE BEHIND THE EFC AGREEMENT

The 2005 reform of the SGP introduced the concept of structural balance that has since gained a relevant role in defining, and assessing compliance with, Member States' obligations under the SGP. ⁽²⁷⁾ The structural balance aims to remove the effects of the economic cycle on government budget balances, through a methodology that is well known and widely used among experts. The rationale behind the 2005 reform was that Member States should be judged on whether they have delivered on their policy commitments, rather than on the basis of budgetary outcomes (typically the headline deficit) that can to a large extent be outside their control because of impact of the economic cycle. This method of judgement is also referred to as "conditional" compliance with the rules.

However, the structural balance suffers from its own weaknesses, notably in terms of measurement. Despite the strong conceptual underpinning of the structural balance approach, its implementation is not without difficulty because it must be calculated rather than observed. It can fail to capture the real fiscal efforts made by governments, essentially due to two methodological and measurement issues. ⁽²⁸⁾

Firstly, in the structural balance, economic fluctuations are measured by (changes in) the gap between real and potential output. The output gap is unobserved and is subject to frequent and often significant revisions, including on an *ex post* basis. This is not only a technical matter, it also relates to the difficulty of estimating the position in the business cycle in real time.

Secondly, the crisis has shown that the structural balance can be seriously affected by

revenue shortfalls/windfalls, in the event of large annual volatility of revenues. The structural balance is built under the assumption of a "standard" response of revenues (and unemployment benefits) to economic fluctuations. While that assumption holds in the medium and long term, revenues typically react differently in the short run. That difference in reaction may especially occur during significant downturns or upturns. In such instances, revenues tend to overreact, which leads to an overly negative or positive picture of the government's fiscal position and change thereof as measured by the structural balance.

Such overreactions raise operational challenges for fiscal policy making and surveillance. From an operational perspective, the difficulty in measuring the structural balance implies important challenges for the conduct of fiscal policy (typically in the context of the preparation and implementation of annual budgets) if based solely on that indicator. It also raises issues of assessing the delivery of the required fiscal effort in the context of surveillance procedures that can ultimately lead to financial sanctions.

Some aspects of the 2011 six-pack reform and subsequent non-legislative changes to the EU's fiscal surveillance framework have sought to mitigate the shortcomings of the structural balance approach. In the preventive arm of the SGP, the 2011 reform introduced the so-called expenditure benchmark, which essentially defines the fiscal effort required in fiscal surveillance in terms of an upper limit for the growth rate of government primary expenditure unless the excess is funded by revenue-increasing measures. ⁽²⁹⁾ In the corrective arm of the Pact, the structural balance approach has undergone a number of adjustments. In particular, revisions affecting the estimates for potential output and the response of revenues to economic developments are taken into account at the time of assessments. In addition, the

⁽²⁷⁾ The 2005 reform took the form of Council Regulations (EC) No 1055/2005 and 1056/2005 amending Council Regulations (EC) No 1466/97 and 1467/97, respectively.

⁽²⁸⁾ See also European Commission (2013), Carnot and de Castro (2015).

⁽²⁹⁾ The expenditure benchmark was introduced through Regulation (EU) No 1175/2011 of the European Parliament and of the Council amending Council Regulation (EC) No 1466/97.

structural balance approach has been complemented by a quantification of fiscal policy measures (essentially on the revenue side), which is known as the "bottom-up approach".⁽³⁰⁾

Those changes have put greater emphasis on policy levers but have also led to increased complexity. The changes introduced in the surveillance framework have put greater emphasis on aggregate expenditure developments and revenue-increasing (or -decreasing) measures, that is, on what is more directly under the control of the government. However, they have also led to a multiplicity of indicators, a complex formulation thereof and, ultimately, to increased complexity.

As a result, currently two different sets of indicators are used in assessing compliance with each of the two arms of the Pact. While conceptually related, the structural balance indicators used in the preventive and the corrective arms of the SGP are not fully consistent with each other (non-adjusted change in the structural balance in the preventive arm, adjusted change in the corrective arm). That absence of perfect consistency is also true for the expenditure benchmark and the bottom-up approach, which are arguably in most respects the closest. Assessments within each arm are subject to judgement through an overall assessment (called "careful analysis" in the corrective arm), not least when the two indicators convey different messages. While that judgement allows for a comprehensive evaluation, taking into account the relevant circumstances, there is a potential lack of certainty given the absence of a pre-determined dominant indicator.

Against that background, the Commission and the Council have agreed a common interpretation of the rules. That agreement took the form of two opinions of the EFC of 29 November 2016 which were endorsed by the Council on 6 December 2016.⁽³¹⁾⁽³²⁾ The EFC agreement essentially consists in introducing the expenditure benchmark in the corrective arm of the SGP. At the same time, it clarifies the working of the preventive arm in certain aspects.

⁽³⁰⁾ For a description of the indicators used up until then in the corrective arm of the SGP, see European Commission (2014).

⁽³¹⁾ Council of the European Union (2016a, 2016b).

⁽³²⁾ Council of the European Union (2016c).

2.2. DEFINITION AND RATIONALE BEHIND THE EXPENDITURE BENCHMARK

The expenditure benchmark is essentially an expenditure ceiling for setting and assessing fiscal policies under the SGP. The expenditure benchmark sets an upper limit to the rate at which government expenditure can grow in a single year. It can therefore be seen as the maximum amount that a government can spend in a year. That maximum is benchmarked against the expected growth of the economy over a period of ten years.

Governments can spend more than the ceiling provided that they raise the corresponding additional revenues. Any excess expenditure growth over the benchmark rate can be funded by revenue-increasing fiscal policy measures. Conversely, revenue-decreasing measures should be funded by additional savings, thereby reducing the expenditure ceiling by the same amount.

The underlying principle behind the expenditure benchmark is sound. The use of such a benchmark allows for a greater focus upon those policy levers that are controlled by government while guarding against expenditure growth based on temporary revenue streams. The latter situation occurred in the pre-crisis period when windfall revenues served to fund what later turned out to be unsustainable expenditure patterns.

In particular, the expenditure benchmark provides a predictable and stable benchmark and is relatively easy to measure. Government expenditure is a policy lever mostly in the hands of government rather than a policy outcome influenced by external factors. Non-discretionary spending items, such as interest payments and cyclical unemployment expenditure, are excluded from the benchmark whereas investment expenditure, which can be highly volatile, is smoothed over a number of years. Similarly, on the revenue side the focus is on fiscal policy measures, which are less volatile than non-discretionary changes in revenues, despite suffering from some weaknesses themselves. The expenditure benchmark is also easier to measure than the structural balance as government expenditure is a national accounts concept compiled by national statistical offices. There is no reliance on the

output gap when it comes to measuring the actual or forecast growth rate of expenditure.

The expenditure benchmark can be directly used for the conduct of fiscal policy at the national level. Domestic fiscal policy decisions, and in particular annual budgets, are essentially a matter of setting expenditure ceilings and legislating revenue-increasing (or -decreasing) fiscal policy measures. By contrast, non-discretionary changes in revenues and some non-discretionary expenditure items are cyclically or market driven and are therefore largely dependent on the underlying macroeconomic assumptions. Therefore, beyond its role at the EU level, the expenditure benchmark also constitutes an operational guide for setting fiscal policies and monitoring their in-year execution at the national level.

It is also easy to communicate to stakeholders and the general public. Because expenditure caps are widely used in the preparation and consideration of national budgets throughout the EU, the expenditure benchmark is also easy to communicate to Ministers, to other stakeholders and to the public. In addition, it highlights the policy "ownership" of national governments, which exercise direct control over expenditure.

At the same time, the expenditure benchmark does not restrain governments' "size". Any excess growth over the benchmark rate can be funded by revenue-increasing fiscal policy measures, meaning that the expenditure benchmark leaves governments free to set what they think is the appropriate level of spending, as long as it is funded appropriately.

Despite those advantages, the expenditure benchmark has its own weaknesses and can face similar challenges to other budgetary indicators. Returns from discretionary revenue measures, which are a key component of the expenditure benchmark, can sometimes be subject to a large degree of uncertainty and their estimation can be largely model-dependent. That uncertainty calls for constantly improving costing methods and making them as transparent as possible. The expenditure benchmark also requires the estimation of the medium-term benchmark growth rate of the economy to set the requirements. Therefore, even though estimates of

potential growth rates are typically more stable and reliable than estimates of output gap levels, the expenditure benchmark does not fully dispense with a gauge for cyclical conditions.

2.3. IMPROVING THE ASSESSMENT OF EFFECTIVE ACTION IN THE CONTEXT OF THE EXCESSIVE DEFICIT PROCEDURE

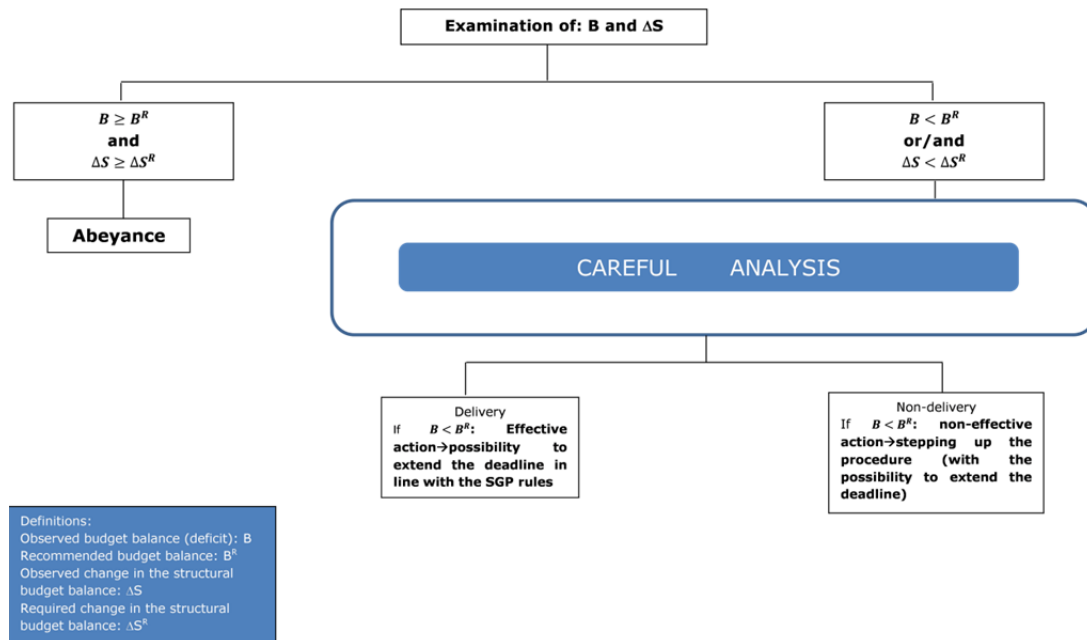
The EFC agreement makes the expenditure benchmark the cornerstone of the assessment of Member States' policy actions under the Excessive Deficit Procedure (EDP). Sub-section II.2.3.1 recalls the steps followed by the Commission when assessing compliance with EDP recommendations –the assessment of "effective action taken". The central part of that assessment is called "careful analysis". Sub-section II.2.3.2 describes how the careful analysis will be carried out in assessing compliance with any future EDP recommendations. Box II.2.1 presents an example of how it will be done in practice.

2.3.1. The sequence of steps in evaluating compliance with EDP recommendations remains unchanged

Following a Council recommendation to correct the excessive deficit, the Member State concerned has to take effective action. Where it establishes that an excessive deficit exists in a Member State, the Council issues a recommendation under Article 126(7) TFEU to the Member State concerned with a view to bringing that situation to an end within a given period. The recommendation contains annual targets both for the headline deficit and the improvement in the structural balance, which are linked by an underlying macroeconomic scenario set on the basis of the Commission forecasts. Moreover, until now a quantification of the policy response required to attain those targets, in terms of the total amount of measures to be taken, was also given.⁽³³⁾

⁽³³⁾ The same logic applies with respect to notices issued under Article 126(9) TFEU to euro area Member States which have been found by the Council not to have taken effective action to comply with an Article 126(7) recommendation or with a revised notice under Article 126(9) TFEU.

Graph II.2.1: EDP decision tree for assessing effective action



Source: Commission services.

The Commission and the Council monitor compliance with EDP recommendations on a regular basis. The Commission undertakes a first assessment, which looks at whether the Member State is on track to correct its excessive deficit, i.e. if it has taken effective action, within six months of the Council recommendation, or three months if the situation is judged to be particularly difficult. Depending on the outcome of that assessment, the procedure may be put into abeyance, if the Member State has acted in compliance with the recommendation – meaning it is put on hold until the excessive deficit is eventually corrected, as long as the Member State continues to comply with the recommendation – or alternatively stepped up, if the Member State has not complied with the recommendation. An EDP in abeyance is subject to continuous monitoring, on the basis of each of the Commission forecasts, and may be activated again if that monitoring shows the Member State not to be on course to comply with the recommendation.

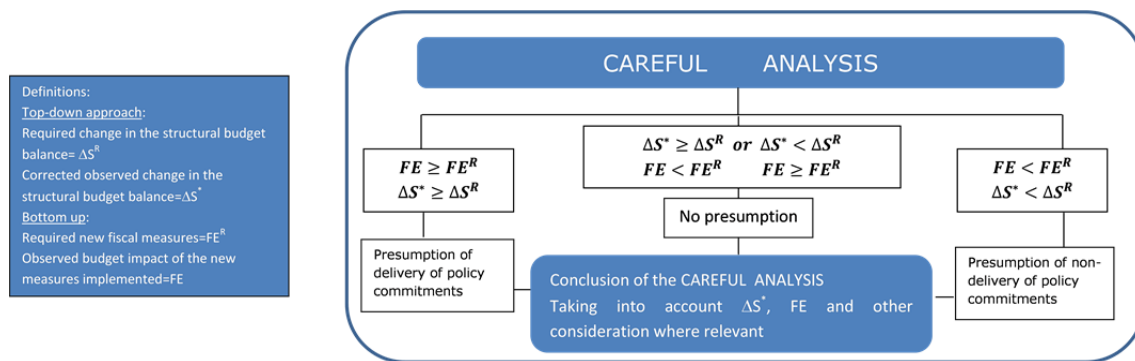
For the assessment of whether effective action has been taken, a decision tree sets out the order of logical and procedural steps (Graph II.2.1 for a schematic overview). First, the changes in the headline and structural balances are

assessed. When a Member State achieves both its headline deficit target and the recommended improvement in the structural balance, it is considered to have delivered effective action and the EDP is held in abeyance. When they are not achieved, the Commission engages in a more detailed examination, known as a careful analysis. The aim of the careful analysis is to evaluate whether the Member State concerned has delivered on the policy commitments set out in the recommendation despite the effects of the action taken not being reflected in the headline deficit or structural balance figures. If the Member State is found to have taken effective action in compliance with the recommendation and "unexpected adverse economic events with major unfavourable consequences for government finances occurred" after the adoption of that recommendation, it may be issued with a revised recommendation, including the possibility of extending the deadline for correction.⁽³⁴⁾ Failure to take effective action entails the stepping up of the procedure.⁽³⁵⁾

⁽³⁴⁾ See Article 3(5) of Council Regulation (EC) No 1467/97.

⁽³⁵⁾ For further detail see European Commission (2017).

Graph II.2.2: "Old" careful analysis



Source: Commission services.

The decision tree for assessing effective action remains unchanged after the EFC agreement.

As has been the case until now, the assessment of effective action will first look at the achievement of the headline deficit targets and the underlying improvements in the structural balance. The careful analysis remains needed if one (or both) of those targets are missed. If the Member State is found to have taken effective action, the deadline for correction may be extended, provided that "unexpected adverse economic events with major unfavourable consequences for government finances occurred". If not, the EDP is stepped up.

2.3.2. The expenditure benchmark becomes the cornerstone of the careful analysis

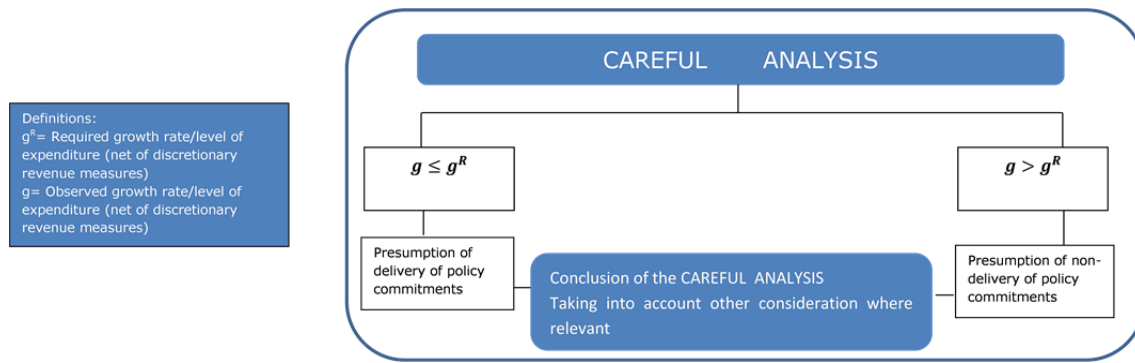
Until the EFC agreement, the careful analysis was based on two complementary fiscal indicators (Graph II.2.2). The first one is based on the structural balance, but the annual change therein is adjusted for possible forecast errors on government revenues and revisions to potential growth estimates. Those corrections are aimed at addressing the two main shortcomings of the structural balance referred to in Section II.2.1. The second indicator of compliance is known as the bottom-up approach as it aims to quantify the amounts of fiscal policy measures taken by governments.

Following the EFC agreement, the careful analysis will be centred on the expenditure benchmark, leading to a reduction in the number of compliance indicators (Graph II.2.3). For any future EDP recommendation, when the headline deficit or the underlying required

improvement in the structural balance is not met, the Commission will use the expenditure benchmark to assess the delivery of effective action. If the expenditure benchmark is met, meaning that it shows an effort equal to or above what was recommended, there is a presumption that the Member State concerned has delivered on its policy commitments. If the expenditure benchmark is not met, there is a presumption that the Member State has not delivered on its policy commitments.

For the sake of transparency and predictability, future EDP recommendations will also have to be formulated in terms of the expenditure benchmark. For each year covered by the Council recommendation, the recommendation will specify the maximum allowable growth rate of government expenditure. The expenditure benchmark will be consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. Thus, if fully complied with, the expenditure benchmark will effectively lead to a timely correction of the excessive deficit (including compliance with the forward-looking component of the debt-reduction benchmark), as long as macroeconomic developments and events that are outside government control remain in line with the so-called "EDP scenario" (that is, the set of assumptions underpinning the EDP recommendation). Therefore, the benchmark growth rate of net expenditure is computed on the basis of the EDP scenario. Concretely, the (yearly) benchmark is the limit to the annual change in government expenditure consistent with meeting

Graph II.2.3: "New" careful analysis



Source: Commission services.

the targets for the headline deficit and the change in the structural balance.

The composition of fiscal adjustment will remain a policy choice. Member States will remain free to increase expenditure by more than the benchmark rate as long as the excess growth is funded by revenue-increasing fiscal policy measures. Conversely, should revenue-decreasing policy measures be implemented, the allowable rate of growth of expenditure will have to be reduced proportionately.

The allowable growth rate of government expenditure will be formulated in nominal terms and net of one-off measures. In turn, when assessing compliance with the expenditure benchmark, both the expenditure aggregate and the amounts of discretionary revenue measures to be subtracted from that aggregate will be calculated net of one-off measures, and the growth rate of net expenditure will be expressed in nominal terms.

The careful analysis will continue to take other considerations into account where relevant. The Commission will continue to use quantitative and qualitative economic judgement in making its final assessment where relevant. Any conclusion will need to take into consideration the quantitative information from the expenditure benchmark together with other considerations – including of qualitative nature – that do not emerge from the benchmark itself. Those considerations are typically related to the reasons that have caused the non-fulfilment of the expenditure benchmark and are directly linked to fiscal developments, such as possible statistical revisions of data; unexpected

dynamics in certain expenditure items driven by unusual events outside the control of the government; unforeseen inflation developments; or a high degree of uncertainty surrounding the quantitative assessment of the revenue measures implemented by the government.

For multi-annual EDPs, compliance with the expenditure benchmark will be assessed on a cumulative basis from the start of the recommendation. The experience gained since the entry into force of the six-pack reform in 2011 has shown that focusing on the evolution of the fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with the recommendations. Therefore, since autumn 2014, the Commission has examined whether the fiscal effort over the correction period under scrutiny was delivered on a cumulative basis. In that way, a Member State cannot be unduly punished for a frontloaded effort. At the same time, it ensures that a Member State meeting its headline deficit target the first year without delivering the recommended annual fiscal effort would only be found compliant with the recommendation in the following years if it has delivered the cumulative fiscal effort over the correction period under scrutiny, in case the headline deficit falls short of the recommended one thereafter. Thus, for the purposes of assessing effective action, for Member States that do not meet the annual headline deficit target or the cumulative change in the structural balance, or neither of them, the assessment of the "cumulative" expenditure benchmark will be considered in the careful analysis.

Box II.2.1: **A numerical example of the expenditure benchmark in the corrective arm of the SGP**

This box presents an example of setting the EDP targets following an Article 126(7) recommendation or notice under Article 126(9) TFEU and assessing effective action on the basis of the expenditure benchmark.

Setting the EDP targets

The baseline, no-policy change scenario

Defining the EDP scenario – that is, the EDP targets and the underlying assumptions – always starts by looking at what would happen if no further fiscal policy measures were taken. This is known as the baseline, no-policy change scenario. The EFC agreement does not change the logic of the EDP scenario and the way it is constructed.

The baseline scenario is actually the Commission's most recent forecast available at the time of recommendation. Typically, it shows that the headline deficit breached the 3% of GDP limit in the previous year, which triggers the opening of an EDP. In some cases, the Commission's forecast horizon (which covers years T and T+1, and T+2 in the case of the autumn forecast) is extended if a longer correction period is being contemplated.

In the example shown in Table II.2.a, the headline deficit reached 4% of GDP in year T-1, based on notified data. The deficit is forecast to stay at 4% in years T and T+1, meaning that it would remain above 3% of GDP if no further measures were taken. By further measures are meant any measures that would come on top of those included in the Commission's no-policy change forecast.

Table II.2.a: **The baseline, no-policy change scenario**

	Year t-1	Year t	Year t+1
	Outturn	Forecast	
GDP growth (constant prices – in %)		1.5	1.5
GDP growth (current prices – in %)		3.5	3.5
Potential GDP growth (constant prices – in %)		1.0	1.0
Output gap (in % of potential GDP)	-3.0	-2.5	-2.0
General government balance (in % of GDP)	-4.0	-4.0	-4.0
Structural balance (in % of potential GDP)	-2.5	-2.7	-3.0
Change in structural balance (in % of potential GDP)		-0.2	-0.2

Note: Annual changes in the structural balance may not match annual levels due to rounding effects.

Source: Commission services.

The headline deficit path is also dependent on the forecast macroeconomic outlook. Here GDP is expected to grow by 1.5% in years T and T+1 in real terms and inflation to be 2% in both years.

With growth forecast above potential, the output gap is narrowing over the forecast horizon.

For the sake of simplicity, it is assumed that there are no one-off measures taken by the Member State, implying that all measures are of a permanent nature.

On this basis, and using the commonly agreed methodology for the cyclically-adjusted balance, the structural balance is estimated to deteriorate by 0.2% of potential GDP in both year T and year T+1.

(Continued on the next page)

Box (continued)

The EDP scenario

The EDP scenario is composed of headline deficit targets and required annual improvements in the structural balance which – if followed – allow bringing the headline deficit below 3% of GDP by a given deadline while ensuring that an appropriate fiscal effort is pursued.

The EDP scenario is built in an iterative way. Specifically, starting from the baseline scenario, the Commission looks at whether a one-year deadline seems reasonable in terms of the underlying fiscal effort and the impact on the macroeconomic outlook. If this seems unrealistic, for example because it would imply too high of a fiscal effort and/or because the adjustment would have too large a negative impact on GDP growth, there may be a case for a two-year deadline. And so on (for further detail on the conditions under which a longer deadline can be envisaged see European Commission (2017)).

Table II.2.b: The EDP scenario

	Year t-1	Year t	Year t+1
	Outturn	Forecast	
GDP growth (constant prices – in %)		0.8	0.7
GDP growth (current prices – in %)		2.8	2.7
Potential GDP growth (constant prices – in %)		1.0	1.0
Output gap (in % of potential GDP)	-3.0	-3.2	-3.4
General government balance (in % of GDP)	-4.0	-3.4	-2.7
Structural balance (in % of potential GDP)	-2.5	-1.8	-1.0
Change in structural balance (in % of potential GDP)		0.7	0.8

Note: Annual changes in the structural balance may not match annual levels due to rounding effects.

Source: Commission services.

In the example, the EDP scenario as shown in Table II.2.b is such that it brings the headline deficit to 3.4% of GDP in year T and 2.7%, i.e. below the 3% limit, in year T+1. The corresponding improvements in the structural balance that allow reaching these deficit targets under the projected cyclical developments are 0.7% of (potential) GDP in year T and 0.8% in year T+1.

Following the EFC agreement, the EDP targets will from now on be defined also in terms of the expenditure benchmark, that is, the maximum allowable growth rate of expenditure consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. The expenditure benchmark is net of the possible fiscal policy (discretionary) measures assumed on the revenue side in the EDP scenario. It excludes the projected amounts of interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed government gross fixed capital formation is smoothed over a 4 four-year period. Any possible one-off measures, whether on the expenditure or on the revenue side, are also excluded.

In the example as shown in Table II.2.c, in the EDP scenario total government expenditure is projected to reach 51.3 billion of national currency in year T and 52.5 billion in year T+1, from 50 billion in year T-1. The modified expenditure aggregate is 47.8 billion in year T and 49.0 billion in year T+1. The latter is then corrected for the non-one-off discretionary revenue measures assumed in the EDP scenario, which gives the expenditure benchmark (1.2% in year T, 1.4% in year T+1).

(Continued on the next page)

Box (continued)

Table II.2.c: The expenditure benchmark as per the EDP scenario

	Year t-1	Year t	Year t+1
<i>in billions of national currency</i>	Outturn	Forecast	
1 General government expenditure	50.0	51.3	52.5
2 Interest expenditure	3.0	3.0	3.0
3 Expenditure on EU programmes fully matched by EU funds revenue	0.1	0.1	0.2
4 Gross fixed capital formation t net of EU funds revenue spent in investment projects	2.8	3.0	2.9
5 Annual average gross fixed capital formation t-3 to t net of EU funds revenue spent in investment projects	2.9	2.9	2.9
6 Cyclical unemployment expenditure	0.2	0.2	0.2
7 One-off expenditure measures	0.0	0.0	0.0
8 Corrected expenditure aggregate = $(1)-(2)-(3)-((4)-(5))-(6)+(7)$	46.8	47.8	49.0
9 Non-one-off revenue measures		0.5	0.6
10 Expenditure benchmark (in %) = $[(8)_t-(9)_t]/(8)_{t-1} * 100$		1.2	1.4

Source: Commission services.

Assessing effective action

As explained in the text, a decision tree sets out the order of logical and procedural steps for the assessment of effective action under the EDP (Graph II.2.1). First, the headline balance and the change in the structural balance are assessed. When a Member State achieves both its headline deficit target and the recommended improvement in the structural balance, the Member State is considered to have acted in compliance with the recommendation and the EDP is held in abeyance – meaning it is put on hold until the excessive deficit is eventually corrected, as long as it continues to comply with the headline and structural targets. When this is not achieved, the Commission engages in a more detailed examination, known as the careful analysis, primarily based on an assessment of compliance with the expenditure benchmark.

Table II.2.d: Most recent forecast/outturn data available at the time of assessment

	Year t-1	Year t	Year t+1
	Outturn	Forecast/outturn	
GDP growth (constant prices - in %)		-0.1	-0.2
GDP growth (current prices - in %)		1.9	1.7
Potential GDP growth (constant prices - in %)		1.0	1.0
Output gap (in % of potential GDP)	-3.0	-4.0	-5.2
General government balance (in % of GDP)	-4.0	-3.7	-3.4
Structural balance (in % of potential GDP)	-2.5	-1.7	-0.8
Change in structural balance (in % of potential GDP)		0.8	0.9
Corrected expenditure aggregate net of non-one-off revenue measures (in %)		1.0	1.3

Source: Commission services.

In the example as shown in Table II.2.d, the headline deficit is above the EDP targets (3.7% of GDP in year T and 3.4% in year T+1 versus 3.4% and 2.7%, respectively). A careful analysis is therefore needed to see whether the breach is due to the macroeconomic situation turning worse

(Continued on the next page)

Box (continued)

than forecast in the EDP scenario or any other reason that is outside government control, or to the Member State not delivering on its policy commitments. In the example, the growth rates of the modified expenditure aggregate net of non-off discretionary revenue measures (1.0% in year T and 1.3% in year T+1 – see Table II.2.e for the detailed calculations) are below the recommended growth rates (1.2% and 1.4%, respectively), which means that the expenditure benchmark is met and there is a presumption that the Member State has delivered on its policy commitments.

Table II.2.e: Calculating the growth rate of expenditure at the time of assessment

	Year t-1	Year t	Year t+1
<i>in billions of national currency</i>	Outturn	Forecast/outturn	
1 General government expenditure	50.0	51.0	51.9
2 Interest expenditure	3.0	3.0	3.0
3 Expenditure on EU programmes fully matched by EU funds revenue	0.1	0.2	0.2
4 Gross fixed capital formation t net of EU funds revenue spent in investment projects	2.8	2.8	2.7
5 Annual average gross fixed capital formation t-3 to t net of EU funds revenue spent in investment projects	2.9	2.8	2.8
6 Cyclical unemployment expenditure	0.2	0.3	0.4
7 One-off expenditure measures	0.0	0.0	0.1
8 Corrected expenditure aggregate = (1)-(2)-(3)-((4)-(5))-(6)+(7)	46.8	47.5	48.5
9 Non-one-off revenue measures		0.3	0.4
10 Corrected expenditure aggregate net of non-one-off revenue measures (in %) = $[(8)_t - (9)_t / (8)_{t-1}] * 100$		1.0	1.3

Source: Commission services.

2.4. CLARIFYING THE WORKING OF THE PREVENTIVE ARM OF THE SGP

2.4.1. The overall logic and working of the preventive arm remain unchanged...

In the preventive arm, Member States are required to attain their medium-term budgetary objectives (MTO) over the horizon of their stability and convergence programmes. The preventive arm of the SGP endeavours to ensure that fiscal policy is conducted so as to lead to healthy public finances over the short and longer term. It requires that Member States attain a country-specific MTO for their budgetary position after adjusting for the cyclical position of the economy as well as for one-off and other temporary measures. For Member States that are not at their MTO, an appropriate adjustment path towards it is defined and should be adhered to. The country-specific MTOs are set taking into account their respective debt levels, the country-specific sustainability challenges posed by the costs of an

ageing population and the standard operation of automatic stabilisers.

To remain at their MTO, or make adequate progress towards it in terms of the change in the structural balance, Member States ensure that annual government expenditure growth does not exceed the expenditure benchmark. In particular, Member States at their MTO ensure that government expenditure grows at most in line with the benchmark defined by the medium-term rate of potential GDP growth – which is the rate that ensures adherence to the MTO over time – unless any excess expenditure growth is matched by discretionary measures yielding additional revenues. Member States on the adjustment path to the MTO ensure that their expenditure grows at a rate below that medium-term rate of potential GDP growth – the difference in growth rates being called the convergence margin – unless the excess growth in expenditure is matched by discretionary measures yielding additional revenues. The expenditure benchmark is derived (as specified in Box II.2.2) from the required improvement in the structural balance, so to be consistent with, and

conducive to, the fulfilment of the required adjustment towards the MTO. ⁽³⁶⁾

Progress towards the MTO is assessed annually by the Commission and the Council. That assessment is done on the basis of each of the Commission forecasts. Compliance with the preventive arm requirements is evaluated notably on the basis of the structural balance and the expenditure benchmark, taking their respective strengths into account. The indication provided by the structural balance and the expenditure benchmark is always qualified through an overall assessment. It focuses on the possible sources of discrepancy between the two indicators and, on that basis, reaches a conclusion. The overall assessment can conclude that there is compliance with the requirements, or some deviation, ⁽³⁷⁾ or a significant deviation, with the latter triggering a "significant deviation procedure" if the conclusion is based on outturn data.

The EFC agreement brings no major change to the working of the preventive arm. In particular, progress towards the MTO will continue to be gauged on the basis of the change in the structural balance and the expenditure benchmark.

2.4.2. ... but certain aspects are clarified

The EFC agreement has brought a number of clarifications on the assessment of compliance with the preventive arm of the SGP. It introduces the following clarifications.

The requirements in terms of the expenditure benchmark are now included in the Council's country-specific recommendations. Until 2016, for Member States that had not yet attained their MTOs, the adjustment requirements were set out only in terms of change in the structural balance. The corresponding expenditure benchmarks were communicated to Member States but not formally included in the country-specific recommendations. By contrast, the recommendations adopted in 2017 specified the maximum allowable growth rate of government expenditure for 2018.

⁽³⁶⁾ For further detail on the calculation of the expenditure benchmark in the preventive arm see European Commission (2017).

⁽³⁷⁾ "Some" deviation refers to any deviation which is not significant – for the purposes of Articles 6(3) and 10(3) of Council Regulation (EC) No 1466/97.

The expenditure benchmark is formulated in nominal terms. For the purposes of surveillance, the medium-term rate of potential GDP growth is converted into nominal terms by using the GDP deflator from the Commission's spring forecast of the preceding year, i.e. at the time of issuing of the country-specific recommendations. The medium-term rate of potential GDP growth together with the convergence margin thus allows the required improvement in the structural balance to be translated into a maximum allowable nominal growth rate of (net) expenditure.

The expenditure benchmark is systematically corrected for one-off measures. When assessing compliance with the expenditure benchmark, the impact of one-off measures will be systemically corrected for in the context of the overall assessment: in particular, one-off expenditure measures will be systematically removed from the expenditure aggregate; similarly, any one-off revenue measures will be systematically removed from the amount of discretionary revenue measures. In previous years, there were no such systematic removals and it was a source of discrepancy between the structural balance and the expenditure benchmark which is now eliminated.

The EFC agreement recognises the more predictable and measurable nature of the expenditure benchmark over the structural balance as a rule. At the same time, the EFC agreement acknowledges that the structural balance may better reflect "structural shifts" in potential output growth, given that it uses a single year estimate of potential growth whereas the reference rate for potential underpinning the structural balance may include some exceptionally high or low yearly estimates of potential growth. It also recognises that the structural balance might provide an incentive for effective revenue administration. The Commission goes one step further in streamlining the use of surveillance indicators, to ensure equal treatment of Member States and consistency of assessments over time. As transparently indicated to Member States, it has since the EFC agreement given prominence to the expenditure benchmark when assessing compliance with the preventive arm of the SGP, unless there is a clear reason to depart from that indicator.

Box II.2.2: Derivation of the expenditure benchmark in the preventive arm of the SGP

The expenditure benchmark is derived from a medium-term growth rate of potential output and a country-specific convergence margin.

Specifically, the expenditure benchmark L_t for year t is derived from the medium-term growth rate R_t by the deduction of a convergence margin C_t (all expressed in percentage points), as follows:

$$L_t = R_t - C_t$$

The medium-term growth rate is calculated over a 10-year window, on the basis of forward-looking projections and backward-looking estimates from the Commission spring forecast of the preceding year. The medium-term growth rate is recalculated every year.

For countries not at their MTO, the convergence margin serves to support the annual improvement of the structural balance towards the MTO (adj_t , expressed in percentage points), as required under the preventive arm of the SGP. Member States' required annual fiscal adjustment is varied so as to take into account the economic cycle as well as their debt levels and sustainability risks: it can be therefore lower or higher than the benchmark of 0.5% of GDP and reflects that greater or lower adjustment need. The size of the convergence margin also depends on the share of government primary expenditure in GDP in the preceding year (P_{t-1} , expressed in percentage points). Thus, the convergence margin is given by:

$$C_t = \frac{adj_t}{P_{t-1}} \times 100$$

For Member States at their MTO, the convergence margin is by construction set to zero.

Following the EFC agreement, for the purposes of surveillance the reference rate L_t is then converted into nominal terms by using the GDP deflator from the Commission spring forecast of the preceding year. The convergence margin thus allows translating the required improvement in the structural balance into a maximum allowable nominal growth rate of expenditure.

Council Regulation (EC) No 1466/97 does not envisage any specific adjustment requirements for Member States that are above their MTO. For analytical purposes, however, it is possible to calculate the reference rate L_t that is compatible with the Member State returning to the MTO, on the basis of the initial distance from the MTO.

In that case, the convergence margin is given by:

$$C_t = \frac{distanceMTO_{t-1}}{P_{t-1}} \times 100 \times -1$$

where $distanceMTO_{t-1}$ corresponds to the (positive) difference between the structural balance at the start of the year and the MTO. The convergence margin thus obtained does not reflect any specific requirement, under the SGP, whether in terms of the level or pace of adjustment towards the MTO.

3. THE COMMISSION'S "CONSTRAINED JUDGEMENT" APPROACH TO ASSESS THE OUTPUT GAP

3.1. THE USE OF "CONSTRAINED JUDGEMENT" IN RELATION TO OUTPUT GAP ESTIMATES

3.1.1. Introduction

The structural balance has played a central role in the EU's fiscal framework since the 2005 reforms of the Stability and Growth Pact (SGP). That measurement is an essential part of fiscal surveillance, in that it allows for an assessment of whether the underlying fiscal position of a Member State is sound beyond the observed government balance. A key input into the calculation of the structural balance is the output gap estimates, i.e. the numerical assessment of the current cyclical position of the economy. However, estimating the output gap is difficult since potential growth is not directly observable whilst the actual evolution of GDP is subject to significant historical and forecast revisions, which have a sizeable influence on output gap estimates.

The estimates of the output gap used in the surveillance process are calculated using a production function methodology. ⁽³⁸⁾ That methodology is decided collectively through committee work by all relevant actors involved in surveillance who take decisions by unanimity. Given the importance of those estimates, the EU's Economic Policy Committee (EPC) has a dedicated working group (i.e. the "Output Gap Working Group" - OGWG) which meets regularly to discuss the operational effectiveness, relevance and possible further improvement of the existing production function methodology.

As an unobservable variable, there is necessarily a large degree of uncertainty surrounding output gap estimates. In light of this, in March 2016 the Ministers of Finance of eight Member States (Italy, Spain, Latvia, Lithuania, Luxembourg, Portugal, Slovenia and Slovakia) sent a letter to the Commission expressing their concerns regarding the estimation of potential output. Subsequently, the April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly

agreed methodology for the estimation of potential growth and the output gap. In line with the mandate from the Council, two concrete steps were agreed in October 2016. First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment would be introduced in the commonly agreed methodology. That change was implemented in the Commission autumn forecast 2016. Second, it was agreed that a new "plausibility tool" could be used to signal cases where the results of the agreed methodology could be interpreted as being subject to a large degree of uncertainty. Specifically, the Economic and Financial Committee approved the use of the "plausibility tool" within the autumn 2016 surveillance exercise as part of a wider approach to considering estimates of the output gap within the fiscal framework. That wider approach has been named "constrained judgement" and is discussed in the present Chapter.

Against this background, the purpose of Chapter II.3. is to describe how the Commission applies the "constrained judgement" approach. Section II.3.1 provides an overview of the "plausibility tool", including a detailed box on the underlying statistical methodology. Section II.3.2 explains in greater detail how the "constrained judgement" approach can be derived from the "plausibility tool". Section II.3.3 explains how the "constrained judgement" approach affects the assessments of compliance within the fiscal framework. Finally, the fiscal surveillance implications of the application of "constrained judgement" in the autumn of 2016, and in the spring and the autumn of 2017 are set out in Section II.3.4.

3.1.2. The role of the "plausibility tool" and "constrained judgement"

The application of "constrained judgment" is a two-step approach. First, it allows the Commission – under limited and specific circumstances – to depart from the output gap estimates of the commonly agreed methodology in its assessment of the cyclical position of the Member State concerned when conducting its fiscal assessments. Second, it allows the Commission to apply a "constrained" degree of

⁽³⁸⁾ See Havik et al. (2014).

judgement in conducting Member States' budgetary assessments. The boundaries to that discretion have been agreed by the Economic and Financial Committee that also agreed to apply the "constrained judgement" for a trial period of up to two years.

The practical implementation of "constrained judgement" is done in two steps. Firstly, the "plausibility tool" is used to identify cases that warrant further examination. The tool is based on a statistical assessment methodology, which has been discussed in the OGWG on the basis of the proposed approach by the Commission (Box II.3.1). It should be recalled that the "plausibility tool" is thus intended to provide information on the degree of uncertainty/improbability of the output gap –at a certain point in time– when estimated on the basis of the common methodology. The technicalities of that step are discussed in Section II.3. The second step consists of the use of expert judgement in using the results of the tool. It will be described below in Section II.4.

As agreed with the Economic and Financial Committee, the results of the "plausibility tool" are used asymmetrically, in that only cases where the tool indicates that the common methodology's estimate may not be sufficiently negative are considered as part of the "constrained judgement" process.

It is important to note that the "plausibility tool" has not affected the Commission autumn forecast 2016 or the spring and autumn forecast 2017 figures. The output gap and the implied structural balance estimates published in the forecasts continue to be based on the common methodology.

While the "plausibility tool" flags possible uncertainty regarding the level of the output gap, it is in itself not part of the fiscal surveillance framework. Instead, the results of the tool provide a trigger for the Commission to analyse the economic situation of the Member State concerned in more detail. This analysis is described in the second step in the application of "constrained judgement", which occurs once the identification process has been completed for the Member States flagged by the "plausibility tool". The results of the "plausibility tool" can instead be

used as an additional qualitative factor to be considered in the context of the fiscal assessments, that is, the assessments of the Draft Budgetary Plans (DBPs) and Stability and Convergence Programmes (SCPs) and possible Article 126(3) reports for relevant Member States. The DBP opinions and SCP Staff Working Documents provide an explicit explanation of the outcome of the "plausibility analysis" for all Member States where the tool indicates that the output gap based on the common method may be subject to a large degree of uncertainty.

3.2. IMPLEMENTATION OF THE "PLAUSIBILITY TOOL'S" RESULTS WITHIN "CONSTRAINED JUDGEMENT"

3.2.1. Running the "plausibility tool"

The "plausibility tool" is applied to signal cases when the outcome of the commonly agreed methodology could be interpreted as being subject to particularly unusual uncertainty and therefore deserving of further investigation on the part of the Commission. As described in detail in Box II.3.1, further investigation is needed when the output gap estimates calculated using the common methodology fall outside a given statistical confidence interval, which has been agreed within the OGWG as explained above (see also the example provided in Graph II.3.1).

Graph II.3.1 provides a simplified illustrative situation where the estimate of the output gap based upon the common method is not flagged. Let us assume that the interval of reasonable output gap values built around the "plausibility tool's" central estimate is between -3.5% and -1.5% for a given year. At the same time, let us assume that the common methodology estimate for that same year is -2.0%. Given that -2.0% falls inside the interval of [-3.5, -1.5], there is no reason to flag the common methodology estimate as potentially problematic and so activate the "constrained judgment" process.

Box II.3.1: Technical description of plausibility tool

On 25 October 2016, the EFC gave the green light for the use of the plausibility tool as part of the constrained discretion approach for improving the commonly-agreed output gap methodology. This box provides a technical description of the tool (for details, see Hristov et al. (2017)).

The procedure of running the plausibility check consists of the following steps:

- a. Firstly, the output gaps OG_{it} are regressed on a commonly-agreed set of $k=1, \dots, K$ variables X_{it}^k that are known to be correlated with the business cycle: $OG_{it} = \sum_k \gamma^k X_{it}^k + \varepsilon_{it}$;
- b. Secondly, in-sample forecasts are produced (plausibility tool projections) \widehat{OG}_{it} of the output gaps as implied by the regression: $\widehat{OG}_{it} = \sum_k \gamma^k X_{it}^k$;
- c. Finally, potentially "counterintuitive" output gaps are identified as those gaps that differ from their plausibility tool projection by a number above a certain threshold criterion.

Concerning step c), two different threshold criteria are used, with different implications for the Member States whose gaps have been "flagged". The two of them are based on the Root Mean Square Error (RMSE) criterion, which has some useful and intuitive econometric properties. The country-specific RMSEs are defined as:

$$RMSE^i = \sqrt{\frac{1}{T^i} \sum_t (OG_{it} - \widehat{OG}_{it})^2}$$

where i identifies the specific Member States and T^i denotes the number of yearly observations for country i . Two different confidence bands, based on the RMSE measure, are used, depending on the targeted degree of certainty that the violation of the bounds by an output gap estimate is not occurring purely by chance. Let us define Q^m the m^{th} quantile of the normal distribution. Then, the bounds are defined as:

$$Bound_{it}^{low} = \widehat{OG}_{it} - Q^m RMSE^i$$

$$Bound_{it}^{high} = \widehat{OG}_{it} + Q^m RMSE^i$$

Given these bounds, the first two criteria are:

- i) RMSE68 for $m=68$;
- ii) RMSE90 for $m=90$.

A plausibility check based on one of these two criteria is akin to identification of outliers. For example, for $m=68$ quantile, the endogenous variable (in this case the output gap) is expected to fall within the bounds in 68 out of 100 cases. For $m=90$ it is 90 out of 100 cases. If the output gap falls outside the bounds, it may be then viewed an outlier and is hence flagged as potentially "counterintuitive". It should be noted, however, that the lower the quantile used, the higher the probability of a "false positive". For example, the probability that a correctly estimated output gap is nonetheless flagged by the RMSE68 criterion is $1-0.68=0.32$. Hence, this criterion should be expected to flag many false positive cases. The idea behind using such a broad criterion is to ensure that no "true positives" slip through the net.

By definition the RMSE90 criterion is stricter than the RMSE68 criterion in that it flags fewer output gaps. Equivalently, relatively larger discrepancies between the output gap and the plausibility tool projection could pass the former criterion. For this reason, following the EFC decision, only Member States flagged using the stricter 90% RMSE criterion are considered "clear-cut" cases (clear-cut in the sense that the risk

(Continued on the next page)

Box (continued)

that the official production function output gap estimates may be implausible is considered sufficiently high to automatically trigger an in-depth assessment by the respective ECFIN desk officer). For borderline cases (i.e. those Member States flagged using the less strict 68% RMSE criterion), no such automaticity applies.

An additional important remark is that the bounds based on the RMSE criterion are country-specific. Indeed, as demonstrated in Table II.3.1, this interval may be very wide (for example the size of the interval for the bounds based on RMSE68 for Greece is close to 7pps) or very narrow (the same interval for Italy is only 0.8pp). The Greek output gap will be flagged as implausible if it is more than 3½pps away from the estimate of the plausibility tool, while the Italian output gap will be flagged as implausible if it is more than 0.4pp away from the plausibility tool estimate.

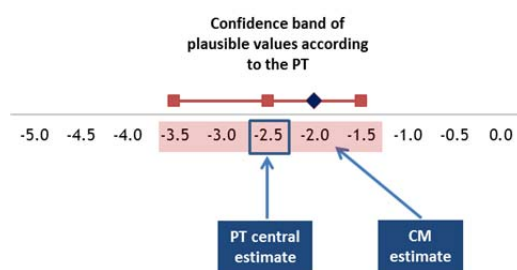
Data

The endogenous variable, the output gap, is by definition the gap between actual and potential GDP. The most recent available data vintage is used.

The table exogenous variables are:

Variable	Source
Capacity Utilisation	Capacity utilisation in the manufacturing industry (Eurostat)
Short term Unemployment Rate (as proxied by STUR)	Total unemployment rate (Eurostat, DG ECFIN)
	Long-Term Unemployment in % of Unemployment (Eurostat)
	STUR = Harmonised unemployment rate minus the long-term unemployment rate
Wage Inflation	Annual growth rate of wages per employee (DG ECFIN)
Slack in the Economy	Business Surveys (DG ECFIN), Construction Confidence Indicator
	Business Surveys (DG ECFIN), Industrial Confidence Indicator
	Service Surveys (DG ECFIN), Services Confidence Indicator
	Gross value added for each sector (DG ECFIN)
Growth in GDP (lagged)	Lagged annual change in real GDP (DG ECFIN)

Graph II.3.1: The common methodology estimate falls inside the range of plausible values defined by the "plausibility tool"



Note: PT = plausibility tool, CM = common methodology.

Source: Commission services.

The "constrained judgment" is applied in a situation where the common methodology estimate falls outside the interval of reasonable

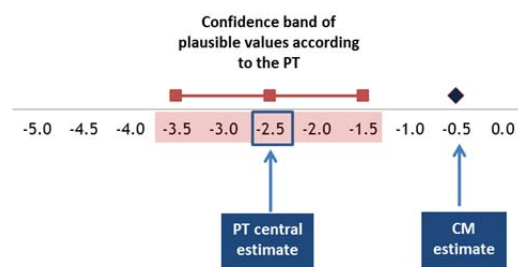
values defined by the "plausibility tool". In contrast to the example provided in Graph II.3.1, such a situation is depicted in Graph II.3.2. In that latter case the fictional common methodology estimate (-0.5%) is not reasonably near to the plausible estimate.

3.2.2. Second step: Making the "constrained judgement" approach operational – "plausibility range" and expert judgement

The second step involves the application of "constrained judgement". That second step is to be applied when the estimate of the output gap based on the common methodology falls outside the statistically significant range of values around the "plausibility tool" central estimate, as described in Graph II.3.2. Once the common

methodology estimate of the output gap has been flagged by the "plausibility tool", the Commission has the discretion to identify the plausible level of the output gap. The latter has to be within the range defined, on the one hand, by the common methodology estimate and, on the other hand, the "plausibility tool" central estimate – i.e. [-2.5, -0.5] in the example depicted in Graph II.3.2.

Graph II.3.2: The common methodology estimate falls outside the range of plausible values defined by the "plausibility tool"



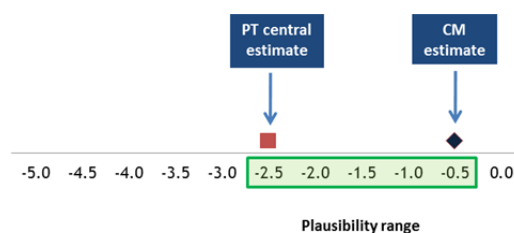
Note: PT = plausibility tool, CM = common methodology.
Source: Commission services.

The tool, however, does not specify where precisely within the "plausibility range" the most accurate estimation of the output gap lies. It is neither possible nor desirable to specify *ex ante* criteria that mechanically determine an exact position within that range. In fact, the "constrained judgment" approach is intended to allow the Commission to depart from the common methodology estimate, but not to routinely substitute it with an alternative estimate. The "plausibility range" shown in Graph II.3.3 therefore represents the constraints within which the Commission applies its judgement to identify a plausible level of the output gap. In other words, based on sound economic judgement the Commission could consider a value of the output gap other from that estimated by the common methodology, provided that it remains within that range.

It is important to stress that such a "plausibility analysis" is performed only on the current or last observed year, and cannot be produced for future years. Therefore it is not possible to generate a "plausibility range" for future years using the "plausibility tool's" results. The reason for that limitation is that the "plausibility tool"

estimates rely on a regression of variables for which future values are not available. As outlined in Box II.3.1, the "plausibility tool" relies on a regression of the output gap on the main variables which are considered to be closely correlated with the economic cycle. For the tool to provide reliable results it is crucial that the estimates of those input variables are stable. As a result, the "plausibility tool" can only be used on the basis of outturn data or, at least, on the basis of released data for the first three quarters of the year (i.e. at the time of the autumn forecast). In that way the probability of significant revisions is considerably reduced. Therefore, it is not possible to generate a "plausibility range" for future years or even for the ongoing year (or at least not until the autumn forecasts are available).

Graph II.3.3: Plausibility range for the scenario of Graph II.3.2



Note: PT = plausibility tool, CM = common methodology.
Source: Commission services.

However, to make the "plausibility tool" operational for fiscal surveillance purposes covering future years, it is necessary to extrapolate the "plausibility range", in order to analyse if a more plausible estimate of the output gap can be identified for those years.

The Commission chose to implement the simplest available approach. It consists of taking the difference between the two estimates for T (2016 in the case of both the 2017 DBPs and SCPs) and adding it to the output gap estimate based on the common methodology for T+1 (2017) to derive a "plausibility range" for 2017 and for T+2 (2018) in the case of the SCPs. Although crude, that method is transparent and simple. Chapter II.3.3 discusses how the estimate of the output gap that has been identified within the "plausibility range" affects the fiscal surveillance procedures.

The assessment of the plausible level of the output gap under the "constrained judgment" approach has been carried out by the Commission on the basis of expert country knowledge, drawing upon a sound economic assessment. In making their assessment, Commission experts can take into account the following elements: (i) a comprehensive set of macroeconomic indicators (including but not necessarily confined to those on which the "plausibility tool" is based); (ii) relevant country-specific factors and (iii) the output gap estimates produced by the other international organisations, such as the IMF and OECD.

Following that qualitative assessment, Commission experts have two options:

- **To continue to rely on the output gap estimate based on the common methodology.** To do so implies that the uncertainty on the exact level of the output gap has no implications for the fiscal assessment of the Member State concerned;
- **To apply constrained judgment and consider the output gap estimate based on the common methodology implausible on the basis of the "plausibility tool" outcomes and expert judgment.** Depending on the level of the output gap that is found to be more plausible within the "plausibility range", there may be implications for the fiscal assessment if an alternative fiscal adjustment requirement is implied. That assessment is made in a qualitative manner and is detailed in the accompanying Commission documents, as was done for the autumn 2016 and spring 2017 surveillance exercises. However, while the alternative output gap estimate emerging from the constrained judgment process is used for surveillance purposes, it does not replace the value of the output gap in the Commission's publications.

3.3. IMPLICATIONS OF "CONSTRAINED JUDGEMENT" FOR FISCAL SURVEILLANCE

3.3.1. Application of the unfreezing principles

Under the preventive arm of the SGP, the requirements for year T are fixed in T-1, mainly on the basis of the level of the output gap in year T projected by the spring forecast of year T-1. Those requirements are derived from the matrix of requirements included in the Commonly Agreed Position on Flexibility in the Stability and Growth Pact. ⁽³⁹⁾ Concretely, the requirement for 2018 has been fixed in spring 2017 and the one for 2017 in spring 2016. Once the requirements are fixed, they are considered to be frozen. ⁽⁴⁰⁾ The principles for that freezing have been agreed with the Council to ensure predictability.

The availability of a new information set regarding the cyclical position of the Member State results in an unfreezing of the requirement in only a very restricted number of cases:

- i) Where a Member State has been re-assessed as being in very bad or exceptionally bad economic times, measured as an output gap below -3% of potential output.
- ii) Where the level of a Member State's structural balance has been revised, so that to deliver on its original requirement would imply an over-achievement of its MTO.

Those freezing principles are also applied regarding the implications of the "plausibility tool's" results for Member States' requirements, including the categorization of Member States under the matrix. For example, if a Member State is identified as experiencing "implausible" output gaps, and the application of the "plausibility analysis" to the 2017 output gap estimate would result in an output gap estimate below -3% of GDP, the effect of unfreezing the 2017 requirement can be taken into account in the Commission's assessment. Similarly, Member States who are close to their MTO and have been

⁽³⁹⁾ Council of the European Union (2015).

⁽⁴⁰⁾ See Section 1.3.2.2 of European Commission (2017).

identified as experiencing "implausible" output gaps has the effect of unfreezing their requirements considered if the Commission's analysis leads to a structural balance that is even closer to the MTO. The distance to MTO is based on the previous year's structural balance.⁽⁴¹⁾ While it thus needs to be analysed whether the adjustment requirement derived from the matrix would warrant unfreezing based on the two cases just described, it does not lead to an actual revision of the formal requirement set in the country-specific recommendations. Instead, the outcome of the analysis can be taken account of as a qualitative factor when conducting the overall assessment of compliance.

3.3.2. Application to eligibility for flexibility clauses

The level change in the output gap implied by the Commission's analysis may also have an impact on some Member States' eligibility for use of the structural reform and investment clauses. The output gap change may bring them in compliance with i) the safety margin criterion (i.e. the minimum benchmark) used for assessing eligibility for both clauses or ii) the -1.5% output gap eligibility threshold for use of the investment clause. In such a case, it is mentioned in the Commission's assessments.

3.3.3. Limitations of the "plausibility tool" for "constrained judgement"

As indicated above, it is not possible to generate a "plausibility range" for future years or even for the ongoing year (or at least not until the autumn forecasts are available). As outlined in Box II.3.1, the "plausibility tool" relies on a regression of the output gap on the indicators of the cyclical position of the economy. For the tool to provide reliable results it is crucial that the estimates of those input variables are stable, and so the "plausibility tool" can only be used on the basis of outturn data or at least on the basis of released data for the first three quarters of the year (i.e. at the time of the autumn forecast). The "plausibility

ranges" can only be extrapolated to future years from the most recent results available (2016 at the moment), which further underlines the fragility of the exercise.

It is also important to reiterate that only output gap levels provided by the "plausibility tool", but not the changes to those levels, can be utilised for fiscal surveillance purposes. That limitation arises because the "plausibility tool" works on a discrete year-by-year basis. In other words, the tool needs to be run separately to produce the results for each year, one at a time. Therefore, it is not designed to produce a consistent series over multiple years, a feature which would be necessary to ensure the integrity of measurements of the fiscal effort. The reason is that the measurement of the fiscal effort centres on the change in the structural balance, which itself relies on the change in output gap from one year to the next.

As a result, the "constrained judgement" approach does not affect the calculation of the change in the output gap used by the Commission for the calculation of the fiscal effort, even while it allows the point estimate of the output gap for a given year to be amended in favour of a more judgement-based estimate. The measurement of the fiscal effort used in the surveillance process continues to be calculated on the basis of the estimates delivered by the common methodology and is unaffected by the "constrained judgement" approach.

3.4. RESULTS OF THE APPLICATION OF "CONSTRAINED JUDGEMENT" IN THE FISCAL SURVEILLANCE EXERCISES SINCE AUTUMN 2016

Three Member States were found to have implausible output gap estimates in spring 2016. The results of the "plausibility tool" based on the Commission autumn forecast 2016 are shown in Table II.3.1. Based on the RMSE90 criterion, three Member States were flagged by the "plausibility tool" as experiencing common methodology output gap estimates which were subject to a large degree of uncertainty: Austria, Finland and the UK. Based on the looser RMSE68 criterion, a total of seven Member States were flagged by the "plausibility tool": Austria, Finland,

⁽⁴¹⁾ For example, if a Member State's requirement in 2017 was +0.5% of GDP, but its structural balance in 2016 was revised to a position only 0.4% below the MTO, then the original requirement would be unfrozen as its delivery implies over-achieving the MTO.

Italy, Luxembourg, Latvia, Slovenia and the UK. In all but Finland, the detailed analysis indicated that the "plausibility tool's" results had no impact on the assessment of compliance with the SGP. In the case of Finland, the analysis concluded that the alternative output gap would mean the Member State is expected to respect the safety margin in relation to the 3% of GDP deficit threshold, which is an eligibility criterion for use of the structural reform and investment clauses.

On the basis of the Commission spring forecast 2017, no Member States were flagged by the "plausibility tool" as experiencing common methodology output gap estimates which were subject to a large degree of uncertainty based on the stricter RMSE90 criterion. However, nine Member States were flagged based on the RMSE68 criterion: Austria, Cyprus, Finland, Croatia, Italy, Luxembourg, Netherlands, Latvia and the UK (Table II.3.2). As in the autumn 2016, in all but Finland's case, the detailed analysis did not affect the assessment of compliance with the SGP. In the case of Finland, the analysis confirmed that Finland is expected to meet the minimum benchmark in 2017.

On the basis of the Commission autumn forecast 2017, only Italy was flagged by the "plausibility tool" as experiencing common methodology output gap estimates which were subject to a large degree of uncertainty based on the stricter RMSE90 criterion. However, five Member States were flagged based on the RMSE68 criterion: Cyprus, Finland, Croatia, Italy and Slovenia (Table II.3.3). For Cyprus and Finland, although the "plausibility tool" provided indications of particular uncertainty, the Commission did not see sufficient ground to deviate from the estimates based on the common methodology after taking into account all relevant factors. For neither Italy nor Slovenia applying "constrained judgement" approach would affect the requirements under the preventive arm. It would thus have no implication for the assessment of their DBP.

The uncertainty surrounding the estimated output gaps for Italy and Slovenia was taken into account by the Commission when applying its degree of discretion. In line with its decision to apply its degree of discretion when assessing a departure from the required fiscal adjustment for

2018, the Commission has taken into account the uncertainty surrounding the estimated output gap, as flagged by the "plausibility tool", in its wider assessment of the cyclical situation of Member States with large fiscal requirements for 2018 and at risk of significant deviation from those requirements, namely Italy and Slovenia. Box II.3.2 explains the context behind such analysis, its rationale and its conclusions in the context of Commission's opinions on the 2018 Draft Budgetary Plans submitted by euro area Member States.

Table II.3.1: Output gap flagged by the "plausibility tool" - Year 2016a

PF Gap	PT Projection	RMSE90			RMSE68		
		MS	Lower Bound	Upper Bound	MS	Lower Bound	Upper Bound
-0,7	-2,2	AT	-3,4	-0,9	AT	-2,9	-1,4
-0,4	-1,0	BE	-2,0	0,0	BE	-1,6	-0,4
-0,2	1,1	BG	-1,7	3,8	BG	-0,6	2,7
-0,8	-1,1	CY	-2,4	0,1	CY	-1,9	-0,4
0,1	1,3	CZ	0,4	2,2	CZ	0,8	1,9
0,0	0,0	DE	-1,0	0,9	DE	-0,6	0,6
-2,6	-1,8	DK	-3,1	-0,5	DK	-2,6	-1,0
-0,1	1,0	EE	-0,8	2,8	EE	-0,1	2,1
-10,5	-5,1	EL	-10,8	0,6	EL	-8,6	-1,7
-1,5	-1,2	ES	-3,1	0,6	ES	-2,3	-0,1
-1,8	-3,4	FI	-4,7	-2,1	FI	-4,2	-2,6
-1,4	-1,5	FR	-2,5	-0,4	FR	-2,1	-0,8
-0,9	0,6	HR	-0,7	1,8	HR	-0,2	1,3
0,7	1,0	HU	-0,3	2,4	HU	0,2	1,9
0,0	0,0	IE			IE		
-1,6	-2,1	IT	-2,8	-1,4	IT	-2,5	-1,7
0,9	0,3	LT	-1,9	2,5	LT	-1,0	1,7
-1,4	-3,4	LU	-6,1	-0,8	LU	-5,1	-1,8
1,4	-0,3	LV	-2,5	1,9	LV	-1,6	1,1
0,9	1,3	MT	0,2	2,5	MT	0,7	2,0
-0,8	-1,5	NL	-2,8	-0,3	NL	-2,3	-0,8
-0,1	-0,3	PL	-2,3	1,7	PL	-1,5	0,9
-0,8	0,1	PT	-1,2	1,4	PT	-0,7	0,9
0,3	-0,7	RO	-3,2	1,9	RO	-2,2	0,9
0,5	0,0	SE	-1,2	1,2	SE	-0,7	0,7
-0,3	-1,5	SI	-3,2	0,2	SI	-2,5	-0,5
-0,4	0,3	SK	-1,7	2,2	SK	-0,9	1,5
0,7	-0,7	UK	-1,9	0,6	UK	-1,4	0,1

Note: The output gap based on the PF methodology (PF Gap) and on the panel estimation ("plausibility tool" projection), including the lower and upper bounds for the RMSE68 and RMSE90 criteria.

Source: Commission autumn forecast 2016.

Table II.3.2: Output gap flagged by the "plausibility tool" - Year 2016b

PF Gap	PT Projection	RMSE90			RMSE68		
		MS	Lower Bound	Upper Bound	MS	Lower Bound	Upper Bound
-0,8	-1,6	AT	-2,9	-0,3	AT	-2,4	-0,8
-0,6	-0,6	BE	-1,4	0,3	BE	-1,1	-0,1
-0,2	0,4	BG	-2,2	3,1	BG	-1,2	2,0
-0,8	-1,8	CY	-3,2	-0,4	CY	-2,7	-1,0
0,2	1,5	CZ	0,6	2,5	CZ	0,9	2,1
-0,1	0,3	DE	-0,8	1,3	DE	-0,4	0,9
-1,4	-1,1	DK	-2,4	0,1	DK	-1,9	-0,4
0,3	0,9	EE	-0,8	2,7	EE	-0,1	2,0
-9,8	-5,1	EL	-10,8	0,6	EL	-8,6	-1,7
-1,8	-2,3	ES	-4,4	-0,3	ES	-3,6	-1,1
-1,8	-2,5	FI	-3,6	-1,4	FI	-3,2	-1,8
-1,3	-0,9	FR	-1,9	0,1	FR	-1,5	-0,3
-1,3	-2,0	HR	-2,7	-1,2	HR	-2,4	-1,5
0,2	1,5	HU	0,0	3,1	HU	0,6	2,5
0,0	0,0	IE			IE		
-1,7	-2,2	IT	-2,9	-1,5	IT	-2,6	-1,8
0,8	-0,3	LT	-2,7	2,1	LT	-1,8	1,1
-1,0	-2,6	LU	-4,9	-0,3	LU	-4,0	-1,2
1,6	-0,2	LV	-2,2	1,9	LV	-1,4	1,1
1,6	2,0	MT	-0,5	4,6	MT	0,5	3,6
-0,8	-1,6	NL	-2,7	-0,4	NL	-2,2	-0,9
-0,3	0,8	PL	-1,3	3,0	PL	-0,5	2,1
-0,6	-0,7	PT	-2,4	1,0	PT	-1,7	0,4
-0,1	0,6	RO	-2,2	3,4	RO	-1,1	2,3
0,2	-0,1	SE	-1,3	1,2	SE	-0,8	0,7
-0,4	-1,0	SI	-2,6	0,6	SI	-2,0	0,0
-0,3	-0,8	SK	-2,6	1,1	SK	-1,9	0,4
0,5	-0,3	UK	-1,4	0,8	UK	-0,9	0,4

Note: The output gap based on the PF methodology (PF Gap) and on the panel estimation ("plausibility tool" projection), including the lower and upper bounds for the RMSE68 and RMSE90 criteria.

Source: Commission spring forecast 2017.

Table II.3.3: Output gap flagged by the "plausibility tool" - Year 2017

PF Gap	PT Projection	RMSE90			RMSE68		
		MS	Lower Bound	Upper Bound	MS	Lower Bound	Upper Bound
-0,2	-0,5	AT	-1,8	0,8	AT	-1,3	0,3
-0,3	0,3	BE	-0,7	1,2	BE	-0,3	0,8
0,0	1,5	BG	-1,2	4,1	BG	-0,1	3,1
1,3	0,3	CY	-1,1	1,7	CY	-0,6	1,2
0,9	1,9	CZ	0,6	3,1	CZ	1,1	2,6
0,0	1,0	DE	-0,1	2,0	DE	0,3	1,6
-0,8	-0,6	DK	-1,8	0,7	DK	-1,3	0,2
1,8	1,4	EE	-0,3	3,0	EE	0,4	2,4
-7,7	-4,4	EL	-10,0	1,3	EL	-7,8	-1,0
-0,1	-1,0	ES	-3,1	1,0	ES	-2,3	0,2
-0,7	-1,5	FI	-2,6	-0,4	FI	-2,2	-0,9
-0,8	-0,2	FR	-1,2	0,8	FR	-0,8	0,4
0,6	0,0	HR	-0,8	0,7	HR	-0,5	0,4
1,5	2,1	HU	0,7	3,6	HU	1,2	3,0
0,0	0,0	IE			IE		
-0,6	-1,7	IT	-2,5	-0,9	IT	-2,2	-1,2
2,4	0,9	LT	-1,6	3,4	LT	-0,6	2,4
-0,4	-1,1	LU	-3,4	1,3	LU	-2,5	0,4
2,3	1,0	LV	-1,1	3,1	LV	-0,2	2,3
1,1	1,9	MT	-0,4	4,2	MT	0,5	3,3
0,2	-0,4	NL	-1,4	0,7	NL	-1,0	0,3
0,6	1,5	PL	-0,7	3,6	PL	0,2	2,8
0,4	0,2	PT	-1,6	2,1	PT	-0,9	1,4
0,7	1,1	RO	-1,8	3,9	RO	-0,7	2,8
0,2	0,4	SE	-0,8	1,6	SE	-0,3	1,1
1,8	0,2	SI	-1,7	2,1	SI	-1,0	1,4
0,0	0,5	SK	-1,2	2,3	SK	-0,5	1,6
0,6	0,0	UK	-1,3	1,3	UK	-0,8	0,8

Note: The output gap based on the PF methodology (PF Gap) and on the panel estimation ("plausibility tool" projection), including the lower and upper bounds for the RMSE68 and RMSE90 criteria.

Source: Commission autumn forecast 2017.

Box II.3.2: The application of discretion in the autumn 2017 fiscal surveillance exercise.

In the recitals of the Council Recommendations of 11 July 2017 the Commission's intended treatment of Member States for which the matrix implies a fiscal adjustment of 0.5% of GDP or above was highlighted. The recitals state the following: "[...], the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of [Member State]'s public finances. In that context, the Council notes that the Commission intends to carry out an overall assessment in line with Regulation (EC) No 1466/ 97, in particular in the light of the cyclical situation of [Member State]."

The Commission can exercise a degree of discretion when considering departures from the fiscal adjustments implied by the matrix. While compliance continues to be assessed with respect to the matrix-based requirement as indicated in the Recommendations, the Commission can exercise some discretion when assessing the compliance with the SGP of a Member State that is flagged by quantitative indicators as (at risk of) significantly deviating from its required adjustment. In fact, the so-called overall assessment might eventually conclude that a Significant Deviation Procedure is not warranted even in the event of the significant deviation threshold of 0.5% of GDP being exceeded with respect to the matrix-based requirement. The legal basis can be found from the specific terms of Article 6(3) of Council Regulation (EC) No 1466/97, whereby the overall assessment is linked to precise quantitative criteria without being limited to those criteria, which allows for other elements to be taken into account.

Discretion is conceived as a mean to tackle a specific situation in a time of atypical and incomplete economic recovery. As highlighted in the Commission autumn forecast 2017, the current recovery is strengthening but remains atypical and incomplete. Specifically, there is persistent labour market slack, core inflation remains unusually subdued, and the large current account surplus, in excess of its fundamental level, indicates the persistence of a domestic demand shortfall. Lastly, the recovery is supported by ECB's accommodative monetary policy. This becomes even more relevant in the context of monetary policy on a gradual road towards normalisation.

A structured and holistic assessment of a comprehensive set of economic indicators allows the identification of cases where an effort below that required by the matrix could be deemed adequate. For Member States in (at risk of) a significant deviation from the matrix requirements for 2018, the overall assessment may include a methodical scrutiny of its stabilisation and sustainability needs with the ultimate goal of achieving an appropriate fiscal stance at the Member State level. This is based on a structured and systematic analysis of a comprehensive set of economic indicators that is intended to ensure predictability and equal treatment among Member States.

The analysis encompasses both an assessment of sustainability and stabilisation challenges. A thorough analysis of debt levels as well as short and medium term sustainability challenges allow determining if the Member State presents sustainability challenges or not. In parallel, stabilisation needs are assessed considering the position of the economy in the economic cycle and the possible existence of inflationary pressures. In particular, the indication provided by the output gap from the common methodology is complemented by alternative measures of the spare capacity of the economy. In addition, indicators of inflationary pressures can also be taken into account.

The Commission concluded that a fiscal adjustment that departs from the requirement can be deemed adequate for Italy and Slovenia, provided that they effectively ensure such a fiscal adjustment in 2018. The analysis considers the following sequential arguments.

- In cases when short-term fiscal sustainability challenges are identified, no discretion is warranted. No Member State is in this situation now.

(Continued on the next page)

Box (continued)

- In cases when the economic recovery of the Member State is considered sufficiently robust, no discretion is warranted either, as for Belgium, France, and Portugal.
- For Member States where the recovery appears still fragile or a too large fiscal tightening could jeopardise it, as in the cases of Italy and Slovenia, a fiscal adjustment that departs from the requirement can be deemed adequate. However, if these Member States are also facing sustainability needs in the medium-term and/or have a debt-to-GDP ratio above 60%, an important provision is that they should ensure the effective delivery of a reasonable fiscal adjustment. The latter could be roughly proxied by at least half of the requirement from the matrix. Providing such a cap responds to the need of striking the right balance between the Member State's stabilisation and sustainability needs. Nevertheless, full compliance with this fiscal adjustment is required. Effectively ensuring a minimum fiscal adjustment is essential in particular for Member States not respecting the debt reduction benchmark *prima facie* and therefore facing the possibility of a debt-based Excessive Deficit Procedure.

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