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The 2016 Stability and Convergence Programmes

An Overview and Implications for the Euro Area Fiscal Stance

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EXECUTIVE SUMMARY

This paper provides an overview of the current fiscal policy in the euro area and the EU, and at Member State level. It presents an overview of Member States' 2016 Stability and Convergence Programmes (SCPs) as well as an analysis of the recent and prospective fiscal stance in the euro area. The fiscal stance is assessed analytically and without prejudice to the obligations under the EU fiscal framework.

According to both the latest Commission forecast and this year's SCPs, no further consolidation is expected in 2016 and 2017 in the euro area. In 2016, the fiscal stance is expected to be mildly expansionary. This more supportive orientation of fiscal policy reflects in part a broad-based shift towards policies of cutting taxes, notably, though not exclusively, taxes on labour; albeit revenue-to-GDP ratios remain around 2% of GDP above pre-crisis levels. Gradually more sustained growth of public expenditure within the area, especially so in Germany, also adds to the supportive orientation. In 2017, fiscal adjustment remains close to zero in the euro area, resulting in a broadly neutral fiscal stance. Debt-to-GDP ratios are expected to decrease somewhat on the back of a favourable snowball effect and primary balances.

A neutral fiscal stance in 2017 appears appropriate given the current situation in the euro area. The monetary stance has been eased in the recent past through a package of unconventional instruments. This has substantially improved financial and borrowing conditions across the euro area and supported firmer demand and prices. Despite this, inflation remains persistently low, calling for a consistent policy mix. On the one hand, a supportive fiscal stance is aligned with monetary policy and could eventually allow a quicker return to a normalised environment and thus to a standard monetary policy, also if downside risks materialise. On the other hand, at the country level it is essential to re-build sustainability buffers where needed. A neutral fiscal stance thus appears appropriate, but a modulation should be considered if and as the recovery accelerates or decelerates.

The euro area fiscal stance should be differentiated depending on the situation of individual Member States in terms of sustainability and stabilisation. Although not inconsistent with a close to neutral aggregated stance in 2017, the plans presented in the latest stability programmes could be improved upon. Plans that are tilted towards the stabilisation objective in some large countries, including in Italy and Spain and to a lesser extent France, should be rebalanced towards more consolidation, while the remaining fiscal scope in Germany could be used to support short- and long-term growth. The low funding cost environment makes it an ideal time to frontload public investments. In conjunction with gradually strengthening nominal growth, it also offers an opportunity to curb high debt ratios by cutting non-future oriented spending and tax loopholes through structural fiscal reforms.

Medium-term fiscal sustainability risks remain. According to this year's SCPs, some improvement in the structural balance is projected for 2018 and 2019. Around half of the Member States are expected to be at or above their MTOs by 2019, the end of the programme horizon. Headline balances are expected to steadily decline in both the euro area and the EU by 2019. The debt-to-GDP ratio is expected to continue to decrease over the medium term but to remain high, above 80% of GDP in 2019. Over time, primary balances become the main driver of this decrease. The assumptions on revenue elasticities which underlie several Member States' projections for 2018 and 2019 seem rather optimistic though.

The remainder of this paper is structured as follows. Chapter 1 offers an overview of public finances in 2015 and the fiscal plans over 2016-2019 as presented in the SCPs, both at the country level and aggregated for the euro area and the EU as a whole. Chapter 2 examines the recent and prospective fiscal stance in the euro area.

Part I

The 2016 stability and convergence programmes: an overview

1. THE 2016 STABILITY AND CONVERGENCE PROGRAMMES: AN OVERVIEW

This chapter provides an overview of the 2016 Stability and Convergence Programmes (SCPs). It offers an opportunity to take an overall view of public finances in 2015 and the fiscal plans over 2016-2019, both at the country level and the euro area and EU as a whole.

Headline deficits continued to decrease in 2015, more so than expected last year on aggregate terms. This was mostly due to GDP growth exceeding Member States' prospects. At the same time, the structural balance remained broadly unchanged in both the euro area and the EU, implying a broadly neutral fiscal stance at the aggregate level.

Debt-to-GDP declined in 2015 for the first time since 2007 both in the EU and the euro area. Although the decline was mostly driven by the stock-flow adjustment, a favourable interest rate-growth differential contributed, for the first time since 2007, to debt reduction in the euro area and the EU.

According to this year's SCPs, Member States plan a slightly expansionary fiscal stance in 2016, which is expected to support the still fragile recovery. Fiscal consolidation resumes in the EU in 2017, but remains close to zero in the euro area. It should then pick up in a somewhat back-loaded fashion, with the bulk of the improvement in the structural balance being projected for the years 2018 and 2019. Around half of the Member States are expected to be at or above their MTOs by 2019, the end of the programme horizon. Headline balances are expected to steadily decline to reach -0.4% of GDP in both the euro area and the EU by 2019.

On the aggregate, the 2019 debt-to-GDP ratio is expected to still be at 85% of GDP in the euro area (80% of GDP in the EU), compared to 91% in 2015 (85% in the EU). Around half of the projected debt reduction is expected to stem from the nominal growth rate persistently exceeding the implicit interest rate on the stock of debt, i.e. from a favourable snowball effect. Primary surpluses account for the remaining projected debt reduction.

The comparison of the 2016 SCPs with the Commission 2016 spring forecast shows that the projected budgetary figures are plausible for 2016 and 2017. However, the assumptions on revenue elasticities which underlie several Member States' projections for the last two years of the programmes seem rather optimistic.

Regarding fiscal sustainability, risks to short-term fiscal stress have been reduced in all Member States in the last years. However, medium-term sustainability risks remain: debt projections show that even if the fiscal plans in the SCPs were fully implemented, additional fiscal consolidation measures of around ¾ percentage points of GDP would be needed over the period 2020-2024 to bring the debt-to-GDP ratio to 60% by 2030.

1.1. INTRODUCTION

This chapter provides an overview of the 2016 vintage of Stability and Convergence Programmes (SCPs) submitted by the Member States ([1]). The chapter aims at offering a cross-country aggregated view of fiscal policy plans in the Union and the euro area as a whole ([2]). This is an analytical chapter focusing on a set of common indicators. It cannot substitute for the richer and more detailed country-specific assessments of the 2016 Stability and Convergence Programmes. Fiscal surveillance decisions are taken on the basis of the latter.

This overview of the 2016 SCPs analyses the fiscal outlook and outcomes for the 2015-2019 period. In its conclusions of 15 January 2016, the Council indicated that there is still a need to secure long-term control over deficit and debt levels. It also stressed that the fiscal effort should be differentiated by individual Member States in compliance with the requirements under the Stability and Growth Pact. The country-specific recommendations, adopted by the Council on the basis of SCPs, are expected to feed into the national budgets for 2017. For these reasons, the analysis of the budgetary plans for 2017 is given primary attention in the present chapter. At the same time, an economic assessment of the euro area fiscal stance is needed for the whole period to identify the orientation of the fiscal stance in the euro area, that is, whether it is expansionary, neutral or contractionary. The detailed analysis and discussion of the euro area fiscal stance is provided in chapter 2.

The chapter consists of five sections. Section I examines the implementation of SCPs in 2015. Section II presents the budgetary plans set out by Member States in their SCPs over the period 2016 to 2019. Section III contains an analysis of the risks present in the SCPs plans. It focuses on risks to projections of macroeconomic variables and related revenue targets. Section IV looks at the longer-term implications of the plans for fiscal sustainability, by taking into account the projected changes in age-related expenditure.

1.2. 2015 AT A GLANCE: BUDGETARY DEVELOPMENTS

Overall budgetary performance in 2015

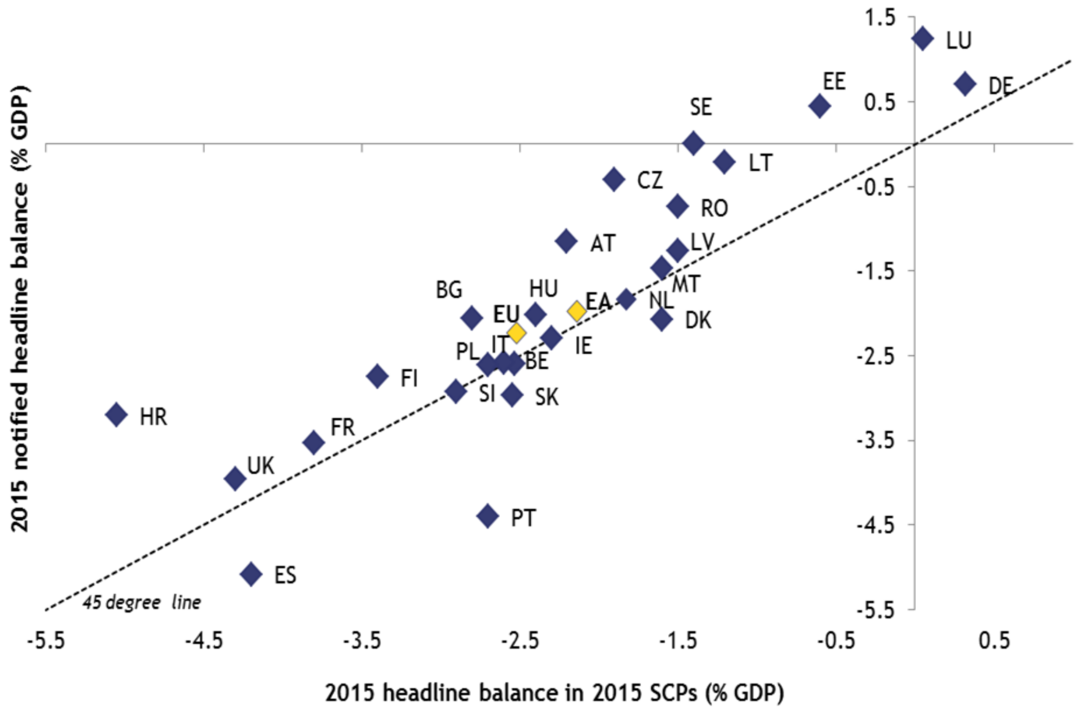
Public deficits decreased further as a share of GDP over 2015, whereas the fiscal adjustment in structural terms came to a halt. The headline deficit continued to decline in 2015, both in the euro area where it fell to 2% from 2.6% of GDP and the European Union (EU) where it fell to 2.2% from 2.9% in 2014. The structural deficit narrowed by 0.1% of GDP in the euro area, reaching 0.7% of GDP, while it decreased by 0.2% in the EU, coming out at 1.5% of GDP. The discretionary fiscal effort (DFE) provides with similar estimations of the 2015 fiscal effort in both the euro area and the EU (see box 3 for methodological references on the DFE). Therefore, the slight expansion in the structural balance partly offset the deficit-reducing automatic stabilisers in a context of continued recovery. Across Member States, EE, IE, UK, SE, AT, LT and HR stand out with a positive change in the structural balance that ranges from 0.5% of GDP in the case of EE to 1.8% of GDP in the case of HR. This contrasts with a marked deterioration in the structural balances of DK, LU and ES, which varies from 1% to 2% of GDP.

The improvement in the headline balance was featured by a decline in the primary expenditure ratio, further supported by a fall in interest payments. Primary expenditure fell by 0.5% of GDP and interest expenditure by 0.2% of GDP, both in the euro area and the EU. Conversely, revenues fell by

([1]) The analysis is built around data reported by Member States in their 2016 Stability and Convergence Programmes, unless otherwise specified. As Greece is under a macroeconomic adjustment programme it did not submit a Stability Programme and is not part of this analysis. In Section I, which concerns 2015, Cyprus is not included since it was not required to submit a Stability Programme that year. The data for the UK correspond to fiscal years and, when relevant, other (Commission) data for the UK are adjusted to be comparable

([2]) The overview of the 2015 vintage of the SCPs is available at: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip002_en.pdf

Graph I.1.1: **Headline deficit (% of GDP) in EU Member States in 2015, outturn vs 2015 SCPs.**



Note: The graph plots the planned headline budget balance (horizontal axis) against the notified 2015 headline budget balances (vertical axis). Member States above (below) the bi-sector line are those where the 2015 headline balances came in better (worse) than planned.
Source: European Commission services

0.2% of GDP in the euro area, but held steady in the EU, in particular thanks to a strong performance in the UK.

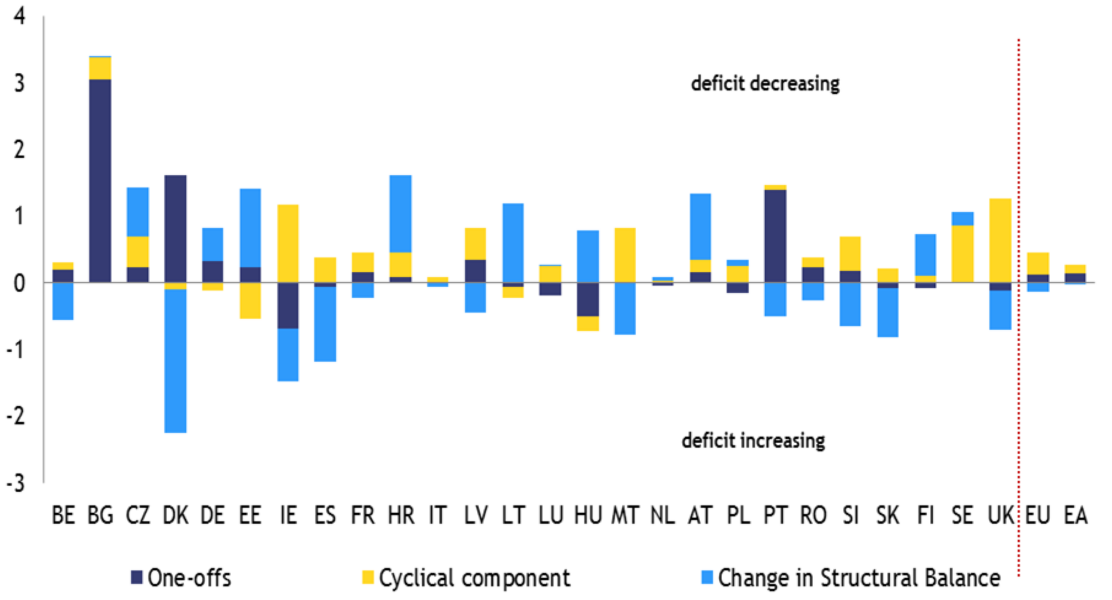
Debt decreased in 2015 both in the EU and the euro area, for the first time since 2007. After peaking in 2014 at 87% and 93% of GDP respectively, the aggregate debt ratio decreased in 2015 by slightly more than 1% of GDP in both areas.

Comparison with 2015 Stability and Convergence Programmes

Compared to 2015 SCPs, headline balances turned out slightly better than expected both in the euro area (by 0.1 pp of GDP) and the EU (by 0.3 pp of GDP). On the back of a positive growth surprise, the large majority of Member States registered better-than-planned headline balance outcomes, in some cases by even more than 1 pp. PT and ES are the biggest exceptions to this general trend, with deviations from plans by almost 1 pp or more, as shown in Graph I.1.1.

The change in the structural balance came in roughly as expected last spring. This broad stability in the aggregate structural balance masks however sizeable differences across Member States. As shown in Graph I.1.2, underperformance relative to the planned change in the structural balance is evident for several countries (DK, ES, MT, IE and SK are particularly noticeable) while some other Member States managed to outperform their plans in 2015 (LT, EE, HR, AT, HU, CZ and FI stand out).

Graph I.1.2: Observed changes in the EU Member State's budget balances in 2015 *vs* changes planned in 2015 SCPs: breakdown (pp. of GDP)



Note: Negative (positive) values in any of the three components above are to be interpreted as it contributing less (more) to the improvement in the headline deficit than planned one year ago.
Source: European Commission services

The cyclical component of the general government deficit was more favourable than expected. On average it contributed more to the overall reduction in the headline deficit in 2015 than anticipated last year. In fact, as shown in Table I.1.1, aggregate real GDP growth outpaced what Member States were expecting one year ago. With estimated potential growth broadly unchanged, output gaps have closed in 2015 at a faster pace than anticipated in the 2015 SCPs. While GDP deflator growth turned out as expected on aggregate terms, inflation remained subdued. This can to some extent have hindered fiscal

Table I.1.1: **Economic conditions in the EU and the euro area in 2015**

		2015 SCPs planned	COM 2016 spring forecast
EU	Real GDP growth	1.8	2.0
euro area		1.5	1.7
EU	Nominal GDP growth	3.1	3.2
euro area		2.8	3.1
EU	Inflation (GDP deflator)	1.3	1.2
euro area		1.3	1.3
EU	Output gap	-1.6	-1.3
euro area		-2.0	-1.5
EU	Change in output gap	0.4	0.9
euro area		0.3	0.8

Source: European Commission services

Table I.1.2: **Composition of fiscal developments in EU and euro area (% of GDP in 2015)**

		2014 outurn	2015 SCPs planned change	2015 outturn change
EU	Revenues	45.2	-0.3	-0.1
euro area		46.6	-0.2	-0.2
EU	Primary expenditure	45.6	-0.5	-0.5
euro area		46.5	-0.3	-0.5
EU	Interest expenditure	2.5	-0.2	-0.2
euro area		2.6	-0.2	-0.2

Note: The table compares the changes in the revenue-, primary expenditure- and interest-to-GDP ratios in 2015, as planned in last year's SCPs and as outturn.
Source: European Commission services

consolidation efforts in 2015 since, on the one hand, persistently low inflation makes it harder to reduce public expenditure as a share of GDP ([3]) and, on the other hand, leads to lower tax revenues at medium-term standard elasticities.

Compared to the 2015 SCPs the primary expenditure ratio in the euro area declined by more than anticipated, whereas revenue was stronger than expected in non-euro area member states. Expenditure was reduced by 0.2% of GDP more than planned in the euro area. While in line with plans for the euro area, revenue performance was around 0.2% of GDP better-than-expected in the EU, thanks mainly to developments in the UK. Finally, overall interest expenditure turned out as expected by Member States last year.

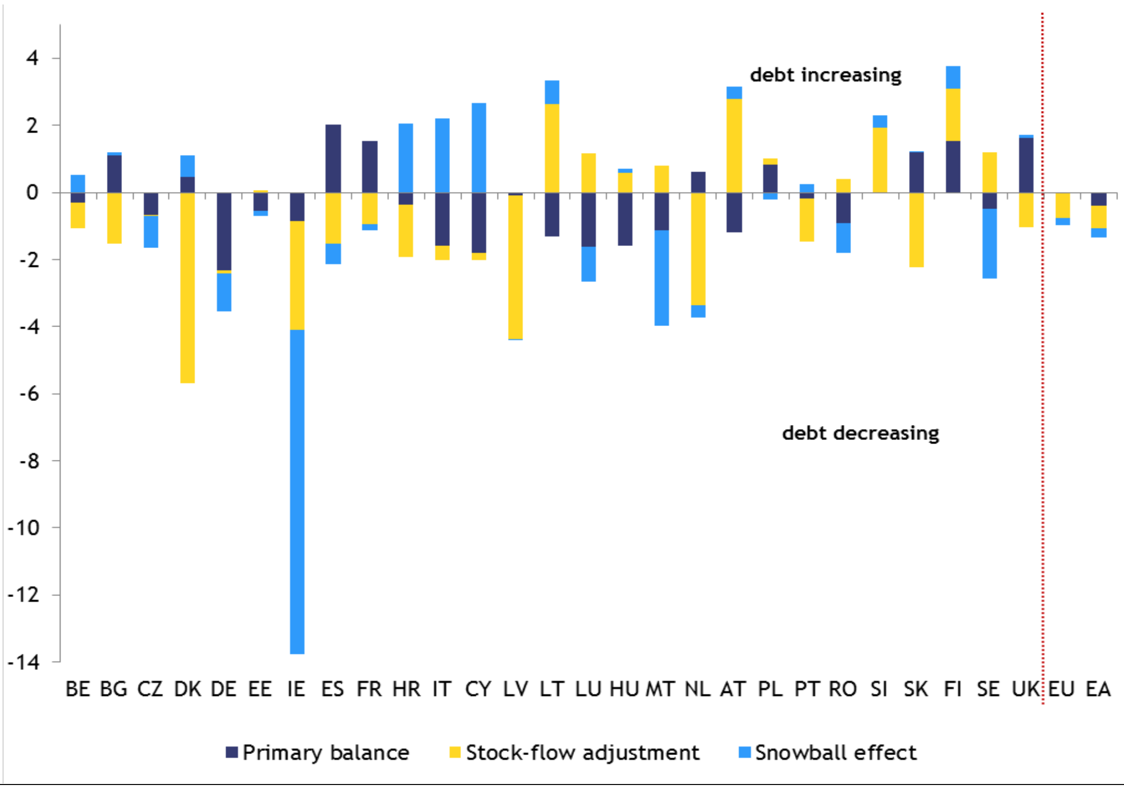
Developments in the debt-to-GDP ratio in 2015

The debt-to-GDP ratio decreased in 2015, standing at 91% and 85% of GDP in the euro area and the EU respectively. The stock-flow adjustment was the main driver of the 2015 decrease in the debt ratio in both areas, mainly as a result of net disposal of financial assets. Besides, for the first time since 2007, the favourable dynamic in the interest rate-nominal growth differential (the so-called snowball effect) also contributed to debt reduction overall in the euro area, meaning that growth exceeded the cost of debt on the aggregate. The debt-decreasing effect of the above two factors was further leveraged by a primary surplus in the case of the euro area.

However, the debt ratio continued to increase in ten countries (FR, HR, IT, LT, AT, PL, SI, FI, CY and the UK). For IT, CY, AT and LT, the debt ratio increased in spite of sizeable primary surpluses, which were more than offset by unfavourable snowball effects or stock-flow adjustments. Conversely, debt-to-GDP decreased in 2015 in the remaining eighteen Member States. Primary surpluses reinforced the debt-decreasing impact of favourable snowball effect for several of them (CZ, IE, DE, MT, LU and SE).

([3]) Persistently low inflation renders ineffective some typical expenditure-decreasing measures, such as freezing public sector wages or pensions in nominal terms. Also, the existence of nominal rigidities in certain expenditure items drives up expenditure relative to GDP in a low inflation environment.

Graph I.1.3: **Contributions to the change in the debt-to-GDP ratio in 2015 (pp. of GDP)**



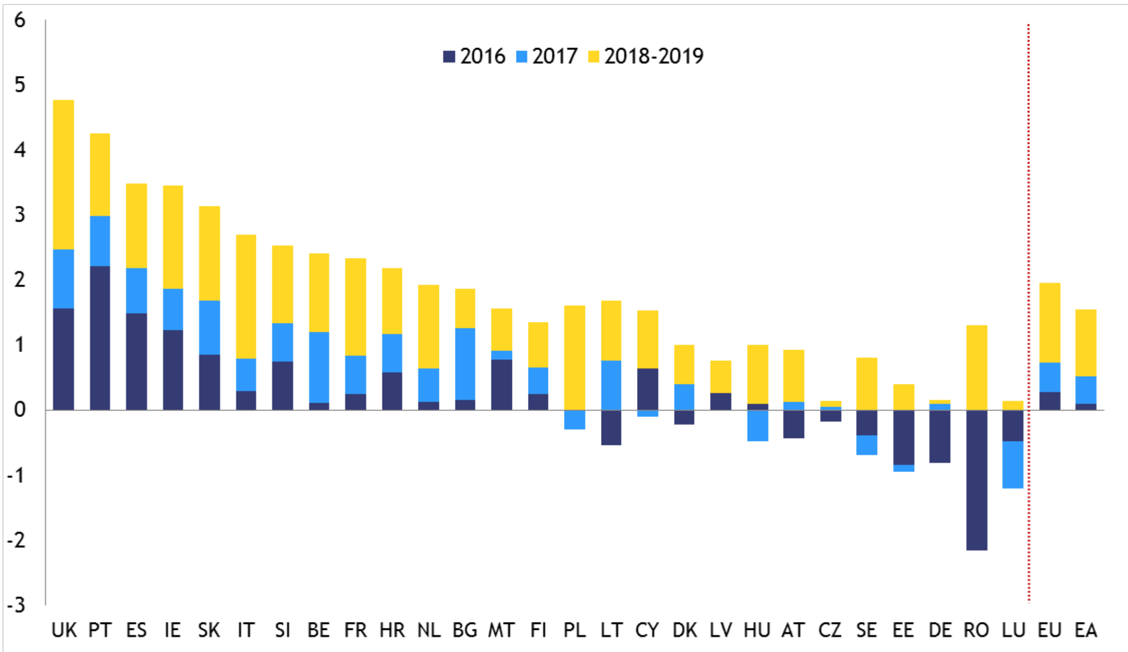
Note: The graph disaggregates the changes to Member States debt-to-GDP ratios recorded in 2015 between the contributions of the primary balance, stock-flow adjustments and the snowball effect, the latter of which refers to the interest rate-growth rate differential. Negative (positive) values indicate that the concerned factor contributed to a decrease (increase) in the debt-to-GDP ratio.
Source: European Commission services

1.3. BUDGETARY PLANS FOR 2016 AND BEYOND: DESCRIPTION OF PLANS

Headline balances in the EU and euro area are estimated to fall steadily in 2016 and beyond to reach -0.4% of GDP in 2019, according to the 2016 SCPs. The time profile is somewhat back-loaded, as the outer years of the programme horizon, i.e. 2018 and 2019, account for around two-thirds of the total improvement in the headline balance. In 2016, the nominal adjustment in the euro area is estimated at 0.1% of GDP and at 0.3% of GDP in the EU.

Five Member States plan a nominal adjustment of more than 3% of GDP over the programme horizon, whereas four envisage a deterioration in their headline balances (see Graph I.1.4). Among the former five (ES, IE, PT, SK, UK), three still exceeded the 3% deficit reference value of the Treaty in 2015. DE, EE and LU envisage a deterioration in their headline balance positions, but remain close to balance. Only RO envisages a larger deterioration towards a deficit of 2.9% of GDP in 2016 and 2017. For the remaining countries, the envisaged adjustment is fairly dispersed: five Member States expect an improvement in the headline balance by less than 3% of GDP and more than 2% of GDP; twelve Member States by less than 1% of GDP and more than 0% of GDP.

Graph I.1.4: **Time profile of fiscal developments: planned change in headline budget balance (pp of GDP, cumulative) in EU Member States for 2016-2019, as presented in 2016 SCPs**



Note: The graph shows the change in the headline balance over the period 2015-2019 according to 2016 SCPs. Countries are ordered from largest to smallest cumulative change in the headline budget balance in the period 2016-2019.
Source: European Commission services

Concerning the (recalculated) structural balance, a majority of Member States plan a small deterioration in 2016, followed by back-loaded consolidation ([4]). In 2016, the structural balance is expected to worsen by 0.3% in the euro area and 0.1% in the EU. Consolidation is planned to restart mildly in 2017 at around 0.3% of GDP in the EU, but remains below a ¼% of GDP in the euro area (a more detailed assessment of the fiscal stance in the euro area can be found in chapter 2). It is then expected to gain some steam in 2018 and 2019, especially in the EU as a whole. Throughout the period 2016-2019, the structural balance is planned to improve by 0.3% in the euro area and 1.0% in the EU. As a result of that, the structural deficit is projected to reach -0.6% and -0.5% in the euro area and the EU respectively.

Mirroring the developments of the headline balance, a majority of Member States plan a structural adjustment over the full SCP horizon, the bulk of which is projected to come in the final years. The change in the structural balance is particularly back-loaded for IE, IT, PT, FR, PL and NL. In turn, eight Member States (CY, LU, RO, EE, DE, SE and CZ) envisage an overall deterioration of their structural balance.

Most Member States plan to converge towards their MTOs, including those currently overarchieving them. As shown in Graph I.1.6, all eight Member States which envisage an overall deterioration of their structural balance in the 2016 SCPs, are currently at or above their MTO and plan to remain adhering to them throughout the programme horizon, with the exception of RO and CY. At the same time, all Member States currently below their MTO, intend to pursue a structural adjustment. By the

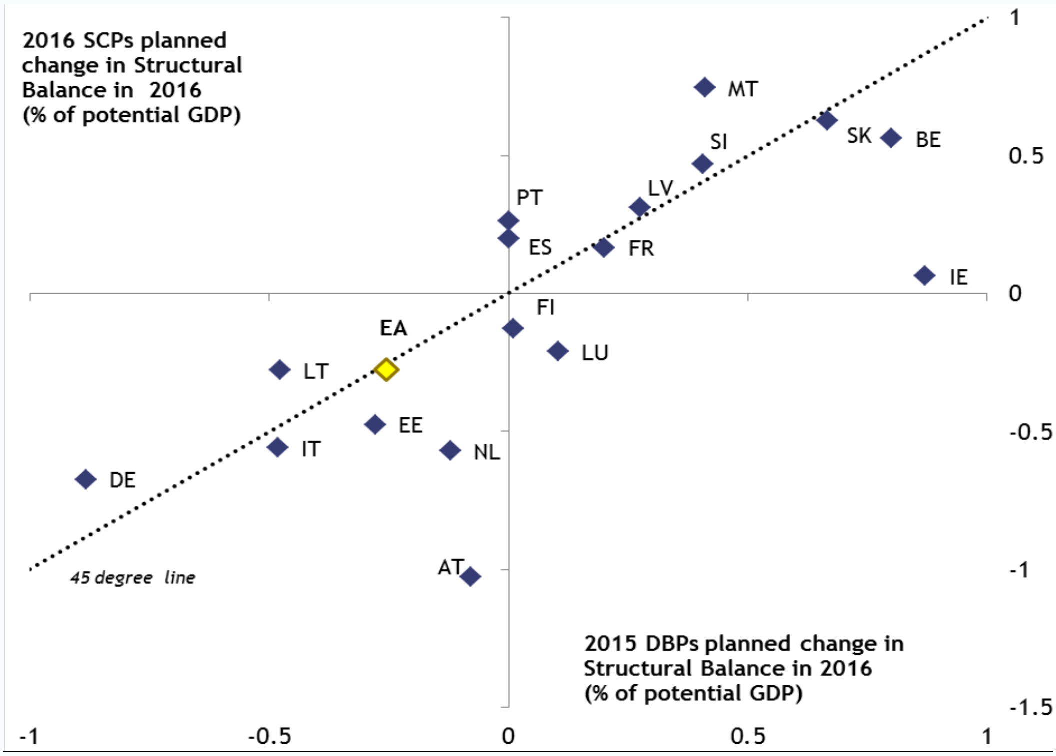
([4]) Structural balances as recalculated by the Commission based on the information contained in the Stability and Convergence Programmes, following the commonly agreed methodology.

Box I.1.1: **Comparison with the Draft Budgetary Plans**

The cycle of fiscal surveillance for euro area Member States is structured around two main milestones in the calendar year: the submission of Stability Programmes (SPs) in the spring and the submission of Draft Budgetary Plans (DBPs) in the autumn. While the latter concerns only the following year, the SPs cover a wider timespan and contain the authorities' medium-term fiscal strategies. However the two fiscal documents overlap for one year, 2016 in this case. The information contained in the SPs for 2016 is thus an update of Member States' plans as presented to their Eurozone peers last autumn. This box compares the 2016 overall macroeconomic outlook and budgetary targets for the euro area, as presented in the most recent DBPs and SPs. One caveat should however be borne in mind: Portugal did not submit a DBP last autumn and is therefore not included in the euro area average for the DBPs, while it is included in the euro area average for the 2016 SPs. CY did not submit a DBP as it was under a macroeconomic adjustment programme. For 2016, the growth outlook is broadly unchanged from last autumn, with GDP growth forecast at 1.8% in the euro area versus 1.9% projected in the DBPs. The inflation outlook remains subdued, broadly in line with DBPs' projections, and is expected to be around 1% in 2016.

Graph 1: Change in the structural balance in 2016 as planned in the 2016 SCPs vs. 2015 Draft Budgetary Plans (% of potential GDP)

Graph I.1.a: **Change in the structural balance in 2016 as planned in the 2016 SCPs vs. 2015 Draft Budgetary Plans (% of potential GDP)**



Source: European Commission services

Euro area Member States are on aggregate planning a ¼ pp of GDP loosening of the structural balance in 2016, in line with the projections included in last DBPs. However, several Member States have updated their planned change in the structural balance since autumn last year: six countries are now planning a more restrictive – or less expansionary – fiscal stance than some months ago (MT, PT, DE, LT, ES and SI) while

(Continued on the next page)

Box (continued)

another eight are now envisaging a looser one (AT, IE, NL, LU, BE, EE, FI and IT) ([a]). In some of the latter cases this is due to different treatment of certain expenditure items (e.g. in the case of BE the divergence is explained by the fact that the 2016 Stability Programme includes exceptional refugee-related expenditure in the structural balance, while it was considered as a one-off expenditure in the DBP).

Turning to the headline balance, last autumn euro area Member States were planning to reduce the aggregate headline budget deficit by a slight 0.2 pp of GDP in 2016. The reduction in the headline deficit for 2016 is now planned to be shallower, by 0.1 pp, to 1.9% of GDP.

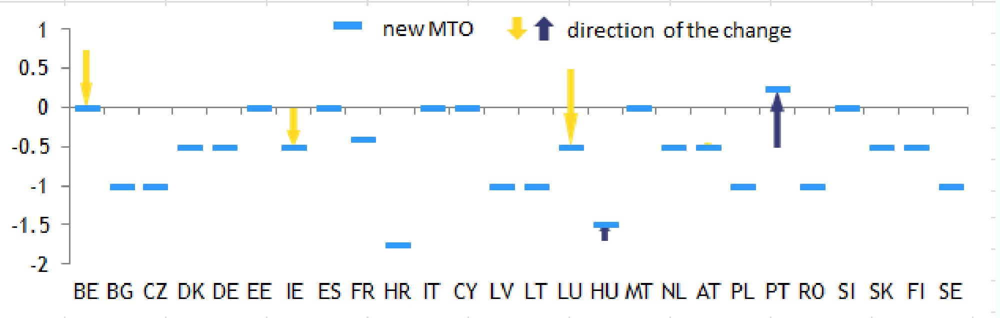
([a]) For LV, FR, and SK the difference amounts to less than 0.05% of GDP.

end of the programme horizon, sixteen Member States would be in vicinity or above their MTO according to the recalculated structural balances, while three Member States (ES, FR and SI) would maintain a distance to their MTO of more than 1% of GDP through 2019 ([5]). Box I.1.2 shows MTO revisions in the 2016 SCPs.

Box I.1.2: MTO revisions in the 2016 SCPs

In early 2016, the Commission and Member States have updated the minimum MTOs, in line with the agreed methodology of the Code of Conduct of the SGP. Most Member States, i.e. twenty, maintained their MTOs for 2017 at the current level. Three Member States (BU, IE, LU) decided to revise their MTOs downwards, making use of room ensuing a fall in their implicit costs of aging. HU, PT adjusted their MTOs upwards. SI keeps its MTO unchanged although it falls short of its updated minimum MTO, since it does neither adequately take into account the need to bring debt below the Treaty reference value nor the implicit liabilities related to ageing. HR nominated its MTO for the first time, given its relatively recent accession to the EU. However, the value chosen is not sufficient to ensure compliance with the debt rule in the medium term.

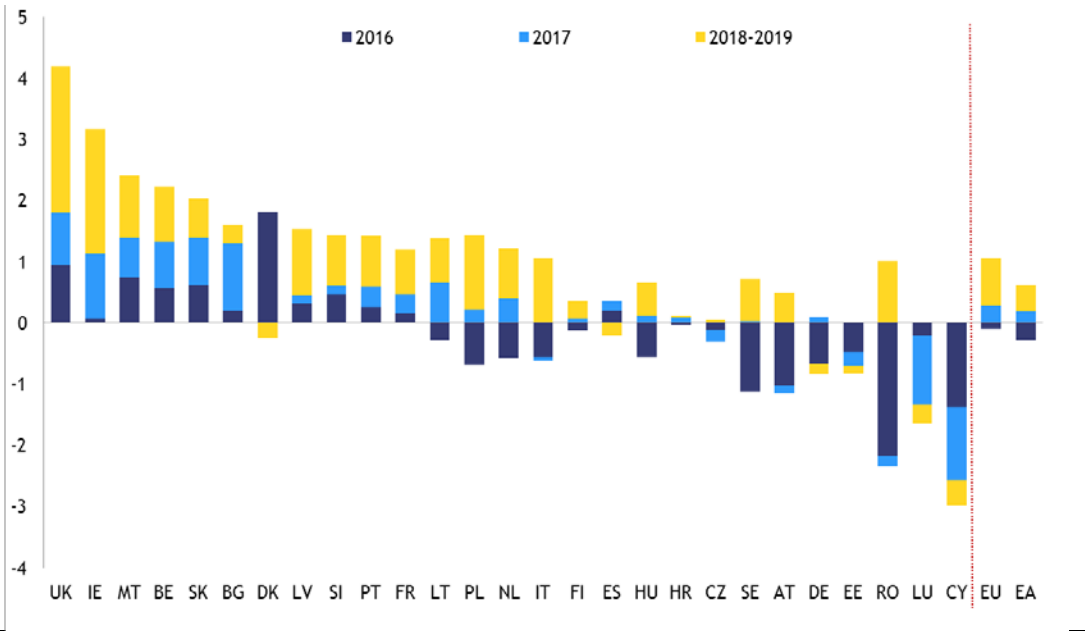
Graph I.1.b: **MTO revisions in 2016 SCPs (% of potential GDP)**



Source: European Commission services
Note: The graph compares MTOs as set in the 2016SCPs for the year 2017 to the previous ones from the 2015.

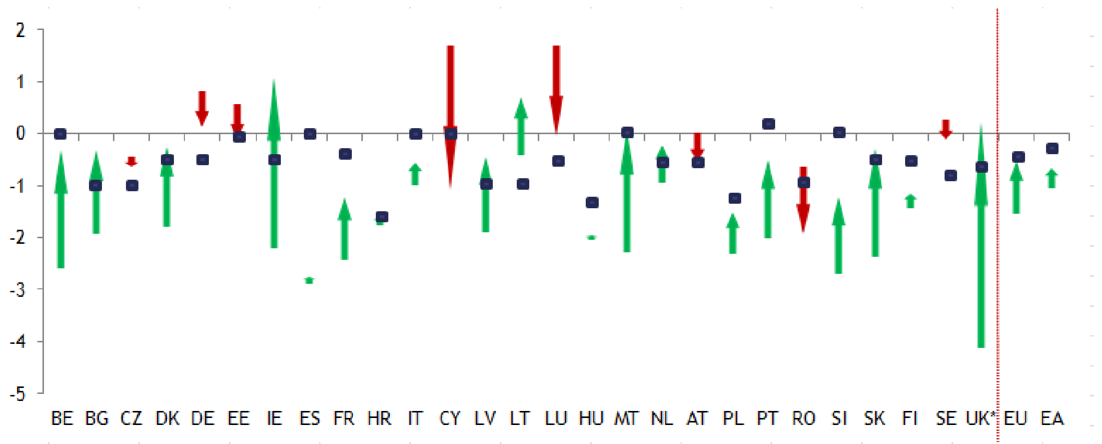
([5]) This is according to the recalculated levels of the structural balance in 2019. Note that on the basis of the non-recalculated figures of the structural balance contained in the SCPs, 21 Member States plan to be at their MTOs by 2019.

Graph I.1.5: **The change in the structural balance (% of potential GDP, cumulative) planned from 2016 to 2019 in the EU Member States**



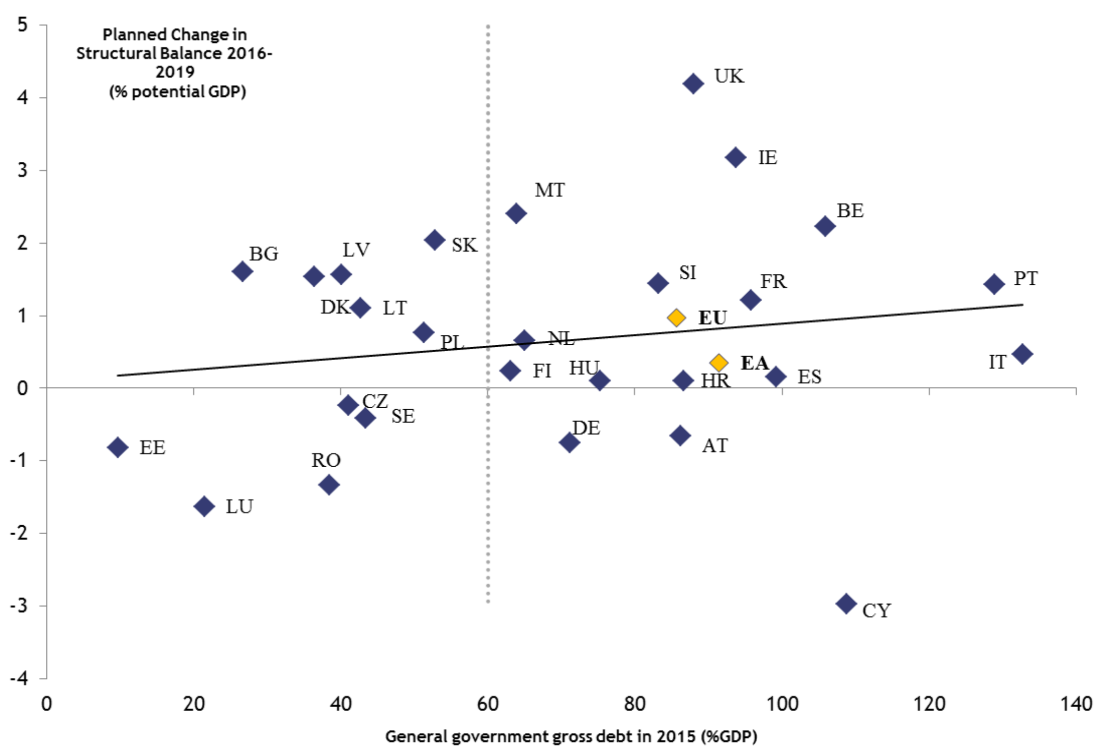
Note: The graph shows the change in the structural balance over the period 2015-2019 according to 2016 SCPs. Countries are ordered from largest to smallest cumulative change in the structural budget balance in the period 2016-2019
Source: European Commission services

Graph I.1.6: **Progress towards MTO (% of potential GDP)**



Note: The graph sets out Member States' reported progress towards their respective MTO throughout the programme horizon. The base of the arrow represents the starting position of the structural balance in 2015, while the tip of the arrow represents the projected (recalculated) structural balance for 2019. Thus, the size of the green (red) arrow corresponds to the projected overall improvement (deterioration) in the structural balance throughout the programme horizon. Finally, the dark markers represent each Member State's MTO for 2017 and beyond. For the euro area and the EU, area-specific MTOs were calculated as weighted averages for illustrative purposes.
(*) The UK has not nominated its MTO. Graph shows minimum MTO instead.
Source: European Commission services

Graph I.1.7: **Starting level of debt in 2016 versus cumulated change in structural budget balance over the period 2016-2019**



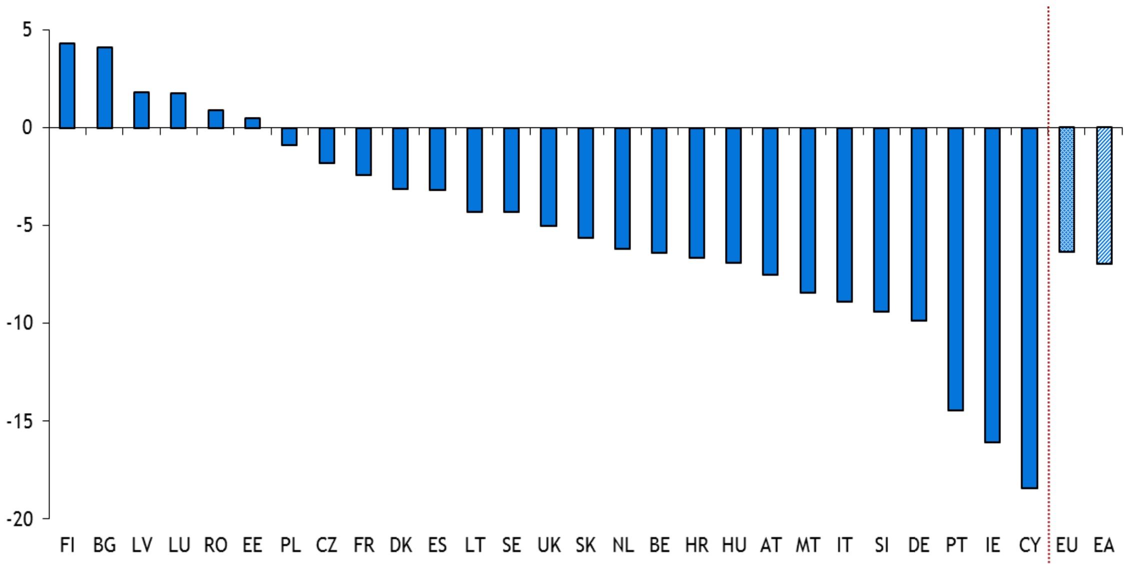
Source: European Commission services

The structural improvement planned by Member States is only weakly related with their debt positions. This suggests that the projected structural effort is weakly differentiated across Member States according to their debt levels. To put high levels of public debt on a sustainably decreasing path, fiscal adjustment is needed over the medium term. Graph I.1.7 shows that more indebted Member States are more likely to pursue further structural adjustment. However, ES, HR, CY and IT envisage limited structural adjustment despite high levels of public debt.

After peaking in 2014 at almost 95% of GDP, the aggregate debt ratio for the euro area is planned to somewhat decrease throughout the programme horizon and reach 85% of GDP in 2019. Similarly, debt-to-GDP is projected to gradually decline in the EU and reach 79% of GDP by 2019, 7 pps smaller than its 2015 value. The aggregate evolution of the debt ratio masks a wide range of national figures, with the projected debt reduction being particularly remarkable in the case of CY, IE and PT. At the same time debt is planned to increase or decrease very moderately throughout the SCPs period in a few countries. Debt ratios in 2019 are projected to vary across individual Member States from above 100% of GDP in Italy and Portugal to just around 10% of GDP in Estonia.

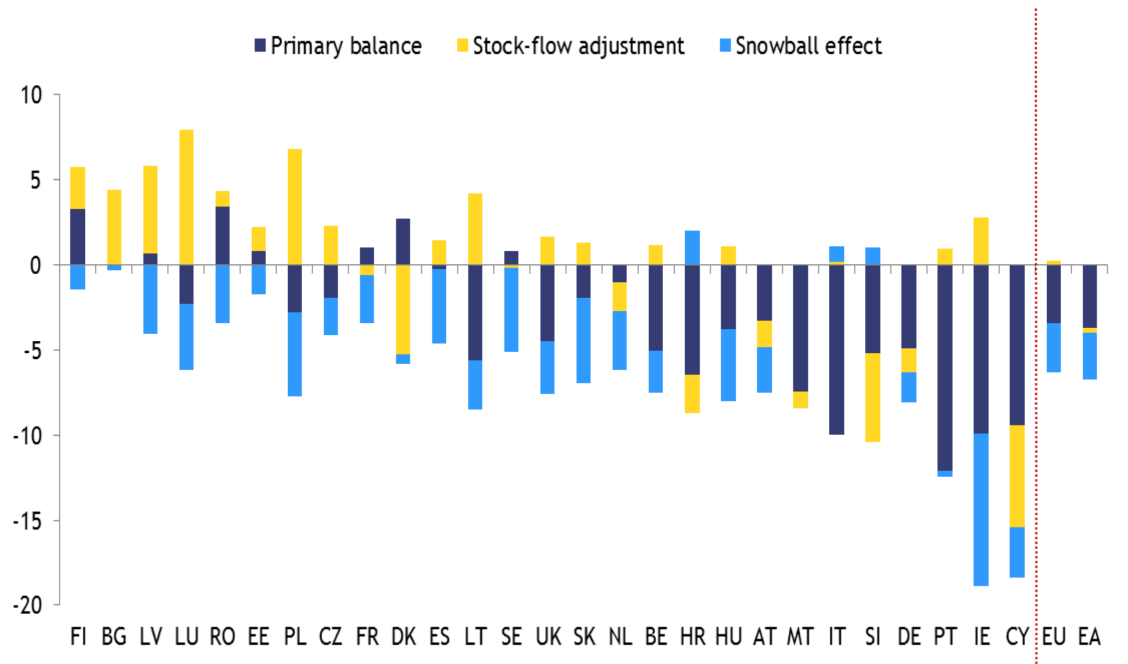
Primary surpluses and a favourable snowball effect are expected to contribute in roughly similar terms to the projected reduction in the debt ratio of both the euro area and the EU. As shown in Graph I.1.9 around half of the projected overall debt reduction throughout the SCPs period is expected to stem from nominal growth persistently exceeding the implicit nominal interest rate on the stock of debt (i.e. a favourable snowball effect). Primary surpluses account for the remaining debt reduction projected for the euro area and the EU.

Graph I.1.8: **Changes in general government debt in the period 2016-2019, as planned in 2016 SCPs (% of GDP)**



Source: European Commission services

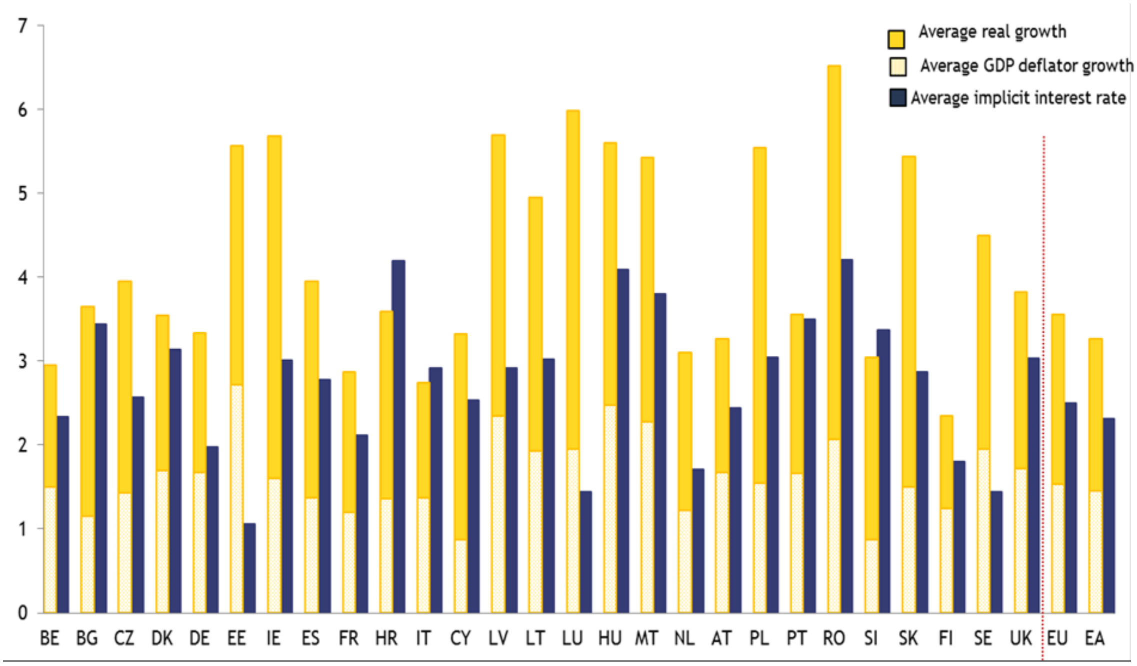
Graph I.1.9: **Contributions to the change in the debt-to GDP ratio in the period 2016-2019, as planned in the 2016 SCPs (pp. of GDP)**



Source: European Commission services

Notes: The graph disaggregates the 2015-2019 change to Member States debt-to-GDP ratios between the contributions of the primary balance, stock-flow adjustments and the snowball effect, the latter of which refers to the interest rate-growth rate differential. Values below (above) zero imply that the concerned element is contributing to a decrease (increase) in the debt ratio.

Graph I.1.10: **Implicit nominal interest rate and nominal GDP growth rate, as planned in the 2016 SCPs (average 2016-2019).**



Source: European Commission services
Note: The graph shows the 2016-2019 average implicit nominal interest rate on the stock of government debt, according to the 2016 SCPs. It also shows the 2016-2019 average nominal GDP growth, according to the 2016 SCPs.

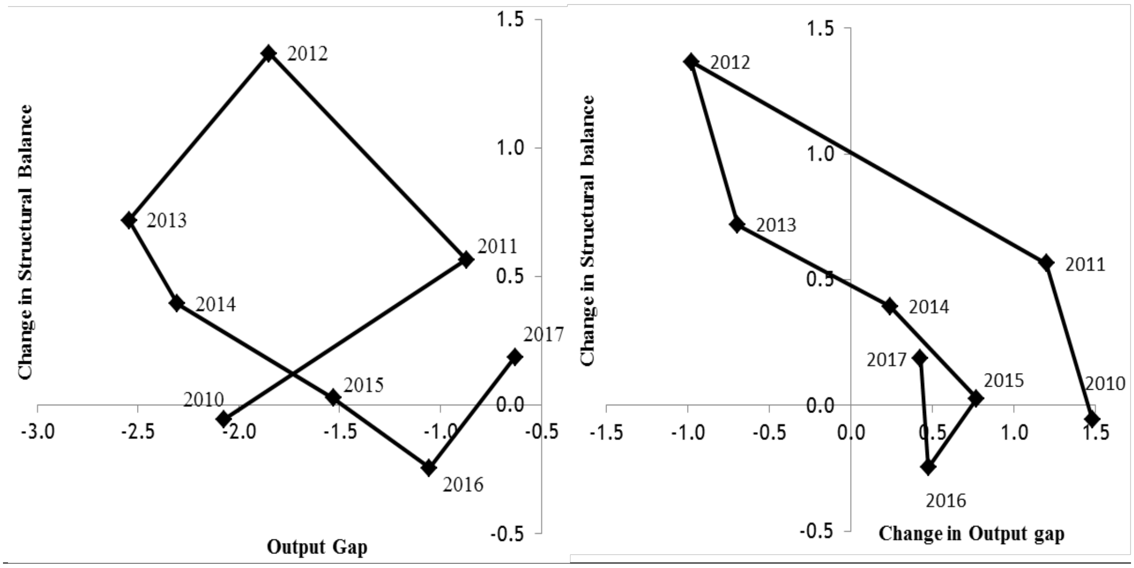
Concerning the drivers of the change in the debt ratio, the picture varies significantly across Member States. Still, general patterns can be discerned to some extent. In particular, most countries project primary surpluses that will contribute to overall debt reduction in the programme period, while only in five countries – DK, FR, RO, FI and SE – is the contribution of the primary balance projected to be overall debt-increasing. As shown in Graph I.1.10, the vast majority of Member States expect a favourable contribution of the snowball effect, with average nominal GDP growth exceeding the implicit interest rate on outstanding debt throughout the programme horizon. This is despite the fact that euro area Member States expect inflation to remain somewhat subdued throughout the SCPs period on average. Conversely, adverse snowball effects are expected to partly offset the debt-reducing impact of the primary

Table I.1.3: **Composition of fiscal plans (% of GDP)**

		2015	2016	2017	2018	2019
		Commission forecast	2016 SCPs			
EU	Primary expenditure ratio	45.1	44.1	43.6	43.1	42.4
euro area		46.1	45.7	45.2	44.7	44.2
EU	Interest expenditure ratio	2.3	2.2	2.1	2.0	2.0
euro area		2.4	2.2	2.1	2.0	2.0
EU	Revenue ratio	45.1	44.3	44.2	44.2	44.1
euro area		46.5	46.0	45.9	45.9	45.8
EU	Headline balance	-2.2	-2.0	-1.6	-1.0	-0.4
euro area		-2.0	-1.9	-1.4	-0.9	-0.4

Source: European Commission services

Graph I.1.11: **Aggregate fiscal effort and economic conditions in the euro area**



Source: European Commission services
Note: The graph plots the structural balance against the change in the output (left-hand side panel) and the output gap in levels (right-hand side panel) in the euro area, as outturn in years 2005-2014 and as planned in the 2016 SCPs for years 2016 and 2017.

surpluses planned by IT, HR and SI throughout the programme period.

Concerning the composition of the fiscal adjustment over the programme horizon, primary expenditure is expected to be the main driver of the reduction in headline deficit ratio. Member States plan a steady reduction in primary expenditures of around 0.5% of GDP each year (see Table I.1.3). Part of this decline is likely to come from a closure of the output gap, as opposed to primary expenditure growing less than potential growth. In 2016, a fall in interest expenditure by around 0.2% of GDP further supports the decline in total expenditure. However, a drop in the revenue ratio eats up most of the efforts on the expenditure side in 2016. In 2017 and beyond, revenue ratios are projected to remain broadly stable, as well as interest expenditure.

The overall fiscal policy stance in the euro area in 2016 is supportive of the recovery. The structural deficit is expected to increase by around ¼ pp of GDP against a negative output gap of around 1% of GDP. This slightly expansionary fiscal stance thereby supports the further narrowing of the output gap while it ensures a shift from external to domestic sources of growth. The need for output stabilisation in the short term has to be balanced with a structural effort over the medium term to deliver a sustained debt reduction. In 2017, euro area Member States plan to resume with a structural adjustment of around 0.2% of GDP as the output gap is virtually closing (see Graph I.1.11).

1.4. RISK ASSESSMENT OF PLANS

This section analyses possible risks to the attainment of the aggregate budgetary targets set out in the 2016 SCPs. The assessment of risks is conducted differently for the sub-period 2016-2017 and the outer years of the programme horizon (2018-2019). The reason is that only the 2016-2017 period is covered by the Commission 2016 spring forecast. Section IV.I presents a comparison between the aggregate headline deficit targets for 2016 and 2017, as planned in the SCPs and as forecast by Commission services. The drivers of possible differences between the two are discussed. Section IV.2

Box I.1.3: **The change in the structural balance and the DFE: two alternative measures of discretionary fiscal policy actions**

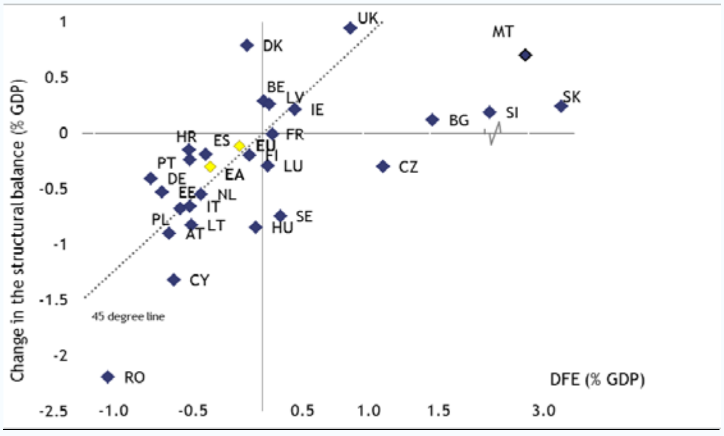
Discretionary fiscal policy actions implemented by governments are frequently approximated by the structural balance or rather the change therein. In fact, since the 2005 reform of the Stability and Growth Pact the change in the structural balance plays a central role in the European fiscal framework.

This indicator has well-known advantages, among which is that it is widely-known and routinely calculated. However, it has also been increasingly challenged since its endogenous relation with GDP may interfere with the estimations of governments' fiscal actions. Another source of trouble in interpreting the change in the structural balance relates to its tendency to undergo revisions, reflecting the difficulty of real time measurement of the output gap. It is thus generally acknowledged that the change in the structural balance is frequently distorted by non-policy effects.

The discretionary fiscal effort (DFE) provides an alternative indication of the fiscal stance, combining a narrative approach on the revenue side with a refined top-down approach on the expenditure side ([a]). Its definition is meant to largely avoid the endogeneity problem biasing the structural balance, as it is not exposed to short-term changes in revenue or spending elasticities. At the same time it relies on a smoother and more stable notion of potential growth than the structural balance.

While over time the DFE and the change in the structural balance tend to convey the same message, sizeable differences between the two indicators can be observed in specific periods of time. Graph I.1.c below plots the fiscal stance in 2016 as measured by the change in the structural balance and the DFE.

Graph I.1.c: **Aggregate fiscal effort and economic conditions in the euro area**



Source: European Commission services

Both indicators provide roughly the same picture for the euro area and the EU aggregates. This is also the case for around half of the Member States, with the difference between the two indicators being of ¼ pp or less.

([a]) See Chapter III of the Report on Public Finances in EMU 2013: http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

(Continued on the next page)

Box (continued)

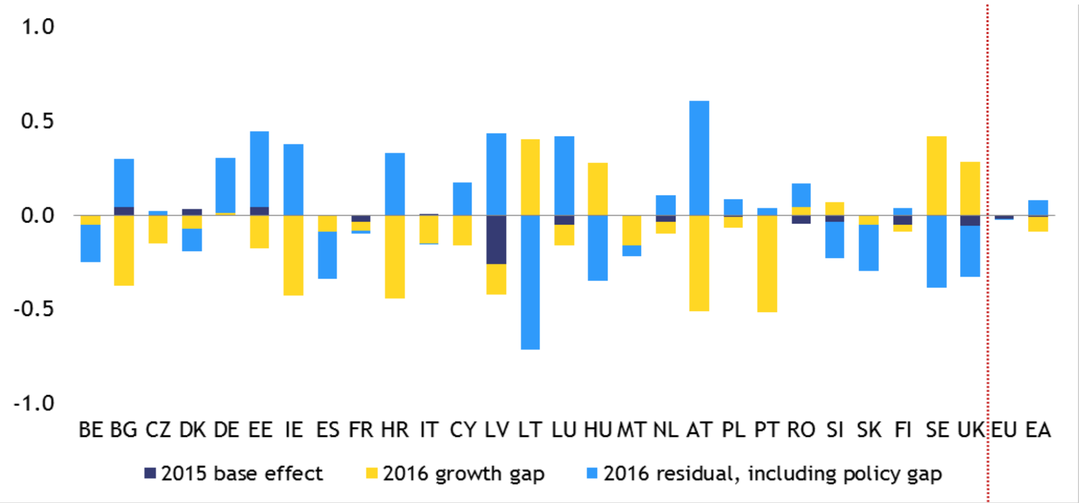
However, in light of the DFE figures, the change in the structural balance may be underestimating the actual underlying fiscal effort implemented by ten Member States in 2016. In all ten cases this is mainly due to revenue shortfalls which distort the estimation provided by the change in the structural balance. This is particularly prominent in the case of SK, MT, SI, BG, CZ, SE and RO, for which the DFE points to a considerably larger tightening (or smaller loosening) of the fiscal stance than suggested by the change in the structural balance.

The opposite is true for some other Member States (mainly DK, PT, DE and ES), where the DFE points to a more accommodative fiscal stance than the change in the structural balance. In these cases, the relatively better picture provided by the change in the structural balance is mainly driven by revenue windfalls and the decrease in interest payments.

checks the feasibility and internal consistency of Member States' budgetary targets for 2018 and 2019, by mainly focusing on projected revenue dynamics.

The comparison between Commission and SCPs projections shows that risks to the attainment of budgetary targets in 2016 and 2017 are moderate on the aggregate; however risks are higher over the medium term. In particular, several Member States are implicitly assuming considerable revenue windfalls which are instrumental to the achievement of their revenue – and ultimately deficit – targets by the end of the programme horizon. Were revenues to respond to growth in their standard fashion, these Member States would need to implement larger revenue measures than they are currently envisaging in order to meet their projected headline deficit plans.

Graph I.1.12: **General government deficit for 2016: decomposition of the gap between SCPs and Commission 2016 spring forecast (% of GDP)**



Source: European Commission services
Notes: The graph shows a decomposition of the difference between the deficit figure in 2016, as per the SCPs and Commission forecast into (i) base effect, (ii) difference in a standardized measure of the growth gap and (iii) a residual. The growth gap is calculated multiplying the difference in nominal growth assumptions times the standard OECD semi-elasticities. The residual includes the so-called 'policy gap', i.e. the difference in the evaluation of budgetary measures. It also includes possible differences in revenue elasticities or interest payments. Values below zero imply that the component has a deficit reducing effect in the SCPs relative to the Commission 2016 spring forecast, while values above zero indicate that the component increases the SCPs deficit relative to the Commission forecast. The sum of the components is the difference between the COM headline balance forecast and the SCP headline balance forecast.

1.4.1. Forecast horizon: risks to 2016 and 2017 programmes.

The Commission 2016 spring forecast provides with a natural benchmark against which to assess the macroeconomic projections for 2016-2017 and the expected yield of the budgetary measures as planned in the 2016 SCPs.

In the comparison between Commission and SCPs projections, risks to headline deficit targets seem limited in 2016 and 2017 on aggregate terms. The overall divergence between Member States' and Commission services' headline deficit projections is minor in 2016 and boils down to less than ¼ pp of GDP in 2017, as shown in Table I.1.4.

The difference in headline deficit projections with respect to Commission forecast can be decomposed into three main components: a base effect, reflecting possible differences in the previous year deficit forecast; a standardised measure of the growth gap which measures the difference resulting from different nominal growth assumptions ([6]), and a residual which includes the so-called 'policy gap' and measures the difference in the assessment of budgetary measures underlying the projected fiscal targets. The remainder of this sub-section discusses the contribution of the above three elements to the difference in headline deficit projections by Member States and by Commission services in 2016 and 2017.

Regarding 2016, the largest divergences between Commission and Member States' deficit projections concern PT, ES, LT, SK and BE. These Member States project smaller headline budget deficits than Commission services, by an amount that ranges between ¼ and ½ pp of GDP. With the exception of PT, the residual accounts for the bulk of the difference between the two estimates, suggesting that these Member States' evaluation of the 2016 budgetary measures may be optimistic compared to Commission's assessment.

The SCPs real growth assumptions for 2016 are generally close to those of the Commission, while differences turn more marked when it comes to expected inflation. For nine Member States there is a negative growth gap in 2016, implying that they expect a larger cyclical improvement in their headline deficit than the Commission does. This is particularly noticeable in the case of PT, AT, HR, IE and BG, as shown in Graph I.1.12. The opposite is true for SE, LT, HU and UK that expect lower nominal growth

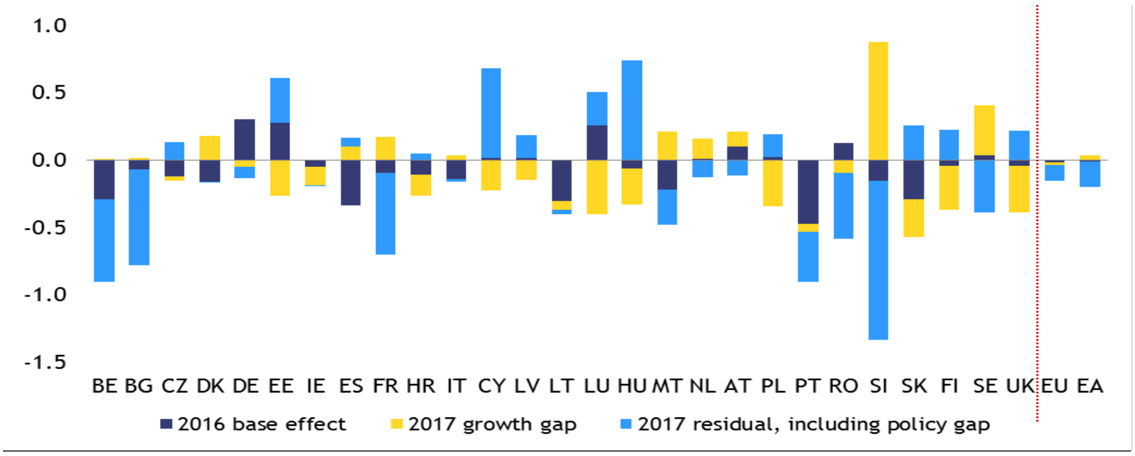
Table I.1.4: **Nominal growth and Government headline balance targets in 2016 SCPs and Commission forecast**

		2015	2016		2017	
		Commission forecast	Commission forecast	2016 SCPs	Commission forecast	2016 SCPs
EU	Headline balance (% GDP)	-2.2	-2.1	-2.0	-1.7	-1.6
euro area		-2.0	-1.9	-1.9	-1.6	-1.4
EU	Real GDP growth (% change)	2.0	1.9	2.0	1.9	1.9
euro area		1.7	1.6	1.8	1.8	1.7
EU	GDP deflator (% change)	1.2	1.4	1.2	1.5	1.5
euro area		1.3	1.3	1.3	1.3	1.3

Source: European Commission services

([6]) Different nominal growth forecast for a given year can result in different headline deficit forecast. The OECD standard semi-elasticities are used- in the absence of a better parameter- to approximate the effect that such different nominal growth forecast can have in the headline deficit prospects.

Graph I.1.13: **General government deficit for 2017: decomposition of the gap between SCPs and Commission 2016 spring forecast (% of GDP)**



Source: European Commission services
Notes: The graph shows a decomposition of the difference between the deficit figure in 2016, as per the SCPs and Commission forecast into (i) base effect, (ii) difference in a standardized measure of the growth gap and (iii) a residual. The growth gap is calculated multiplying the difference in nominal growth assumptions times the standard OECD semi-elasticities. The residual includes the so-called 'policy gap', i.e. the difference in the evaluation of budgetary measures. It also includes possible differences in revenue elasticities or interest payments. Values below zero imply that the component has a deficit reducing effect in the SCPs relative to the Commission 2016 spring forecast, while values above zero indicate that the component increases the SCPs deficit relative to the Commission forecast. The sum of the components is the difference between the COM headline balance forecast and the SCP headline balance forecast.

in 2016 than Commission services. Finally, the 2015 base effect is negligible for most Member States.

Turning to 2017, the largest differences in headline deficit projections for 2017 concern BE, PT and BG – for which Commission services estimate a headline deficit around 1% of GDP higher than the authorities. Differences are also rather large for FR, SI and RO – where Commission forecast point to a 2017 headline deficit around 0.5% of GDP higher than targeted in the SCPs. In most cases the residual explains the main part of these differences. This suggests that policy measures contribute more to the improvement in the headline balance according to Member States' programmes than according to Commission forecast. The fact that on average Member States' projections for 2017 are somewhat more favourable than the Commission ones is not surprising, as the budgetary measures for next year have not always been communicated in time or in sufficient detail to be taken into consideration in the last Commission forecast, which are based on the 'no-policy change' assumption. ([7])Larger measures contained in the SCPs than taken into account by the Commission (represented in Graph I.1.13 as a negative policy gap) can be found in eleven Member States in 2017.

SCPs projections for 2017 real growth and GDP deflator are in line with the Commission forecast on aggregate terms. Differences however turn more substantial at country level, with EE, LU, HU, PL, SK, FI and the UK standing out as the most optimistic Member States compared to the Commission forecast. On the contrary, SI, SE, MT, DK, FR and NL are basing their fiscal plans for 2017 on comparatively prudent macroeconomic projections. ([8]) Finally, the 2016 base effect does not appear to have a relevant explanatory role in 2017 either.

([7]) The 'no-policy change' assumption, implies the extrapolation of revenue and expenditure trends and the inclusion of only those measures that are known in sufficient detail.
([8]) The large growth gap in the case of SI is mainly stemming from a large difference in expected inflation and hence, nominal GDP growth. In the case of FR, the difference between the macroeconomic scenarios of the authorities and the Commission is largely explained by the difference in the structural effort.

1.4.2. The outer years: risks to 2018 and 2019 plans.

Risks to the realisation of the later years' deficit targets can stem from the size of the implied fiscal measures, on the one hand, and the plausibility of revenue projections, on the other hand. First, the targets, even if based on realistic macroeconomic assumptions, can turn unachievable if their realisation implicitly requires a (too) large amount of additional discretionary measures. Second, the underlying assumptions – other than growth – on which the budgetary targets are based, may turn out too optimistic. Thus, the evaluation of risks in the later years of the programmes mainly focuses on the comparison between the fiscal targets as declared by national authorities and their no-policy change projections.

This subsection focuses mainly on the revenue side. This is due to the fact that more information on the revenue side is made available through the SCPs due to reporting obligations by Member States. ([9])

At first sight, risks stemming from the size of the additional required measures seem restrained on the aggregate. In fact, the comparison between euro area Member States' overall revenue targets for 2018 and 2019 and their no-policy change revenue projections results in that no additional discretionary measures are required in either 2018 or 2019 (see Table I.1.5). In the case of the EU some additional 0.1% of GDP annual effort will be required to reach its overall revenue target in 2019. ([10]) Across Member States, this comparison shows nevertheless that some countries will need to implement substantial additional revenue measures in order to bridge the gap between their no-policy change projections and their declared revenue targets. This constitutes a source of risk to the achievement of the deficit targets of PT, SI and UK in 2018 and 2019. Conversely, the attainment of the revenue targets of BG, EE, LU, and SK seems compatible with some revenue-decreasing measures in the later years of the programme.

However, the underlying assumptions on which the budgetary targets are based may be too optimistic in the case of several Member States. This partly explains the fact that the size of the additional required revenue measures appears so small (or is even negative) for some countries. Ten Member States are relying on a favourable evolution of revenues under the no-policy change scenario by implicitly including revenue windfalls in their SCPs' projections. As shown in Table I.1.5, PL, SE, LT, EE, BG, RO, NL, FI and AT stand out with revenue windfalls amounting to somewhere between 0.5% and 1.2% of GDP cumulatively in 2018 and 2019. If these windfalls were not to materialise but instead revenues react to growth in line with OECD standard elasticities, these Member States will need to implement substantially larger revenue measures to attain their revenue targets in the later years of the programmes.

Furthermore, the envisaged fiscal adjustment relies mostly on savings in current expenditure as a share of GDP, whereas past experience shows that such savings can be difficult to achieve. As discussed in section II current expenditure is envisaged to fall by around 1% of GDP over 2018 and 2019 in both the euro area and the EU. As output gaps are expected to have fallen to around 1% of GDP by 2017, automatic stabilisers only explain part of these savings. Besides, interest expenditure is expected to be reduced somewhat in 2017 and 2018, albeit already at historically low levels.

([9]) The submission of no-policy change revenue projections has been agreed upon by all Member States according to the code of conduct of the Stability and Growth Pact. Conversely, the submission of no-policy change expenditure projections remains voluntary.
http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

([10]) Figures above do not include Spain since it has not submitted its no-policy change revenue projections. The EU aggregate figure is mainly driven by the UK.

Table I.1.5: **Implicit amount of revenue measures and revenue windfalls for 2018 and 2019 (% of GDP)**

	Change in revenue targets (I)		Change in 'no-policy change' revenue projections (II)		Implied annual measures (III)=(I)-(II)		Reported annual DRMs		Annual revenue windfalls (+) / shortfalls (-) implicit to the 2016 SCPs	
pp GDP	**2018**	**2019**	**2018**	**2019**	**2018**	**2019**	**2018**	**2019**	**2018**	**2019**
BE	0.0	-0.1	-0.2	-0.1	0.2	0.0	0.2	0.0	-0.1	0.0
BG	-0.1	-0.2	0.0	0.3	0.0	-0.5	0.5	0.1	0.2	0.5
CZ	-0.1	-0.4	-0.3	-0.5	0.2	0.1	0.2	0.0	-0.1	-0.2
DK	-0.6	-0.1	-0.6	-0.1	0.0	0.0	0.0	0.0	-0.3	0.1
DE	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.2	0.1
EE	-0.7	0.0	-0.5	0.2	-0.2	-0.2	-0.1	-0.1	0.1	0.7
IE	-0.4	-0.2	-0.4	-0.2	0.0	0.0	0.0	0.0	-0.4	-0.2
ES	0.1	0.1	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
FR	-0.2	-0.2	-0.1	-0.3	-0.1	0.1	-0.1	-0.2	-0.1	-0.3
HR	0.0	-0.6	0.0	-0.6	0.0	0.0	*n.a.*	*n.a.*	0.2	-0.4
IT	0.2	0.0	0.2	0.0	0.0	0.0	0.3	0.3	0.1	-0.1
CY	-0.2	0.1	-0.2	0.1	0.0	0.0	0.0	0.0	-0.1	0.2
LV	0.2	-1.0	0.2	-1.0	0.0	0.0	0.2	-0.4	0.7	-0.5
LT	0.5	-0.4	0.5	-0.4	0.0	0.0	0.2	0.0	0.9	0.0
LU	-1.1	-0.6	-0.9	-0.6	-0.2	0.0	-0.8	-0.8	-0.9	-0.7
HU	-0.7	-2.5	-0.8	-2.5	0.1	0.0	0.0	0.0	-0.5	-2.2
MT	-0.5	-0.4	-0.7	-0.4	0.2	0.0	0.0	0.0	-0.4	-0.2
NL	0.2	0.2	0.2	0.2	0.0	0.0	0.1	0.0	0.4	0.3
AT	0.0	0.0	0.1	0.0	0.0	0.0	-0.5	-0.5	0.3	0.2
PL	0.4	0.0	0.2	0.0	0.2	0.0	0.4	0.4	0.7	0.5
PT	-0.2	-0.1	-0.4	-0.3	0.2	0.2	0.0	0.0	-0.3	-0.2
RO	0.2	-0.1	0.2	-0.1	0.0	0.0	0.0	0.0	0.5	0.2
SI	-0.6	-0.9	-0.6	-1.2	0.0	0.3	0.0	0.0	-0.5	-1.1
SK	-0.6	-1.3	-0.4	-1.2	-0.2	-0.1	-0.1	0.0	0.1	-0.6
FI	-0.2	0.0	-0.1	0.0	-0.1	0.0	-0.1	0.0	0.2	0.4
SE	0.3	0.1	0.3	0.1	0.0	0.0	0.0	0.0	0.6	0.4
UK	0.1	0.3	-0.1	-0.1	0.2	0.4	-0.2	0.5	-0.3	-0.1
EU	0.0	0.0	0.0	-0.1	0.0	0.1	0.0	0.1	0.0	0.0
EA	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	0.0

Source: European Commission services
Note: (*) Unchanged policy revenues for the aggregate EU and euro area do not include Spain, since Spain did not submit this information in its Stability Programme.

1.5. SUSTAINABILITY

The sustainability of public finances across Member States, against the background of revised macroeconomic scenario, fiscal outlook, fiscal plans and the demographic ageing is analyzed in this section. The analysis presented here takes therefore as a point of departure the latest Commission 2016 spring forecasts and the 2016 Stability and Convergence Programmes. The long-term budgetary projections released with the 2015 Ageing Report have been incorporated in the simulations. ([11])

The Commission uses a multidimensional approach to assessing fiscal sustainability. It integrates the longer term with an assessment of more immediate challenges and risks, underpinned with appropriate indicators which can point to the scale and the scope of the sustainability challenges. This multidimensional approach enables assessing:

- short-term fiscal challenges, through a combination of fiscal, financial and competitiveness indicators aiming at an *'early detection of fiscal stress'*. The S0 indicator is an 'early-detection indicator', designed to highlight shorter-term (one-year horizon) risks for fiscal stress stemming from the fiscal as well as the financial and competitiveness sides of the economy. A whole set of fiscal and financial-competitiveness variables are used in the composite indicator S0. ([12])

- medium-term fiscal challenges, looks at the risks to fiscal sustainability over the medium run, based on debt sustainability analysis (DSA) and the S1 sustainability indicator, in line with the Fiscal Sustainability Report 2015. ([13]) The S1 indicator shows the fiscal gap related to the excess of projected government expenditure, including projected age-related expenditure, over projected revenue together with any gap with respect to the steady adjustment in the structural primary balance over the five years after the period covered by the forecast, to bring the debt-to-GDP ratio to 60% of GDP by 2030 (S1 indicator).

- long-term fiscal challenges. The S2 indicator shows fiscal gap related to the excess of projected government expenditure, including projected age-related expenditure over projected revenue together with any gap with respect to the primary balance needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path over an infinite horizon.

1.5.1. Short-term fiscal sustainability challenges: the S0 indicator – early detection of fiscal stress.

In terms of short-term challenges, risks for fiscal stress have been reduced in all Member States in the last years. While in 2009 more than half of the EU Member States were above the critical threshold for the S0 indicator, indicating at that time elevated risks of fiscal stress for 2010, in following years short-term risks have been progressively reduced.

According to the S0 indicator, highlighting fiscal risks for 2016, only one country (CY) faces short-term risks of fiscal stress among the EU countries (see Table I.1.6), while all other (non-programme) countries do not have challenges on either the fiscal or macro-financial/competitiveness sides of the

([11]) European Commission (DG ECFIN) and Economic Policy Committee (AWG) (2015), *"The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)"*, European Economy, No 3|2015. The impact of the 2015 pension reform in Belgium is incorporated in the analysis.

([12]) The methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators, which quantify the required fiscal adjustment, the 'fiscal gap'. S0 does not assess 'fiscal gaps' but is a composite indicator estimating risks of 'fiscal stress' in the short term, using risk thresholds (based on the observation of past episodes of 'fiscal stress' for relevant variables and their combinations).

([13]) For details about the sustainability risk classification and the methodology behind the Debt Sustainability Analysis (DSA), see European Commission (2016), 'Fiscal Sustainability Report 2015', European Economy, Institutional papers, No 18, EC, Brussels.

economy. [14] Furthermore, despite remaining above the threshold, the S0 value for CY has been on a decreasing path since 2012, with a particularly strong decrease in 2015 (highlighting risks for 2016) compared to 2014 (highlighting risks for 2015).

1.5.1. Medium- to long-term fiscal sustainability challenges.

Challenges related to government debt projections

Turning to medium- and longer-term implications for fiscal sustainability, taking account of the projected changes in age-related expenditure, the macroeconomic scenario and the fiscal outlook and plans, two main scenarios are considered:

- the 'COM no-policy-change' scenario, with structural primary balance/GDP ratio kept constant at 2017 estimated level as in the Commission 2016 spring forecast (reflecting a "no-policy-change" assumption);
- the 'SCP' scenario (structural primary balance/GDP ratio kept constant at end of programme period covered by the Stability and Convergence Programmes), reflecting planned changes in fiscal policies as reported in the SCPs.

Graph I.1.14 shows the projected evolution for the government gross debt ratio (including the projected change in age-related expenditure), for the EU as a whole. The solid thick line shows the outcome for this scenario under the assumption of no fiscal consolidation measures beyond those contained in the Commission 2016 spring forecast (structural primary balance/GDP ratio kept constant at estimated 2017 level) and incorporates expected future age-related spending, as projected in the 2015 Ageing Report. [15]

Public debt is expected to decrease until 2017 and beyond. According to the Commission 2016 spring forecast, debt will continue to decrease and reach 85.5% of GDP in 2017 in the EU as a whole. Given the fiscal consolidation until 2017 and the expected economic recovery, debt is projected to continue to decline in the following years. Moreover, the cost of ageing as a share of GDP is projected to rise only slowly in the years to the mid-2020s.

In contrast, the debt path for the EU under the 'SCP' scenario lies well below the path obtained based on the 'COM no-policy-change' scenario (a difference of around 10 p.p. between debt ratios in 2026). Indeed, the 'SCP' scenario would lead to a more marked reduction in the debt-to-GDP ratio with debt falling to 69.4% of GDP by 2026.

Medium-term fiscal sustainability challenges

Developments in the Commission no-policy-change scenario

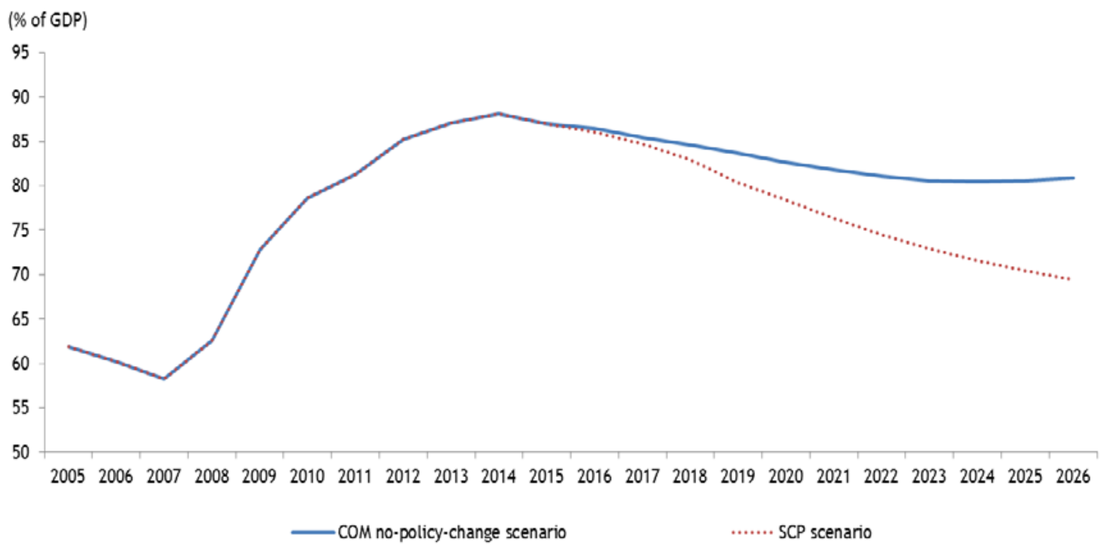
The adjustment needed in the medium-to-long term with respect to unchanged policies is calculated as the additional fiscal adjustment required up to t+5 [16], in order to reach a debt-to-GDP ratio at 60% by 2030 (see Graph I.1.15). The improvement relative to the 'COM no-policy-change' scenario required in the structural primary balance to achieve a debt-to-GDP ratio target of 60% by 2030 amounts

(14) Cyprus faces short-term challenges stemming from the macro-financial/competitiveness side of the economy, related to variables like the current account (3-year moving average), the net international investment position, private debt and net savings of households, expressed in percentage of GDP.

(15) This consists of projections of pension, health care, long-term care, education and unemployment benefit spending. In addition the projected changes in property income and in taxes on pensions are incorporated.

(16) Base year t being either the end forecast (2017) or the end Stability and Convergence Programme horizon (country specific, with values between 2019 and 2021), depending on the scenario considered.

Graph I.1.14: **Medium-term gross debt projections for the EU (% GDP)**



Source: European Commission services

Notes: The medium-term projections are based on the Commission services' Spring 2016 forecast (up to 2017) and on the 2015 Stability and Convergence Programmes and the updated t+10 projections and the projections in the 2015 Ageing Report. The output gap is assumed to close in t+5. The inflation rate (GDP deflator) converges linearly to 2% in t+5, when the output gap is closed and remains constant thereafter, for all countries. The long-term interest rate on new and rolled over debt is assumed to converge to 5% (in nominal terms) by the end of the 10-year projection horizon, based on the AWG-EPC agreed assumption, while the short-term interest rate on new and rolled over debt converges to an end of projection value that is consistent with the 5% long-term interest rate and the value of the historical (pre-crisis) euro area yield curve (0.83). The structural primary balance is kept unchanged after either the end forecast or the end programme year, apart from the projected change in age-related expenditure according to the AWG reference scenario from the 2015 Ageing Report. The primary balance is adjusted by using the budget sensitivities in the period until the output gap is assumed to be closed in t+5. No stock-flow adjustment assumed after the end of forecast or programme horizon).

to 2.2 pp of GDP over the period 2018–2022 in the EU as a whole, i.e., an average annual fiscal consolidation effort of just below 0.5 pp. per year. In other words, the structural primary balance in the EU has to improve from a forecasted surplus of 0.4% of GDP in 2017 (structural balance of -1.7% in2017) to a surplus of 2.6% in 2022.

According to the S1 indicator, 8 countries face high risk, 8 countries face medium risk and 11 countries face low risk over the medium-term. For the majority of Member States, the overall medium-term risk classification coincides with classification based on the S1 indicator. However, for some (IE, HR, CY, HU and PL) it becomes one step higher, thanks to the debt sustainability analysis pointing to additional risks. ([17])

Developments assuming implementation of the fiscal plans in the Stability and Convergence programmes

If the fiscal plans in the SCPs are fully implemented and additionally not weakened after the end of the programme horizon, the fiscal gap would be reduced to one third of the gap (0.7 % of GDP instead of 2.2%) in the no-policy-change scenario. Consequently, risks would be reduced and according to the S1 indicator, 4 countries face high risk, 6 countries face medium risk and 17 countries face low risk.

([17]) For details about the sustainability risk classification and the methodology behind the Debt Sustainability Analysis (DSA), see European Commission (2016), 'Fiscal Sustainability Report 2015', European Economy, Institutional papers, No 18, EC, Brussels.

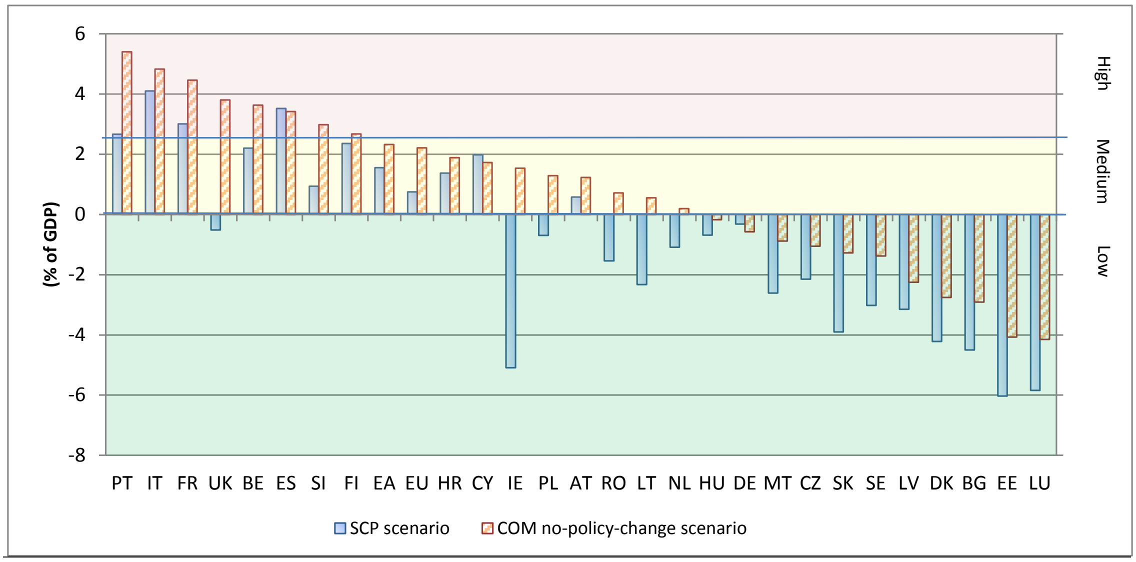
Long-term fiscal sustainability challenges

Developments in the Commission no-policy-change scenario

In the long term, the sustainability of the fiscal position is assessed by the gap relative to the primary balance required to stabilize debt at the current level and pre-finance all the future increases in age-related expenditures. Graph I.1.16 shows the S2 sustainability indicator according to the 'COM no-policy-change' scenario. It shows the initial fiscal position (IBP) on the horizontal axis and the long-term change in the fiscal position due to cost of ageing (CoA) on the vertical axis. A position to the left has a favourable IBP; if it is below zero, it means that the budgetary position contributes positively to fiscal sustainability. A position towards the bottom of the axis has a low long-term 'cost of ageing'. For a majority of countries (16 Member States) both the CoA and the IBP components contribute to the fiscal gap. Finally, the diagonal lines indicate the size of the sustainability gap. Among the Member States, 1 country face high risk, 13 countries face medium risk and 14 countries face low risk over the medium-term. Overall, the EU a whole has a sustainability gap of 1.8 p.p. of GDP. The cost of ageing (CoA) contributes with 1.1 pp. of GDP to the gap, and the initial budgetary position (IBP) by 0.7 pp. of GDP.

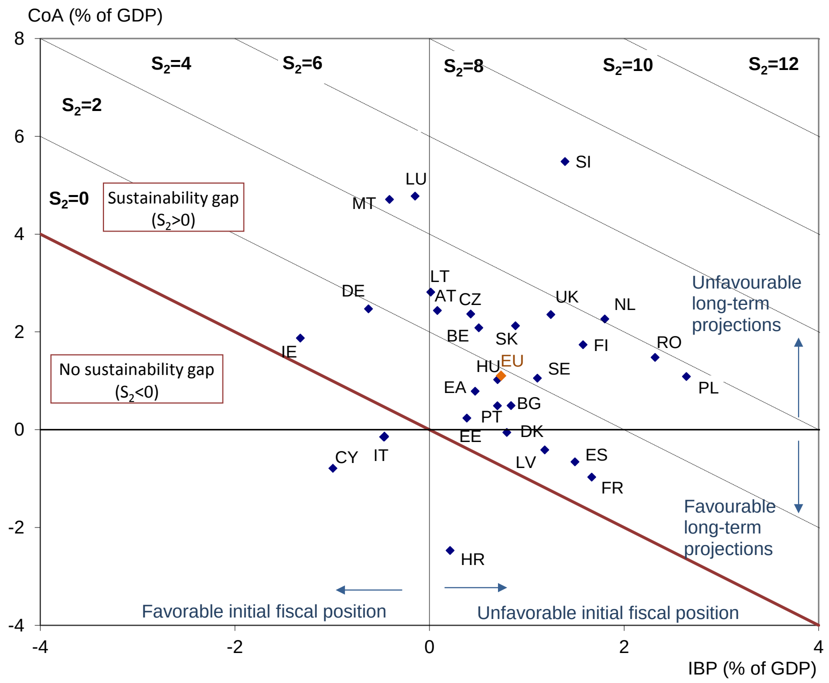
Even assuming the full implementation of the fiscal plans in the SCPs, 12 Member States would still face sustainability gaps. Graph I.1.17 shows the S2 indicator with two different starting points: (i) the 'COM no-policy-change' scenario and (ii) the "SCP" scenario. The 'SCP' scenario shows the extent to which the implementation of the fiscal consolidation plans would contribute to ensuring fiscal sustainability. Under the assumption that the fiscal plans in the programmes are fully implemented, nearly all Member States are expected to have a lower sustainability gap (as shown by a position below the 45° degrees line in the graph). In the EU as a whole, the S2 fiscal gap would be 0.5% of GDP, i.e. less than one third of the gap in the no-policy-change scenario. Even assuming the full implementation of the fiscal plans in the SCPs, 12 Member States would still have sustainability gaps in excess of 2% of GDP (Czech Republic, Germany, Luxembourg, Hungary, Malta, the Netherlands, Austria, Poland, Romania, Slovenia, Slovakia and Finland). In terms of risk classification, in the 'SCP' scenario, five Member States would go to a lower risk category (Belgium, Lithuania, Sweden and the United Kingdom from 'medium' to 'low'

Graph I.1.15: **S1 indicator (fiscal adjustment required to reach a 60% public debt/GDP ratio by 2030, in per cent of GDP)**



Source: European Commission services. 2016 Stability and Convergence Programmes.

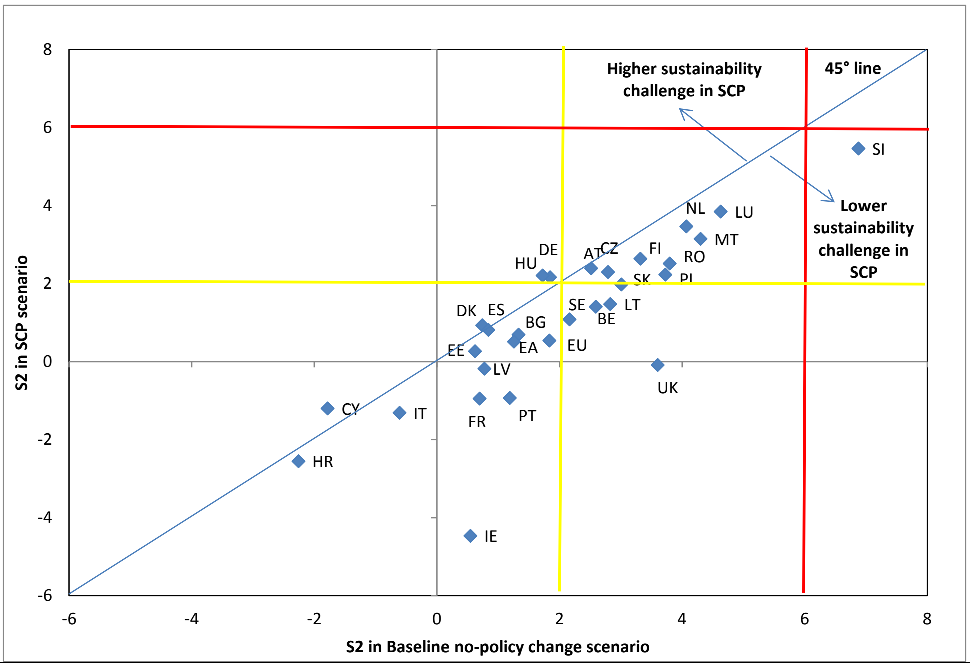
Graph I.1.16: **The S2 sustainability gap decomposed**



Source: European Commission services

risk and Slovenia from 'high' to 'medium' risk).

Graph I.1.17: **The S2 sustainability gap: 'COM no-policy-change' and 'SCP' scenarios**



Source: European Commission services

On the basis of the multidimensional approach and the indicators described in this section, a summary of the fiscal sustainability analysis is provided in Table I.1.6.

Table I.1.6: **Risk classification in the spring 2016 assessment round, COM 'no-policy-change' scenario**

	S0 Overall SHORT-TERM risk category	Debt sustainability analysis - overall risk assessment	S1 indicator - overall risk assessment	Overall MEDIUM-TERM risk category	S2 Overall LONG-TERM risk category
BE	LOW (0.1)	HIGH	HIGH (3.6)	HIGH	MEDIUM (2.6)
BG	LOW (0.2)	LOW	LOW (-2.9)	LOW	LOW (1.3)
CZ	LOW (0.2)	LOW	LOW (-1.1)	LOW	MEDIUM (2.8)
DK	LOW (0.3)	LOW	LOW (-2.8)	LOW	LOW (0.7)
DE	LOW (0.1)	LOW	LOW (-0.6)	LOW	LOW (1.8)
EE	LOW (0.2)	LOW	LOW (-4.1)	LOW	LOW (0.6)
IE	LOW (0.4)	HIGH	MEDIUM (1.5)	HIGH	LOW (0.5)
ES	LOW (0.2)	HIGH	HIGH (3.4)	HIGH	LOW (0.8)
FR	LOW (0.2)	HIGH	HIGH (4.5)	HIGH	LOW (0.7)
HR	LOW (0.2)	HIGH	MEDIUM (1.9)	HIGH	LOW (-2.3)
IT	LOW (0.2)	HIGH	HIGH (4.8)	HIGH	LOW (-0.6)
CY	HIGH (0.5)	HIGH	MEDIUM (1.7)	HIGH	LOW (-1.8)
LV	LOW (0.3)	LOW	LOW (-2.3)	LOW	LOW (0.8)
LT	LOW (0.2)	LOW	MEDIUM (0.5)	MEDIUM	MEDIUM (2.8)
LU	LOW (0.2)	LOW	LOW (-4.2)	LOW	MEDIUM (4.6)
HU	LOW (0.2)	MEDIUM	LOW (-0.2)	MEDIUM	LOW (1.7)
MT	LOW (0.1)	LOW	LOW (-0.9)	LOW	MEDIUM (4.3)
NL	LOW (0.2)	LOW	MEDIUM (0.2)	MEDIUM	MEDIUM (4.1)
AT	LOW (0.1)	MEDIUM	MEDIUM (1.2)	MEDIUM	MEDIUM (2.5)
PL	LOW (0.3)	HIGH	MEDIUM (1.3)	HIGH	MEDIUM (3.7)
PT	LOW (0.3)	HIGH	HIGH (5.4)	HIGH	LOW (1.2)
RO	LOW (0.2)	MEDIUM	MEDIUM (0.7)	MEDIUM	MEDIUM (3.8)
SI	LOW (0.1)	HIGH	HIGH (3)	HIGH	HIGH (6.9)
SK	LOW (0.2)	LOW	LOW (-1.3)	LOW	MEDIUM (3)
FI	LOW (0.2)	HIGH	HIGH (2.7)	HIGH	MEDIUM (3.3)
SE	LOW (0.1)	LOW	LOW (-1.4)	LOW	MEDIUM (2.2)
UK	LOW (0.3)	HIGH	HIGH (3.8)	HIGH	MEDIUM (3.6)
EU	:	:	MEDIUM (2.2)	:	LOW (1.8)
EA	:	:	MEDIUM (2.3)	:	LOW (1.3)

Source: European Commission services
Notes: S0 indicator: The critical threshold for the overall S0 indicator is 0.43.
The S1 indicator: The following thresholds for the S1 indicator were used:
- if the S1 value is less than zero, the country is assigned low risk.
- If a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk.
- if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

The Debt Sustainability Analysis (DSA): a range of factors (such as debt levels, alternative underlying assumptions, stochastic projections) are used for the risk classification. For details about the sustainability risk classification and the methodology behind the Debt Sustainability Analysis (DSA), see European Commission (2016), 'Fiscal Sustainability Report 2015', European Economy, Institutional papers, No 18, EC, Brussels.

The S2 indicator: The following thresholds for the S2 indicator were used:
- if the value of S2 is lower than 2, the country is assigned low risk.
- if it is between 2 and 6, it is assigned medium risk.
- if it is greater than 6, it is assigned high risk.

ANNEX 1

Table I.A1.1: **General government total debt (% of GDP)**

	2016: updates of the stability and convergence programmes							Commission services' spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	106.0	106.2	104.7	102.2	99.6	n.a.	n.a.	106.5	106.0	106.4	105.6	0.0	-0.2	-0.9
DE	71.2	68 1/4	65 3/4	63 1/2	61 1/4	59 1/2	n.a.	74.7	71.2	68.6	66.3	0.0	-0.4	-0.5
EE	9.7	9.6	10.4	10.6	10.2	9.6	n.a.	10.4	9.7	9.6	9.3	0.0	0.0	1.1
IE	93.8	88.2	85.5	81.3	77.7	73.3	68.9	107.5	93.8	89.1	86.6	0.0	-0.9	-1.1
ES	99.2	99.1	99.0	97.9	96.0	n.a.	n.a.	99.3	99.2	100.3	99.6	0.0	-1.1	-0.6
FR	95.7	96.2	96.5	95.4	93.3	n.a.	n.a.	95.4	95.8	96.4	97.0	-0.1	-0.2	-0.5
IT	132.7	132.4	130.9	128.0	123.8	n.a.	n.a.	132.5	132.7	132.7	131.8	0.0	-0.3	-0.9
CY	108.9	105.6	101.7	97.8	90.5	n.a.	n.a.	108.2	108.9	108.9	105.4	0.0	-3.3	-3.7
LV	36.4	40.3	38.3	37.5	38.2	n.a.	n.a.	40.8	36.4	39.8	35.6	0.0	0.5	2.7
LT	40.0	41.1	39.9	38.1	35.7	n.a.	n.a.	40.7	42.7	41.1	42.9	-2.7	0.0	-3.0
LU	21.5	22.4	22.9	23.1	23.3	23.5	n.a.	22.9	21.4	22.5	22.8	0.0	-0.1	0.1
MT	63.9	62.6	60.4	57.5	55.5	n.a.	n.a.	67.1	63.9	60.9	58.3	0.0	1.6	2.2
NL	65.1	65.4	64.1	61.6	58.9	n.a.	n.a.	68.2	65.1	64.9	63.9	0.0	0.5	0.1
AT	86.2	84.3	82.6	80.8	78.7	76.6	n.a.	84.3	86.2	84.9	83.0	0.0	-0.6	-0.3
PT	129.0	124.8	122.3	118.7	114.5	110.3	n.a.	130.2	129.0	126.0	124.5	0.0	-1.2	-2.2
SI	83.2	80.2	78.2	76.5	73.8	70.8	n.a.	81.0	83.2	80.2	78.0	0.0	0.0	0.2
SK	52.9	52.9	52.2	49.8	47.3	n.a.	n.a.	53.9	52.9	53.4	52.7	0.0	-0.5	-0.5
FI	63.1	65.0	66.7	67.4	67.4	67.2	n.a.	59.3	63.1	65.2	66.9	0.0	-0.2	-0.2
EA	91.4	90.3	89.0	87.0	84.4	63.5	n.r.	92.9	91.4	90.7	89.6	0.0	-0.4	-0.6
BG	26.7	31.7	31.2	31.8	30.8	n.a.	n.a.	27.0	26.7	28.1	28.7	0.0	3.6	2.5
CZ	41.1	41.1	40.7	40.2	39.3	n.a.	n.a.	42.7	41.1	41.3	40.9	0.0	-0.2	-0.2
DK	40.2	38.9	38.0	37.9	37.1	35.1	n.a.	44.8	40.2	38.7	39.1	0.0	0.2	-1.1
HR	86.7	85.9	84.7	82.8	80.0	n.a.	n.a.	86.5	86.7	87.6	87.3	0.0	-1.7	-2.6
HU	75.3	74.5	73.6	72.4	68.4	64.6	n.a.	76.2	75.3	74.3	73.0	0.0	0.2	0.6
PL	51.3	52.0	52.5	52.0	50.4	n.a.	n.a.	50.5	51.3	52.0	52.7	0.0	0.0	-0.2
RO	38.4	39.1	39.8	39.9	39.3	n.a.	n.a.	39.8	38.4	38.7	40.1	0.0	0.4	-0.3
SE	43.4	42.5	41.1	40.3	39.1	n.a.	n.a.	44.8	43.4	41.3	40.1	0.0	1.2	1.0
UK	88.0	88.3	87.1	85.6	83.0	80.3	n.a.	87.4	88.0	87.9	87.7	0.0	0.4	-0.6
EU	85.8	84.8	83.6	81.8	79.3	68.3	n.r.	86.7	85.6	85.0	84.0	0.1	-0.2	-0.4

Source: Commission services
Note: in case of missing programmes: weighted average of the figures for those countries that have submitted a programme. Commission EU averages are based on UK Fiscal year data.

Table I.A1.2: **General government balance (% of GDP)**

	2016: updates of the stability and convergence programmes							Commission services' spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	-2.6	-2.5	-1.4	-0.4	-0.2	n.a.	n.a.	-3.1	-2.6	-2.8	-2.3	0.0	0.3	0.9
DE	0.7	-0	-0	-0	0	-0	n.a.	0.3	0.7	0.2	0.1	0.0	-0.3	-0.2
EE	0.4	-0.4	-0.5	-0.2	-0.1	0.1	n.a.	0.8	0.4	-0.1	-0.2	0.0	-0.3	-0.3
IE	-2.3	-1.1	-0.4	0.4	1.2	2.0	2.8	-3.8	-2.3	-1.1	-0.6	0.0	0.0	0.2
ES	-5.1	-3.6	-2.9	-2.2	-1.6	n.a.	n.a.	-5.9	-5.1	-3.9	-3.1	0.0	0.3	0.2
FR	-3.5	-3.3	-2.7	-1.9	-1.2	n.a.	n.a.	-4.0	-3.5	-3.4	-3.2	0.0	0.1	0.5
IT	-2.6	-2.3	-1.8	-0.9	0.1	n.a.	n.a.	-3.0	-2.6	-2.4	-1.9	0.0	0.1	0.1
CY	-1.0	-0.4	-0.5	-0.2	0.4	n.a.	n.a.	-8.9	-1.0	-0.4	0.0	0.0	0.0	-0.5
LV	-1.0	-1.0	-1.0	-1.0	-0.5	n.a.	n.a.	-1.6	-1.3	-1.0	-1.0	0.3	0.0	0.0
LT	-0.2	-0.8	0.0	0.8	0.9	n.a.	n.a.	-0.7	-0.2	-1.1	-0.4	0.0	0.3	0.4
LU	1.3	0.8	0.0	0.1	0.2	0.4	n.a.	1.7	1.2	1.0	0.1	0.0	-0.3	-0.1
MT	-1.5	-0.7	-0.6	-0.2	0.1	n.a.	n.a.	-2.0	-1.5	-0.9	-0.8	0.0	0.2	0.3
NL	-1.8	-1.7	-1.2	-0.4	0.1	n.a.	n.a.	-2.4	-1.8	-1.7	-1.2	0.0	0.0	0.0
AT	-1.2	-1.6	-1.5	-0.9	-0.7	-0.4	n.a.	-2.7	-1.2	-1.5	-1.4	0.0	-0.1	-0.1
PT	-4.4	-2.2	-1.4	-0.9	-0.1	0.4	n.a.	-7.2	-4.4	-2.7	-2.3	0.0	0.5	0.9
SI	-2.9	-2.2	-1.6	-1.0	-0.4	n.a.	n.a.	-5.0	-2.9	-2.4	-2.1	0.0	0.2	0.5
SK	-3.0	-2.1	-1.3	-0.4	0.2	n.a.	n.a.	-2.7	-3.0	-2.4	-1.6	0.0	0.3	0.3
FI	-2.7	-2.5	-2.1	-1.8	-1.4	-1.3	n.a.	-3.2	-2.7	-2.5	-2.3	0.0	0.0	0.2
EA	-2.0	-1.9	-1.4	-0.9	-0.4	0.0	n.r.	-2.6	-2.0	-1.9	-1.6	0.0	0.0	0.2
BG	-2.1	-1.9	-0.8	-0.4	-0.2	n.a.	n.a.	-5.4	-2.1	-2.0	-1.6	0.0	0.1	0.8
CZ	-0.4	-0.6	-0.5	-0.5	-0.5	n.a.	n.a.	-1.9	-0.4	-0.7	-0.6	0.0	0.1	0.0
DK	-2.1	-2.3	-1.9	-1.8	-1.3	0.0	n.a.	1.5	-2.1	-2.5	-1.9	0.0	0.2	0.0
HR	-3.2	-2.6	-2.0	-1.6	-1.0	n.a.	n.a.	-5.5	-3.2	-2.7	-2.3	0.0	0.1	0.2
HU	-2.0	-1.9	-2.4	-1.8	-1.5	-1.2	n.a.	-2.3	-2.0	-2.0	-2.0	0.0	0.1	-0.4
PL	-2.6	-2.6	-2.9	-2.0	-1.3	n.a.	n.a.	-3.3	-2.6	-2.6	-3.1	0.0	0.0	0.2
RO	-0.7	-2.9	-2.9	-2.3	-1.6	n.a.	n.a.	-0.9	-0.7	-2.8	-3.4	0.0	-0.1	0.5
SE	0.0	-0.4	-0.7	-0.4	0.1	n.a.	n.a.	-1.6	0.0	-0.4	-0.7	0.0	0.0	0.0
UK	-3.9	-2.9	-2.0	-1.1	0.3	0.4	n.a.	-5.0	-4.0	-2.9	-2.2	0.1	0.0	0.2
EU	-2.2	-2.0	-1.6	-1.0	-0.4	0.1	n.r.	-2.8	-2.2	-2.1	-1.7	0.0	0.0	0.1

Source: Commission services
Note: in case of missing programmes: weighted average of the figures for those countries that have submitted a programme. Commission EU averages are based on UK Fiscal year data.

Table I.A1.3: **General government total revenue (% of GDP)**

	2016: updates of the stability and convergence programmes							Commission services'spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	51.3	50.8	50.8	50.8	50.7	n.a.	n.a.	52.0	51.3	50.9	50.7	0.0	-0.1	0.0
DE	44.6	44 1/2	44 1/2	44 1/2	44 1/2	44 1/2	n.a.	44.6	44.6	44.5	44.6	0.0	-0.1	-0.2
EE	40.0	40.4	40.2	39.5	39.5	39.0	n.a.	38.7	40.0	40.1	40.0	0.0	0.3	0.2
IE	32.8	30.9	30.3	29.9	29.7	29.5	29.4	34.8	32.8	31.3	30.8	0.0	-0.4	-0.6
ES	38.2	38.2	38.3	38.4	38.5	n.a.	n.a.	38.6	38.2	38.2	38.3	0.0	0.0	0.0
FR	53.2	52.8	52.7	52.5	52.3	n.a.	n.a.	53.4	53.2	52.8	52.6	0.0	0.0	0.1
IT	47.9	47.2	46.9	47.1	47.1	n.a.	n.a.	48.2	47.9	47.2	46.7	0.0	0.0	0.2
CY	39.0	38.4	37.9	37.7	37.8	n.a.	n.a.	39.8	39.0	38.3	38.1	0.0	0.1	-0.2
LV	35.3	35.1	35.3	35.5	34.5	n.a.	n.a.	35.9	35.9	35.8	36.4	-0.6	-0.7	-1.1
LT	34.9	34.6	35.2	35.7	35.3	n.a.	n.a.	34.1	34.9	34.2	34.1	0.0	0.5	1.0
LU	42.8	42.3	40.6	39.6	39.0	39.2	n.a.	44.1	42.8	42.5	41.0	0.0	-0.2	-0.4
MT	41.9	39.4	39.3	38.8	38.4	n.a.	n.a.	41.2	41.9	39.6	39.4	0.0	-0.2	-0.1
NL	43.0	42.7	42.7	42.9	43.1	n.a.	n.a.	43.9	43.0	42.6	42.6	0.0	0.1	0.1
AT	50.6	49.4	49.2	49.2	49.2	49.2	n.a.	49.9	50.6	49.9	49.4	0.0	-0.5	-0.2
PT	43.9	43.7	43.4	43.1	43.0	42.7	n.a.	44.5	43.9	44.0	43.5	0.0	-0.3	-0.1
SI	45.1	43.5	43.8	43.2	42.3	n.a.	n.a.	44.9	45.1	43.4	43.2	0.0	0.1	0.6
SK	42.7	38.6	37.6	37.1	35.8	n.a.	n.a.	39.2	42.7	38.9	38.6	0.0	-0.3	-1.0
FI	55.5	55.6	55.5	55.3	55.3	55.0	n.a.	54.9	55.5	55.8	55.9	0.0	-0.2	-0.4
EA	46.5	46.0	45.9	45.9	45.8	44.3	n.r.	46.7	46.5	46.1	46.0	0.0	-0.1	0.0
BG	38.2	36.5	36.8	36.7	36.5	n.a.	n.a.	36.6	38.2	37.0	37.2	0.0	-0.5	-0.4
CZ	42.2	40.6	40.7	40.5	40.2	n.a.	n.a.	40.8	42.2	40.7	40.7	0.0	-0.1	-0.1
DK	52.4	51.2	50.5	49.9	49.8	50.4	n.a.	57.4	53.6	52.3	51.6	-1.2	-1.1	-1.1
HR	43.7	44.1	43.7	43.7	43.1	n.a.	n.a.	42.6	43.7	44.1	44.4	0.0	0.1	-0.7
HU	48.7	46.6	46.7	45.9	43.4	41.8	n.a.	47.5	48.7	46.4	46.1	0.0	0.2	0.6
PL	38.9	39.0	39.0	39.4	39.4	n.a.	n.a.	38.9	38.9	39.1	39.1	0.0	-0.1	-0.1
RO	34.8	32.5	31.7	31.9	31.8	n.a.	n.a.	33.5	34.8	31.8	31.5	0.0	0.7	0.2
SE	50.4	50.1	50.3	50.6	50.7	n.a.	n.a.	50.2	50.4	49.8	49.7	0.0	0.3	0.6
UK	36.0	36.7	36.7	36.8	37.1	37.0	n.a.	38.6	39.1	39.6	39.5	-3.1	-2.9	-2.8
EU	44.6	44.3	44.2	44.2	44.1	41.9	n.r.	45.3	45.1	44.7	44.8	-0.5	-0.4	-0.7

Source: Commission services
Note: in case of missing programmes: weighted average of the figures for those countries that have submitted a programme. Commission EU averages are based on UK Fiscal year data.

Table I.A1.4: **General government total expenditure (% of GDP)**

	2016: updates of the stability and convergence programmes							Commission services'spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	53.9	53.4	52.2	51.2	50.9	n.a.	n.a.	55.1	53.9	53.7	53.0	0.0	-0.3	-0.9
DE	43.9	44 1/2	44 1/2	44 1/2	44 1/2	44 1/2	n.a.	44.3	43.9	44.3	44.5	0.0	0.2	0.0
EE	39.6	40.8	40.7	39.7	39.6	38.9	n.a.	38.0	39.5	40.3	40.2	0.1	0.5	0.5
IE	35.1	32.0	30.7	29.6	28.6	27.5	26.6	38.6	35.1	32.4	31.5	0.0	-0.4	-0.8
ES	43.3	41.8	41.2	40.6	40.1	n.a.	n.a.	44.5	43.3	42.1	41.3	0.0	-0.3	-0.1
FR	56.8	56.0	55.3	54.4	53.5	n.a.	n.a.	57.3	56.8	56.2	55.9	0.0	-0.2	-0.6
IT	50.5	49.6	48.4	47.5	46.7	n.a.	n.a.	51.2	50.5	49.7	48.6	0.0	-0.1	-0.2
CY	40.1	38.7	38.4	37.9	37.4	n.a.	n.a.	48.7	40.1	38.7	38.2	0.0	0.0	0.2
LV	36.3	36.1	36.3	36.5	35.0	n.a.	n.a.	37.5	37.2	36.8	37.3	-0.9	-0.7	-1.0
LT	35.1	35.4	35.2	34.9	34.4	n.a.	n.a.	34.8	35.1	35.2	34.5	0.0	0.2	0.6
LU	41.5	41.6	40.6	39.4	38.8	38.8	n.a.	42.4	41.5	41.5	40.9	0.0	0.1	-0.3
MT	43.3	40.1	39.9	39.0	38.3	n.a.	n.a.	43.2	43.3	40.5	40.2	0.0	-0.4	-0.4
NL	44.8	44.4	43.9	43.3	43.0	n.a.	n.a.	46.2	44.9	44.3	43.7	0.0	0.1	0.2
AT	51.7	51.0	50.6	50.1	49.8	49.6	n.a.	52.6	51.7	51.4	50.7	0.0	-0.4	-0.1
PT	48.3	45.9	44.8	44.0	43.2	42.4	n.a.	51.7	48.3	46.6	45.8	0.0	-0.7	-1.0
SI	48.0	45.7	45.4	44.3	42.7	n.a.	n.a.	49.9	48.0	45.7	45.2	0.0	0.0	0.2
SK	45.6	40.7	38.9	37.5	35.6	n.a.	n.a.	41.9	45.6	41.3	40.2	0.0	-0.6	-1.3
FI	58.3	58.2	57.6	57.0	56.7	56.4	n.a.	58.1	58.3	58.3	58.1	0.0	-0.1	-0.5
EA	48.5	47.9	47.3	46.8	46.2	44.2	n.r.	49.3	48.5	48.0	47.6	0.0	-0.1	-0.3
BG	40.2	38.5	37.5	37.1	36.7	n.a.	n.a.	42.1	40.2	38.9	38.7	0.0	-0.4	-1.2
CZ	42.6	41.2	41.2	41.0	40.6	n.a.	n.a.	42.8	42.6	41.4	41.3	0.0	-0.2	-0.1
DK	54.5	53.5	52.5	51.7	51.1	50.4	n.a.	56.0	55.7	54.8	53.5	-1.2	-1.3	-1.0
HR	46.9	46.8	45.7	45.3	44.2	n.a.	n.a.	48.1	46.9	46.8	46.6	0.0	0.0	-0.9
HU	50.7	48.5	49.1	47.7	44.9	43.0	n.a.	49.8	50.7	48.4	48.1	0.0	0.1	1.0
PL	41.5	41.6	41.9	41.4	40.7	n.a.	n.a.	42.2	41.5	41.7	42.2	0.0	-0.1	-0.3
RO	35.5	35.4	34.6	34.1	33.4	n.a.	n.a.	34.3	35.5	34.6	34.9	0.0	0.8	-0.3
SE	50.4	50.5	51.0	51.0	50.6	n.a.	n.a.	51.7	50.4	50.1	50.4	0.0	0.4	0.6
UK	39.9	39.5	38.6	37.8	36.8	36.6	n.a.	43.6	43.0	42.5	41.7	-3.1	-3.0	-3.1
EU	46.8	46.3	45.7	45.1	44.4	41.8	n.r.	48.1	47.4	46.8	46.5	-0.5	-0.5	-0.9

Source: Commission services
Note: in case of missing programmes: weighted average of the figures for those countries that have submitted a programme. Commission EU averages are based on UK Fiscal year data.

Table I.A1.5: **Structural balance (% of GDP)**

	2016: updates of the stability and convergence programmes							Commission services'spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	-2.6	-2.0	-1.2	-0.4	-0.3	n.a.	n.a.	-2.8	-2.6	-2.3	-2.1	0.0	0.2	0.8
DE	0.9	0.2	0.3	0.2	0.1	0.0	n.a.	0.7	0.8	0.4	0.4	0.1	-0.2	-0.1
EE	0.7	0.2	0.0	-0.1	-0.1	-0.1	n.a.	0.1	0.6	0.0	-0.2	0.1	0.2	0.2
IE	-2.1	-2.0	-0.9	0.0	1.1	2.2	3.3	-2.7	-2.2	-2.0	-1.0	0.1	0.0	0.0
ES	-2.9	-2.7	-2.5	-2.7	-2.7	n.a.	n.a.	-1.9	-2.9	-3.1	-3.2	0.0	0.4	0.7
FR	-2.4	-2.3	-2.0	-1.6	-1.2	n.a.	n.a.	-2.7	-2.4	-2.4	-2.7	0.0	0.2	0.7
IT	-1.0	-1.6	-1.6	-1.2	-0.5	n.a.	n.a.	-1.1	-1.0	-1.7	-1.7	0.0	0.1	0.1
CY	1.9	0.5	-0.7	-1.1	-1.1	n.a.	n.a.	3.0	1.7	0.4	-0.5	n.a.	n.a.	n.a.
LV	-2.0	-1.7	-1.5	-1.2	-0.4	n.a.	n.a.	-1.7	-1.9	-1.6	-1.6	-0.1	0.0	0.1
LT	-0.4	-0.7	0.0	0.4	0.7	n.a.	n.a.	-1.5	-0.4	-1.2	-0.8	0.0	0.6	0.8
LU	1.6	1.4	0.3	-0.1	0.0	0.9	n.a.	2.8	1.7	1.4	0.3	-0.1	0.0	0.0
MT	-2.3	-1.5	-0.9	-0.3	0.1	n.a.	n.a.	-2.2	-2.3	-1.6	-1.2	0.0	0.0	0.3
NL	-0.9	-1.4	-1.0	-0.5	-0.2	n.a.	n.a.	-0.6	-0.9	-1.5	-1.2	0.1	0.1	0.2
AT	0.1	-0.9	-1.0	-0.6	-0.5	-0.4	n.a.	-0.7	0.0	-0.9	-1.2	0.1	0.0	0.1
PT	-1.9	-1.7	-1.3	-0.9	-0.5	-0.3	n.a.	-1.4	-2.0	-2.2	-2.5	0.1	0.6	1.2
SI	-2.6	-2.2	-2.0	-1.7	-1.2	n.a.	n.a.	-2.6	-2.7	-2.5	-2.9	0.1	0.3	0.8
SK	-2.3	-1.7	-0.9	-0.4	-0.3	n.a.	n.a.	-2.0	-2.3	-2.1	-1.5	0.1	0.4	0.6
FI	-1.4	-1.5	-1.5	-1.4	-1.2	n.a.	n.a.	-1.6	-1.4	-1.6	-1.5	0.0	0.1	0.1
EA	-1.0	-1.3	-1.1	-0.9	-0.6	0.1	n.r.	-1.1	-1.0	-1.3	-1.4	0.0	0.1	0.3
BG	-1.9	-1.7	-0.6	-0.3	-0.3	n.a.	n.a.	-2.0	-1.9	-1.8	-1.4	0.0	0.1	0.8
CZ	-0.4	-0.5	-0.7	-0.7	-0.6	n.a.	n.a.	-0.8	-0.4	-0.7	-0.9	0.1	0.2	0.2
DK	-1.8	0.0	0.0	-0.1	-0.2	-0.3	n.a.	0.2	-1.8	-1.0	-0.9	0.0	1.0	0.9
HR	-1.7	-1.7	-1.6	-1.7	-1.6	n.a.	n.a.	-3.5	-1.7	-1.9	-2.1	0.1	0.2	0.5
HU	-2.1	-2.6	-2.5	-2.1	-2.0	-1.8	n.a.	-2.2	-2.0	-2.9	-2.5	0.0	0.2	0.0
PL	-2.3	-3.0	-2.7	-2.0	-1.5	n.a.	n.a.	-2.6	-2.3	-3.0	-3.3	0.0	0.0	0.5
RO	-0.6	-2.7	-2.9	-2.4	-1.9	n.a.	n.a.	-0.2	-0.6	-2.8	-3.4	0.1	0.1	0.5
SE	0.3	-0.8	-0.8	-0.4	-0.1	n.a.	n.a.	-0.3	0.3	-0.5	-0.9	0.0	-0.3	0.1
UK	-3.9	-3.0	-2.1	-1.3	0.2	0.6	n.a.	-4.7	-4.1	-3.2	-2.5	0.2	0.1	0.3
EU	-1.5	-1.6	-1.3	-1.0	-0.5	0.2	n.r.	-1.6	-1.5	-1.7	-1.6	0.0	0.1	0.3

Source: Commission services
Note: for SCPs: recalculated by Commission services on the basis of the information in the programme according to the commonly-agreed methodology.
In case of missing programmes: weighted average of the figures for those countries that have submitted a programme.
Commission EU averages are based on UK Fiscal year data.

Table I.A1.6: **Output gap (% of GDP)**

	2016: updates of the stability and convergence programmes							Commission services'spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	-0.7	-0.6	-0.4	-0.1	0.1	n.a.	n.a.	-1.0	-0.7	-0.7	-0.5	0.0	0.1	0.1
DE	-0.4	-0.6	-0.8	-0.6	-0.2	0.0	n.a.	-0.2	-0.3	-0.6	-0.6	-0.1	-0.1	-0.2
EE	0.1	-0.7	-0.4	0.0	0.3	0.4	n.a.	1.8	0.3	-0.2	0.2	-0.3	-0.6	-0.6
IE	1.4	1.7	0.9	0.6	0.1	-0.4	-0.9	-1.9	1.6	1.7	0.6	-0.2	-0.1	0.2
ES	-3.7	-1.7	-0.3	0.9	2.1	n.a.	n.a.	-6.7	-3.7	-1.5	0.3	0.0	-0.2	-0.6
FR	-1.8	-1.4	-1.1	-0.5	0.0	n.a.	n.a.	-2.1	-1.8	-1.5	-0.9	0.0	0.0	-0.2
IT	-2.8	-1.6	-0.4	0.6	1.2	n.a.	n.a.	-3.9	-2.9	-1.6	-0.4	0.0	0.0	0.0
CY	-4.0	-1.8	0.3	1.8	2.8	n.a.	n.a.	-6.4	-3.6	-1.4	0.9	-0.4	-0.4	-0.6
LV	1.9	1.8	1.4	0.7	-0.1	n.a.	n.a.	1.2	1.7	1.8	1.7	0.2	0.0	-0.3
LT	0.1	0.0	0.1	0.3	0.6	n.a.	n.a.	1.0	0.1	0.5	1.1	0.0	-0.5	-1.0
LU	-0.8	-1.5	-0.6	0.6	0.4	-1.0	n.a.	-2.9	-1.1	-1.0	-0.3	0.2	-0.5	-0.2
MT	1.5	1.6	0.5	0.2	-0.2	n.a.	n.a.	-0.3	1.5	1.3	0.6	0.0	0.3	0.0
NL	-1.5	-0.9	-0.3	0.2	0.5	n.a.	n.a.	-2.5	-1.4	-0.7	0.0	-0.1	-0.1	-0.3
AT	-1.1	-0.8	-0.4	-0.3	-0.1	0.0	n.a.	-0.9	-1.0	-0.7	-0.3	-0.2	-0.1	-0.1
PT	-2.4	-1.3	-0.6	0.0	0.7	1.3	n.a.	-3.8	-2.3	-1.1	0.0	-0.1	-0.2	-0.6
SI	-0.5	0.2	1.0	1.5	1.7	n.a.	n.a.	-2.5	-0.4	0.6	1.8	-0.1	-0.4	-0.8
SK	-1.1	-1.2	-1.0	-0.2	1.1	n.a.	n.a.	-1.8	-0.9	-0.6	-0.3	-0.1	-0.6	-0.7
FI	-2.4	-1.7	-1.1	-0.7	-0.4	n.a.	n.a.	-2.8	-2.3	-1.6	-1.2	-0.1	-0.1	0.1
EA	-1.6	-1.1	-0.6	-0.1	0.4	0.0	n.r.	-2.3	-1.5	-1.0	-0.4	0.0	0.0	-0.2
BG	-0.3	-0.7	-0.7	-0.3	0.3	n.a.	n.a.	-0.7	-0.3	-0.6	-0.5	0.0	-0.1	-0.2
CZ	-0.1	0.1	0.2	0.3	0.4	n.a.	n.a.	-2.2	0.0	0.2	0.7	-0.1	-0.1	-0.5
DK	-2.7	-2.5	-1.8	-0.8	0.0	0.5	n.a.	-3.1	-2.8	-2.5	-1.6	0.0	0.0	-0.2
HU	0.2	0.0	0.2	0.6	0.9	1.2	n.a.	-0.7	0.1	0.5	1.0	0.1	-0.4	-0.8
HR	-3.1	-2.0	-0.9	0.1	1.2	n.a.	n.a.	-4.0	-2.9	-1.7	-0.3	-0.2	-0.3	-0.6
PL	-0.5	-0.3	-0.1	0.1	0.4	n.a.	n.a.	-1.0	-0.5	0.0	0.4	0.0	-0.3	-0.5
RO	-1.2	-0.4	0.0	0.4	0.9	n.a.	n.a.	-2.1	-1.1	0.0	0.3	-0.1	-0.4	-0.2
SE	-0.5	0.5	0.1	0.0	0.3	n.a.	n.a.	-2.1	-0.5	0.2	0.4	-0.1	0.4	-0.2
UK	0.0	0.2	0.2	0.3	0.1	-0.3	n.a.	-1.7	-0.4	0.2	0.4	0.4	-0.1	-0.1
EU	-1.2	-0.8	-0.4	0.0	0.4	0.0	n.r.	-2.2	-1.3	-0.7	-0.2	0.0	-0.1	-0.2

Source: Commission services
Note: for SCPs: recalculated by Commission services on the basis of the information in the programme according to the commonly-agreed methodology.
In case of missing programmes: weighted average of the figures for those countries that have submitted a programme.
Commission EU averages are based on UK Fiscal year data.

Table I.A1.7: **Real GDP growth**

	2016: updates of the stability and convergence programmes							Commission services'spring 2016 forecast				Difference compared to forecast (red is higher in programme)		
	2015	2016	2017	2018	2019	2020	2021	2014	2015	2016	2017	2015	2016	2017
BE	1.4	1.2	1.5	1.6	1.5	n.a.	n.a.	1.3	1.4	1.2	1.6	0.0	0.0	-0.1
DE	1.7	1.7	1.5	1 3/4	1 3/4	1 3/4	n.a.	1.6	1.7	1.6	1.6	0.0	0.1	0.0
EE	1.1	2.0	3.0	3.3	3.0	2.8	n.a.	2.9	1.1	1.9	2.4	0.0	0.1	0.6
IE	7.8	4.9	3.9	3.9	3.3	3.1	2.9	5.2	7.8	4.9	3.7	0.0	0.1	0.3
ES	3.2	2.7	2.4	2.5	2.5	n.a.	n.a.	1.4	3.2	2.6	2.5	0.0	0.1	-0.1
FR	1.2	1.5	1.5	1.8	1.9	n.a.	n.a.	0.2	1.2	1.3	1.7	0.0	0.2	-0.2
IT	0.8	1.2	1.4	1.5	1.4	n.a.	n.a.	-0.3	0.8	1.1	1.3	0.0	0.1	0.1
CY	1.6	2.2	2.5	2.5	2.5	n.a.	n.a.	-2.5	1.6	1.7	2.0	0.0	0.5	0.5
LV	2.7	3.0	3.3	3.4	3.4	n.a.	n.a.	2.4	2.7	2.8	3.1	0.0	0.2	0.2
LT	1.6	2.5	3.2	3.1	3.1	n.a.	n.a.	3.0	1.6	2.8	3.1	0.0	-0.4	0.1
LU	4.8	2.9	4.5	4.9	3.5	2.3	n.a.	4.1	4.8	3.3	3.9	-0.1	-0.4	0.6
MT	6.3	4.2	3.1	2.9	2.4	n.a.	n.a.	3.7	6.3	4.1	3.5	0.0	0.1	-0.4
NL	2.0	1.8	2.0	1.9	1.8	n.a.	n.a.	1.0	2.0	1.7	2.0	0.0	0.1	0.0
AT	0.9	1.6	1.6	1.6	1.5	1.5	n.a.	0.4	0.9	1.5	1.6	0.0	0.1	0.0
PT	1.5	1.8	1.8	1.9	2.0	2.1	n.a.	0.9	1.5	1.5	1.7	0.0	0.3	0.1
SI	2.9	1.7	2.4	2.3	2.3	n.a.	n.a.	3.0	2.9	1.7	2.3	0.0	0.0	0.1
SK	3.6	3.2	3.6	4.1	4.6	n.a.	n.a.	2.5	3.6	3.2	3.3	0.0	0.0	0.4
FI	0.5	0.9	1.2	1.2	1.1	1.1	n.a.	-0.7	0.5	0.7	0.7	0.0	0.2	0.5
EA	1.7	1.8	1.7	1.8	1.8	1.7	n.r.	0.9	1.7	1.6	1.8	0.0	0.1	0.0
BG	3.0	2.1	2.5	2.7	2.7	n.a.	n.a.	1.5	3.0	2.0	2.4	0.0	0.1	0.1
CZ	4.2	2.5	2.6	2.4	2.4	n.a.	n.a.	2.0	4.2	2.1	2.6	0.0	0.4	0.0
DK	1.2	1.1	1.7	2.2	2.2	1.9	n.a.	1.3	1.2	1.2	1.9	0.0	-0.1	-0.2
HR	1.6	2.0	2.1	2.3	2.5	n.a.	n.a.	-0.4	1.6	1.8	2.1	0.0	0.2	0.1
HU	2.9	2.5	3.1	3.4	3.1	3.2	n.a.	3.7	2.9	2.5	2.8	0.0	0.0	0.3
PL	3.6	3.8	3.9	4.0	4.1	n.a.	n.a.	3.3	3.6	3.7	3.6	0.0	0.1	0.3
RO	3.8	4.2	4.3	4.5	4.7	n.a.	n.a.	3.0	3.8	4.2	3.7	0.0	0.0	0.6
SE	4.1	3.8	2.2	1.8	2.1	n.a.	n.a.	2.3	4.1	3.4	2.9	0.0	0.4	-0.7
UK	2.2	2.0	2.2	2.1	2.1	2.1	n.a.	2.8	2.2	2.1	1.5	0.0	-0.1	0.7
EU	2.0	2.0	1.9	2.0	2.0	1.9	n.r.	1.4	2.0	1.9	1.9	0.0	0.1	0.1

Source: Commission services
Note: in case of missing programmes: weighted average of the figures for those countries that have submitted a programme. Commission EU averages are based on UK Fiscal year data.

Part II

The fiscal stance and the policy mix in the euro area

1. THE FISCAL STANCE AND THE POLICY MIX IN THE EURO AREA

This chapter examines the recent and prospective fiscal stance in the euro area. The fiscal stance is assessed analytically and without prejudice to the legal obligations under the EU fiscal framework. Such an analysis helps appraising the appropriateness of national fiscal policies while taking an overall view of their joint consequences. The chapter considers in particular the sustainability and stabilisation dimensions of fiscal policies. It also includes, given the currently unusual monetary and financial environment and its potential implications for fiscal policies, a description of the monetary stance. It passes no normative judgment on monetary policy.

Following considerable consolidation in 2011-13, the euro area fiscal stance has turned closer to neutrality since 2014. According to the latest Commission forecast, it would be mildly expansionary in 2016. This more supportive overall orientation reflects in part a broad-based shift towards policies of cutting taxes, notably, though not exclusively, taxes on labour. It also stems from a gradually more sustained growth of public expenditure within the area, especially so in Germany, where it is partly a consequence of the recent inflow of refugees.

The monetary stance has been considerably eased in the recent past through a package of unconventional instruments. This has substantially improved financial and borrowing conditions across the area and supported firmer demand and prices, though inflation has so far remained low. Indeed, the euro area remains in an environment of persistent lowflation. In this context, there is a need to avoid 'overburdening' monetary policy and instead aim at a consistent policy mix, in line with the G20 three-pronged strategy.

Looking forward to next year, a supportive overall fiscal stance aligned with monetary policy would speed up the decline in unemployed resources, and could eventually allow a quicker return to a normalized environment and standard monetary policy, also if downside risks materialise. Meanwhile GDP growth is expected to continue garnering strength even without fiscal support, and it is also essential to re-build sustainability buffers where needed at country level. Taken together, these considerations suggest that it would be appropriate to pursue a broadly neutral stance as the aggregation of national fiscal policies. A modulation of the fiscal stance should be considered if and as the recovery accelerates of decelerates. In the future, the achievement of a balanced policy mix would be facilitated by the introduction of a stabilisation tool at the European level as recommended in the Five Presidents' report..

This overall euro area stance should be differentiated depending on the situations of countries in terms of sustainability and stabilisation. In this respect, although not inconsistent with a close to neutral aggregated stance in 2017, the plans presented in the latest stability programmes could be improved upon. In particular plans that are tilted towards the stabilisation objective in other large countries, including in Italy and Spain and to a lesser extent France, should be rebalanced towards more consolidation, while the remaining fiscal scope in Germany could be used to support short- and long-term growth, notably by fostering investment.

Moreover, budgetary plans for 2017 and over the medium-term should across the board contribute to improving the quality of the public finances. In this regard, the low funding cost environment makes it an ideal time to frontload public investments. At the same time, in conjunction with gradually strengthening nominal growth, it will offer an opportunity to curb high debt ratios by cutting non-future oriented spending and tax loopholes through structural fiscal reforms.

1.1. INTRODUCTION

This chapter lays the basis for a discussion of the euro area fiscal stance as an outcome of current and prospective national fiscal policies. Both Member States and the EU institutions have called for a regular monitoring of overall fiscal policy in the euro area, in particular in connection with Stability and Convergence Programmes (SCPs) and Draft Budgetary Plans (DBPs).([18]) The present chapter builds on and extends the previous exercise in view of the Eurogroup discussion on 11 July 2016.

The chapter examines the fiscal stance analytically, without prejudice to the obligations from the EU fiscal framework. In the EU and euro area, national fiscal policies are primarily shaped by the rules-based framework embodied in the Treaty and the Stability and Growth Pact (SGP). An analytical examination of fiscal policies can in no way dispense Member States from their legal obligations under this setting, but it may nonetheless be useful on two counts:

- First, it helps assessing whether implemented fiscal policies effectively lay the conditions for price stability and strong sustainable growth,([19]) and more specially, whether the best use is made of the room for discretion within the framework.

- Second, by emphasising the aggregate consequences of national policies, such analysis allows considering fiscal policy from a euro area perspective. This is useful to evaluate the common challenges of the overall macroeconomic policy mix,([20]) and may be especially relevant in certain circumstances, such as the present environment characterised by low inflation and stagnation risks. Recognising this policy mix dimension, the present chapter includes a depiction of current monetary policy as a key contextual factor for appraising fiscal policies at this juncture. It does not pass any normative judgment on monetary policy.

Responsible fiscal policies are one of the three pillars of the integrated growth and job strategy put forward in the Annual Growth Survey and endorsed by the European Council. The other two pillars are re-launching investment, to which the Investment Plan for Europe is making a contribution, and pursuing structural reforms to boost potential growth and resilience.([21])

Against this background the chapter centres on the narrative for the euro area taken as a whole. It is complemented with data on the underlying country evolutions, especially for the largest countries that are major contributors to aggregate developments.([22]) Section 2 reviews the orientation and macroeconomic implications of euro area fiscal policy in recent years. Section 3 informs a prospective discussion of the euro area fiscal stance for next year, including by weighing the considerations over sustainability and stabilisation, and raising attention to the particular macroeconomic challenges of the current juncture.

([18]) See notably: Five President's report on Completing Europe's Economy and Monetary Union, 22 June 2015; Commission Communication on 2016 draft budgetary plans: overall assessment, COM(2015) 800, 16 November 2015; Eurogroup statement on the draft budgetary plans for 2016, 23 November 2015; Commission recommendation for a Council recommendation for the euro area, COM(2015) 692, 26 November 2015.

([19]) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and strong sustainable growth conducive to employment creation.

([20]) The policy mix is understood here as the combination of fiscal and monetary policies. In a broader approach, the policy mix includes other policies with macroeconomic significance, such as major structural reforms.

([21]) See *Annual Growth Survey 2016*, Commission Communication, COM(2015) 690, 26 November 2015; and *Europe investing again: taking stock of the Investment plan for Europe and next steps,* Commission Communication, COM(2016) 359, 1 June 2016.

([22]) The chapter therefore complements chapter 1, which is more country-oriented and does not incorporate the broader macroeconomic context.

Box II.1.1: The fiscal stance: a few clarifications

The fiscal stance is a notion with no universally accepted definition but a broadly shared understanding within the economic community. Usually, the fiscal stance refers to the orientation of fiscal policy, which can be qualified as expansionary, restrictive or neutral. A neutral fiscal policy, in the perspective of this note, is one where government discretionary decisions, essentially the growth of spending and the new tax measures, neither support nor drag on the private economy compared with a steady state path. This would for example be the case when government expenditures expand at a pace in line with medium-term growth and no tax measures in either direction are taken, or more generally, when the gap between expenditure growth and potential growth equates the amounts of new tax measures. The indicator of discretionary fiscal effort (DFE) put forward by DG ECFIN encapsulates this idea and is considered more robust for the purpose of characterising the discretionary stance than the traditional change in the structural balance (or the change in the structural primary balance) ([a]) :

In this setting, fiscal policy is considered restrictive when the discretionary fiscal effort is positive, expansionary when negative, and neutral when close to zero. Combining this information on the orientation of fiscal policy with the evidence on the business-cycle position of the economy, the fiscal stance can in turn be depicted as pro-cyclical (when the fiscal stance is expansionary in an upturn, or restrictive in a downturn), counter-cyclical (when the polar situations hold), or as simply neutral (when the DFE is close to null, irrespective of the precise cyclical position).

Beyond this simple canvas, there are a number of further points to consider when assessing the macroeconomic import of fiscal policy. First, the above considerations focus solely on the short-run effects of fiscal policy on aggregate demand, leaving aside other important concerns such as medium-term supply side effects. Second, the demand impact of fiscal developments reflects not only the discretionary part of fiscal policy, but also the effects of the automatic stabilisers. The two can as well add up or go in opposite directions. Third, these effects on the economy depend on the values of fiscal multipliers. Multipliers are uncertain as well as country- and time-dependent, and sensitive to the composition of fiscal changes. Therefore, a given fiscal stance, as measured e.g. by the DFE, will not always exert the exact same traction on output, given variations in circumstances and composition. Finally, lags should be acknowledged: the effect of fiscal policy in a given year combines the immediate effect of current policy with the incremental lagged effect of prior policies.

([a]) See for example DG ECFIN's 2013 *Public Finance Report*, chapter3.

1.2. THE EURO AREA FISCAL STANCE: RECENT AND CURRENT DEVELOPMENTS

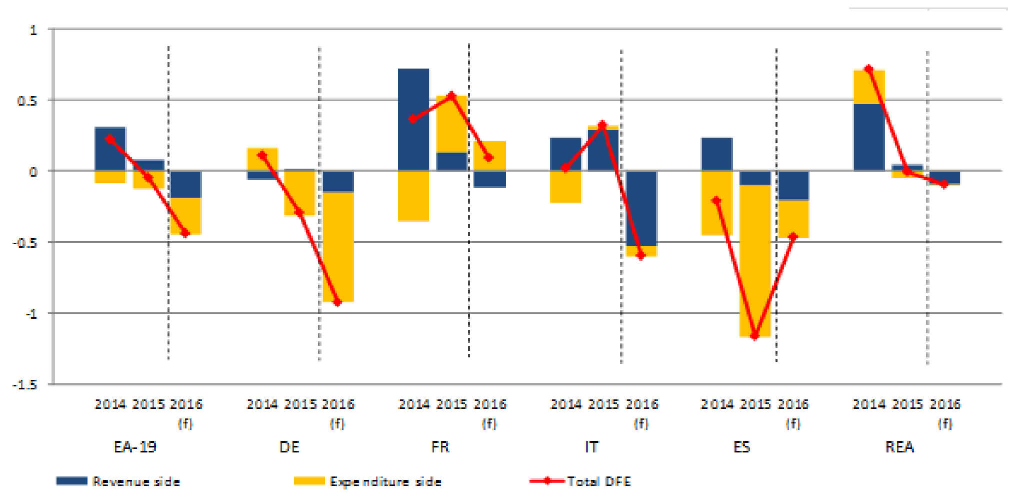
This section examines the evolution, composition and macroeconomic implications of the fiscal stance in the euro area over the period 2014-16. The main data source is the Commission's spring 2016 forecast, which incorporates all available information on Member States' budget laws for 2016 and the developments observed in the first months of the year.

1.2.1. The orientation of fiscal policy

Following considerable retrenchment over 2011-13, the euro area fiscal stance has on average been broadly neutral from 2014 onwards. Fiscal policy remained slightly restrictive in 2014, was neutral in 2015, and is turning modestly expansionary this year (Graph II.1.1).([23]) In terms of country contributions, Germany recently moved to an expansionary stance and contributes the major part of the euro area fiscal

([23]) The fiscal stance is appraised here with the discretionary fiscal effort (DFE, see box above), but the overall conclusions since 2014 would not be very different using the change in the structural primary balance. The DFE is estimated at 0.2%, 0.0% and -0.4% of GDP in 2014, 2015 and 2016 respectively. This follows a cumulated consolidation of 3½ % of GDP over 2011-2013 according to the DFE metric.

Graph II.1.1: **Discretionary fiscal effort in 2014-2016 (% of GDP)**



Source: European Commission services.
Note: (f) indicates forecasts.

relaxing in 2016, with Italy also easing this year along with continued loosening in Spain over the past three years. France has in the recent past pursued moderate consolidation that tends to dwindle in 2016.

The characterisation of the fiscal stance as mildly expansionary this year should be put into perspective in several respects:

- As noted below (see the remarks on the expenditure dynamics in the next paragraph), this characterisation results in part from the unusually low inflation and weak potential growth post-crisis environment that provides *de facto* little headroom for budgets in many countries.

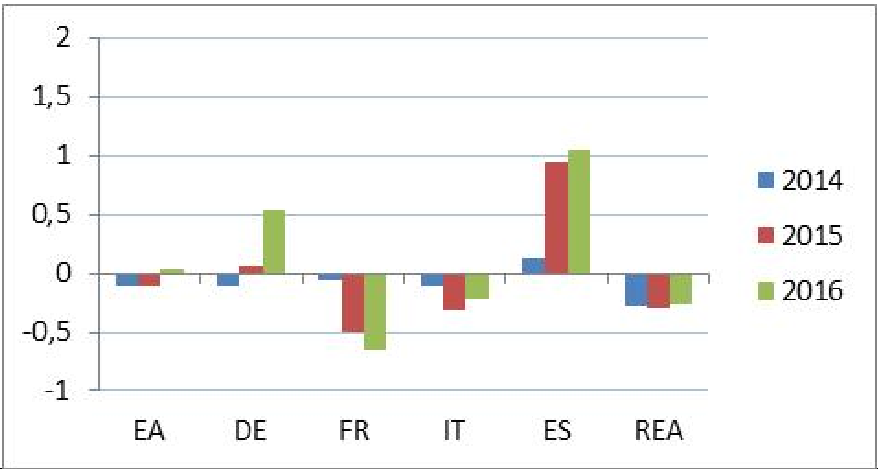
- Headline balances are projected to continue falling: area-wide, the headline deficit would decrease by a further 0.2% of GDP in 2016, implying a cumulated reduction of over 1 % of GDP since 2013. The corresponding figures for the primary balance are a change of +0.1% of GDP in 2016 and +0.6% of GDP since 2013, as interest payments have fallen. This means that when including the effects of the automatic stabilisers, the public finances still subtract slightly from the momentum in the economy.

- Moreover, the current stance is affected by two specific developments that bring support to the demand and supply sides of the economy:

    - The extra spending induced by the refugees crisis, the incremental budgetary impact of which is estimated at about 0.1% of GDP in 2016 area-wide, following a similar impact last year, with major differences between countries, and measurement uncertainty in general.

    - The growth-promoting flexibility granted within the SGP under the structural reform and investment clauses, which contributes over 0.1% of GDP to the euro area stance in 2016, focused on few countries.

Graph II.1.2: **Real GDP effects of the fiscal stance (%)**



Source: European Commission services
Note: The chart represents the difference in the real GDP level between actual and a counterfactual where the fiscal stance would have been strictly neutral from 2014 onwards. QUEST simulations as described in the text

The recent move towards an easier stance reflects both a reversal from tax hikes to tax cuts and faster spending, though the latter remains moderate by historical standards in most countries (Graph II.1.1 and Table II.1.1):

- While there were still a few tax increases in 2014-2015, including on consumption-oriented taxes, policies on the revenue side are being loosened in 2016. This involves cuts in labour taxes and social contributions in many countries (including the four largest ones), and more residually lower corporate taxes as well as the removal of a property tax in Italy.

- Public spending is gathering moderate pace in the zone, expanding overall by about 2½ in 2016 in nominal terms, against below 2% in 2014 and about 2¼ % in 2015. Because these figures are a bit higher than nominal medium-term growth (2.0% in 2016), this translates into a slight expansion from the expenditure side according to the discretionary fiscal effort. However, it can be noted that the 'benchmark' nominal growth rates used in this framework reflect the unusually low inflation environment and the weakness of (10-year smoothed) potential growth estimates, which still incorporate lagged effects from the crisis (as evidenced by Table II.1.1).([24])

- On the whole, while picking up a bit public spending dynamics appears to remain under control in an historical perspective, notably in France and Italy (in Spain, moderate growth in 2016 would follow clear expansion in 2015). The major contributor to firmer expenditure is Germany, where discretionary spending is expected to rise by about 5% this year in nominal terms, boosted notably by refugee-related spending.

([24]) A key underlying question is what should be taken as the 'new normal' for euro area medium-term growth. A more sanguine assumption than that presented in Table 1 would have medium-term real growth in the range of 1.0-1.5%, where the upper end of the range could correspond to a scenario of substantial structural reforms. With inflation getting back over time to the ECB objective, this would lead to estimate the new normal for nominal growth at 3.0-3.5% for the euro area average. This is higher than the current growth of 2½ % of primary spending but not by much, especially if one considers the more prudent lower end of the range.

Table II.1.1: **Expenditure dynamics and medium-term potential GDP growth (% change)**

	EA-19			DE			FR			IT			ES			REA		
	2014	2015	2016(f)	2014	2015	2016(f)	2014	2015	2016(f)	2014	2015	2016(f)	2014	2015	2016(f)	2014	2015	2016(f)
Discretionary expenditure growth (nominal)	1.8	2.3	2.6	2.6	4.2	5.1	2.2	1.5	1.6	1.0	0.5	0.9	1.0	3.7	1.8	1.2	2.0	2.3
Medium-term potential growth (nominal)	1.6	2.0	2.0	3.0	3.4	3.1	1.5	2.2	2.0	0.5	0.5	0.7	-0.2	0.8	1.1	1.5	2.0	2.1
of which:																		
medium-term potential growth (real)	*0.7*	*0.7*	*0.8*	*1.3*	*1.3*	*1.3*	*1.0*	*1.0*	*1.0*	*-0.3*	*-0.2*	*-0.1*	*0.2*	*0.2*	*0.2*	*0.8*	*0.9*	*1.0*
GDP deflator	*0.9*	*1.3*	*1.2*	*1.7*	*2.1*	*1.8*	*0.6*	*1.2*	*1.0*	*0.8*	*0.8*	*0.8*	*-0.4*	*0.6*	*0.9*	*0.7*	*1.1*	*1.1*

Source: European Commission services.
Note: Discretionary expenditure is total government expenditure net of one-offs, interest payments and non-discretionary unemployment expenditure.

1.2.2. The macroeconomic impact of euro area fiscal policy

The fiscal policy pursued since 2014 is estimated to have had limited effects on growth. These effects are gauged by model-based (QUEST) estimates by comparing developments under actual policies with those under a counterfactual that assume a strictly neutral fiscal stance since 2014.([25]) As could be expected given the broadly flat fiscal impulses over the period of consideration, estimated output effects are limited: for the euro area as a whole, real GDP growth is estimated to have been slightly reduced by discretionary fiscal policy in 2014 (by 0.1% of GDP) and to be slightly supported in 2016 (by 0.15% of GDP). For the year 2016 specifically, growth in Germany is estimated to benefit by close to ½ % of GDP from fiscal support, with the growth of Italy and Spain also being supported but to a significantly lesser extent. Output growth in France remains slightly curtailed by the ongoing consolidation. These evaluations of the impact of discretionary fiscal policy should be complemented by a consideration of the effects of the automatic stabilisers, as noted earlier.

1.3. FISCAL STANCE AND THE POLICY MIX IN 2017: CHALLENGES, INTERACTIONS AND PROSPECTS

This section lays the basis for a discussion on the prospective fiscal stance given the broader policy mix. Section 3.1 exposes the current monetary policy stance and draws implications for fiscal policies. Section 3.2 presents the 'sustainability stabilisation' map capturing the critical challenges facing fiscal policies along these two dimensions. Section 3.3 discusses further the prospective euro area fiscal stance emerging from the SCPs in the light of these challenges and environmental context.

1.3.1. The monetary policy stance and its implications

1.3.1.1 The monetary policy stance

The monetary policy stance has been considerably eased in the recent past. Preventing a prolonged period of low inflation in a context of stabilising energy prices and slow aggregate demand has been the

([25]) The counterfactual scenario is thus a zero discretionary fiscal effort from 2014 onwards in all countries. The effect of the large consolidation prior to 2014 is not captured, though it may have had still some residual effect. However, it is deemed that such lags are likely to be negligible by 2016. The composition of the actual discretionary fiscal effort across the main expenditure and revenues categories is fully embodied in the simulation. As all country paths are simulated jointly, cross-country spillovers are taken into account by the simulation. The simulation assumes constant nominal interest rates.

primary motivation for the recent monetary expansion. With policy rates already close to the zero lower bound (ZLB), the ECB has had recourse to a range of unconventional instruments since mid-2014:

- Cuts in policy rates: the deposit facility rate (DFR) was lowered to -0.10% in June 2014, and then gradually to -0.40% as of last March. Other policy rates have also been lowered, with the main refinancing operations rate cut down to 0% last March.

- A sizeable asset purchase programme: the purchases have already expanded the Eurosystem balance sheet from around EUR 2 tn in September 2014 to above EUR 3 tn by May 2016. The pace of purchases has been raised from an initial EUR 60 bn per month to 80 bn, and their horizon extended to at least March 2017.

- Targeted long-term refinancing operations aimed at supporting bank lending (TLTROs and TLTROs II).

- Strengthened forward guidance: initially introduced in July 2013, forward guidance was adjusted to communicate prolonged accommodation, including policy rates at present or lower levels for an extended period of time, and well past the horizon of net asset purchases.

Taken together, these measures imply that monetary easing has gone beyond what is suggested by a simple comparison between policy rates and basic Taylor rules (see box II.1.2).

These measures have considerably eased monetary and financial conditions. Money market rates (EONIA) have adjusted to the DFR and expected to remain close to current level for several years. The yield curve has markedly flattened. An estimated 'shadow interest rate' for the euro area has fallen to about -3% at the current juncture ([26]). Average rates on new bank loans have fallen by about 80 basis points, with most of the decline materialising by mid-2015 and larger declines in countries where financing conditions were initially tighter. The composite financing cost indicator (CFCI) ([27]) for non-financial corporations also declined, by about 30 basis points, between June 2014 and June 2015, while its cross-country dispersion narrowed significantly. It rose in early 2016 on the back of heightened global financial market tensions and has now stabilised at a low level.

The impact on the broader economy is more uncertain, though model-based estimates suggest that the monetary expansion has supported output and inflation. While domestic demand has been gently gathering strength and core inflation stabilised, it is methodologically difficult to separate the baseline evolution of the economy from the effects of monetary policy measures. Model-based simulations undertaken with the QUEST model suggest that through lower risk premia and a slightly lower exchange rate, the asset purchases measures announced in 2014-15 have sustained nominal GDP by about 1½ % by 2016, with roughly two-thirds of the effect on prices and one third on real output. Relatively stronger effects are estimated for countries where financial conditions were initially tighter. ([28])

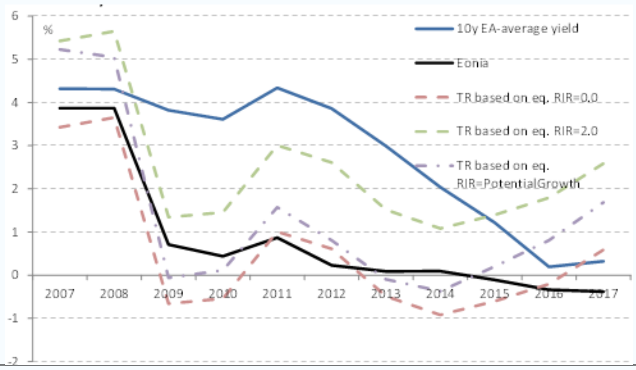
At the same time, headline inflation has remained persistently low. Headline inflation has recently hovered around zero with core inflation fluctuating just below 1%. Inflation would, however, likely have been even lower in the absence of ECB measures and is forecast to rebound going forward.

([26]) The shadow interest rate is an estimated rate that would be consistent with the OIS curve term structure in the absence of a lower bound. The estimates presented here are based on the methodology of Krippner (2013). There are considerable uncertainties surrounding these estimates, which should therefore be only viewed as illustrative.
([27]) The CFCI combines information on loan rates and market-based debt and equity funding.
([28]) These estimates do not include the latest decisions announced in March 2016. They appear broadly consistent with ECB assessments. See speech by Peter Praet, *The ECB's monetary policy response to disinflationary pressures*, 7 April 2016.

Box II.1.2: **Taylor rules for the euro area**

This box presents simple Taylor rule (TR) estimates with equal weights for core HICP inflation and output stabilisation.([1]) The aim is not a normative assessment of the adequacy of the ECB's monetary policy with the primary objective of price stability, which the ECB defines in terms of headline HICP inflation. Instead, TR estimates are a conventional yardstick that can help illustrate the orientation of monetary policy. It should be borne in mind that TR estimates are surrounded by large uncertainty, in particular arising from the choice of the explanatory variables. For instance, there is disagreement on whether to include levels of economic slack, as done here, or growth rates of economic activity in the estimations. Similarly, it is arguable whether to consider current or expected levels of these explanatory variables as relevant. Another important uncertainty pertains to the level of the natural real interest rate (RIR). A range of values is considered here, with the equilibrium RIR assumed to be within a 0-2% interval, reflecting the past range of potential growth estimates. As an intermediary curve, the RIR is equated to potential growth.([2])

Graph II.1.a: **Taylor rule estimates for the euro area based on core inflation**



Source: DG ECFIN calculations based on the Commission Spring 2016 forecast

While highly uncertain, these TR estimates confirm that the ZLB has been constraining over the past few years. The lower range of TR estimates, arguably the most relevant given the crisis-induced slowdown([3]), moved into negative territory as of 2013. This suggests that resort to unconventional instruments was needed to provide additional monetary easing from that juncture. Indeed, the overnight interest rate (EONIA), the market rate which is direct affected by standard monetary policy (i.e. key ECB rates), has evolved broadly in line with this lower range in recent years, albeit lagging at first the decline in TR estimates in 2013-14. The ECB's unconventional policies also contributed to the strong decline in longer-term rates in the past years and the associated flattening of the yield curve as the spread between overnight rates and 10-year yields has narrowed considerably from over 350 basis points back in 2012 to about 50 basis points in 2016.

While TR estimates are projected to pick up above EONIA rates in 2017 as the economy and inflation continue to recover, this should be put into perspective. Providing additional monetary accommodation at the ZLB requires central banks to project their accommodative stance further out in time. Accordingly, the ECB Governing Council recently reiterated through its forward guidance that it expected key policy rates to remain at present or lower levels for an extended period of time. In addition, it should be noted that TR

([1]) Equilibrium RIR + Core HICP inflation + 0.5*(Core HICP inflation - 1.9) + 0.5*Output Gap {in %}.
([2]) The RIR is the rate at which aggregate demand in the economy would equal its potential output. In a long-run approach, it can be proxied by potential growth. According to DG ECFIN's estimates, euro area potential growth was around 2% in the early 2000s and bottomed out at 0.2% in 2012.
([3]) The natural rate of interest has likely substantially declined in recent years; it may modestly pick up again in the future as the economy gathers strength.

(Continued on the next page)

Box (continued)

projections, which are based here on Commission forecasts, assume a strengthening recovery that is itself predicated on continued monetary accommodation, and would thus not unfold similarly under a tighter environment. A further, more general caveat arises from the fact that the non-standard monetary policy measures employed in the past years are by construction not reflected in a Taylor rule estimated on pre-crisis empirical regularities. Taylor rules therefore represent an incomplete measure for the monetary policy stance in current conditions.

Although overall successful, it can be argued that monetary policy has become to some extent 'overburdened'. The effects of unconventional monetary policy measures might be limited due to hurdles on growth that cannot be resolved by more monetary accommodation, such as private sector deleveraging, weak global demand, and risk aversion driven by uncertainty about future demand prospects. Some observers also raise attention to the possible side effects of large unconventional measures, most prominently risks to financial stability due to excessive risk-taking by financial market agents and a possible adverse impact on financial sector profitability.

1.3.1.2 Implications for fiscal policies

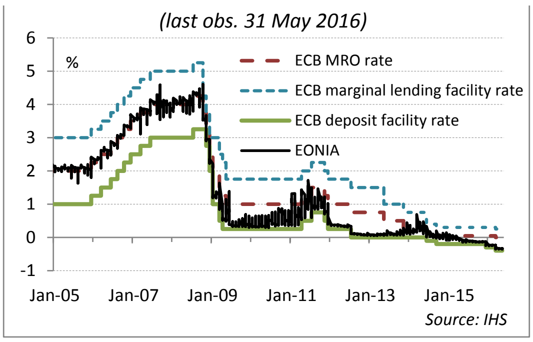
The easier monetary environment creates more favourable financing conditions for governments. Together with slowly improving growth, this has led to a negative interest rate growth differential, reversing the unfavourable 'snowball effect' of the early 2010s (Graph II.1.7).

This has important implications for the design of fiscal policies:

- In particular, the low funding cost environment makes it an ideal time for governments to frontload investment programmes through new lending, especially where public investments are at historical lows and there are identified needs.

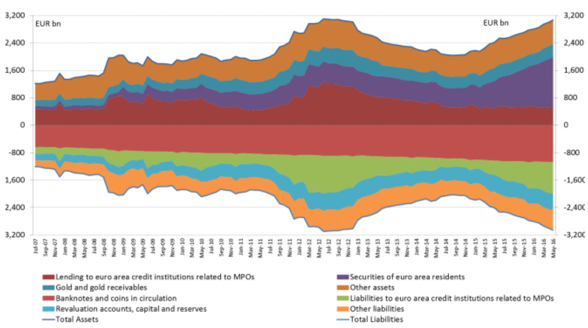
- At the same time, periods of negative interest rate growth differential are propitious to make a dent on high debt ratios. This means that governments should also seize the opportunity to strengthen the sustainability of their policies, especially where debt ratios are high, by curbing non-future oriented spending and cutting tax loopholes.

Graph II.1.3: ECB policy and euro overnight rates



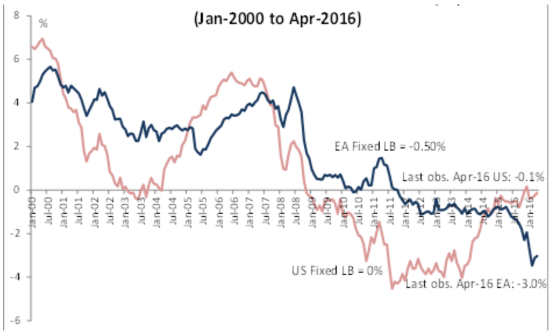
Source: European Commission services

Graph II.1.4: Eurosystem – Main Balance Sheet items



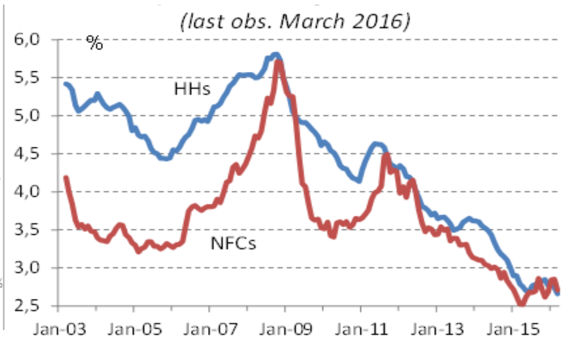
Source: ECB and European Commission services

Graph II.1.5: EA vs EU Shadow rate with fixed lower bound (LB)



Source: European Commission services

Graph II.1.6: Composite financing cost indicators



Source: ECB, Bloomberg, HIS, European Commission services

In terms of the overall policy mix, there is a need for fiscal and monetary policies to work in conjunction in the current unusual episode. While the ECB has had recourse to an unprecedented set of measures, it has also made clear that it cannot bring about a sufficiently rapid stabilisation of the economy and ensure durable growth on its own. In particular, the ECB has called for a growth-friendly fiscal policy as an essential component to support the euro area recovery ([29]). In 2016, loose monetary conditions are set to coincide with slightly expansionary fiscal policy, making for an overall supportive policy mix on the demand side. However, the slightly expansionary fiscal stance has come partly from slower fiscal consolidation in countries that face sustainability challenges. In such a situation, the policy mix could in the future be improved by a centralised support from European level tools as envisaged in the Five Presidents' Report on completing EMU (see box II.1.3).

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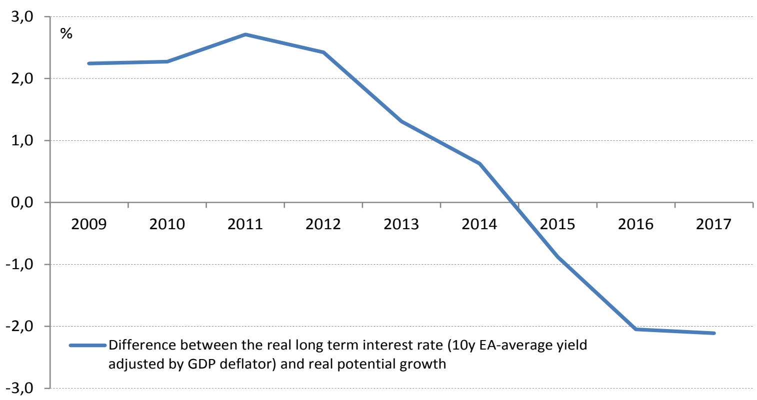
Graph II.1.7: Euro area: R-G



Source: DG ECFIN calculations on the Commission Spring 2016 forecast

([29]) See notably Mario Draghi, *Unemployment in the euro area*, speech at the Jackson Hole symposium, 22 August 2014, and *On the importance of policy alignment to fulfil our economic potential,* speech at the Brussels Economic Forum, 9 June 2016. Structural reforms are another other critical component of a consistent strategy for sustainable growth. The G20 three-pronged strategy similarly calls for a consistent policy mix.

Box II.1.3: **Euro-area stabilization capacity**

The recent experience suggests that the EMU set up may not leave enough policy space for stabilising large economic shocks, and the Five Presidents' Report on completing EMU advocates the setting up, in stage 2 and under appropriate conditions, of a stabilisation function to better deal with shocks that cannot be managed at the national level alone. This can be for smoothing out country-specific shocks, common shocks to the area as a whole, or both kinds of shocks.

For the euro area as a whole, monetary policy can stabilise common shocks as a consequence of its action to maintain price stability. However, in unusual circumstances such as large downturns and/or at the zero lower bound, monetary policy may be overburdened and be usefully complemented by fiscal support. The combined action of coordinated national fiscal policies can then be powerful, as it was for example in the post-Lehman fallout but in general, the aggregate fiscal stance is an indeterminate outcome in the euro area. Non-binding coordination may not suffice to overcome this problem.

A common fiscal capacity can thus complement monetary policy for stabilising area-wide shocks. In addition, stabilising the area wide position is generally helpful to also stabilise national shocks, given the existence of a common component in national business cycles. The case for a common fiscal capacity has been recently made also by the IMF and the ECB ([a]).

([a]) See IMF concluding statement of the 2016 *Article IV mission*, 16 June 2016; *The euro area fiscal stance, ECB Economic Bulletin* N°4/2016, June 2016.

A better composition of fiscal policies is another essential complementary aspect to improve the policy mix. Together, with efficiency-raising structural reforms, this helps foster a rise in the natural interest rate, thereby increasing the monetary policy space to respond to shocks

1.3.2. The assessment of sustainability and stabilisation

Fiscal policy faces several objectives, two prominent of which at the macroeconomic level are long-term sustainability and short-term stabilisation. This sub-section appraises the position of the euro area and

Member States along these two dimensions.([30])

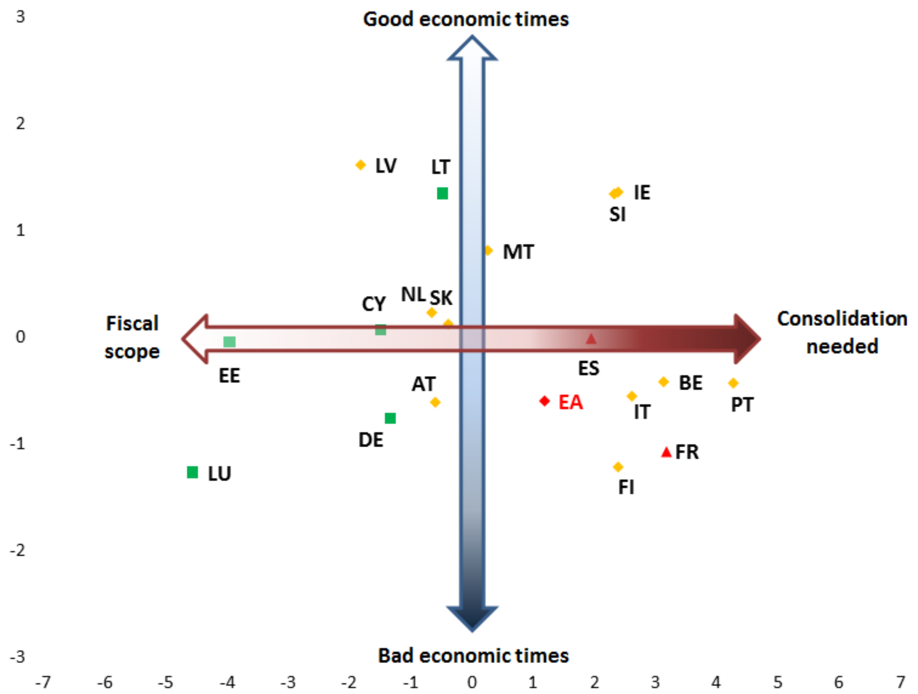
As a first analysis, the sustainability and stabilisation challenges can be presented on a tentative 'fiscal map' (Graph II.1.8):

- For sustainability, the needs as indicated by the S1 indicator.([31])
- The cyclical position is summarised by the projected output gap in 2017 under the assumption of a neutral fiscal policy in 2017.([32]) The resulting output gap thus combines information on the level of slack and the spontaneous growth momentum, corrected for fiscal intervention.

At the same time, while there are good reasons to favour these metrics as summary indicators, they also have limitations and cannot entirely capture a complex reality. Therefore, the below conclusions take into account a robustness analysis based on alternative indicators (see also box II.1.4).

([30]) This follows the approach developed in the Report on Public Finances in EMU (PFR) in December 2015.
([31]) The S1 indicator measures the change in the structural primary balance (SPB) required from 2016 to 2020 to bring general government debt to the reference threshold of 60 % of GDP in 2030. For practical reasons the indicator used here is the S1 indicator according to the "2015 scenario", i.e. where the SPB is held constant at its last outturn value (for 2015). When outturn data for 2016 become available, the updated S1 indicator will take that as a new starting point, and thus be more relevant for assessing consolidation needs in 2017.
([32]) Technically, the output gap expected for 2017 in the Commission forecast is adjusted for the impact of the projected change in the structural primary balance multiplied by an assumed uniform fiscal multiplier of 0.8.

Graph II.1.8: Fiscal map: Sustainability and stabilisation challenges in 2017 (as % of GDP)



Source: European Commission services.
Notes: In this chart, sustainability needs (horizontal axis) are represented by the S1 indicator. A positive S1 indicates that consolidation is needed to ensure sustainability, while a negative S1 indicates that there is some scope for fiscal expansion without putting sustainability at risk. Stabilisation needs (vertical axis) are represented by the expected level for the output gap in 2017 assuming a neutral fiscal stance in 2017 (i.e. no change in the structural primary balance). A positive (negative) output gap denotes good (bad) economic times. When the output gap is not larger than +/- 0.5 % of GDP, it is considered to be broadly closed. The markers indicate the expected situation of each Member State under the SGP at the beginning of 2017: green squares = at or above MTO, orange diamonds = in the preventive arm not yet at MTO, red triangles = in the corrective arm.

For the euro area as whole, the fiscal map points to a remaining trade-off at the current juncture between sustainability and stabilisation needs. The euro area is located in the 'South-East quadrant' of the map where such a trade-off is at play. It reflects the maintenance, despite earlier consolidation, of a residual adjustment gap *vis-à-vis* a trajectory putting the debt on a firm downward path for the future, in conjunction with the persistence of a significant degree of economic slack, albeit a gradually narrowing one. This conclusion is qualitatively robust to the choice of alternative indicators to build the map, though precise magnitudes may differ.

A responsible fiscal policy needs to balance the two objectives of sustainability and stabilisation. There is a need to reduce excessive levels of debt and re-build fiscal buffers. A prudent approach to debt reduction is especially warranted in order to be able to absorb the risks of new shocks. At the same time, the recovery is proceeding only slowly with only a gradual decline in unemployment, while inflation remains persistently low, as highlighted above. Moreover, the current account of the euro area is largely positive (at around 3½ % of GDP), suggesting room for further expanding domestic demand relative to the global economy.

Against these considerations, there is a case for pursuing a broadly neutral stance in the aggregate in 2017:

- A fiscal expansion could be argued should the overarching consideration be a speedier decline of unemployment towards pre-crisis levels, thereby permitting a faster return to a normalised environment and standard monetary policy. It might also be defended as a preventive action to discard any risks of falling into a stagnation trap because of a lack of effective demand.

- This being said, it should be noted that nominal spending is forecast to grow broadly in line with the 'new normal' next year without fiscal support, and that risks to the strength of the recovery stemming from the external environment and domestic factors appear to have recently receded. Moreover, there is also a risk, in view of the past inability to estimate output gaps in real time, of not seizing the opportunity of improving economic times to regain fiscal room for manoeuver where it is needed.

- For the euro area taken as a whole, a robust strategy for managing these uncertainties and minimising risks would be to pursue a broadly neutral stance still in 2017 as the aggregation of national policies. It could be tilted in an appropriate direction as new information unfolds on the outlook for next year, since the latter remains uncertain at this stage.

The fiscal map also highlights the marked diversity of country situations and possible implications for the distribution of fiscal policies:([33])

- Features similar to the overall euro area and a similar trade-off apply to other economies also located in the South-East quadrant of the map, including in particular two of the largest contributors to the overall euro area picture (France and Italy), together with Belgium, Finland and Portugal. Again, this is a situation where credible consolidation needs to be pursued while managing the cyclical consequences. It should be noted that in terms of magnitudes, the precise terms of this trade off vary with the choice of indicators, notably if factoring in the long period of negative output gap and relying on the so called structural NAWRU anchor to appreciate the unemployment gap (see box II.1.4, Graph II.1.b-II.1.c).

- A few Member States, most prominently Germany, which are located in the South-West quadrant of the map, are assessed to combine a degree of fiscal scope, in the sense that their debt is low or being very rapidly reduced (a negative S1), with some stabilisation need, albeit a relatively moderate one in the case of Germany, where the output gap is expected to open up this year, assuming a positive impact on potential output of the inflow of refugees.([34]) This indicates a situation involving no apparent trade-off from an economic perspective, as the existing fiscal scope could be mobilised to support the economy, especially by investing in long-term growth.

([33]) It should be stressed again here, as already noted in the introduction to this note, that the economic considerations drawn from the fiscal map that follow can in no way dispense Member States from their obligations under the SGP. Rather, they are intended to inform the discussion on the best use of the scope for flexibility within the rules, and the ideal distribution of fiscal policies consistent with the rules.

([34]) A caveat also appears in order concerning the large fiscal scope identified by the S1 indicator for Luxembourg and Estonia, which derives from an assumption of convergence of public debt to 60% by 2030. The robustness analysis suggests that these countries do have fiscal scope, but arguably not to the extent suggested by S1.

Box II.1.4: The robustness of the sustainability and stabilisation indicators

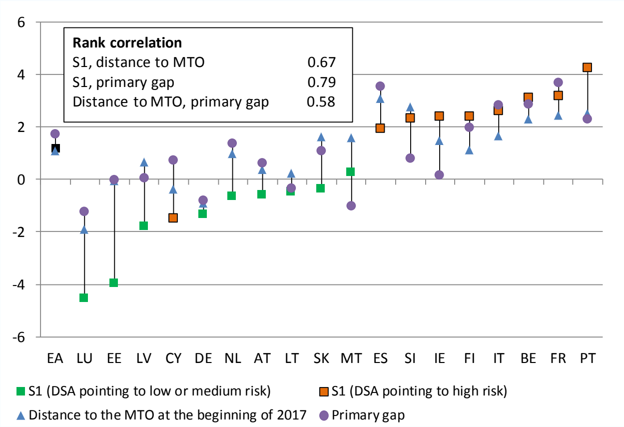
The S1 indicator is an established indicator of sustainability that has several merits, including those of a relevant horizon for policy-making purposes (five years) and of taking into account future ageing-related costs. Nevertheless, it has some limitations, such as the relatively short period of time for achieving the 60% of GDP terminal value, and the sensitivity to output gap estimates. It is thus useful to cross-check the signals provided by S1 with two alternative metrics for assessing the robustness of conclusions over sustainability needs (Graph II.1.10):

– The distance to the medium-term objective (MTO). This has the advantages of being well-known and of stemming directly from the legal fiscal framework. However, as the MTO is measured as structural balance, it is sensitive to output gap estimates as well. Ageing-related spending and the debt situation are only indirectly incorporated, among other factors.

– The primary gap. This is defined as the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over the reference value of 60% of GDP at a yearly pace of 5%, or, for countries with debt below 60%, the primary balance that would stabilise debt at its current level. The advantages of the primary gap are to rely on a simple calculation and of being based on observable values, dispensing in particular from an estimate of the output gap. But it does not incorporate ageing-related spending.

In addition, the Chart also shows as a qualitative indicator the conclusion from the DG ECFIN's debt sustainability assessment (DSA ([a])).

Graph II.1.b: **Sustainability needs: alternative indicators (% of GDP)**



Source: European Commission services.
Notes: There is no DSA for the euro area as a whole. S1 is expressed in terms of structural primary balance, the distance to the MTO in terms of structural balance, and the primary gap in terms of primary balance. A negative distance to the MTO means that the Member State is above its MTO.

Overall, the correlations between indicators are fairly strong. The S1 enjoys the highest pair of correlations with the other two quantitative indicators. Moreover, for the euro area as a whole, the three numerical indicators stand very close to each other. To a lesser extent, this is also the case for the four largest countries

([a]) The overall DSA assessment of risk to debt sustainability in the medium term is based on projections under three different scenarios and classifies Member States as being at low, medium or high risk. For more details, see the Fiscal Sustainability Report 2015, http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip018_en.pdf

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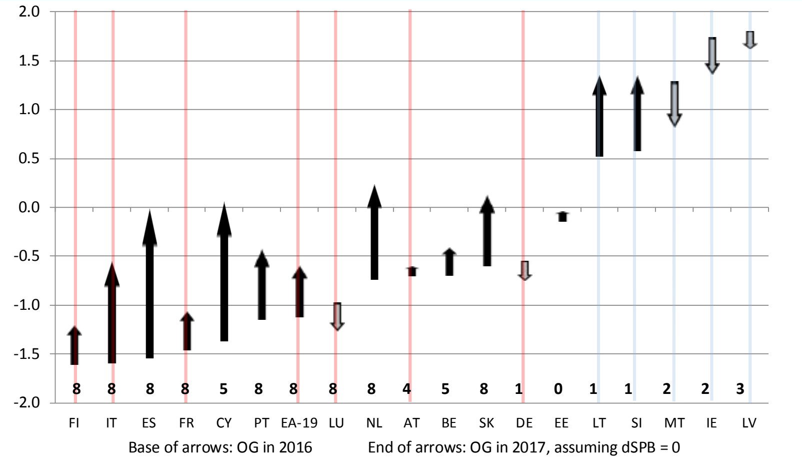
Box (continued)

of the zone. However, there are some significant differences for several countries. In particular, negative values of S1 are not corroborated or only partially so with alternative measures. By contrast, for Member States in which S1 is significantly positive, all the other indicators including the DSA consistently signal risks to sustainability.

On the stabilisation side, the situation of the euro area aggregate and Member States can be refined by a closer analysis of the dynamics of the output gap. Similar levels in 2017 may result from dissimilar conditions. This is shown by the different starting points (the level of the output gap in 2016) and the

numbers of consecutive years with an output gap of the same sign (Graph II.1.c). Although markedly narrowing under the assumption of a neutral fiscal stance in 2017, the output gap for the euro area as a whole would be negative for the ninth year in a row, suggesting persistent slack. This would also be the case for several Member States (including France and Italy). On the other hand, five Member States are expected to have a positive output gap in 2016 for at least the second year in a row and to maintain it in 2017.

Graph II.1.c: **Output gap in 2016-17 assuming no change in the structural primary balance in 2017 (% of GDP)**



Source: European Commission services.
Notes: The Member States are sorted by increasing level of the output gap in 2016. The red vertical bars indicate the Member States that would have a significantly negative output gap (lower than -0.5% of GDP) in 2017, and the blue bars those with a significantly positive output gap (above 0.5% of GDP), assuming a neutral fiscal stance in 2017. The numbers above the country labels indicate the number of consecutive years with an output gap of the same sign in 2016.

Another robustness check for evaluating the cycle is to compare the standard NAWRU estimates with the structural NAWRU anchor (Graph II.1.d). The latter is obtained by regressing the NAWRU on a set of labour market structural indicators ([b]), and it also corresponds to the level that NAWRU would reach at a horizon of about 10 years (2025). Given the effect of the financial crisis and its aftermath on actual unemployment and NAWRUs, it can be expected that the structural NAWRU anchor would generally differ significantly from current NAWRUs. Indeed, a difference of about 1 percentage point is found for the euro area on average. This is indicative of a margin of uncertainty whereby the amount of slack would be a bit higher on average than presented in the fiscal map in the main text. Moreover, the difference can be more

([b]) For more details, see F. Orlandi (2012), Structural unemployment and its determinants in the EU countries, *DG ECFIN Economic Papers*, N°451, May

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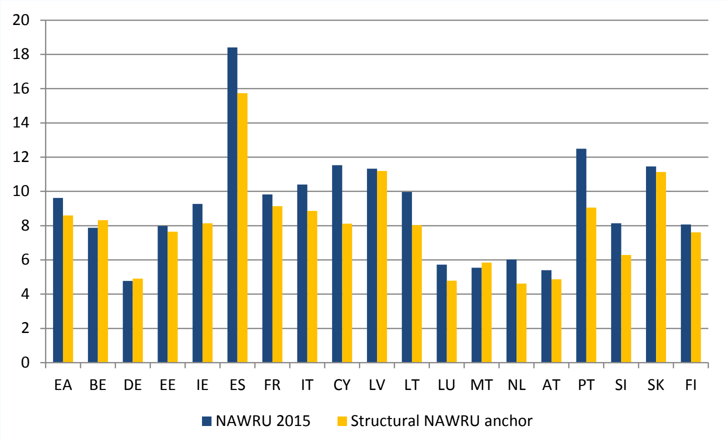
Box (continued)

substantial for some countries, and in particular above 2 percentage points in the case of Cyprus or Spain and Portugal.

Graph II.1.d: **Output gap in 2016-17 assuming no change in the structural primary balance in 2017 (% of GDP)**



Source: European Commission services.
Note: The structural NAWRU anchor is the NAWRU for 2025.

- A few countries located in the North-East quadrant (essentially Ireland and Slovenia) would seem to be in the opposite situation, which unambiguously calls for fiscal retrenchment. These countries indeed face significant remaining consolidation needs while experiencing good times. This being said, the conclusion of good times would be tempered if using the structural NAWRU anchor to appreciate the cyclical position for these countries.

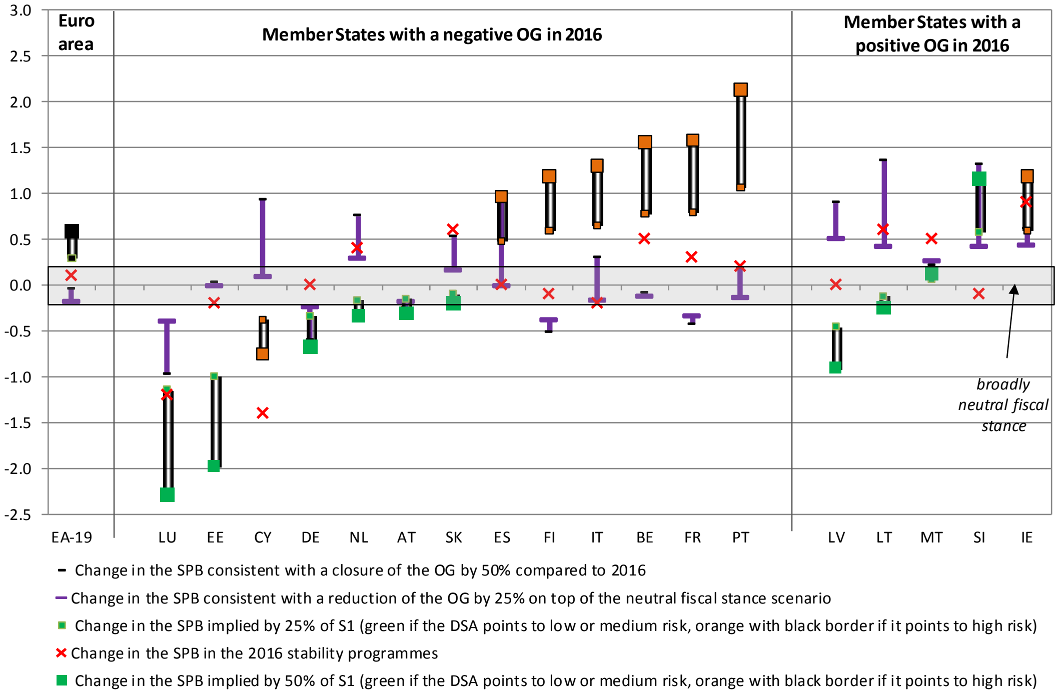
- The policy indications that could be drawn from the fiscal map are less clear for other countries. Latvia and Lithuania are estimated to be in good times while enjoying fiscal scope. The few other countries do not belong to a clear quadrant. Spain is assessed to have still substantial consolidation needs while being close to neutrality in terms of the cycle. Nevertheless, the latter assessment is, again and notably so for Spain, quite sensitive to the precise choice of cyclical indicator.

1.3.3. Prospects and assessment of the fiscal stance from the stability programmes

This sub-section describes the fiscal stance as planned in the stability programmes against the challenges underlined in previous sub-sections, and explores whether improvements can be sought in the distribution or design of the plans, consistent in particular with the recommendations for the euro area and within the rules of the Stability and Growth Pact.

For the euro area as a whole, the neutral fiscal stance for 2017 resulting from governments' plans is consistent with some stabilisation and less restrictive than implied by sustainability needs. The

Graph II.1.9: Change in the SPB (structural primary balance in 2017 in the stability programmes against sustainability and stabilisation needs (% of GDP)



Source: European Commission services.
Notes: Member States are grouped by the sign of their output gap in 2016, then sorted by S1. There is no DSA for the euro area as a whole.
How to read this chart:
The sustainability criterion is based on the S1 indicator and assumes that 25 % to 50 % of the indicated change in the SPB is implemented in 2017, corresponding to more or less frontloading of the consolidation effort if S1 is positive (squares above the horizontal axis). For countries with a negative S1 (squares below the horizontal axis), this indicates some scope for expansionary policies in response to possible stabilisation needs.
In addition to the position of squares above or below the horizontal axis, the colour code signals whether the DSA assessment points to low or medium risk (green squares) or to high risk (orange squares with black lining).
The stabilisation criterion is measured by a range that combines two methodological approaches:
i/ The short black bars indicate the change in the SPB consistent with a closure of the output gap by 50% compared to its level of 2016, as in the 2015 Report on Public Finances in EMU. As the expected change in the output gap in 2017 is not only driven by fiscal policy, the spontaneous closure of the output gap may, in certain cases, already reach or even exceed 50% under a neutral-fiscal-policy assumption. In these cases, some fiscal consolidation would therefore still be compatible with a closure of the output gap.
ii/ The long horizontal purple bars indicate the change in the SPB for which fiscal policy reduces by 25% the output gap that would result from a neutral-fiscal-policy scenario in 2017, as in the note presented to the Eurogroup Working Group in October 2015. This assumes that fiscal policy always plays a countercyclical role, either supporting the closure of the output gap or mitigating its widening. If the neutral-fiscal-policy assumption implies that the output gap is changing sign, then the stabilisation objective caps the closure of the output gap at 100%, thus avoiding pro-cyclicality.
Depending on the expected closure of the output gap under the neutral-fiscal-policy scenario, this can lead to a closure by various proportions compared with the level of 2016, which explains why the purple bars can be above or below the black bars.
The red crosses show the planned changes in the SPB presented by Member States in their 2017 stability programmes, as recalculated by the Commission using the commonly agreed methodology for potential output.
The shaded area indicates a zone where the fiscal stance can be considered broadly neutral. It corresponds to a change in the SPB of between -0.2 pp and 0.2 pp.

aggregation of the plans presented in the stability programmes ([35]) points to a close to neutral fiscal stance (an improvement in the structural primary balance by 0.1 % of GDP, Graph.II.1.9). This is line with the above tentative assessment that a broadly neutral stance would be appropriate area-wide, striking a balance of considerations.

- The sustainability needs would point to a needed consolidation of 0.3 to 0.6 % GDP (to close the S1 gap by 25 to 50%).

- As regards stabilisation, a neutral fiscal policy would be consistent with a closure of the output gap by 50 % next year given the spontaneous momentum of the economy expected in the forecast. A mild expansion of close to 0.2 percent of GDP would ensure that fiscal policy supports a closure of the output gap by 25% on top of that expected momentum.

In terms of the country distribution, there would seem to be scope for rebalancing:

- Germany plans to switch from an expansionary stance this year to a neutral orientation in 2017. Meanwhile and as noted already, the indications are that the remaining fiscal scope could be used for supporting growth, preferably by fostering future-oriented outlays.([36])

- In some other countries the plans are tilted towards the stabilisation objective, although this conflicts with the identified sustainability needs. Among the large countries, this is most apparent in the case of Italy and Spain, the plans of which do not evidence any consolidation. While the above analysis has acknowledged the existence of a trade-off between economic objectives for these countries, the plans favour the dimension of stabilisation. For France, the stability programme strikes a balance but the somewhat large remaining sustainability gap in the context of an improving economy calls for keeping a firm momentum on consolidation.

([35]) The structural primary balance from the plans is computed based on the public finances projections in the stability programmes while using the common methodology for estimating potential GDP. This may differ from the projections in the stability programmes to the extent that there are differences in estimating potential GDP.

([36]) The effects of an increase in public investment in Germany, as well as in the Netherlands, are studied in "*QUEST simulations of spillovers of a public investment stimulus in surplus countries" (Jan int'Veld)*, publication forthcoming. In Germany and the Netherlands, an investment stimulus would boost domestic demand, lift up prices and reduce the current account surpluses. Other euro area economies would benefit from positive trade spillover effects on GDP, and a limited favourable impact on their current accounts. The positive effects and spillovers are magnified under the assumption that monetary policy stays at the zero lower bound and accommodates the stimulus. When monetary policy is constrained, GDP in the rest of the euro area is increased by about 0.3% at a 2-year horizon following a 1% of GDP investment increase in Germany and the Netherlands.

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