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2017 Draft Budgetary Plans : Overall Assessment

Executive summary

This Communication summarises the Commission's assessment of the 2017 Draft Budgetary Plans (DBPs) submitted by the eighteen euro area Member States not under a macroeconomic adjustment programme (EA-18), including no-policy change plans submitted by Lithuania and Spain due to the presence of caretaker governments in these countries at the time of submission. In line with Regulation (EU) No 473/2013, the Commission has assessed these plans and the overall budgetary situation and fiscal stance in the euro area as a whole.

The overall assessment of the 2017 DBPs and the aggregate fiscal stance for the euro area can be summarised as follows:

1. The Member States' plans imply a continuing decrease in the aggregate headline budget deficit in the euro area in the context of a recovery that remains fragile and with a number of downside risks. After falling from 2.0% of GDP in 2015 to reach 1.8% of GDP this year, the aggregate deficit is planned to decline further to 1.5% of GDP in 2017. Having peaked in 2014, the aggregate debt ratio based on the DBPs is also planned to decrease slightly from just over 90% for the current year to 89% of GDP in 2017. This corresponds to a deterioration in the structural balance in 2016 of 0.2% of GDP, which then remains broadly unchanged in 2017.
2. Compared to the medium-term plans formulated in the spring 2016 Stability Programmes, the planned deficit reduction in 2017 was revised downward and would be smaller by 0.2 percentage points in the euro area, though starting from a slightly lower deficit in 2016 than had been anticipated in the spring of 2016.
3. The macro-fiscal outlook emerging from the DBPs is broadly confirmed by the Commission's 2016 autumn forecast. Real GDP growth is projected to weaken slightly from 1.7% this year to 1.5% in 2017, though the negative output gap is expected to continue to narrow to 0.5% of potential GDP. The Commission also forecasts a reduction in the headline deficit similar to the DBPs in 2017 (by 0.3 percentage points), to arrive at the same headline balance of -1.5% of GDP. The Commission projects that the aggregate debt-to-GDP ratio will decrease for the second year in a row to 90% in 2016 and fall further to 89% in 2017, which is in line with the plans set out in the DBPs.
4. As in 2015, Member States budgetary positions are being supported by significant falls in borrowing costs. Temporary savings from low interest payments can be used according to the Member State's fiscal position, translating into lower deficits in countries with large budgetary imbalances while allowing a larger increase in future-related expenditure if fiscal space is available.
5. At the aggregate level, the DBPs and the Commission's forecast point to the euro area fiscal stance being broadly neutral over the period 2014-2017, continuing the pause of fiscal consolidation that has occurred since 2013. More specifically, the fiscal stance became broadly neutral in 2014-2015 and slightly expansionary in 2016, against the background of an economic recovery. For 2017, both the aggregation of Member States' DBPs and the Commission forecast point to a broadly neutral fiscal stance again. This should be assessed against the double objectives of short-term macroeconomic stabilisation and long-term sustainability of public finances.
6. As detailed in the Commission's Communication *"Towards a Positive Fiscal Stance for the Euro Area"*, there is a case for a moderately expansionary fiscal stance for the euro area as a whole at this point in time, in the light of the slow recovery and risks in the macroeconomic environment.[1]

   However, designing such an appropriate fiscal stance for the euro area is the individual and

[1] See COM(2016) 727 final, 16.11.2016.

collective responsibility of the Member States. This approach is also reflected in the proposed Recommendation on the economic policy of the euro area for 2017-2018.[2]

7. The analysis of the appropriateness of the fiscal stance in the euro area is not just a question of the sign and size of the budget balance, but also very much of the quality and composition of the public finances leading to it. At a broad level, tax revenue structures are not planned to be changed significantly, while the composition of expenditure also shows limited progress towards being more growth-friendly, with capital expenditure still failing to recover as a share of GDP. In addition, improvements in national fiscal governance, including the setting-up of efficient spending reviews, could support the growth-friendliness of public spending.

8. The Commission's assessment of individual Member States' plans can be summarised as follows:

No DBP for 2017 has been found in particularly serious non-compliance with the requirements of the Stability and Growth Pact (SGP). In several cases, however, the Commission finds that the planned fiscal adjustments fall short, or risk doing so, of what is required by the SGP.

Specifically:

Regarding the fifteen countries in the preventive arm of the SGP:

- for five countries (**Germany, Estonia, Luxembourg, Slovakia and the Netherlands**), the DBPs are found to be **compliant** with the requirements for 2017 under the SGP.

- for four countries (**Ireland, Latvia, Malta, Austria**), the DBPs are found to be **broadly compliant** with the requirements for 2017 under the SGP. For these countries, the plans might result in some deviation from the adjustment paths towards each country's medium-term budgetary objective.

- for six countries (**Belgium, Italy, Cyprus, Lithuania, Slovenia, Finland**), the DBPs pose a **risk of non-compliance** with the requirements for 2017 under the SGP. The DBPs of these Member States might result in a significant deviation from the adjustment paths towards the respective medium-term objective. However, **Finland** has applied for use of the structural reform clause and investment clause. The Commission will take account of the uncertainty surrounding the output gap estimates when considering Finland's eligibility for the clause, which may in turn impact upon the assessment of compliance. In the case of **Lithuania**, the no-policy-change DBP included an application for use of the structural reform clause. The complete assessment of both Finland and Lithuania's possible eligibility for flexibility will take place within the normal European Semester cycle in the context of the assessment of the 2017 Stability Programme.

Regarding the three countries currently in the corrective arm of the SGP (i.e. in Excessive Deficit Procedure):

- for **France**, the DBP is found to be **broadly compliant** with the requirements for 2017 under the SGP, as the Commission 2016 autumn forecast projects that the headline deficit will be slightly below the Treaty reference value of 3% of GDP in 2017, although there is a significant shortfall in fiscal effort compared to the recommended level and the correction would not be durable in 2018 on the basis of unchanged policies.

- for **Spain**, the DBP is found to be at **risk of non-compliance** with the requirements for 2017 under the SGP. While acknowledging the no-policy-change nature of these projections, the Commission's forecast for 2017 projects that neither the intermediate headline deficit target, nor the recommended fiscal effort will be achieved.

- for **Portugal**, the DBP is found to pose a risk of non-compliance with the requirements for 2017 under the SGP, although the projected deviation exceeds the threshold for a significant deviation by a very narrow margin. The risks seem therefore contained provided the necessary

[2] See COM(2016) 726 final, 16.11.2016.

fiscal measures are delivered. Portugal, which is currently under the corrective arm, is projected to respect the Treaty reference value of 3% of GDP this year, as recommended. It could become subject to the preventive arm from 2017, if a timely and sustainable correction of the excessive deficit is achieved.

Portugal and **Spain** submitted their DBPs by mid-October, as well as reports on action taken in response to the Council decisions to give notice, adopted on 8 August 2016 in accordance with Article 126(9) of the Treaty. The Commission has in the meantime assessed such documents and engaged in a structured dialogue with the European Parliament. The Commission has come to the conclusion that the Excessive Deficit Procedures of both Member States should be held in abeyance. Accordingly, the event that required a proposal by the Commission to suspend parts of the European Structural and Investment Funds is no longer present and there will be no such proposal.

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I. Introduction

EU legislation foresees that euro area Member States submit Draft Budgetary Plans (DBPs) for the following year to the Commission by 15 October with the aim of improving coordination of national fiscal policies in the Economic and Monetary Union[3].

These plans summarise the draft budgets that governments submit to national parliaments. On each plan, the Commission provides an Opinion, assessing whether it is compliant with the Member State's obligations under the Stability and Growth Pact (SGP).

The Commission is also required to provide an overall assessment of the budgetary situation and prospects for the euro area as a whole. The latter assessment is provided in the present Communication along with the Commission Communication "*Towards a Positive Fiscal Stance for the Euro Area*"[4].

Eighteen euro area Member States were required to submit their 2017 DBPs to the Commission by 17 October, in line with the provisions of the so-called Two-Pack[5]. As the remaining euro area country under a macroeconomic adjustment programme, Greece is not obliged to submit a plan, as the programme already provides for close fiscal monitoring.

In line with the indications of the Two-Pack Code of Conduct[6], two countries, Lithuania and Spain, submitted no-policy change DBPs due to caretaker governments being in place. The incoming governments are expected to submit full DBPs once they take office.

While respecting Member States' budgetary competence, the Commission's Opinions provide objective policy advice, in particular for national governments and parliaments, to facilitate the assessment of the draft budgets' compliance with EU fiscal rules. The Two-Pack provides for a comprehensive toolbox to treat economic and budgetary policy as a matter of common concern within the euro area, as intended by the Treaty.

In addition, in July 2015, the Council invited the Eurogroup to monitor and coordinate euro area Member States' fiscal policies and the aggregate fiscal stance for the euro area to ensure a growth-friendly and differentiated fiscal policy[7]. The Council recommended that euro area Member States, without prejudice to the fulfilment of the requirements of the SGP, "coordinate fiscal policies to ensure that the aggregate euro area fiscal stance is in line with sustainability risks and cyclical conditions".

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3 As set out in Regulation (EU) No 473/2013 on common provisions for monitoring and assessing Draft Budgetary Plans and ensuring the correction of excessive deficits of the Member States in the euro area. It is one of the two Regulations in the so-called Two-Pack which entered into force in May 2013.

4 See COM(2016) 727 final, 16.11.2016, and: http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm

5 As the submission deadline of 15 October fell on a Saturday in 2016, in line with the applicable legal rules, the deadline was extended to Monday 17 October.

6 An updated version of the Two-Pack Code of Conduct is forthcoming, with the current version available at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

7 Council Recommendation of 14 July 2015 on the implementation of the broad guidelines for the economic policies of the Member States whose currency is the euro (OJ C 272, 18.8.2015, p. 100).

In November 2015, the Commission proposed an updated Recommendation on the economic policy for the euro area, which was discussed in Council and endorsed by EU leaders at the European Council meeting on 18 and 19 February 2016[8].

This recommendation is an anchor for the Commission's assessment. As part of the annual cycle of the European Semester, the Commission is also proposing a new Recommendation on the economic policy of the euro area for 2017-2018 alongside this package.[9]

The objective of this Communication is twofold. Firstly, it provides an aggregate picture of budgetary policy at euro area level, building on a horizontal assessment of the DBPs. This exercise mirrors the horizontal assessment of Stability Programmes that takes place in the spring, but with a focus on the forthcoming year rather than on medium-term fiscal plans. Secondly, it provides an overview of the DBPs at country level, explaining the Commission's approach in assessing them, specifically, for compliance with the requirements of the SGP. The assessment is differentiated according to whether a Member State is in the preventive or the corrective arm of the SGP and also takes into account the requirements relating to the level and dynamics of government debt.

[8] See Council Recommendation on the economic policy of the euro area: http://data.consilium.europa.eu/doc/document/ST-5540-2016-INIT/en/pdf

[9] See COM(2016) 726 final, 16.11.2016.

II. Main euro area findings

Economic outlook contained in DBPs and Commission 2016 autumn forecast

Governments see the recovery from the economic and financial crisis proceeding steadily but not accelerating in the euro area. According to the macroeconomic assumptions provided in the DBPs, GDP will grow by 1.7% in 2016 in the eighteen Member States concerned (EA-18), slightly below the 1.8% expected at the time of the Stability Programmes in April 2016 (Table 1). For 2017, the growth outlook follows the same pattern, with GDP growth forecast at 1.6% in the EA-18 versus 1.7% projected in the Stability Programmes. With the recovery forecast to proceed, though not gain pace, the difference between actual and potential output continues to narrow. According to the plans, the output gap in the EA-18 is projected to be -0.8% of potential GDP in 2016 and to narrow further to -0.5% in 2017, having been below -2% as recently as 2014. This trend is evident in the majority of Member States, though not without differences across countries. The inflation outlook remains subdued, with the expected level of HICP inflation 2016 falling notably compared to the Stability Programmes submitted in the spring. According to the DBPs, the rate of inflation will be 0.4% in 2016 but is projected to increase to 1.2% in 2017 (slightly below the 2017 projection of 1.4% from the Stability Programmes). Seventeen Member States comply with the requirement of Regulation EU No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts[10].

The economic picture emerging from the eighteen DBPs is broadly confirmed by the Commission's forecast. It also points to a continued albeit sluggish economic recovery amid more challenging global conditions. The Commission's forecast projects that real GDP growth will weaken slightly (from 1.7% in 2016 to 1.5% in 2017). Domestic demand is currently supported by a conjuncture of low oil prices, spillovers from a still relatively low euro exchange rate and accommodative monetary policy. At the same time, the underlying dynamics of domestic demand remain slow. Global economic conditions face mounting uncertainty, particularly in the wake of the United Kingdom's referendum on EU membership and other geopolitical developments, while world trade has slowed down. The above emphasises the need to strengthen domestic sources of growth. Moreover, a number of developments could result in lower growth than expected by the Commission, such as a further deterioration of world trade. The fragile but ongoing recovery is reflected in a continuing narrowing in the difference between actual and potential output in the Commission's forecast. The negative output gap of 2.2% of potential GDP in 2014 is expected to contract to 0.8% this year and 0.5% in 2017. Given continuing uncertainty over the measurements of the output gap in some Member States, the Commission has explored potential means to improve the methodology and its application while remaining consistent with the established principles for setting Member States' fiscal requirements (see Box 1 below).

The continuing, if slow, growth is not reflected in price developments, as the inflation outlook remains muted at the aggregate level. The Commission's forecast projects HICP inflation of just 0.3% this year, with a forecast pick-up to 1.4% in 2017, reflecting the closing output gap and a very accommodative monetary stance. Notwithstanding differences across

[10] In the case of Germany, there is no independent body in charge of producing or endorsing macroeconomic forecasts.

Member States, interest rates are assumed to stay at historically low levels in 2017. At the same time, the large excess of saving over investment is expected to persist in 2017, with the external balance of the euro area forecast in surplus by 3.5% of GDP, only marginally below its size in 2016 (3.7% of GDP).

Fiscal outlook contained in DBPs and Commission 2016 autumn forecast

The aggregate headline budget deficit is planned to continue to narrow this year and next according to the DBPs. In the EA-18, the deficit is forecast to be 1.8% of GDP in 2016, down from 2.0% last year[11]. In 2017, the aggregate deficit ratio is planned to decline to 1.5% of GDP. This adjustment is smaller than the 0.5 percentage point reduction in 2017 projected in the Stability Programmes, though starting from a slightly lower deficit in 2016 than had been anticipated in the spring. Allowing for the marginally downgraded macroeconomic outlook, the smaller reduction in the deficit may still be driven by a lower fiscal effort (see hereafter). Increases in expenditures related to the refugee crisis and security-related measures are expected to contribute to expenditure developments in a few Member States.

Table 1: Overview of economic and budgetary aggregates (EA-18) for 2016-17

	2016			2017		
	2016 Stability Programmes (April)	**Draft Budgetary Plans (October)**	**Commission 2016 autumn forecast (November)**	**2016 Stability Programmes (April)**	**Draft Budgetary Plans (October)**	**Commission 2016 autumn forecast (November)**
Real GDP growth (% change)	1.8	1.7	1.7	1.7	1.6	1.5
HICP inflation (% change)	1.2	0.4	0.3	1.4	1.2	1.4
Headline deficit (% GDP)	-1.9	-1.8	-1.8	-1.4	-1.5	-1.5
Change in structural balance (p.p. GDP)	-0.3	-0.2	-0.2	0.2	0.1	0.0
Debt (% GDP)	90.3	90.1	90.1	89.0	89.0	89.1
Cyclically-adjusted exp. ratio (% potential GDP)	47.3	47.4	47.5	46.9	47.2	47.3
Cyclically-adjusted rev. ratio (% potential GDP)	46.0	46.1	46.2	45.9	46.0	46.1

11 When referring to Member States' plans, data for 2015 are based on the figures included in the DBPs and thus may not incorporate revisions made by Eurostat as part of the autumn 2016 EDP notification.

The budgetary position as measured by the change in the aggregate structural balance, remains broadly stable over 2016-2017 according to the DBPs. The structural balance is planned to slightly decline in 2016 (0.2% of GDP), to be followed by a 0.1% of GDP increase next year. The trend in the structural budgetary position at the aggregate level is broadly confirmed by using an alternative measurement of discretionary fiscal effort, also known as the DFE, which suggests a negative adjustment of 0.4% according to the DBPs in 2016, and of 0.2% in 2017. (Graph A4.1 of Annex 4)[12]. However, given uncertainties surrounding output gap estimates, the developments in 2016 should not be overstated. These developments are broadly in line with the projections for the 2016-17 period included in the spring Stability Programmes. The pause of fiscal consolidation takes place against the background of a gradually improving but still fragile economic outlook and narrowing output gap. Together with the fact that only five Member States (and only one amongst the largest economies) plan to be at or above their medium-term budgetary objectives at the end of 2017[13], the planned lack of structural adjustment in 2017 is ostensibly falling short of the requirements of the SGP. However, the aggregate adjustment should only be viewed as illustrative in this respect, as it fails to capture the important differences across Member States vis-à-vis the requirements of the SGP, which are the subject of the Commission's country-specific assessments.

The Commission 2016 autumn forecast expects the aggregate headline deficit to decline from 1.8% of GDP in 2016 to 1.5% of GDP in 2017, with the structural balance broadly stable over the two-year period. The stability in the structural balance in 2016 and 2017 anticipated by the Commission incorporates a projected decrease in interest expenditure of 0.2% of GDP in 2016 and 0.1% of GDP in 2017. At the aggregate level, the structural primary balance is thus estimated by the Commission Forecast to fall by 0.4% of GDP in 2016 and by 0.2% of GDP in 2017. This reading is confirmed by the DFE, which shows a negative adjustment of 0.5% of GDP in 2016 and 0.3% of GDP in 2017. The gains arising from the historically low levels of interest rates on government debt are therefore, on aggregate, mostly not used to reduce deficits. The Eurogroup advised to use these gains to improve public finances and – depending on the country-specific situation – invest in infrastructure or structural reforms[14].

The aggregate picture for the deficit in the euro area broadly coincides between the DPBs and the Commission's forecast. Differences between individual DBPs' and the Commission's deficit forecasts can be relatively large, for reasons varying from one country to another. In the majority of countries, the Commission forecasts the deficit to be higher compared to the respective DBPs, with the largest such differentials seen in Slovenia, Portugal, Belgium and Lithuania (Table A4.1 and Graph A4.4 of Annex 4). The remaining positive forecast differentials are all within a 0.3 percentage point range, while the Commission's forecast is for a lower deficit figure in Germany, Cyprus, Estonia, Latvia, the Netherlands and Finland.

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[12] The DFE is an alternative indicator of the fiscal effort developed for analytical purposes and is separate from the indicators used to assess compliance under the SGP. It consists of a 'bottom-up' approach on the revenue side and an essentially 'top-down' approach on the expenditure side. For further information, see part III of "Report on Public Finances in EMU 2013", *European Economy*, 4, 2013.

[13] Germany, Estonia, Lithuania, Luxembourg, and the Netherlands. Moreover, two Member States are expected to remain in Excessive Deficit Procedure next year, namely Spain and France.

[14] These principles were affirmed by the Eurogroup on 5 October 2015: http://www.consilium.europa.eu/en/meetings/eurogroup/2015/10/05/.

The distribution of the change in the aggregate structural balance across Member States does not seem to reflect the position of Member States vis-à-vis the requirements of the SGP and the availability of fiscal space. In particular, some Member States, which remain relatively far from their MTOs, are expected to either pursue an expansionary policy or deliver very little fiscal adjustment, notably Spain, France and Italy. Conversely, some Member States which overachieve their MTOs, are expected to make little use of their fiscal space, notably Germany.

Turning to public debt, after peaking in 2014 at 93% of GDP, the aggregate debt ratio is planned to continue to decrease both in 2016 and in 2017 according to the DBPs, in line with the projections underpinning the Stability Programmes. This is driven by positive primary balances and favourable stock-flow adjustments[15]. At 89% of GDP in 2017, the planned aggregate ratio masks a wide range of national figures. The debt ratios in individual Member States vary from 133% of GDP in Italy to 10% of GDP in Estonia. Data for Greece, which experiences an exceptionally high level of debt, are not included.

The Commission forecasts are in line with the aggregate debt projected by Member States. While the aggregate debt ratio remains at a very high level, the Commission expects it to decline both this year and next, reaching 89.1% of GDP in 2017, reflecting the same drivers as in the government plans (the decline in the debt interest burden and the so-called snowball effect no longer contributing to rising debt in the aggregate). However, it should also be recognised that a large portion of the debt reduction in the euro area is being driven by Germany. When Germany is excluded from the calculations, the aggregate debt ratio forecast by the Commission only falls by 0.2 percentage points in both 2016 and 2017, compared to 1 percentage point falls in both years for the full aggregate. In addition, the level of aggregate debt remains significantly higher excluding Germany, at 99% of GDP. Here again, differences between the DBPs and the Commission's forecast can be larger at Member State level, for reasons varying from one country to another. The larger positive differentials relate to Portugal and France, while there are also negative differentials in a number of countries, where the Commission's debt projections are below those of the Member States (Table A4.3 and Graph A4.5 of Annex 4). At the aggregate level, the change in debt projected by Member States in 2017 is larger than that projected by the Commission, mostly reflecting stock-flow adjustments.

The aggregate euro area debt ratio cannot be assessed in terms of compliance with the debt requirements of the SGP as the Member States of which it is comprised have a differing status vis-à-vis the SGP[16]. However, ten euro area Member States that submitted DBPs are subject to the debt reduction benchmark. According to the Commission's forecast, seven of these ten are expected to be compliant with it (or with the transitional debt rule if applicable).

Application of the Stability and Growth Pact

The flexibility embedded in the SGP allows for accommodating exceptional spending linked to unusual events outside the control of the government and having a major impact on public finances, both under the preventive and the corrective arm of the Pact. As in 2015, a number of Member States' DBPs reference the budgetary impact of the exceptional

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[15] The planned reduction of the aggregate debt ratio is much smaller when excluding Germany from the aggregate (-1.6 versus -3.9 percentage points over 2015-17).

[16] Member States' debt requirements under the SGP differ depending on whether they are in the corrective or preventive arm and whether their debt ratio is above or below 60% of GDP.

inflow of refugees (Austria, Belgium, Italy, Slovenia and Finland). On a similar basis, Belgium, Italy and Austria have also made reference in their DBPs to additional costs related to the terrorist threat. In addition, Italy has made a request for special treatment in relation to costs arising from the recent earthquakes. Finland has submitted an application for use of the structural reform clause and the investment clause in 2017 while, although a no-policy change DBP has been submitted due to national elections, Lithuania has also indicated its intention to apply for use of the structural reform clause.

The adjustment requirements under the SGP, in both the preventive and the corrective arms, are set in terms of change in the structural balance. The Commission will assess (on an ex post, case by case basis) the temporary deviation from the requirements for 2016 and 2017 due to the additional costs in each of these two years resulting from the exceptional costs incurred compared to the previous year. Where relevant, the Commission opinions on the DBPs include factual statements on how the assessment of compliance could be impacted if corrected for unusual events, such as refugee inflow and costs related to the terrorist threat.

Box 1: Implementation of the "constrained judgement" approach in autumn 2016 fiscal surveillance exercise

Agreement to examine plausibility of output gap estimates

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. To respect this mandate from the Council, two concrete steps were agreed with the Member States in October 2016.

First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment would be introduced in the commonly agreed methodology. This change has already been implemented in the Commission 2016 autumn forecast. Second, it was agreed that a new "plausibility tool" could be used to signal cases where the results of the agreed methodology could be interpreted as being economically counter-intuitive.

The plausibility tool provides an alternative country-specific estimate of the level of the output gap for a given year (i.e. 2016 in the current case), based on a statistical assessment methodology discussed in the output gap working group (OGWG). When the difference between the alternative estimate and the estimate on the basis of the common method exceeds a certain threshold, this indicates that the output gap based on the common method may be "counterintuitive".

The plausibility tool's results

When a Member State's output gap has been identified as counter-intuitive, the range between the common method output gap and the alternative estimate constitutes a "plausibility range", within which a plausible level of the output gap can be identified by the Commission and used for fiscal surveillance purposes (see below).

The plausibility analysis cannot be produced for future years. To make the plausibility tool operational for fiscal surveillance covering the year 2017, it is necessary to extrapolate the plausibility range from 2016, in order to generate an alternative estimate of the output gap for 2017. Extrapolating a "plausibility" range from 2016 to 2017 means that the distance between the common method output gap and the alternative estimate in 2016 is carried through and applied directly to the common method's output gap in 2017. Therefore, there is no impact on the year-on-year change in the output gap.

It is important to note that the plausibility tool's results do not impact upon the Commission 2016 autumn forecast, as the output gap and structural balance estimates in the forecast continue to be based on the common method. The results of the plausibility tool are used as an additional qualitative factor to be considered in the context of the Commission's fiscal assessments.

Use of the plausibility tools' results in fiscal surveillance: 'freezing principles' for determining Member States' requirements

In its opinions on the DBPs, the Commission is assessing compliance with the fiscal requirements for 2016 and 2017 which are given by the Council 2016 country-specific recommendations. Under the preventive arm, the fiscal requirements are derived from the so-called matrix of requirements included in the Commonly Agreed Position on Flexibility in the Stability and Growth Pact, which modulates the required level of fiscal adjustment according to the economic cycle[17].

The requirement for 2017 has been fixed in spring 2016 based on the projection of the output gap for 2017. Once the requirements are fixed, they are considered to be frozen. The availability of a new information set regarding the cyclical position of the Member State results in an unfreezing of the requirement in only a very restricted number of cases:

i) Where a Member State has been re-assessed as being in very bad or exceptionally bad economic times, measured as an output gap below -3% of potential output.

ii) Where the level of a Member State's structural balance has been revised, so that to deliver on its original requirement would imply an over-achievement of its MTO.

These agreed freezing principles will also apply regarding the implications of the plausibility tool's results for Member States' requirements, in particular in considering the requirements derived from the matrix. Therefore, in practice, cases whereby the common method's output gap may be overly negative are not examined as they cannot lead to a lower requirement.

It is important to re-state that this process will not lead to an actual revision of the formal requirement set in the country-specific recommendations. Instead, the outcome of the analysis will be taken account of as a qualitative factor when conducting the overall assessment of compliance.

In addition, the level change implied by the alternative output gaps may also have an impact on some Member States' eligibility for use of the structural reform and investment clauses.

As the tool does not provide indications on the change in the output gap, which impacts the measurement of fiscal effort through the structural balance, there is no impact upon the measurement of fiscal effort in 2017.

Impact on Member States' DBP assessments

On the basis of the Commission 2016 autumn forecast, six euro area countries are indicated by the plausibility tool to possibly have an output gap significantly more negative than that estimated by the common methodology: Austria, Finland, Italy, Luxembourg, Latvia and Slovenia. In all of these countries but Finland, the detailed analysis indicated that the plausibility tool's results have no impact on the Commission's assessment of the country's compliance with the SGP. In the case of Finland, the analysis has pointed out that the output

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

gap is likely to be higher than estimated on the basis of the common methodology as a result of which the country is expected to respect the safety margin towards the 3% of GDP reference value of the Treaty, which is an eligibility threshold for use of the structural reform and investment clauses.

The Commission will continue to work with Member States in the coming months to explore further means to improve upon the output gap methodology and its application.

Composition of fiscal adjustment

The DBPs envisage only very limited changes in the composition of public finances in 2016-17 for the euro area as a whole (Table A4.5 and Graphs A4.2a-b of Annex 4). The ratio of government expenditure to GDP is planned to recede by 0.4 percentage points. in 2017. However, 0.1 percentage points is linked to savings in interest expenditure. The remaining, seemingly substantive reduction is mostly due to the cyclical conditions. In fact, the primary expenditure ratio corrected for the effect of the economic cycle shows a reduction of only 0.1 percentage points. This reduction is partially offset by planned tax cuts, as evidenced by the slight decline in the cyclically adjusted revenue ratio (0.1 percentage points in 2017). In this respect, Members States' plans to reduce expenditure as a share of potential output have, in the aggregate, to a large extent failed to materialise over the last few years. The Commission 2016 autumn forecast confirms this reading. The broadly unitary tax elasticity implied by both the DBPs and the Commission's forecast indicates that the reductions in revenues are driven by government measures (Table A4.6 of Annex 4).

The planned adjustment is not expected to damage medium-term growth prospects, though there may be scope for more growth-friendly choices in reducing spending. Most expenditure categories are planned to fall as a percentage of output, although as noted the overall small decline in expenditure is driven by cyclical factors. The largest declines are affecting compensation of employees and interest expenditure, with Member States benefitting from significant savings on the latter (as discussed in more detail in the next section). As the most productive expenditures are not primarily impacted, the planned adjustment is not expected to damage medium-term growth prospects, though there may be scope for more growth-friendly choices. In particular, capital expenditure is not planned to increase, albeit current levels are low from a historical perspective. In addition, improvements in national fiscal governance, including the setting-up of efficient spending reviews, could support the growth-friendliness of public spending. See Box 2 below on guiding principles for effective spending reviews as agreed by the Eurogroup. The Commission's forecast is broadly in line with the DBPs, confirming the largest reductions in interest payments and public wages, though the Commission's forecast projects a slightly smaller fall in the latter than set out in the DBPs.

Interest expenditure is expected to fall further in 2017, freeing up resources to facilitate consolidation and increases in future-related expenditure if fiscal space is available. Euro area sovereign bond yields remain at historically low levels, with 10-year rates currently ranging from 0% to 1¾ % for the four largest Member States in the euro area. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBPs, interest expenditure for the euro area as a whole is expected to fall from 2.4% of GDP in 2015 to 2.1% in 2016 and is projected to decrease further next year, to 2.0% of GDP, well below the 3.0% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Member States' plans is broadly confirmed by the Commission forecast. While the costs of servicing debt within the euro area are likely to remain historically low in the coming years, using savings from low interest payments to fund permanent increases in government spending or cut taxes could represent a risk due to their non-permanent nature.

Measures presented in the DBPs would only have a very slight effect on the tax composition for the aggregate EA-18 in 2017. Once corrected for the cycle, the revenue ratio decreases by around 0.1% of GDP. Out of the three main revenue categories, social contributions and indirect taxes are expected to recede as a share of GDP, while direct taxes rise. At the same time, the changes are marginal and do not alter their relative weights significantly. On the revenue side, the Commission's forecasts are aligned with the DBPs (Graph A4.3b of Annex 4).

Box 2: Guiding Principles for Effective Spending Reviews

In times of high public debt and low economic growth rates, there is more need than ever to ensure that taxpayers' money is used efficiently. However, too often 'legacy' spending lines inherited from past decisions tend to increase quasi-automatically over the years. Spending reviews are ongoing or have been announced in more than half of the euro area Member States – with various scopes and timelines. The Eurogroup looked at the national experiences and endorsed at its September 2016 meeting a number of principles that need to be followed if spending reviews are to have an optimal impact on the quality of public spending[18].

The ambition of spending reviews is to reconnect spending decisions to policy priorities *(shall this policy be funded with public money?)* and levels of spending to outcomes delivered to the citizens or businesses concerned *(what is the value for public money?).* The instrument consists in the analysis of existing individual baseline expenditures with the aim to detect:

- Opportunities to stop the funding of deprioritized policies or funding with no observed impact on the policy objective,
- Efficiency improvements – a less costly delivery of a public good or service, or a better quality thereof at marginally the same cost.

It usually entails reforms in the scope of publicly funded interventions, in the organisation of public services, in underlying processes and in the human resources of the public administration.

The result should be a better expenditure allocation across policies generating savings (including margins to fund growth-friendly policies), and /or a better quality of public service.

Assessment of fiscal policy orientation in the euro area

Overall, following the significant fiscal consolidation in 2011-13, the euro area fiscal stance is estimated to be broadly neutral over 2014-2017. The fiscal stance became broadly neutral in 2014-2015 and slightly expansionary in 2016, against the background of an economic recovery. For 2017, both the aggregation of Member States' DBPs and the Commission forecast point to a broadly neutral fiscal stance again.

[18] http://www.consilium.europa.eu/en/press/press-releases/2016/09/09-eurogroup-statement/

Box 3: Analysis of the Fiscal Stance

The discussion on the fiscal stance is a key aspect of the Commission's efforts to reinforce the collective discussion on the general interest of the euro area[19]. In the EU and euro area, national fiscal policies are primarily shaped by the rules-based framework embodied in the Treaty and the SGP. In addition, an analytical examination of fiscal policies allows for an assessment of whether implemented fiscal policies effectively lay the conditions for strong sustainable growth, for price stability and more especially, whether the best use is made of the room for discretion within the framework. It helps to emphasise aggregate consequences of national policies and spillovers across Member States.

The euro area fiscal stance has to strike the right balance between 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 impact of new shocks. At the same time, the recovery is proceeding slowly with only a gradual decline in unemployment, while inflation expectations continue to fall short of the objective of price stability.

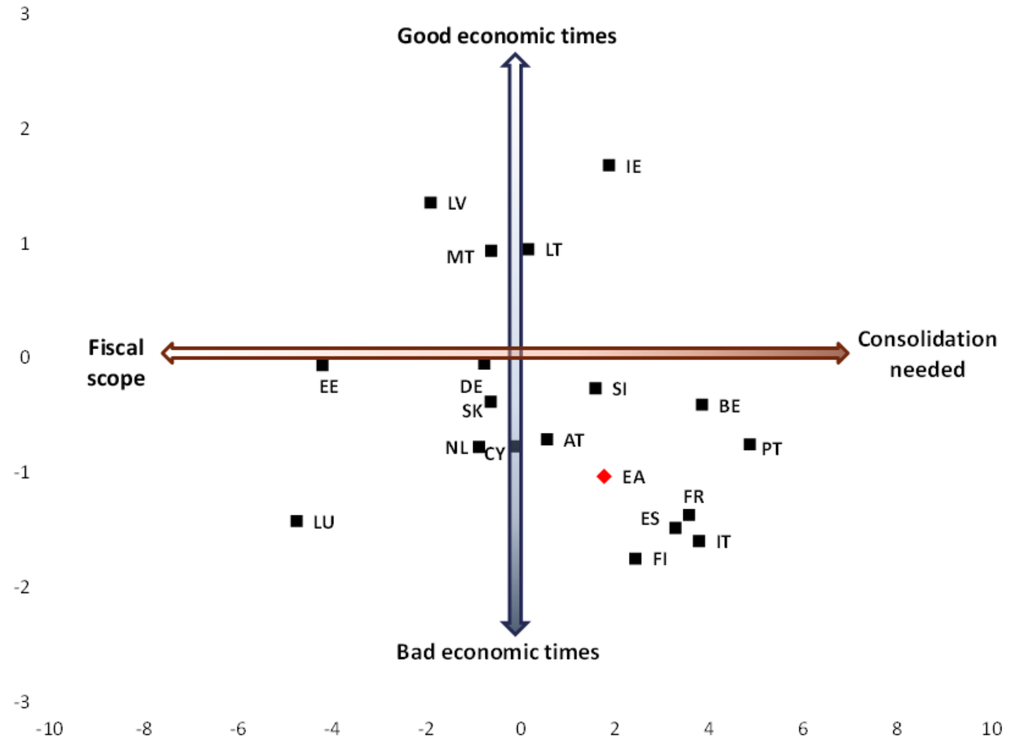
The measurement and analysis of the fiscal stance is methodologically challenging. The fiscal stance is a notion with no universally accepted definition but a broadly shared understanding within the economic community. It is usually understood as the orientation which is given to fiscal policy by governments' discretionary decisions on tax and expenditure. Traditionally, the fiscal stance is captured by the change in the structural primary balance, although other indicators can also be used to characterise it. In this box, consolidation needs are measured by the S1 indicator, which is calculated at the fiscal effort needed to ensure that a Member State's public debt reaches 60% of GDP in 2031. A detailed assessment of different indicators and their robustness can be found in *the 2016 SCPs: Horizontal Overview and Implications for the Euro Area Fiscal Stance* (European Commission Institutional Papers No. 34, 2016).

For the euro area as a whole, there is a further trade-off at the current juncture between sustainability and stabilisation needs. The euro area is located in the 'South-East quadrant' of the fiscal map where such a trade-off is at play, see Graph 1. It reflects the existence of an adjustment gap vis-à-vis a trajectory that puts 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 degree. This conclusion is qualitatively robust to the choice of alternative indicators, though precise magnitudes may differ.

From an economic perspective, the overall euro area stance should be differentiated depending on the situations of countries in terms of sustainability and stabilisation. A number of Member States in the south-east of the fiscal map still have significant consolidation needs. The south-west quadrant shows Member States, which have fiscal scope and whose economies would benefit from limited stimulus. In this respect, the DBPs could be improved upon. In particular plans that are tilted towards the stabilisation objective in some large countries could be rebalanced towards more consolidation, while the remaining fiscal scope could be used to support short and long-term growth, notably by fostering investment.

[19] See COM(2016) 727 final, 16.11.2016.

Graph 1: A Fiscal map for the euro area in 2016



Note: Based on European Commission 2016 autumn forecast. Good(bad) economic times are measured by the output gap in 2016, in % of GDP. The consolidation needs or fiscal scope are measured by the Commission's S1 indicator of risks to sustainability, also in % of GDP, based on 2016 autumn forecast calculations and using 2016 as the base year.

The orientation of the fiscal position in 2016-17 can be assessed against the double objectives of long-term sustainability of public finances and short-term macroeconomic stabilisation (see Box 3 above)**.** Long-term sustainability requires that public debt is put and maintained on a sustainable path, taking into account the current level of debt and projected future ageing-related expenditures[20]. Macroeconomic stabilisation can be expressed in terms of closing the output gap at an appropriate pace in the short to medium term while, in the current situation, also ensuring a more pronounced rotation from external to domestic sources of growth. As monetary policy is already very accommodative, with nominal interest rates almost at the zero limit alongside very low inflation, attention turns to fiscal policy.

As detailed in the Commission's accompanying Communication, *Towards a Positive Fiscal Stance for the Euro Area*[21], designing an appropriate fiscal stance for the euro area is the individual and collective responsibility of Member States. The Communication provides additional analysis of the fiscal stance and guidance on its implications for fiscal policy in the euro area.

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[20] The Commission's S1 sustainability indicator shows the total effort required over 2016-21 so as to bring debt to 60% of GDP by 2031, taking into account contingent liabilities related to ageing. It points to an additional adjustment of 1.8% of GDP for the euro area over the next five years. This translates into an additional yearly adjustment of approximately 1/3% of GDP in 2016 and the four subsequent years.

[21] http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm

III. Overview of the Draft Budgetary Plans

The Commission's Opinion on the DBPs focuses on compliance with the SGP and the recommendations issued on that basis. For Member States in the Excessive Deficit Procedure (EDP), the Commission's Opinions take stock of progress made in correcting the excessive deficits, with respect to both headline deficit and structural effort targets. For Member States in the preventive arm of the SGP, the Commission's Opinions assess adherence to, or the progress towards, the country-specific medium-term budgetary objectives (MTOs), as well as compliance with the debt rule, in order to verify whether the plans are in line with the SGP and the fiscal country-specific recommendations (CSRs) addressed by the Council to the Member States on 12 July 2016.

All non-programme euro-area Member States submitted their DBPs in due time, in line with Article 6 of Regulation (EU) No 473/2013.

No DBP was found in "particularly serious non-compliance" with the SGP as referred to in Article 7(2) of Regulation (EU) No 473/2013. Still, several of the submitted plans give rise to concerns.

Tables 2a and 2b summarise the assessments of individual countries' DBPs as per the Commission's Opinions adopted on 16 November together with the assessment of progress with fiscal-structural reforms. These assessments are based on Commission 2016 autumn forecast. In order to facilitate comparison, the assessment of the plans is summarised in three broad categories, which have different meanings depending on whether a Member State is in EDP or not:

- **Compliant:** according to the Commission's forecast, there is **no need to adapt the budgetary plans** within the national budgetary procedure to ensure that the 2017 budget will be compliant with the SGP rules.
- **Broadly compliant:** According to the Commission's forecast for 2017, the DBP is expected to ensure broad compliance with the SGP rules.

  For Member States in EDP: while the Commission's forecast for 2017 projects that either the intermediate headline deficit target will be achieved or that the excessive deficit will be corrected in a timely manner, there is a noticeable shortfall in fiscal effort compared to the recommended level that puts at risk compliance with the EDP recommendation.

  For Member States in the preventive arm of the SGP: the Commission's forecast for 2017 projects some deviation from the MTO or the adjustment path towards it, but the shortfall relative to the requirement would not represent a significant deviation from the recommended adjustment. These Member States are assessed to comply with the debt rule, where applicable.
- **Risk of non-compliance:** According to the Commission's forecast for 2017, the DBP is not expected to ensure compliance with the SGP rules.

  For Member States in EDP: the Commission's forecast for 2017 projects that neither the recommended fiscal effort will be delivered nor that the intermediate headline deficit target will be achieved or that the excessive deficit will be corrected in a timely manner.

  For Member States in the preventive arm of the SGP: the Commission's forecast for 2017 projects a significant deviation from the MTO or the required adjustment path towards it, and/or non-compliance with the debt reduction benchmark, where applicable.

Following the "Commonly agreed position on flexibility within the Stability and Growth Pact" endorsed by the ECOFIN Council on 12 February 2016, Finland and Lithuania have in their DBP requested flexibility on the basis of the structural reform and investment clause.. Finland has requested in its DBP temporary deviations from the recommended adjustment path towards the MTO in 2017, in view of the implementation of major structural reforms with a positive impact on the long-term sustainability of public finances (request for flexibility amounting to 0.5% of GDP) and of national expenditure on projects co-financed by the EU under the European Structural and Investment Funds (request for flexibility amounting to 0.1% of GDP). Based on the Commission 2016 autumn forecast, whereas Finland does not comply with the minimum benchmark, its output gap estimate is surrounded by uncertainty. A detailed assessment of the output gap estimate for 2016 implies that Finland would meet the minimum benchmark in 2017[22]. As an additional assurance, Finland's government has publicly committed to take the additional measures in 2017, if necessary, to ensure compliance with the SGP, notably including the respect of the Treaty reference value of 3% of GDP. In the case of Lithuania, such a request in the no-policy-change DBP envisaged the planned implementation of major structural labour market and pension reforms with a positive impact on the long-term sustainability of public finances (request for 0.6% of GDP flexibility). Based on the Commission 2016 autumn forecast, it appears that Lithuania has sufficient fiscal space to benefit from a temporary deviation from the required ajdustment path towards the MTO. The complete assessment of both Finland and Lithuania's possible eligibility for flexibility will take place within the normal European Semester cycle in the context of the assessment of the 2017 Stability Programmes.

Furthermore, a number of Member States mentioned the budgetary impact of the increased inflow of refugees and of additional security measures. The provisions of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 allow for a temporary deviation from the adjustment path towards the medium-term budgetary objective in order to cater for such additional expenditure, to the extent that the inflow of refugees as well as the severity of the terrorist threat are exceptional events, their impact on public finances is significant and sustainability would not be compromised. At this stage, the Commission considered a possible temporary deviation for refugee-related costs in 2015 and 2016 (Belgium, Italy, Austria, Slovenia and Finland) and for security-related costs in 2016 and 2017 (Belgium, Italy and Austria). The Commission will make a final assessment, including on the eligible amounts, on the basis of observed data as provided by the authorities. The Commission stands ready to consider additional deviations related to migration related expenditures in 2017, in due course. In addition, Italy has made a request for a special treatment in relation to the budgetary impact of a preventive investment plan for the protection of the national territory against seismic risks under the unusual event clause. The Commission acknowledges that Italy has been facing unprecedented seismic activity in the past months, which makes the link between prevention and emergency intervention less clear-cut. Thus, the Commission considers that the funds earmarked by the government for this purpose in 2017 could also be considered to allow for a temporary deviation from the adjustment path towards the medium-term budgetary objective, subject to the provision of the necessary ex-ante and ex-post data by the Italian authorities.

[22] The Commission, in consultation with the Member States, has developed a screening tool to signal cases where the results of the agreed methodology could be interpreted as being economically counterintuitive. In these cases, a detailed qualitative analysis has been carried out, including on the possible implications for the concerned Member States' requirements under the SGP (see Box 1).

Portugal and Spain submitted their DBPs by mid-October, as well as reports on action taken in response to the Council decisions to give notice, adopted on 8 August 2016 in accordance with Article 126(9) of the Treaty. The Commission has in the meantime assessed such documents and engaged in a structural dialogue with the European Parliament. The Commission has come to the conclusion that the Excessive Deficit Procedures of both Member States should be held in abeyance. Accordingly, the event that required a proposal by the Commission to suspend ESI Funds is no longer present and there will be no such proposal.

Finally, the Commission has preliminarily assessed the degree of progress with the implementation of the fiscal-structural reforms outlined in the country-specific recommendations adopted by the Council on 12 July 2016. The assessment of the DBPs is summarised in the following five broad categories: no progress, limited progress, some progress, substantial progress and fully addressed. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2017 Country Reports and in the context of the 2017 country-specific recommendations to be adopted by the Council in 2017.

Table 2a: Overview of individual Commission opinions on the Draft Budgetary Plans – Member States under the preventive arm of the SGP

Member States	Overall compliance of the DBP with the SGP		Progress in implementing the fiscal-structural recommended in the 2016 CSRs
	Overall conclusion based on the Commission 2016 autumn forecast	Compliance with the preventive arm requirements in 2016-2017	
BE*	Risk of non-compliance	2016: risk of a significant deviation from the adjustment path towards the MTO; *prima facie* non-compliance with the transitional debt rule; 2017: risk of some deviation from the adjustment path towards the MTO in 2017, but risk of a significant deviation over 2016-2017 together; *prima facie* non-compliance with the debt reduction benchmark.	No progress
DE	Compliant	2016: MTO overachieved; compliance with the debt reduction benchmark; 2017: MTO overachieved; compliance with the debt reduction benchmark	Limited progress
EE	Compliant	2016: MTO overachieved; 2017: no deviation from the adjustment path towards the MTO.	n.a.
IE	Broadly compliant	2016: risk of some deviation from the adjustment path towards the MTO; compliance with the transitional debt rule; 2017: risk of some deviation from the adjustment path towards the MTO; compliance with the transitional debt rule.	Some progress
IT*	Risk of non-compliance	2016: risk of some deviation from the adjustment path towards the MTO; without the full allowance of 0.75% of GDP granted under the structural and investment clauses, there would be a risk of a significant deviation from the adjustment path towards the MTO; *prima facie* non-compliance with the debt reduction benchmark; 2017: risk of a significant deviation from the adjustment path towards the MTO; *prima facie* non-compliance with the debt reduction benchmark.	Some progress
CY	Risk of non-compliance	2016: MTO overachieved; compliance with the transitional debt rule; 2017: risk of a significant deviation from the adjustment path towards the MTO; compliance with the transitional debt rule.	Some progress

LT**	Risk of non-compliance	2016: no deviation from the adjustment path towards the MTO; 2017: risk of a significant deviation from the adjustment path towards the MTO based on no-policy-change DBP.	n.a.
LV	Broadly compliant	2016: risk of some deviation from the adjustment path towards the MTO; 2017: no deviation from the adjustment path towards the MTO in 2017, but risk of a small deviation over 2016-2017 together;	Limited progress
LU	Compliant	2016: MTO overachieved; 2017: MTO overachieved.	Limited progress
MT	Broadly compliant	2016: no deviation from the adjustment path towards the MTO; compliance with the debt reduction benchmark; 2017: risk of some deviation from the adjustment path towards the MTO.	No progress
NL	Compliant	2016: MTO achieved; compliance with the transitional debt rule; 2017: MTO overachieved; compliance with the debt reduction benchmark.	No progress
AT***	Broadly compliant	2016: no deviation from the adjustment path towards the MTO; compliance with the transitional debt rule; 2017: risk of some deviation from the adjustment path towards the MTO	Limited progress
SK	Compliant	2016: risk of some deviation from the adjustment path towards the MTO; 2017: no deviation from the adjustment path towards the MTO	Some progress
SI	Risk of non-compliance	2016: risk of some deviation from the adjustment path towards the MTO; compliance with the transitional debt rule; 2017: risk of a significant deviation from the adjustment path towards the MTO; compliance with the transitional debt rule.	Limited progress
FI****	Risk of non-compliance	2016: risk of some deviation from the adjustment path towards the MTO; 2017: risk of a significant deviation from the adjustment path towards the MTO	Some progress

* On 18 May 2016, the Commission issued a report under Article 126(3) of the TFEU, as the Member State did not make sufficient progress towards compliance with the debt rule in 2015. The report concluded that, after the assessment of all relevant factors, the debt criterion should be considered as complied with. A new report will be issued by the Commission shortly.

** DBP submitted by a caretaker government on a no-policy-change basis.

*** This conclusion is reached once the current estimate of the budgetary impact in 2016 of the exceptional inflow of refugees and security measures (from which Austria can still benefit in 2017 in order to ensure a treatment equal to Member States which are further away from their MTO) is deducted from the requirement.

**** On 18 May 2016, the Commission issued a report under Article 126(3) of the TFEU, as Finland's general government debt exceeded 60% of GDP in 2015. The report concluded that, after the assessment of all relevant factors, the debt criterion should be considered as complied with.

Table 2b: Overview of individual Commission opinions on the Draft Budgetary Plans – Member States under the corrective arm of the SGP

Member States	Overall compliance of the DBP with the SGP		Progress in implementing the fiscal-structural recommended in the 2016 CSRs
	Overall conclusion based on the Commission 2016 autumn forecast	Overall conclusion based on the Commission 2016 autumn forecast	
ES*	Risk of non-compliance	2016: intermediate headline target met, fiscal effort not delivered; 2017: intermediate headline target not met: fiscal effort not delivered based on no-policy-change DBP.	Limited progress
FR	Broadly compliant	2016: intermediate headline target met, fiscal effort not delivered; 2017: headline deficit projected just below 3% of GDP; fiscal effort not delivered.	Limited progress
PT**	Risk of non-compliance	2016: expected timely and durable correction of the excessive deficit, fiscal effort delivered. 2017: risk of a significant deviation from the adjustment path towards the MTO*;* *prima facie* non-compliance with the transitional debt rule.	Limited progress

* DBP submitted by a caretaker government on a no-policy-change basis.

** Portugal is currently under the corrective arm of the SGP, but could move to the preventive arm as from 2017 if a timely and sustainable correction were achieved.