BRIEFING

Structural budget balances in EU Member States - August 2019

Structural budget balances play an important role in the fiscal policy frameworks of the EU both as part of the application of the Stability and Growth Pact (SGP) and in the implementation of the balanced budget rule by the contracting parties of the intergovernmental Treaty on Stability, Coordination and Governance in the EMU (the fiscal section of the Treaty is also called the "Fiscal Compact").

This document provides a short overview of the concept and application of the structural balance rule(s) in the EU. It is regularly updated, in particular, the Annex that shows progress made (based on the latest Commission forecast) by Member States in reaching their structural budget commitments under the preventive arm of the SGP.

The objective and role of structural budget positions

The structural budget positions are today a core element of the surveillance of the budgetary policies of the Member States of the EU. Structural budget positions are used in:

- The medium term objectives (MTO) and related fiscal efforts (and assessments) under the preventive arm of the SGP;
- The fiscal effort recommendations and assessments under the Excessive Deficit Procedure (EDP);
- The balanced budget rule included in the so-called "Fiscal Compact" (see Box 2).

This document focuses on the role of the MTO, as it represents the country-specific budgetary objective defined in **structural terms** that each Member State should achieve in accordance with the preventive arm of the SGP. In particular, the provisions of the SGP (included in Regulation 1466/97 and the Code of Conduct) stipulate that each Member State must **have a differentiated MTO for its budgetary position** which shall fulfil the following criteria:

Box 1: Structural budget balances

In line with the methodology used in the SGP, the structural budget balance is a **nominal budget balance adjusted by the cyclical component, excludig one-off and temporary policy measures.** The cyclical component is calculated as the product of the output gap (difference between actual and potential GDP as percent of potential GDP) and a parameter reflecting the automatic reaction of the government balance to an output gap change.

This cyclically adjusted budget balance corresponds to a budget balance prevailing if the economy was running at its full potential.

As it is based on estimates of the potential output, the structural balance is vulnerable to uncertainty and revisions (see separate EGOV note).

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- ensure safety margin so that the nominal 3 % of GDP deficit target would not be triggered in bad economic times;
- ensure the sustainability of public finances (taking into account among other issues any increase in age related expenditure), while allowing room for budgetary manoeuvre, in particular for public investment; it also means that it should be consistent with the so-called debt reduction benchmark, if the debt ratio is higher than 60% of GDP;
- be close to balance or in surplus (Euro Area and ERM2 Member States must have a MTO that corresponds to at least - 1% of potential GDP and signatories of the TSCG of a least -0,5 % of potential GDP (see Box 2).

The Commission provides in this respect regularly to the Member States so-called "minimum MTOs" on the basis of the above criteria and the methodology detailed in Code of Conduct on the SGP implementation (see also below section on the updates of MTOs) in order that Member States take these into account when they prepare their Stability or Convergence Programmes.

Box 2: The Fiscal Compact

The Treaty on Stability, Coordination and Governance in the EMU (TSCG) includes a requirement on the contracting parties to enshrine a balanced budget rule (similarly to the "Medium-term objective" in EU law) with 0,5% GDP as the lowest limit of structural deficit (if public debt is significantly lower than 60% of GDP, this lower limit is set at 1% of GDP) into national law, preferably at constitutional level. Member States may bring proceedings against other Member States before the Court of Justice of the EU in case non-transposition. The Contracting Parties shall ensure rapid convergence towards their respective MTO. Article 3 of the Treaty also stipulates that "*progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised SGP*".

By setting a budgetary target in structural terms (i.e. in relation to a MTO) in the preventive arm of the SGP (and in the balanced budget rule of the "Fiscal Compact"), the main objective is to ensure that the underlying fiscal position of Member States is **conducive to fiscal sustainability, while allowing for the free operation of the automatic stabilisers** over the economic cycle (see also Box 1). Member States, which have not yet achieved their MTO, should **improve their structural balance by 0.5% of potential GDP per year as a benchmark** (more in 'good times' and less in 'bad times').

In February 2016, the ECOFIN Council endorsed a "***commonly agreed position on flexibility within the SGP: Flexibility for cyclical conditions, structural reforms and investment***" which was subsequently annexed to the **code of conduct on the implementation of the SGP** (latest update: February 2017); the new elements include a matrix specifying the 'good times' and 'bad times' and the corresponding appropriate fiscal adjustments.

The Regulation (EC) 1466/97 specifies how a **deviation** from the MTO or the adjustment path towards it will be measured. More specifically, the Regulation states that: "*A deviation from the MTO or from the appropriate path towards it shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of the expenditure net of discretionary revenue measures*".

Temporary deviations from the MTO or the adjustment path towards the MTO may be allowed in cases of:

- major structural reforms, including certain public investments; the above mentioned fleixibility position included in the Code of Conduct on the SGP defines concretely in which cases structural reforms and investments can allow temporary deviations specifies that the cumulative temporary deviation granted under the structural reform clause and the investment clause cannot exceed 0.75 % of GDP;

- an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the government; and/or
- in periods of severe economic downturn for the euro area or the Union as a whole.

The current SGP rules also include an **expenditure benchmark**, notably in the preventive arm, according to which growth of public expenditure (net of discretionary revenue measures and other factors) has to be lower than medium-term potential GDP growth for countries that have not reached their MTO. It serves as a second indicator to measure the fiscal effort taken by the Member States in respect of their obligations under the SGP. Today, the assessment (in judging progress towards or remaining at the MTO) by the Commission is based on both the structural budget balance and the expenditure benchmark . The table in annex 1 of this document focuses only on the **projected structural balance** developments **vis-à-vis the latest Council recommendations under the SGP** issued to the Member States subject to rules of the preventive arm.

The assessment by the Commission of the SCPs during each spring (and also of the Draft Budgetary Plans for euro area Member States during the autumn) evaluates the overall compliance of the Member State with the latest Council recommendations. Based on these assessments, the Commission may reach a conclusion of compliance, (some) deviation or significant deviation. For the *ex ante* assessment, the latter refers to a risk of a significant deviation based on the Member State's plans and the Commission forecast; for the *ex post* assessment (which is based on observed **data as available in spring of year t+1), it triggers the procedural steps set out under Article 121(4) TFEU (hereafter Significant Deviation Procedure, SDP).**

As defined in Articles 6(3) and 10(3) of Regulation (EC) 1466/97, the assessment of whether the deviation from the MTO or the adjustment towards the MTO is significant shall, in particular, include the following criteria:

a) for a Member State that has not reached the MTO: A significant deviation is defined as a deviation of at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in two consecutive years;

b) when assessing expenditure developments net of discretionary revenue measures: The deviation is significant if it has a total impact on the government balance of at least 0.5% of GDP in a single year or cumulatively in two consecutive years.

Where a conclusion of overall significant deviation is reached based on an overall assessment and on validated data, it triggers a **Significant Deviation Procedure** (SDP), which starts with a Commission warning to the Member State in question and can lead to an interest-bearing deposit being required, for euro area Member States.

It may also be noted that those countries that are signatories of the TSCG and bound by the Fiscal Compact must implement automatic correction mechanisms in the national legal orders which will operate in the event of significant observed deviations.

For further information on the above elements, see sections 1.2 and 1.3 of the Vademecum on the SGP (2019 Edition).

Box 3: Implementation of the SDP

On **14 June 2019** (based on COM proposals of 5 June 2019), the the Council took the following measures:

- it decided that **no effective action has been taken** by Hungary and Romania in response to Council decisions of December 2018;
- it adopted recommendations with a view to correcting the significant deviations; for each of both countries (see here: Hungary, Romania) an annual structural adjustment of 1.0 % of GDP in 2019 and 0.75 % of GDP in 2020 is recommended; for Hungary, this recommendation means that the country has to take measures necessary to ensure that the nominal growth rate of net primary ernment expenditure does not exceed 3,3 % in 2019 and 4,7 % in 2020 and for Romania that it has to take the measures necessary to ensure that the nominal growth rate of net primary ernment expenditure does not exceed 4,5 % in 2019 and 5,1 % in 2020.

In December 2018, the Council confirmed that no effective action has been been taken by Romania and Hungary in response to the Council recommendations of June 2018 and adopted, on the basis of COM proposals of 21 November 2018, revised recommendations: for each of both countries, the revised annual structural adjustments amount to at least 1% of GDP in 2019.

On **21 November 2018**, the COM noted that no effective action was taken by Romania and Hungary in response to the Council recommendations of June 2018 and proposed that the Council adopts revised recommendations to correct the significant deviations from the adjustment path towards the MTO:

- **Romania**: "take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 4.5% in 2019, corresponding to an annual structural adjustment of 1.0% of GDP, thereby putting the Member State on an appropriate adjustment path toward the MTO."
- **Hungary**: "take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3,3 % in 2019, corresponding to an annual structural adjustment of 1,0 % of GDP, thereby putting thery Member State on an appropriate adjustment path toward the MTO."

On **15 October 2018**, Romania and Hungary submitted reports on action taken in response to the Council recommendations of 18 June 2018.

On **18 June 2018**, the Council issued recommendations to Romania and Hungary - based on Commission recommendations of 25 May 2018 - requesting the correction of significant deviations from MTO:

- **Romania**: "take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3,3 % in 2018 and 5,1 % in 2019, corresponding to an annual structural adjustment of 0,8 % of GDP in each year, thereby putting the Member State on an appropriate adjustment path toward the MTO". Furthermore, the Council found that Romania (already for one year in a significant deviation procedure) has so far failed to take effective action.
- **Hungary**: "take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 2,8 % in 2018, corresponding to an annual structural adjustment of 1 % of GDP, thereby putting the Member State on an appropriate adjustment path towards the MTO".

Updates and progress on the MTOs

The preventive arm of the SGP stipulates that Member States shall update every three years their MTOs (last update: 2019 Stability and Convergence Programmes of April/May 2019, in which MTOs for the period 2020-2022 have been provided). For this purpose, the Commission submits to Member States so-called "minimum MTOs" (last update: p. 90 of 2019 edition of the Vademecum of the

SGP) based on the criteria included in the regulation governing the preventive arm (see beginning of this briefing). The Member States provide their updated MTOs in their Stability and Convergence Programmes based on these lower bounds as proposed by the Commission or a more ambitious target if, in their view, circumstances are deemed to warrant it. Countries undertaking structural reforms with a major impact on the sustainability of the public finances may revise their MTOs on a case-by-case basis, in agreement with the Commission. In particular, the introduction of major pension reforms having an impact on long-term fiscal sustainability could result in a revision of the MTOs.

The **country specific recommendations** (CSRs) adopted annually by the Council include in most cases explicit quantititave budgetary recommendations ('fiscal effort in structural terms') for the Member States under the preventive arm of the SGP in order for them to make progress towards or remain at their MTO.

The overleaf Annex 1 presents the fiscal targets based on the 2018 CSRs adopted by the Council in July 2018 and the 2019 CSRs proposed by the Commission in May 2019, as well as the estimated or projected progress on structural budget positions for 2019 and 2020 on the basis of the spring 2019 economic forecast by the Commission. It will be regularly updated, in particular once 2019 CSRs have been adopted by the Council in July 2019 or when new Commisison forecasts are available.

The overleaf Annex 2 provides a comparison of the wordings of the "balanced budget rules" included in the SGP, the Fiscal Compact and the Commission propsal of 6 December 2017 to integrate the substance of the Fiscal Compact into the European Union legal framework.

Annex 1: Structural budgetary efforts as requested by the Council and projected by the COM's spring 2019 forecast

Member State	MTO (structural budget position = sbp)	Recommended annual structural effort (percentage points=pp) (to adjust towards or remain at the MTO)		Projections on the structural budget balance (COM spring 2019 forecast)			
		In 2019 (based on 2018 CSRs)	In 2020 (based on 2019 CSRs)	In 2019		In 2020	
				pp	sbp	pp	sbp
BE	0.0 sbp	0.6 pp	0.6 pp	0.0 pp	-1.4 sbp	-0.4 pp	-1.8 sbp
DE	-0.5 sbp	In line with its MTO	In line with its MTO	-0.5 pp	1.1 sbp	-0.3 pp	0.8 sbp
EE	-0.5 sbp	0.6 pp	0.6 pp	0.5 pp	-1.7 sbp	0.2 pp	-1.5 sbp
IE	-0.5 sbp	0.1 pp	In line with its MTO	0.2 pp	-1.2 sbp	0.7 pp	-0.5 sbp
EL	0.25 sbp	n.a.	n.a.	-3.1 pp	1.9 sbp	-1.1 pp	0.8 sbp
ES	0.0 sbp	0.65 pp	0.65 pp	-0.2 pp	-2.9 sbp	-0.3 pp	-3.2 sbp
FR	-0.4 sbp	0.6 pp	0.6 pp	0.0 pp	-2.6 sbp	0.1 pp	-2.5 sbp
IT	0.5 sbp	0.6 pp	0.6 pp	-0.2 pp	-2.4 sbp	-1.2 pp	-3.6 sbp
CY	0.0 sbp	In line with its MTO	In line with its MTO	-0.9 pp	1.1 sbp	-0.4 pp	0.7 sbp
LV	-1.0 sbp	0.4 pp	0.5 pp	0.5 pp	-1.6 sbp	0.5 pp	-1.1 sbp
LT	-1.0 sbp	In line with its MTO	In line with its MTO	-0.2 pp	-1.0 sbp	0.1 pp	-0.9 sbp
LU	0.5 sbp	In line with its MTO	In line with its MTO	-1.2 pp	0.9 sbp	-0.4 pp	0.5 sbp
MT	0.0 sbp	In line with its MTO	In line with its MTO	-0.8 pp	0.6 sbp	-0.1 pp	0.7sbp
NL	-0.5 sbp	In line with its MTO	In line with its MTO	-0.1 pp	0.7 sbp	-0.5 pp	0.2 sbp
AT	-0.5 sbp	0.3 pp	In line with its MTO	0.4 pp	-0.1 sbp	0.1 pp	0.0 sbp
PT	0.0 sbp	0.6 pp	0.5 pp	-0.1 pp	-0.5 sbp	0.0 pp	-0.5 sbp
SI	-0.25 sbp	0.65 pp	0.5 pp	-0.1 pp	-0.8 sbp	0.5 pp	-0.3 sbp
SK	-1.0 sbp	0.5 pp	0.3 pp	0.0 pp	-1.3 sbp	-0.1 pp	-1.4 sbp
FI	-0.5 sbp	-0.2 pp	0.5 pp	0.0 pp	-1.0 sbp	0.4 pp	-0.6 sbp
BG	-1.0 sbp	In line with its MTO	In line with its MTO	-1.2 pp	0.7 sbp	-0.1 pp	0.6 sbp
CZ	-0.75 sbp	In line with its MTO	In line with its MTO	-0.5 pp	-0.1 sbp	-0.3 pp	-0.4 sbp
DK	-0.5 sbp	In line with its MTO	In line with its MTO	0.1 pp	0.9 sbp	0.1 pp	1.0 sbp
HR	-1.0 sbp	In line with its MTO	In line with its MTO	-0.5 pp	-0.8 sbp	0.3 pp	-0.5 sbp
HU	-1.0 sbp	1.0 pp	0.75 pp	0.4 pp	-3.3 sbp	0.6 pp	-2.7 sbp
PL	-1.0 sbp	0.6 pp	0.6 pp	-1.4 pp	-2.8 sbp	-0.2 pp	-3.0 sbp
RO	-1.0 sbp	1.0 pp	0.75 pp	-0.6 pp	-3.6 sbp	-1.2 pp	-4.8 sbp
SE	-1.0 sbp	In line with its MTO	In line with its MTO	-0.1 pp	0.5 sbp	0.1 pp	0.6 sbp
UK	-0.50 sbp	0.6 pp	0.6 pp	0.2 pp	-1.8 sbp	0.4 pp	1.4 sbp

Sources: 2019 SCPs, COM assessments of 2019 SCPs and 2019 CSRs for the level of the MTOs (minimum MTO calclulated by the COM for the UK - see p. 92 of the 2019 edition of the Vademecum on the SGP - since the latter did not submit a MTO); SDP for Hungary and Romania (see Box 3 of this briefing); COM spring 2019 forecast for the projected structural budget balances.
Notes: In the case a Member State does not have a quantitative fiscal effort request for 2019 and/or 2020, it is indicated in the table as being "in line with its MTO" (this may cover cases (1) where the actual structural budget balance is above the target or (2) below the target due to temporar flexibility or (3) only with a minor deviation below the target).
This table does not prejudge the assessment an overall compliance assessment by the COM, which follows an EU methodology that takes into account more aspects than the change in the structural balance.
For Greece, "not applicable (n.a.)" reflect that the country was in 2018 not subject to CSRs and that the 2019 fiscal CSR for Greece states: *"Achieve a sustainable economic recovery and tackle the excessive macroeconomic imbalances by continuing and completing reforms in line with the post-programme commitments given at the Eurogroup of 22 June 2018"; the post programme commitments include a primary suplus target of 3.5% of GDP;* according the the COM spring 2019 forecast, Greece has a primary balance of 4.0% in 2019 and 3.6% in 2020.
The explicit annual structural effort recommended in the 2018 CSRs is included in the recommendations themselves. In the 2019 CSRs, the explicit annual structural effort is included in the recommendations themselves for nearly all Member States, except for Portugal, Slovenia and Slovakia (for them it is only included in the recitals of the CSRs).

Annex 2: Comparison of EU balanced budget rules

<u>Regulation 1466/97</u> on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies as amended by <u>Regulation 1175/2011</u> **(relevant parts)**	**<u>Treaty on Stability, Coordination and Governance (TSCG)</u> of 2 March 2012** **(relevant parts)**	**<u>Proposal</u> for a Directive integrate the substance of the TSCG into the Union legal framework of 6 December 2017** **(relevant parts)**
SECTION 1A **MEDIUM-TERM BUDGETARY OBJECTIVES** *Article 2a* Each Member State shall have a differentiated medium-term objective for its budgetary position. These country-specific medium-term budgetary objectives may diverge from the requirement of a **close to balance or in surplus position,** while providing a safety margin with respect to the 3 % of GDP government deficit ratio. The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment. Taking these factors into account, for participating Member States and for Member States that are participating in ERM2 the country-specific medium-term budgetary objectives shall be specified **within a defined range between -1 % of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures.** The medium-term budgetary objective shall be revised every 3 years. A Member State's medium-term budgetary objective may be further revised in the event of the implementation of a structural reform with a major impact on the sustainability of public finances.	TITLE III **FISCAL COMPACT** **Article 3** 1. The Contracting Parties shall apply the following rules, in addition and without prejudice to the obligations derived from European Union law: a) The budgetary position of the general government **shall be balanced or in surplus.** b) The rule under point a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective as defined in the revised Stability and Growth Pact **with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices.** (...) d) Where the ratio of government debt to gross domestic product at market prices is significantly below 60 % and where risks in terms of long-term sustainability of public finances are low, the lower limit of **the medium-term objective specified under point b) can reach a structural deficit of at most 1.0 % of the gross domestic product at market prices.**	ARTICLE 3 **Fiscal responsibility and medium-term budgetary orientation** 1. Each Member State shall set up a framework of binding and permanent numerical fiscal rules which are specific to it, strengthen its responsible conduct of fiscal policy and effectively promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon for the general government as a whole. That framework shall include in particular the following rules: a) a **medium-term objective** in terms of structural balance **shall be set in order to ensure that the ratio of government debt to gross domestic product at market prices does not exceed the reference value set out in Article 1 of Protocol No 12 on the excessive deficit procedure or approaches it at a satisfactory pace**. b) fiscal planning shall include a medium-term growth path of government expenditure net of discretionary revenue measures and consistent with the medium-term objective or the time-frame for convergence towards it. That path shall be set as soon as a new government takes office in the Member State, for the term of the legislature as established by the constitutional legal order of that

The respect of the medium-term budgetary objective **shall be included in the national medium-term budgetary frameworks in accordance with Chapter IV of Council Directive 2011/85/EU of 8 November 2011** on requirements for budgetary frameworks of the Member States.		Member State, and shall be respected by the annual budgets throughout that period.

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