Box 1.6. **Fiscal consolidation needed after 2015 under the EU fiscal rules**

Despite considerable progress on needed fiscal consolidation over the past few years in EU countries, and additional fiscal tightening over 2014 and 2015 of around 1% of GDP in the euro area, the existing set of EU fiscal rules will require additional budgetary efforts beyond the short-term projection horizon that ends in 2015. This box updates estimates, first presented in the May 2012 *OECD Economic Outlook* and detailed in Barnes et al. (2012), of the amount of fiscal consolidation that EU fiscal rules introduced by recent reforms strengthening the Stability and Growth Pact (the "six-pack" and the "two pack") and the Treaty on Stability Coordination and Governance (the "fiscal compact") imply beyond 2015. The update uses the current set of short-term projections which are then extended into the medium-term following the usual methodology for long-term scenarios presented in Johansson et al. (2013).[1] For the short-term projection horizon up to 2015, fiscal projections are based on current budget and medium-term plans (see Box 1.2). Beyond 2015, the required amount of fiscal consolidation is computed for various fiscal rules. The most restrictive rule (i.e., the one requiring the largest fiscal consolidation) is considered to be binding in that year and the overall amount of fiscal consolidation required over the medium term is then computed from the resulting "most restrictive" path. After 2015, a country's short term interest rate is assumed to continue normalising towards a neutral rate that depends on the country's or area's potential growth rate and inflation target, as well as the country's external debt and fiscal positions.

1. See also Box 4.1 of OECD (2013).

Box 1.6. **Fiscal consolidation needed after 2015 under the EU fiscal rules** *(cont.)*

Three fiscal rules are considered for the period 2016 to 2023:

- *The Excessive Deficit Procedure (EDP)*. It stipulates that the headline deficit should be reduced to below 3% of GDP. Because the exact amount of fiscal consolidation under the EDP is not specified, it is assumed that if the deficit is above the 3% threshold, the structural budget balance in the following year is reduced by ½ per cent of potential GDP.
- *The debt convergence rule*. It requires a debt-to-GDP ratio (Maastricht definition) exceeding 60% of GDP to be reduced over three years at an average rate of 1/20th of the excess over 60% of GDP. The required debt reduction is calculated using the European Commission guidelines. For countries that are currently in the EDP, the rule will start applying after a transition period of three years after closure of the EDP. During this transition period, the debt ratio has to decline at a sufficient pace, approximated here by a constant adjustment of the underlying balance with maximum structural adjustment of ¾ per cent of GDP per year, over the three years.
- *The Medium-term Objective (MTO)* for the structural balance agreed for each country in the context of the Stability and Convergence Programme (SCP). Unless the MTO is already met, countries are assumed to move towards it by consolidating at the annual rate of ½ per cent of potential GDP. MTOs are set at levels agreed in 2013 the SCPs and they are assumed not to vary over the simulation period.

Some important caveats apply and the simulation results should only be treated as indicative. The simulation assumes that countries follow the rules exactly. This may be too mechanistic an assumption given the past experience of over- or under-performance. The results are also sensitive to the interest rate and GDP growth projections and to the assumption that these are independent of fiscal policy. It is assumed that the MTOs remain unchanged throughout the simulation, but they could be revised and imply faster fiscal consolidation. Finally, due to differences in output gap estimates, automatic stabilisers and one-offs, the assessment of structural balances may differ from the official EU estimates.

Keeping these caveats in mind, the following conclusions can be drawn as to which of the EU fiscal rules are likely to be binding in OECD-EU countries[2] (see Table):

- Current EDP procedures are projected to be closed on time with the exception of Ireland, Spain and Portugal where deadlines for EDP correction will likely have to be extended by one year, and Poland, where it will likely have to be extended by a few years, the large 2014 fiscal surplus related to a one-off transfer of pension assets notwithstanding.
- In France, Greece, the Netherlands, Portugal and Slovenia, the debt rule, or its transition version, is expected to be binding after EDP procedures are closed, but in some cases (the Netherlands, France and Slovenia) only over a short period due to the fact that the structural balances consistent with these rules are very close to those implied by the countries' MTOs.
- The debt rule is also binding in Italy before the MTO is reached in 2018. Despite a high debt level, the primary balance is projected to reach 3½ per cent of GDP in 2015, sufficient to put the debt ratio on a fairly steep downward trajectory.
- In Finland, between 2018 and 2023, maintaining the structural balance as required by the MTO rule results in breaching the 60% gross debt ceiling and activation of the debt rule.

One way to assess the fiscal effort that EU fiscal rules will demand is to look the amount of fiscal consolidation necessary to meet them. In 11 out of the 20 OECD economies covered by EU fiscal rules, the required improvement in the underlying primary balance between 2014 and 2023 is less than 1% of potential GDP, with some even afforded a slight fiscal loosening. For the euro zone countries, the aggregate required improvement is 0.7% of potential GDP. However, Spain, Portugal, Ireland and Greece would have to strengthen their underlying fiscal position by up to 4% of GDP (see Figure, panel A).

2. By virtue of Protocol 15 on certain provisions relating to the United Kingdom annexed to the Treaty on the Functioning of the European Union (TFEU), numerical fiscal rules and the EDP reference values on the deficit and the debt do not apply to the United Kingdom.

Box 1.6. **Fiscal consolidation needed after 2015 under the EU fiscal rules** *(cont.)*

Binding fiscal rules over the medium term

	Current deadline for EDP correction	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Austria	2013	..	..	..	..	..	debt	=	=	=	=	=	=	=
Belgium	2013	3%	3%	..	..	..	=	=	=	=	=	=	=	=
Estonia	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Finland	..	..	..	..	..	..	debt	=	debt	debt	debt	debt	debt	debt
France	2015	3%	3%	3%	3%	..	trans.	=	=	=	=	=	=	=
Germany	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Greece	2016	3%	3%	..	..	..	trans.	debt	debt	=	=	=	=	=
Ireland	2015	3%	3%	3%	3%	3%	3%	=	=	=	=	=	=	=
Italy	..	3%	..	..	..	..	debt	debt	=	=	=	=	=	=
Luxembourg	..	..	..	..	..	..	=	=	=	=	=	=	=	=
Netherlands	2014	3%	3%	3%	3%	..	trans.	trans.	=	=	=	=	=	=
Portugal	2015	3%	3%	3%	3%	3%	3%	trans.	trans.	trans.	debt	debt	=	=
Slovak Rep.	2013	3%	3%	..	..	..	->MTO	->MTO	=	=	=	=	=	=
Slovenia	2015	3%	3%	3%	3%	..	trans.	trans.	=	=	=	=	=	=
Spain	2016	3%	3%	3%	3%	3%	3%	3%	=	=	=	=	=	=
Czech Rep.	2013	3%	3%	..	..	..	->MTO	->MTO	=	=	=	=	=	=
Denmark	2013	..	3%	..	..	..	->MTO	=	=	=	=	=	=	=
Hungary	..	..	..	..	..	..	debt	=	=	=	=	=	=	=
Poland	2014	3%	3%	3%	3%	3%	3%	debt	=	=	=	=	=	=
Sweden	..	..	..	..	..	..	=	=	=	=	=	=	=	=

Notes: "3%" is the 3% defiict ceiling rule under the current EDP; "trans." is the transition rule; "debt" is the debt convergence rule; "->MTO" stands for the transition to MTO; "=" denotes that the MTO is reached and maintained. Calculations start in 2016, following the end of the short-term projection horizon.

Source: OECD calculations.

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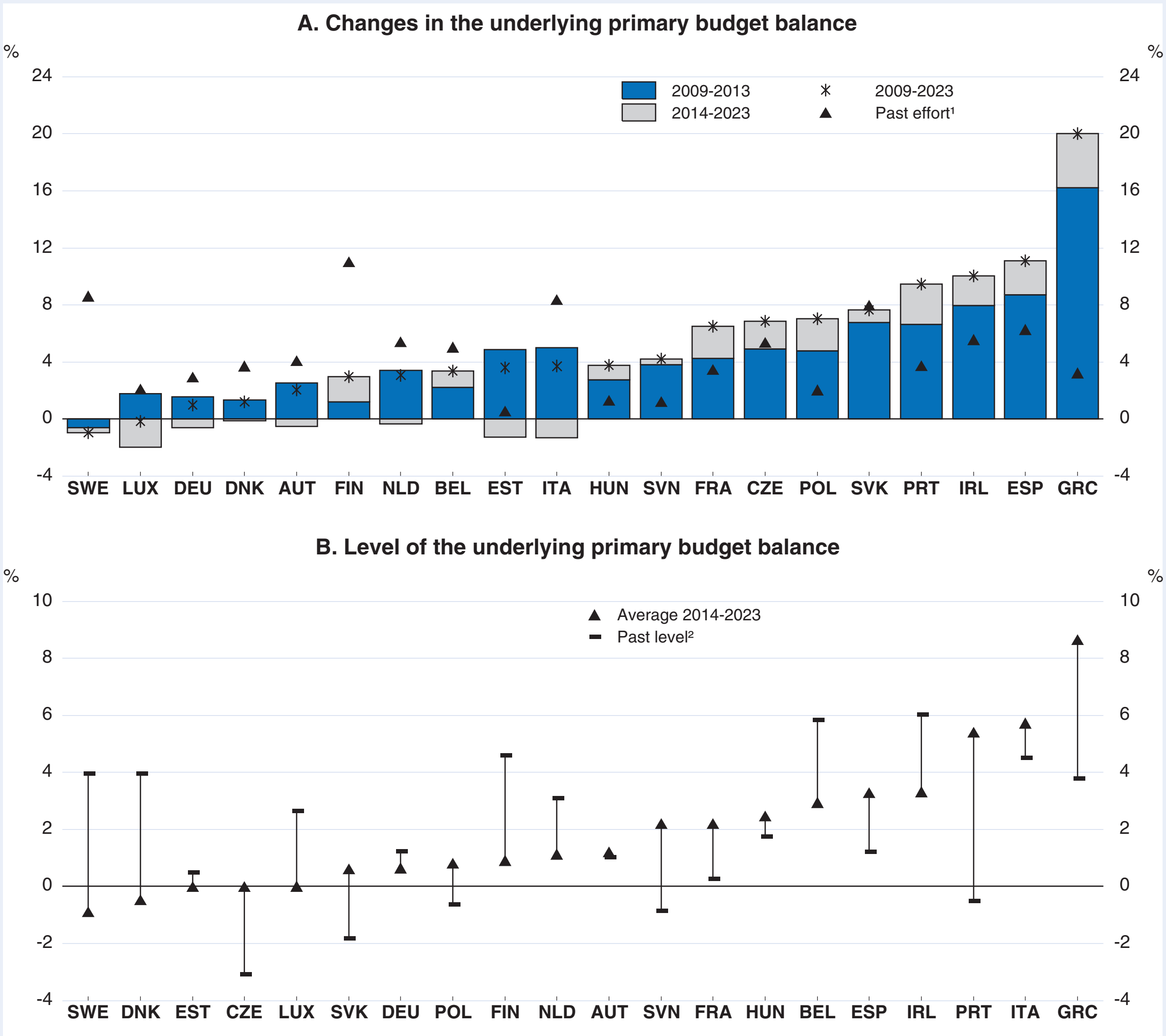
Although the medium-term fiscal headwinds post-2013 appear moderate, mainly a result of the very large fiscal consolidation effort already accomplished, the difficulties of maintaining high structural primary balances over an extended period should not be under-estimated. In Greece, Portugal and Italy for instance, partly because of high debt levels, the fiscal rules imply maintaining an average underlying primary surplus of more than 5% of GDP between 2014 and 2023. Ireland, Spain, Belgium, Hungary, Slovenia and France could all need to have an average underlying primary surplus of 2% of GDP or more during this period. Except for Belgium and Ireland, the other countries have never had such high underlying primary surpluses in any 5-year period between 1987 and 2009 (see Figure, panel B). The difference between the highest underlying primary balance sustained in the recent past and that required by the EU fiscal rules is also large in the Czech Republic.

Box 1.6. **Fiscal consolidation needed after 2015 under the EU fiscal rules** *(cont.)*

Fiscal policy stance under the EU fiscal rules

In per cent of potential GDP



1. Past effort refers to biggest consolidation between 1987 and 2009 (depending on data availability).
2. Past level refers to the country-specific 5-year period between 1987 and 2009 (again, depending on data availability) with the highest level of underlying budget balances.

Source: OECD EO94 database; and OECD calculations.

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