BRIEFING

Stability and Growth Pact - An Overview of the Rules

The Stability and Growth Pact (SGP) is a legal framework (based on primary and secondary EU law) that seeks to ensure sustainable public finances so as to contribute to the stability of the Economic and Monetary Union (EMU). It consists of two main building blocks: the preventive arm and the corrective arm.

The preventive arm of the SGP

Member States that are not subject to an Excessive Deficit Procedure (EDP) have to fulfil the provisions of the **preventive arm of the Stability and Growth Pact (SGP)**.

These provisions stipulate notably that each Member State shall have a differentiated **medium-term objective (MTO)** for its budgetary position:

- ➔ *the MTO is a budget balance in structural terms (i.e. a nominal budget adjusted by the cyclical component and net of one-off and temporary measures, see Box 1);*
- ➔ *it shall ensure the sustainability of public finances or a rapid progress towards it while allowing room for budgetary manoeuvre, in particular for public investment;*
- ➔ *it should be close to balance or in surplus;*
- ➔ *it shall be revised every 3 years and may be further revised in case of a new structural reform with a major impact on the sustainability of public finances.*

Box 1: Structural budget balance

The structural budget balance is a cyclically-adjusted budget balance corrected for one-off and temporary measures. It is the main indicator used for assessing progress towards MTOs under the preventive arm and effective action under the corrective arm of the SGP. It corresponds to the budget balance prevailing if the economy was running at its potential.

The EU fiscal framework consists in subtracting from the actual budget balance the cyclical component of the budget. The cyclical component is calculated as the product of the output gap (difference between actual and potential GDP) and a parameter reflecting the automatic reaction of the government balance to the size of the output gap.

However, there are different ways to calculate the structural balance, including the output gap. For more detailed information:

- European Commission: Economic Papers of Directorate-General ECFIN - 3/2013

- European Central Bank: Monthly bulletin (box 6, page 85) - 9/2014

- International Monetary Fund: Online overview - 8/2014

Taking the above elements into account, the MTOs for euro area Member States (and the Member States belonging to the Exchange Rate Mechanism ERM II) shall be specified within a defined range between -1% of GDP and balance or surplus.

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Member States which have not yet reached their MTO should improve their structural balance by 0.5% of GDP per year as a benchmark (more in "good times", less in "bad times"). The Commission has specified in its Communication "***Making the best use of flexibility within the existing rules of the SGP***" of January 2015 that it will apply a matrix specifying the "good times" and "bad times" and the corresponding appropriate fiscal adjustments.

In case of a "***significant deviation*"** (= 0.5% of GDP in 1 year or cumulatively over 2 years) from the MTO or from its adjustment path, the Commission can express an "early warning".

Temporary deviations from the MTO or the adjustment path may be allowed in the cases of: (1) ***major structural reforms*** (e.g. pension reforms) which have a verifiable long term (positive) impact on the public finances; in its Communication "***Making the best use of flexibility within the existing rules of the SGP***", the Commission announced that will take into account the positive fiscal impact of structural reforms if they (i) are major, (ii) have verifiable direct long-term positive budgetary effects, including by raising potential sustainable growth, and (iii) are fully implemented; it also announced that it will assess the relevant reform plan before recommending allowing a temporary deviation from the MTO or the path towards it. As regards ***public investments***, the Commission stated in the Communication that they will allow Member States to deviate temporarily from their MTO or adjustment path towards if: their GDP growth is negative or GDP remains well below its potential; the deviation does not lead to an excess over the 3 % deficit reference value and an appropriate safety margin is preserved; investment levels are effectively increased as a result; the deviation is compensated within the timeframe of the Member State's Stability or Convergence Programme. Eligible investments are national expenditures on projects co-funded by the EU under the Structural and Cohesion policy, Trans-European Networks and the Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Fund for Strategic Investments.
(2) an ***unusual event outside the control of the Member State concerned*** which has a major impact on the financial position of the government or
(3) in ***periods of severe economic downturn for the euro area or the Union as a whole***; a condition for all deviations is that they do not endanger fiscal sustainability in the medium term. Temporary deviations from the adjustment path are allowed, if a safety margin with respect to the nominal 3 % of GDP government is provided.

Each set of Country Specific Recommendations (CSRs) adopted annually by the Council includes a recommendation ("fiscal effort in structural terms"[1]) on progress towards the MTO and for countries whose debt is higher than 60% of GDP on compliance with the **debt reduction benchmark** (the definition of the benchmark is provided at the beginning of the next section). Non-compliance with the warnings and recommendations may trigger further steps in the procedures, including for euro area Member States the possibility of sanctions.

[1] However, the required fiscal effort in the preventive arm is not clearly specified in numerical terms in the respective CSRs.

Box 2: Difference between the balanced budget rules in the SGP and the "Fiscal Compact"
The allowed ranges in which the country-specific MTOs have to be set differ between the preventive arm of the SGP (EU law) and the "Fiscal Compact" (intergovernmental treaty): While the upper limit ("surplus") is unspecified and identical in both frameworks, the lower limit ("close to balance") is specified differently: if the debt-to-GDP ratio is higher than 60%, the lower limit is more stringent in the Fiscal Compact (structural deficit of 0.5% of GDP) compared to the preventive arm (structural deficit of 1% of GDP). If the public debt is lower than 60% of GDP, there is again no difference between the lower limits in both frameworks (structural deficit of 1% of GDP).

The current SGP rules also include an **expenditure benchmark**, according to which growth of public expenditure (net of discretionary revenue measures) has to be lower than medium-term potential GDP growth. The aim is to complement the assessment based on the structural balance in judging progress towards or remaining at the MTO.

The corrective arm of the SGP

The **corrective arm of the SGP** governs the **Excessive Deficit Procedure (EDP)**. The EDP is triggered by

- ➔ the deficit breaching the 3% of GDP threshold or
- ➔ the debt being above 60% of GDP and not diminishing at a sufficiently rapid pace as defined by the debt reduction benchmark stipulating that the distance to the 60% threshold should be reduced by 5% on average per year (over the past 3 years or in the next 2 years), also taking the economic cycle into account[2].

If the Council decides (on the basis of a Commission recommendation) that a deficit is excessive, the Council issues recommendation to the Member State concerned to correct the excessive deficit and gives a time frame for doing so. In its recommendation, the Council shall request that the Member State achieve **annual budgetary targets** ("fiscal effort in structural and/or nominal terms") which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of the structural balance of at least 0.5 % of GDP as a benchmark, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation. In its Communication "***Making the best use of flexibility within the existing rules of the SGP***" of January 2015, the Commission announced that will will take into account the existence of a dedicated structural reform plan, providing detailed and verifiable information, as well as credible timelines for adoption and delivery, when recommending a deadline for the correction of the excessive deficit.

The Council may decide, on a recommendation from the Commission, to **extend the deadline** for the correction of the excessive deficit by one year as a rule in one of the following two cases:

(i) effective action has been taken by the Member Stat + unexpected adverse economic events with major unfavourable consequences for government finances

[2] For Member States that were subject to an EDP on 8 November 2011, the debt reduction benchmark is applied fully after a transition period of 3 years after the correction of the excessive deficit; within the transition period, the Member States shall make sufficient progress towards compliance with the benchmark.

(ii) severe economic downturn in Euro Area or EU as a whole, provided that it does not endanger medium term fiscal sustainability (like in the preventive arm)

Non-compliance with the recommendations may trigger further steps in the procedures, including for euro area Member States the possibility of sanctions.

Box 3: Assessment of "effective action"

In the corrective arm, progress by Member States is measured on the basis of "fiscal effort" in structural terms[3]. If the improvement is in line with the Council recommendation, the Commission and/or Council conclude that "effective action" has been taken.

The measurement of compliance with the required "fiscal effort" (i.e. of whether "effective action" has been taken or not) has several steps:

First, it is assessed whether the annual change in the structural budget balance is in line with the required fiscal effort ("top down approach"). This assessment takes into account revisions of potential output growth compared to that assumed at the time of the recommendations and the impact of revisions on the composition of economic growth (tax richness) or of other windfalls/shortfalls on revenue.

Secondly, a quantification of measures taken ("bottom up approach") is carried out.

Thirdly, the Commission carries out a careful analysis weighing the top down approach against the bottom up approach and comparing the two.

In June 2014, the Council endorsed "***terms of reference***" following a review of the methodology used for assessing "effective action" taken by Member States in response to Council recommendations. To this end, all relevant data used by the Commission, including data on the yields of discretionary fiscal measures, will be shared with the Member States in a timely manner, enabling them to replicate the calculation underlying the Commission's assessments and recommendations. Furthermore, the "terms of reference" specify in detail the “top down” and “bottom up” approaches.

Possible sanctions in the preventive and corrective arms of the SGP

When?	What?
Adjustment towards the MTO/expenditure rule not respected (preventive arm)	Interest-bearing deposit 0.2% of GDP
Opening of the EDP (if the country was already sanctioned under the preventive arm or if the breach of the threshold is particularly serious)	Non-interest-bearing deposit 0.2% of GDP
Failure to take effective action to correct the excessive deficit	Fine 0.2% of GDP
Repeated failure to take effective action to correct the excessive deficit	Fine 0.2% of GDP + variable component

[3] A similar method is applied in the preventive arm; one difference is that the assessment in the preventive arm also takes account of the compliance with the expenditure benchmark.

It should be noted that the first three sanctions in the table above are voted on the basis of a reverse qualified majority in the Council, which means that the sanctions proposed by the Commission will be adopted, unless opposed by a qualified majority of countries; this mechanism is also called "semi-automatic". The last sanction (repeated failure to take effective action) in the above table is decided on the basis of normal qualified majority voting. Furthermore, the so-called *macro-economic conditionality* (in force since end 2013) implies, both for euro area and non-euro area Member States, possible suspensions of up to five European structural and investment funds in case of failure or repeated failure to take effective action to correct the excessive deficit.

Report on the application of the current rules

As required by the regulations governing both arms of the Pact[4], the Commission published end of 2014 a report on the application of the rules and forwarded to the European Parliament and to the Council. In this report, the Commission assesses that the reformed framework has proven effective in strengthening budgetary surveillance. It considers the performance under the reformed *preventive arm* as encouraging, since most concerned Member States have attained, or made appropriate progress towards their MTO. However, it acknowledges that it is when economic conditions improve that it will be possible to have a better understanding of the effectiveness of the preventive arm. As regards the *corrective arm*, the Commission assesses that a sustainable correction of excessive deficits has been impressive, given that the number of countries under an EDP fell from 23 in December 2013 to 11 by end of August 2014. However, the experience with the *debt benchmark* is very limited, since the new rules included a transition period for the debt benchmark to fully enter into force. It also highlights that the intermediate *nominal and structural deficit targets* under the EDP have enabled more precise and transparent policy advice and monitoring.

For further information:

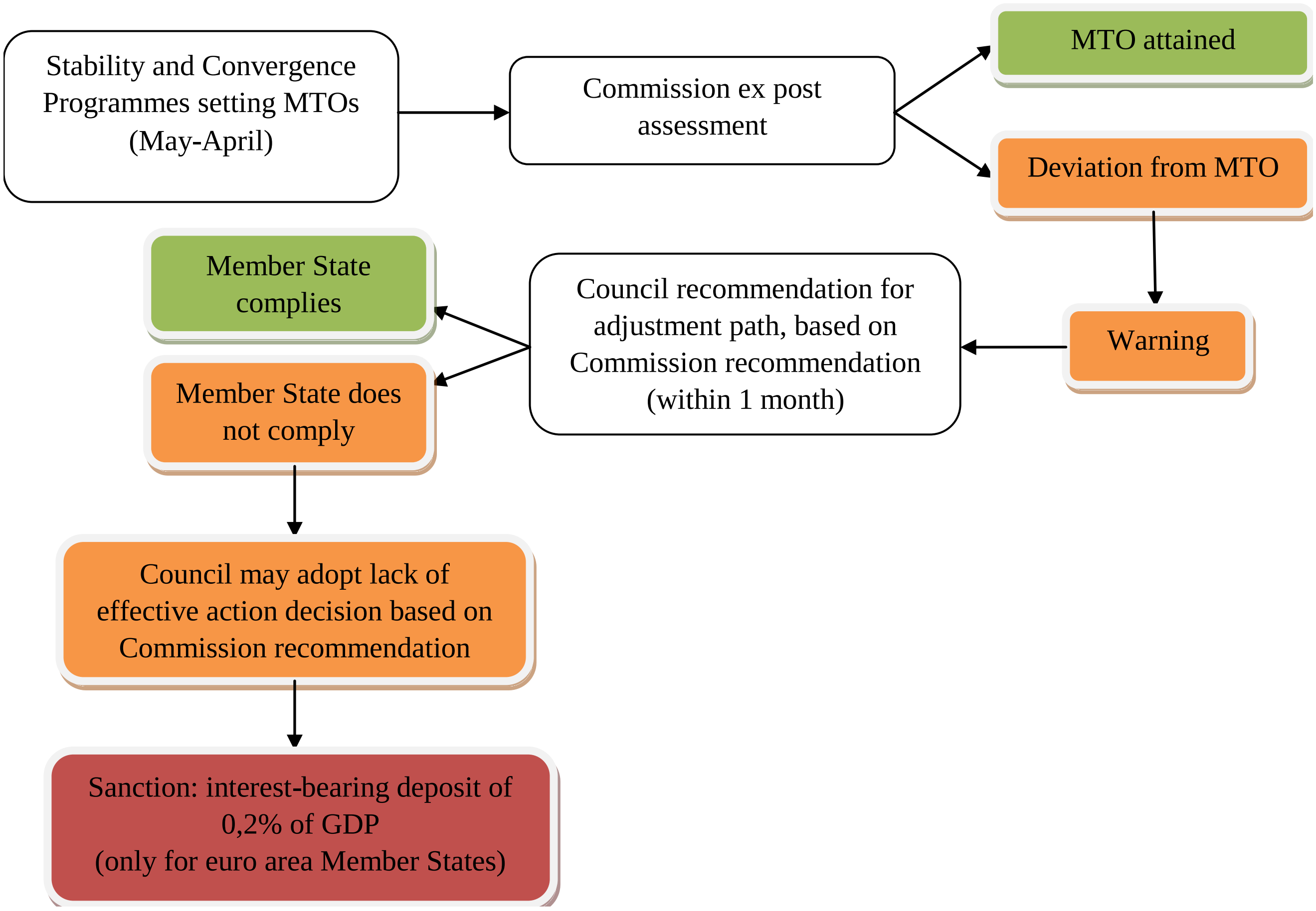
- *Communication "Making the best use of flexibility within the existing rules of the SGP":* http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
- *Review of 28 November 2014 on the application of "Six Pack" and "Two Pack":* *http://ec.europa.eu/economy_finance/economic_governance/documents/com%282014%29905_en.pdf*
- *A Guide to the SGP:* http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp150_en.pdf
- *A Vademecum on the SGP:* http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp151_en.pdf
- *The code of conduct on the implementation of the SGP*: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Annexes:

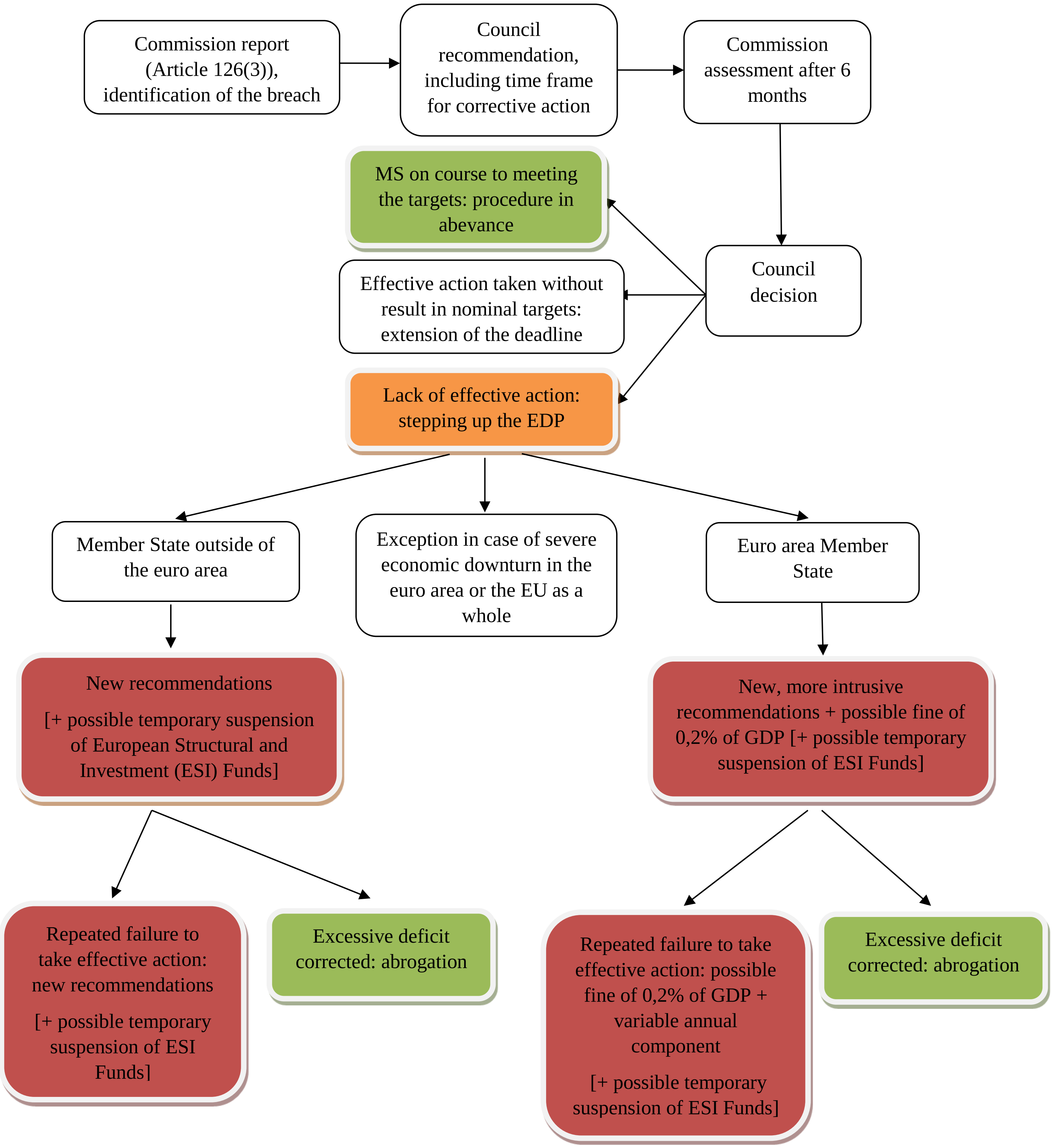
Annex 1 - Steps under the preventive arm of the SGP
Annex 2 - Steps under the corrective arm of the SGP

[4] See: Regulations (EC) No 1466/97 (preventive arm) and 1467/97 (corrective arm) as amended.

Annex 1 - Steps under the preventive arm of the SGP



Annex 2 - Steps under the corrective arm of the SGP



Note: The possible suspensions of up to five ESI funds are in square brackets, since they are formally not belonging to the preventive arm of the Pact but to the so-called regulation on macro-economic conditionality of 5 European Structural and Investment Funds [Regulation (EU) No 1303/2013]