The Stability and Growth Pact

Centrale Raad voor het Bedrijfsleven
Conseil Central de l'Economie

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Outline

1. Origins and legal base of the Stability and Growth Pact

2. Successive reforms and evolution

3. Working of the preventive arm of the Pact

4. Working of the corrective arm of the Pact

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Fiscal policy in the EU context

- EMU as unique model of economic integration
    - **Common monetary policy & decentralized fiscal policies**
- Common monetary policy
    - **Price stability**
    - **Macroeconomic stabilisation: dealing with *common* shocks**
- Fiscal policy at national level
    - **Sustainability: avoiding deficit bias**
    - **Macroeconomic stabilisation: dealing with *idiosyncratic* shocks**
- Common fiscal rules
    - **Overcoming (dis)incentives created by monetary union ('additional' fiscal bias): Avoiding negative spillovers & overburdening monetary policy**
    - **(More recently) Avoiding sovereign debt crises and monetary bail-outs**

European Commission

The Stability and Growth Pact

- Framework within which Member States make their budgetary decisions
  - **Member States are responsible for fiscal policy**
  - **But must be compatible with the rules**

- Legal base: Treaty on the functioning of the EU
  - **Art. 121: multilateral surveillance**
  - **Art. 126: excessive deficit procedure**
  - **Art. 136: specific economic policy guidelines for the euro area**
  - **Protocol No 12 on the excessive deficit procedure**

    Deficit criterion: General government deficit $< 3\%$ of GDP

    Debt criterion: General government debt $< 60\%$ of GDP or sufficiently diminishing towards 60%

The Stability and Growth Pact

- Secondary legislation:
  - **Regulation (EC) 1466/97('preventive arm'):**
    - Aims to ensure sound budgetary positions
    - As long as deficit and debt criteria fulfilled, Member State remains in the Preventive arm
  - **Regulation (EC) 1467/97('corrective arm'):**
    - aims to correct gross policy errors
    - If deficit or debt criterion not fulfilled, Member State enters the Corrective arm (= excessive deficit procedure)
- Commonly agreed guidelines: **Code of Conduct**
    - for example: Commonly agreed position on flexibility within the Stability and Growth Pact (cyclical conditions, structural reforms, investment)

Fiscal policy in EMU: Who does what?

Member States	The European Commission	The Council of Ministers
• Decide on tax and spending levels – which drive borrowing and debt • But must be compatible with the Stability and Growth Pact • Fiscal Compact: National rules	• Implements the Stability and Growth Pact: are Member States compliant with its provisions? • Prepares the analysis to guide the Council	• Take the decisions on the application of the Stability and Growth Pact

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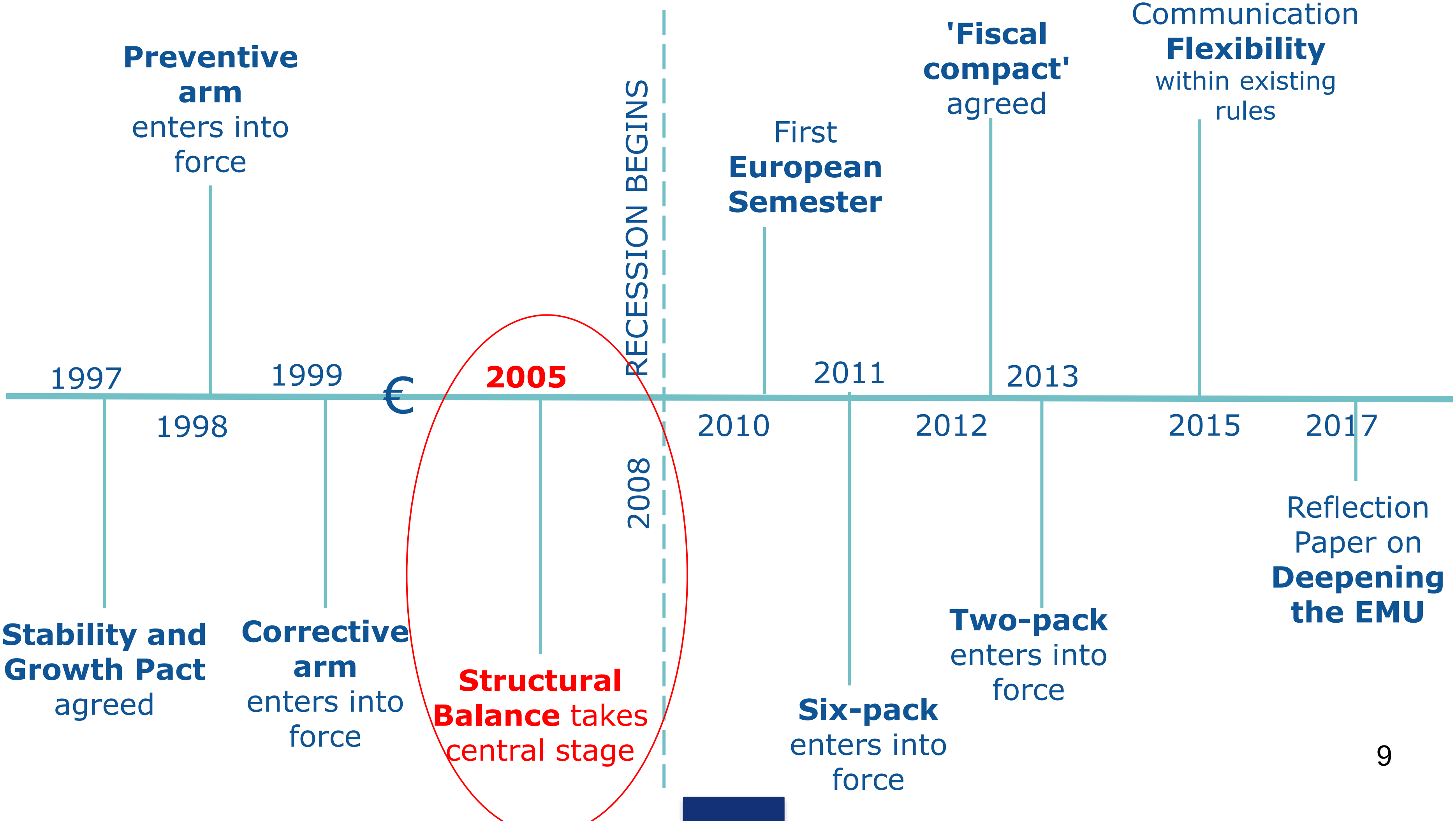
Timeline of relevant changes



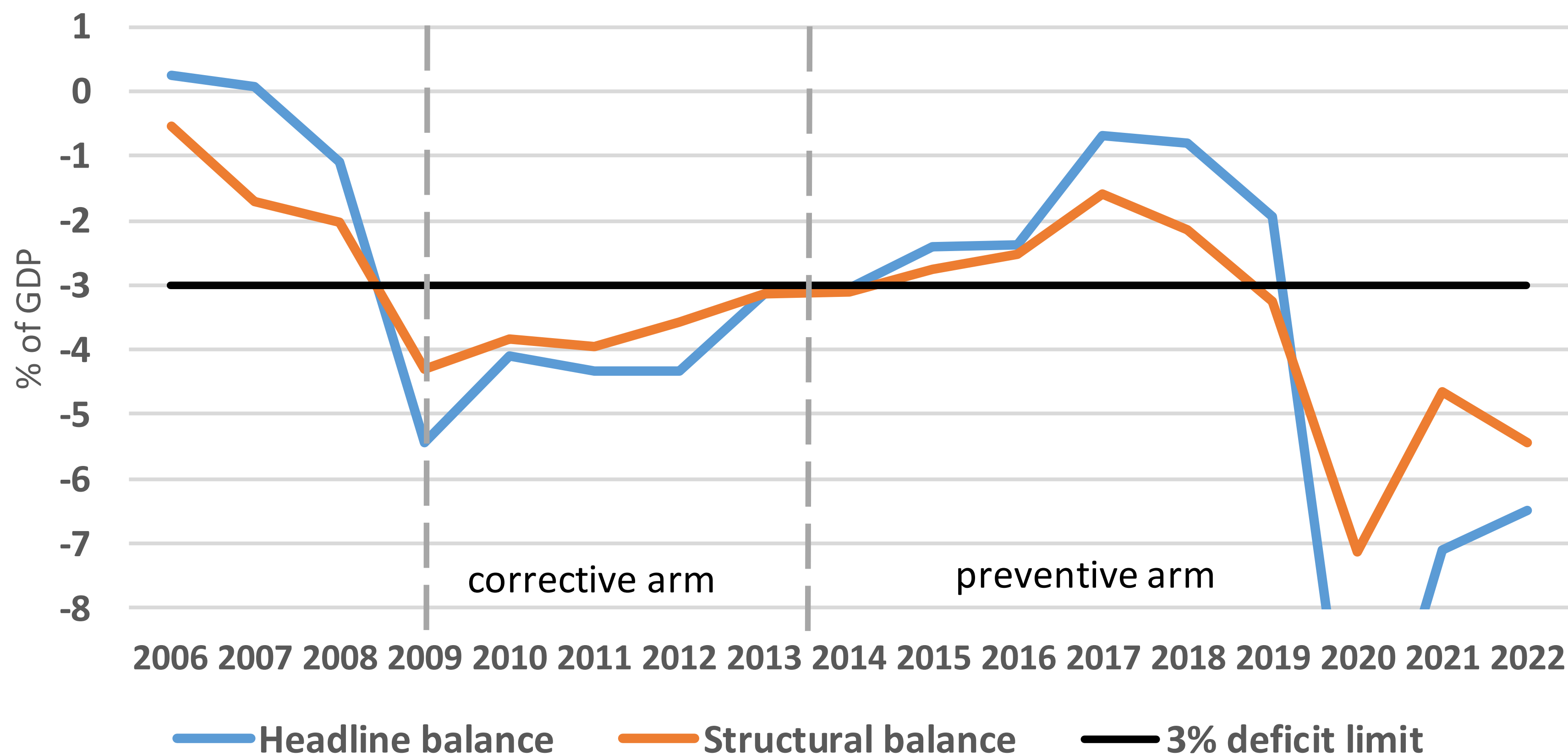
The 2005 reform

- Concept of **structural budget balance** = budget balance but excluding the impact of the economic cycle (and one-offs)

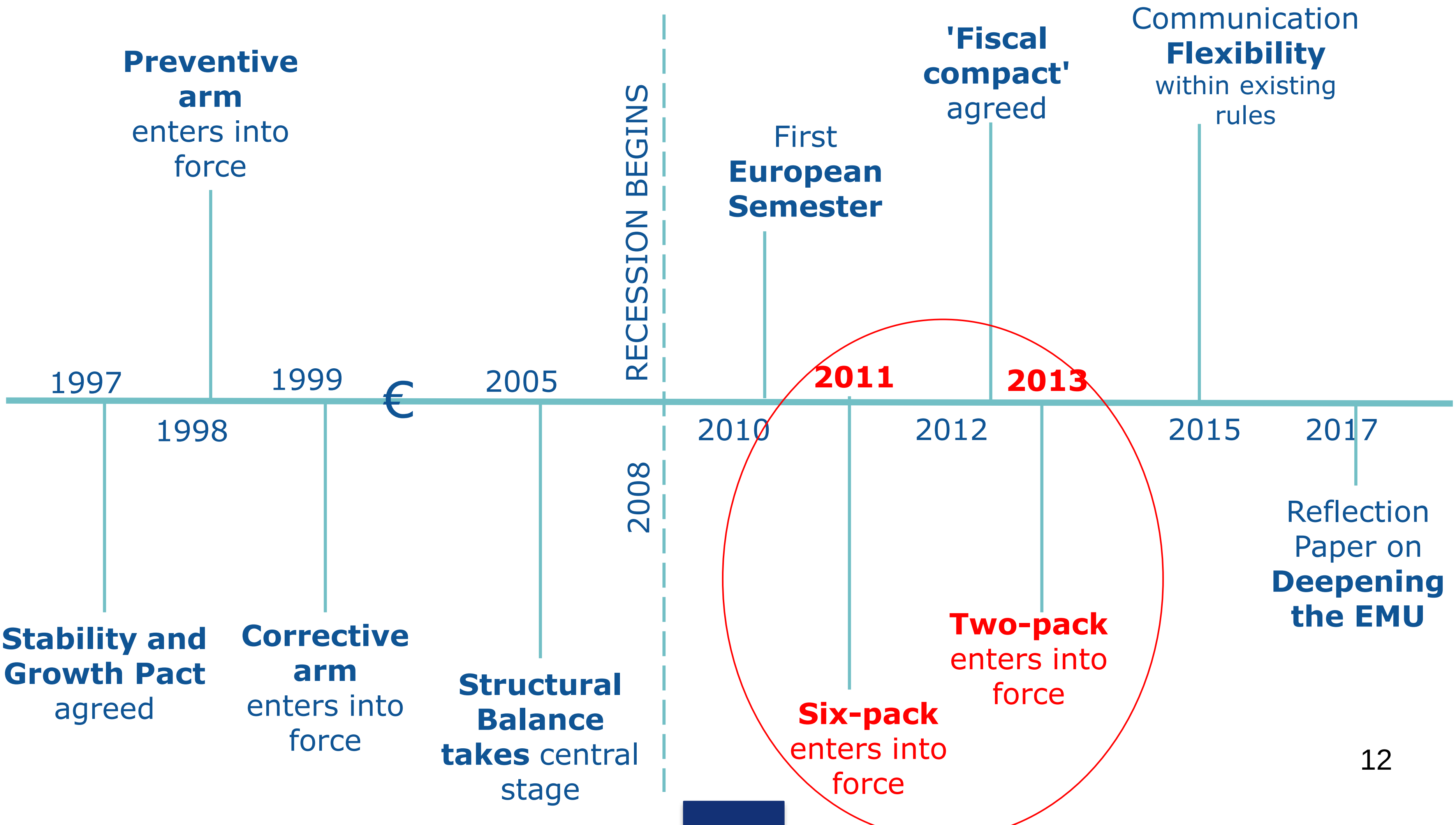
- Possibility to **modulate requirements** dependent on economic conditions

- Give **more time** to bring deficit below 3% of GDP in case of adverse economic events

Illustration: BE structural balance



Timeline of relevant changes



The 2011 reform and 2013 reform

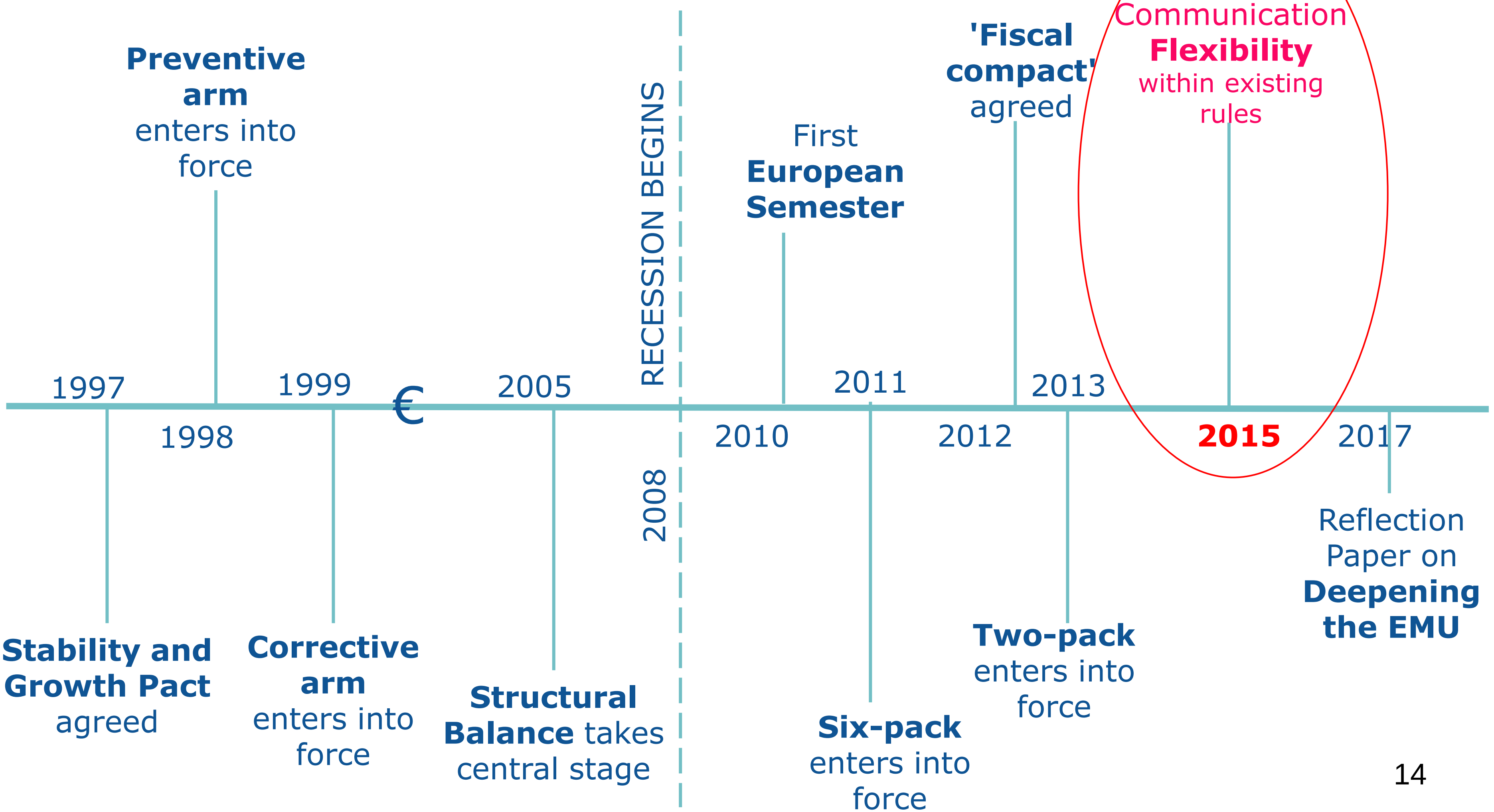
Six-pack reform:

- Prevention of gross policy errors: New expenditure benchmark
- New debt benchmark for sufficiently diminishing debt ratio
- New sanction toolbox
- Minimum requirements for national budgetary frameworks

Two-pack reform (euro area member States):

- Coordinated surveillance of national budgets
- Discussion on euro area fiscal stance in the Eurogroup
- Strengthening budgetary surveillance in face of financial instability

Timeline of relevant changes



Flexibility in the SGP

- **Commonly Agreed Position on Flexibility** – adopted in February 2016

- Provides **additional guidance**, without changing or replacing the existing rules of the Pact

- Focuses **on three specific dimensions**:
  - **Cyclical conditions**
  - **Structural reforms**
  - **Investments,** in particular in relation to the setting up of the European Fund for Strategic Investments (EFSI)

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Aim of the preventive arm: a prudent fiscal policy

- Structurally sound
- Builds a buffer against bad times
- Builds a buffer against too high debt
- Builds a buffer against future liabilities
- Controls expenditure dynamics

Working of the preventive arm: The medium-term budgetary objectives

- Country-specific target for the structural balance

- At a level that :
  (i) Provides a safety margin with respect to the 3% threshold, also in bad times
  (ii) Ensures sustainability or rapid progress towards it
  (iii) taking (i) and (ii) into account, allows room for budgetary manoeuvre, in particular taking into account the needs for public investment.
- Euro area and ERMII countries: minimum -1.0% of GDP
- Allows room for budgetary stabilisation over the cycle since it is expressed in structural terms (= excluding the impact of the economic cycle)

Working: What does the Preventive Arm require Member States to do?

- If Member State at Medium Term Objective in the previous year
  - **Remain at MTO**

- If Member State NOT at MTO in the previous year:
  - **Adjust towards the MTO**
  - Required improvement of the **structural balance**:

    0.5% of GDP as a reference, less in bad times, more in good times + if high debt and/or sustainability concerns
  - Required improvement translated into an **expenditure benchmark**

Working: Adjustment towards the MTO based on the matrix of requirements

		Required annual fiscal adjustment	
	Condition	**Debt ≤ 60% and no sustainability risk**	**Debt > 60% or sustainability risk**
Exceptionally bad times	**Real growth <0 or output gap <-4**	No adjustment needed	
Very bad times	**-4 ≤ output gap <-3**	**0**	**0.25**
Bad times	**-3 ≤ output gap < -1.5**	**0** if growth below potential, **0.25** if growth above potential	**0.25** if growth below potential, **0.5** if growth above potential
Normal times	**-1.5 ≤ output gap < 1.5**	**0.5**	> **0.5**
Good times	**output gap ≥ 1.5**	> **0.5** if growth below potential, ≥ **0.75** if growth above potential	≥ **0.75** if growth below potential, ≥ **1** if growth above potential

Illustration: Member States' distance to their MTO (2019)

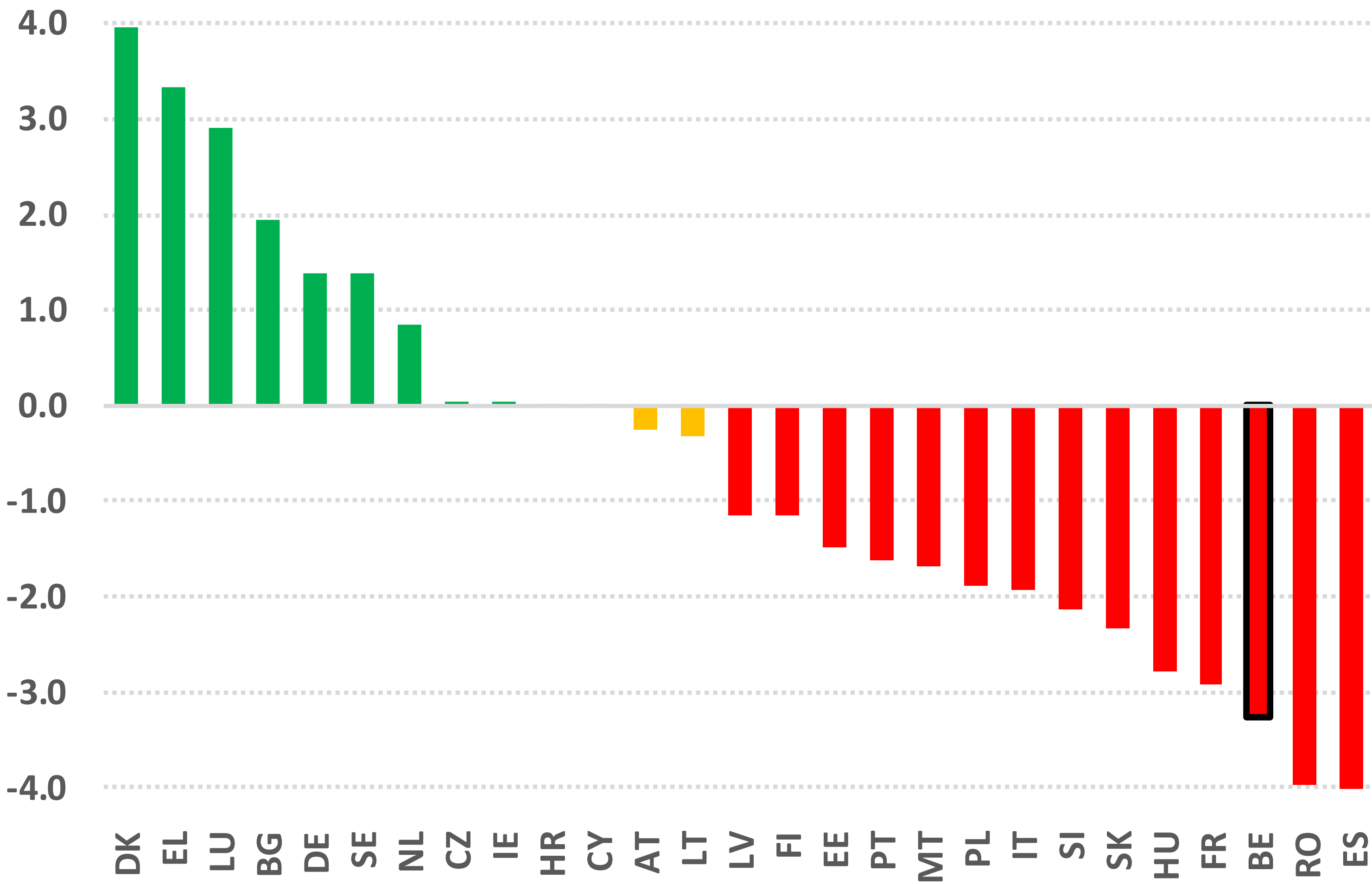
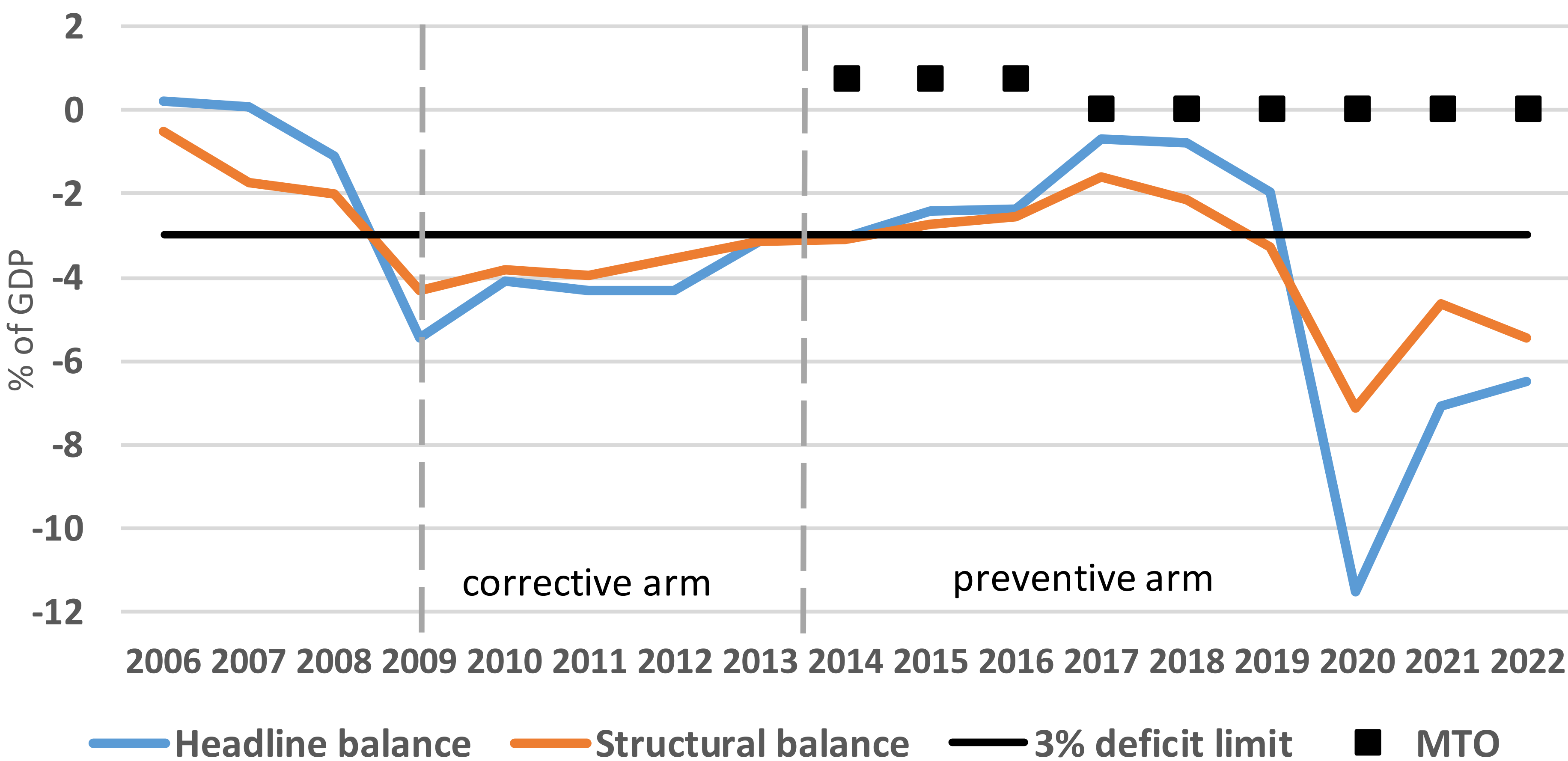


Illustration: BE under the preventive arm



Assessing compliance with the preventive arm requirements

- Assessment based on: **Change in structural Balance** and the **Expenditure benchmark**
  - MS that overachieved MTO: only structural balance
  - Compare observed/forecast developments with the required ones
  - Both over one year and two-year average

- Significant deviation of the MTO or the adjustment path could lead to the opening of a Significant Deviation Procedure

- Thresholds for significant deviation

Year / Indicator	Year *t*	Average (Year t and t-1)
Deviation SB	0.5%	0.25%
Deviation EB	0.5%	0.25%

Assessing compliance with the preventive arm requirements

The expenditure benchmark: An analysis of government expenditure net of discretionary revenue measures

- For countries at their MTO:
  - **Net expenditure must grow at most in line with potential GDP**
- For countries not at their MTO:
  - **Net expenditure must grow at rate below medium-term growth rate of potential GDP**
  - **Difference between two growth rates calculated to ensure structural balance improves as required (0.5% as a rule)**

- Unless excess is matched by discretionary revenue measures: **No cap on expenditure!**

Assessing compliance with the preventive arm requirements

Why have an expenditure benchmark?

- Only expenditure trends can be **controlled** by government over the medium term
- Circumvent **uncertainty** surrounding the structural budget balance
- Provide **operational** guidance to MS concerning appropriate adjustment path towards the MTO
- Strengthen automatic stabilisation
  - **Expenditure on a sustainable path**
  - **Revenues are allowed to fluctuate with the economic cycle**

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Corrective arm of the SGP

Aim	Correct gross policy errors ("excessive deficits")
Legal basis	Art. 126 TFEU and Protocol 12 Regulation 1467/97
Objective	• Deficit: 3% of GDP • Debt: 60% of GDP or sufficiently diminishing and approaching 60% at a satisfactory pace
Assessment	Headline balance, fiscal effort (Δ structural balance and expenditure benchmark)
Process	Excessive Deficit Procedure: Opening – Regular monitoring – Abrogation
Enforcement	Sanctions

How is the debt criterion implemented?

- General government debt < 60% of GDP **OR** sufficiently diminishing towards 60%

- "Sufficiently diminishing towards 60%" = debt reduction benchmark (introduced by Six-pack)

- Debt reduction benchmark = gap to 60% should be reduced by 5% per year on average over a period of 3 years
  - **Example: If debt is 100% of GDP, debt ratio has to decrease by 2pp per year on average over 3 year**

The excessive deficit procedure

- Council recommendation with
  - **A deadline**
  - **An adjustment path (annual deficit targets)**
  - **Annual structural fiscal efforts (at least 0.5% of GDP)**
  - **Annual limit to the growth rate of net primary expenditure (EB)**

- assessment of effective action by the Commission

- Abrogation when deficit durably below 3% of GDP and compliance with forward-looking component of debt benchmark

Sanctions toolbox: euro area

When?	What?
Opening of the EDP	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

For all MS except UK: suspension of commitments or payments under the structural funds

March 2020: activation of the « general escape clause »

Preventive arm (all MS except RO): "…*in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed <u>temporarily to depart from the adjustment path towards the medium-term budgetary objective</u>, provided that this does not endanger fiscal sustainability in the medium term…*"

Corrective arm (RO): "…*in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a <u>revised fiscal trajectory</u>.*"

More reading

SGP legislation

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/legal-basis-stability-and-growth-pact_en

Vade mecum on the Stability and Growth Pact (technical handbook on the SGP)

https://ec.europa.eu/info/publications/vade-mecum-stability-and-growth-pact-2019-edition_en

More reading

Preventive arm page

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/preventive-arm_en

Excessive deficit procedure

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure_en

Stability or convergence programmes

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/stability-and-convergence-programmes_en

Draft budgetary plans

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries_en

Thank you

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The Stability and Growth Pact

- Other related legislation:
  - **Data reporting to Eurostat:** **Regulation (EC) 479/2009** on the application of the Protocol on the EDP
  - **Sanctions for euro area Member States:** **Regulation (EU) No 1173/2011** on the effective enforcement of budgetary surveillance in the euro area
  - **Additional monitoring and reporting for euro area Member States:** **Regulation (EU) No 473/2013** on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area
  - **Enhanced surveillance for euro area Member States with financial difficulties:** **Regulation (EU) No 472/2013** on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability

The 2013 reform ("Two-pack")

Focus: euro area Member States

The aggregate fiscal stance:

- **National fiscal policies must be sustainable while allowing automatic fiscal stabilisers to operate freely**
- **But may not result in an appropriate aggregate euro area fiscal stance (no rules for MS overachieving their targets)**

Two-pack reform:

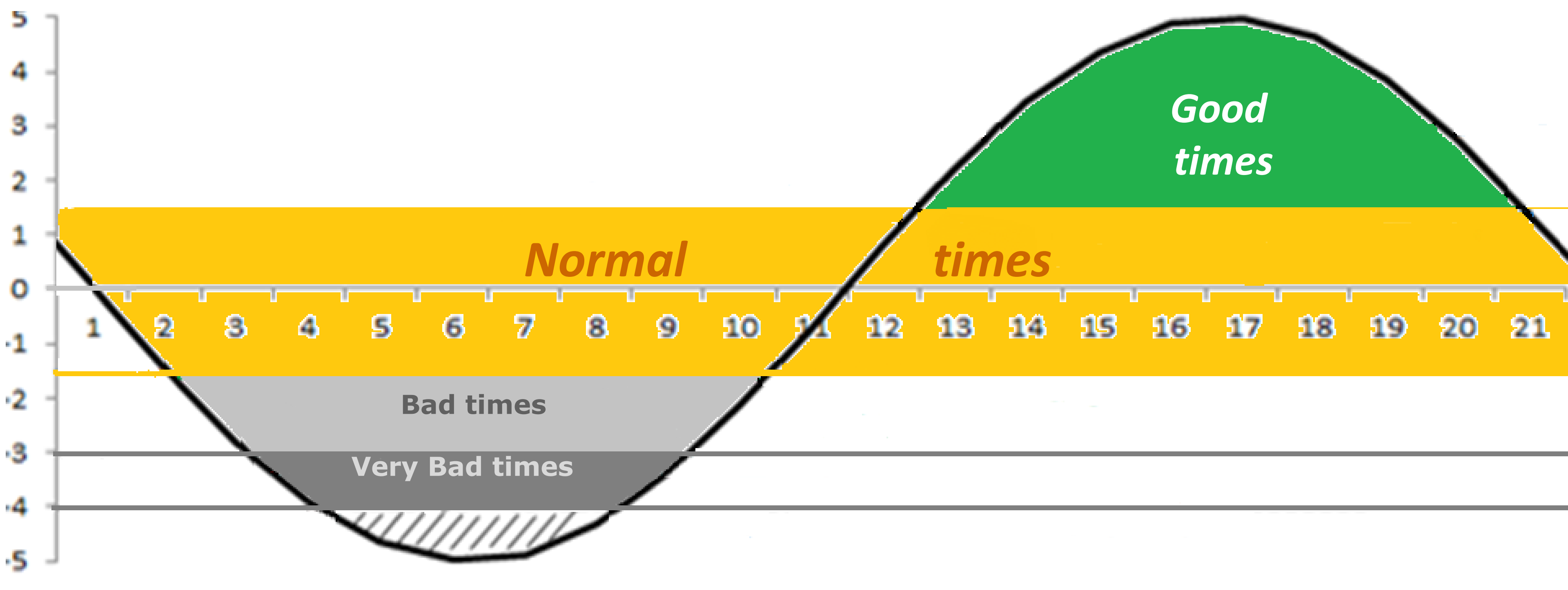
- **Coordinated surveillance of national budgets**
- **Discussion on euro area fiscal stance in the Eurogroup**
- **Strengthening budgetary surveillance in face of financial instability**

Preventive arm of the SGP: overview

Aim	Member States run prudent fiscal policies over the medium run
Legal basis	Art. 121 TFEU, Regulation 1466/97
Objective	"Close to balance or in surplus"
Operationalization	Medium-term budgetary objectives (MTO)
Requirement	At the MTO or on the path towards it
Assessment	Structural budget balance + Expenditure benchmark
Process	European Semester; SCPs
Enforcement	Significant deviation procedure

Illustration: Cyclical conditions

Modulation of the fiscal effort according to the economic cycle



Exceptionally bad times

Working of the preventive arm: The structural balance

- Central concept: **structural budget balance**

  = *budget balance excluding the impact of the economic cycle and the impact of one-off factors*

IF $\Delta SB > 0$ => Fiscal position is improving

IF $\Delta SB < 0$ => Fiscal position is deteriorating

The investment clause: trigger

- National expenditures on projects co-funded by the EU under
  - European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD, EMFF)
  - Trans-European Networks
  - Connecting Europe Facility
- National co-financing of investment projects co-funded by the European Fund for Strategic Investment (EFSI).

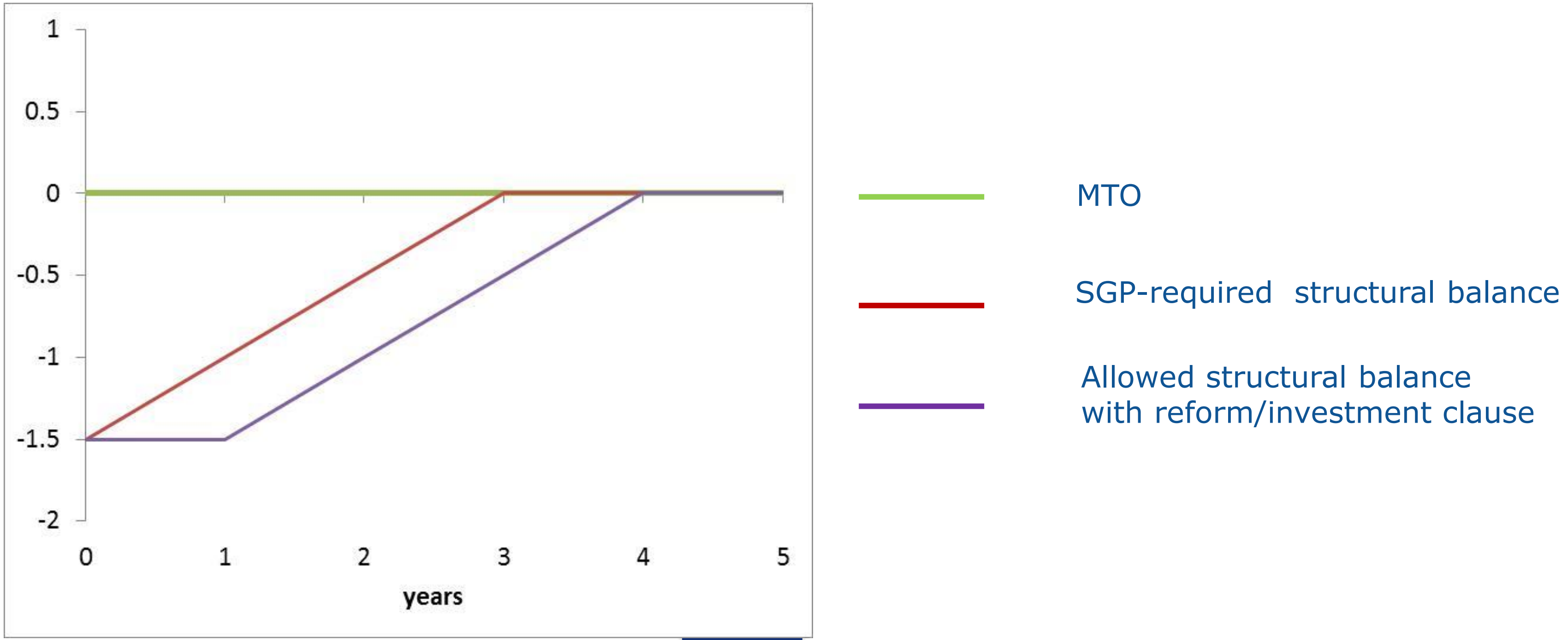
- *National co-financing under these headings meets clause's requirements as their objective is to promote long-term sustainable growth.*
- Projects supported by EU structural funds and the EFSI are subject to an objective selection process.

The investment clause: conditions

- ✓ MS has to be in the **preventive arm**
- ✓ **GDP growth is negative** or **GDP well below its potential** (negative output gap greater than minus 1.5% of GDP)
- ✓ deviation **does not lead to breach of 3% deficit** and "**safety margin**" is preserved (country-specific Minimum Benchmark: BE -1.4% of GDP in 2018 and 2019)
- ✓ total public investment is not decreasing
- ✓ budgetary position aims to return to MTO within 4 years

The investment clause: consequence

- ✓ temporary deviation allowed from MTO or adjustment path towards it
- ✓ amount of deviation linked to investment costs (national expenditure on eligible projects)
- ✓ Max 0.5% of GDP



The excessive deficit procedure

Trigger

Deficit > 3% of GDP

and/or

Debt > 60% of GDP and not diminishing at a satisfactory pace

Step 1

Commission report on the reasons behind the breach

Step 2

Council decision on opening EDP based on **Commission opinion**

Provides **recommendations, deadlines, targets**

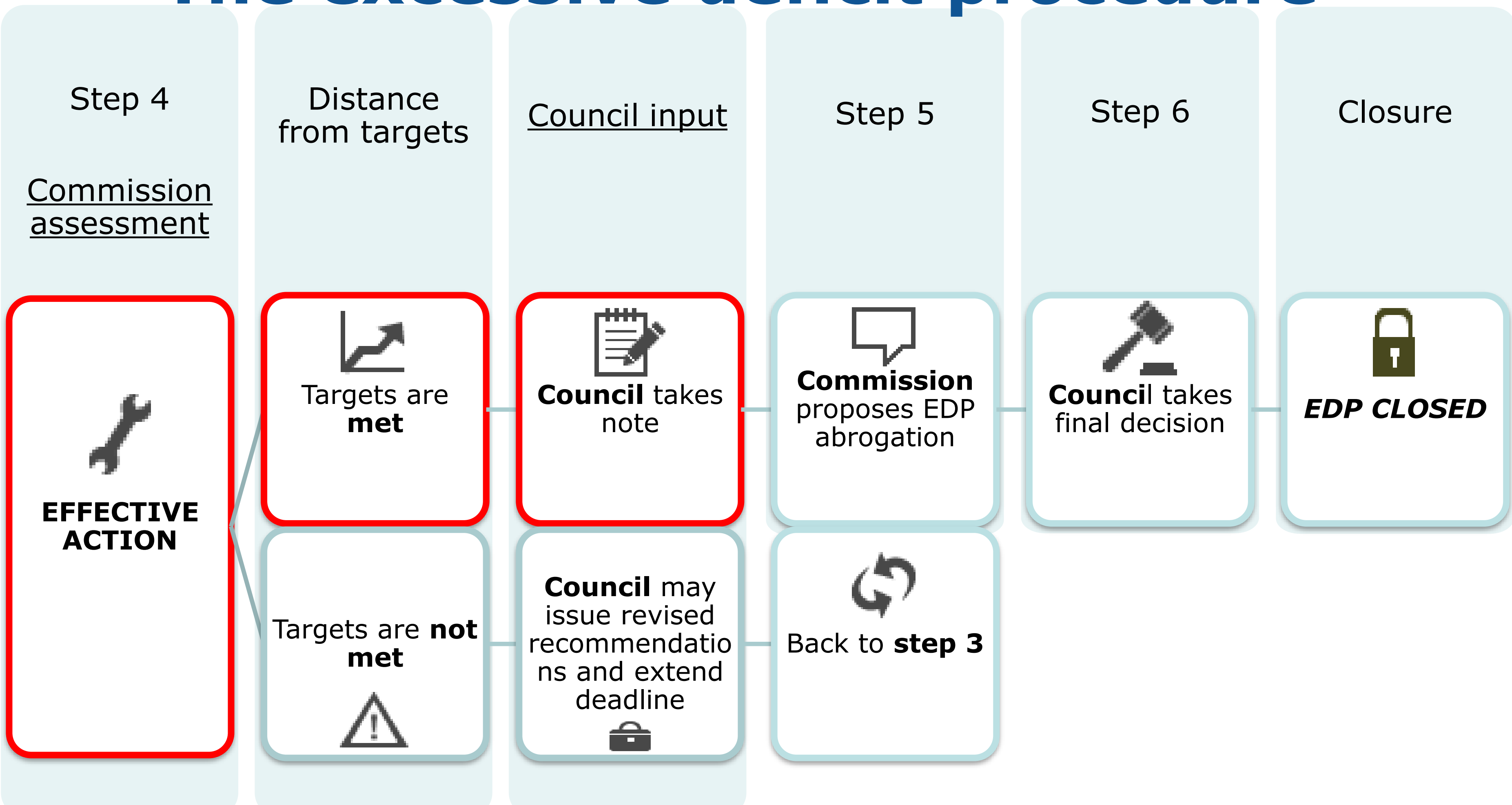
Step 3

MS has **3-6 months to comply** with recommendations

Step 4

Commission assesses **'effective action'** and informs the Council

The excessive deficit procedure



The excessive deficit procedure

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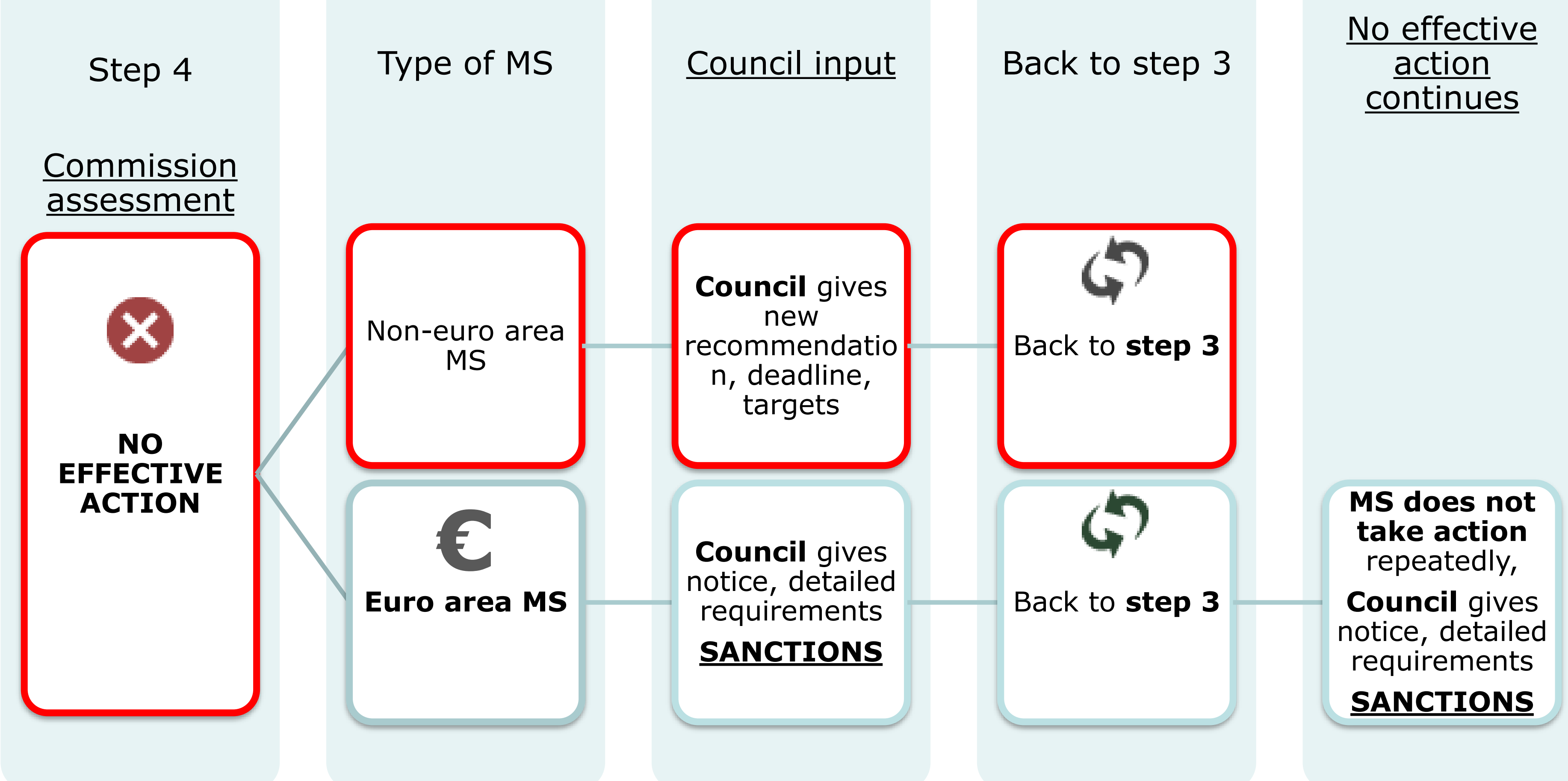

Step 4

Commission assessment

NO EFFECTIVE ACTION

Type of MS

Non-euro area MS

Euro area MS

Council input

Council gives new recommendation, deadline, targets

Council gives notice, detailed requirements **SANCTIONS**

Back to step 3

Back to **step 3**

Back to **step 3**

No effective action continues

MS does not take action repeatedly, **Council** gives notice, detailed requirements **SANCTIONS**

European Semester

- Every spring, on the basis of budgetary plans presented in Stability and Convergence Programmes and COM forecast:
  - **Ex post assessment of previous year (t-1)**
  - **In-year assessment (t)**
  - **Ex ante assessments (t+1 and beyond)**

- Assessment can trigger:
  - **Significant Deviation Procedure under Preventive Arm** (only ex post)
  - **Excessive Deficit Procedure** (if Treaty criteria not fulfilled) **or step-up**
  - **Sanctions**

- Fiscal CSRs for following year (for countries not yet at MTO):

"Achieve the medium-term budgetary objective in 2019."

"Ensure that the nominal growth rate of net primary government expenditure does not exceed x% in 2019, corresponding to an annual structural adjustment of x% of GDP."

Draft Budgetary Plans (euro area MS)

- Every autumn, on the basis of budgetary plans presented in Draft Budgetary Plans (by 15 October) and COM forecast:
  - **In-year assessment (t)**
  - **Ex ante assessment (t+1)**

- Assessment takes the form of COM Opinions
  - **Risk assessment** (“compliant”, “broadly compliant”, “risk of non-compliance”)
  - **Possibility of requesting <u>revised</u> Draft Budgetary Plan** (in case of particularly serious non-compliance with SGP)

Number of countries in excessive deficit procedure