The Stability and Growth Pact

Centrale Raad voor het Bedrijfsleven
Conseil Central de l’Economie

Brussels, 6 May 2021

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DG ECFIN, Fiscal Policy and Surveillance
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
Outline

1. Origins and legal base of the Stability and Growth 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
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?**

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

1. Origins and legal base of the Stability and Growth Pact
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Timeline of relevant changes

1997
Preventive arm enters into force
Stability and Growth Pact agreed

1998
Corrective arm enters into force

1999
First European Semester enters into force

2005
Structural Balance takes central stage

2008
'Response to the crisis' enters into force

2009
'Structural Balance' enters into force

2010
'Six-pack' enters into force

2011
'Two-pack' enters into force

2013
'Fiscal compact' agreed

2015
Communication Flexibility within existing rules

2017
Reflection Paper on Deepening the EMU

2018

Recession begins

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

- Headline balance
- Structural balance
- 3% deficit limit

% of GDP


Corrective arm
Preventive arm
Timeline of relevant changes

- **1997**: Stability and Growth Pact agreed
- **1998**: Preventive arm enters into force
- **1999**: Corrective arm enters into force
- **2005**: Structural Balance takes central stage
- **2008**: RECESION BEGINS
- **2010**: First European Semester
- **2011**: 'Fiscal compact' agreed
- **2012**: Two-pack enters into force
- **2013**: Six-pack enters into force
- **2015**: Communication Flexibility within existing rules
- **2017**: Reflection Paper on Deepening the EMU

Recession begins in 2008.
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

1997:
- Stability and Growth Pact agreed
- Preventive arm enters into force

1999:
- Corrective arm enters into force

2005:
- Structural Balance takes central stage

2008:
- First European Semester

2010:
- 'Fiscal compact' agreed
- Six-pack enters into force

2011:
- REcession begins

2012:
- Two-pack enters into force

2013:
- Communication Flexibility within existing rules

2015:
- Reflection Paper on Deepening the EMU

2017:
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)
Outline

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

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Aim of the preventive arm: a prudent fiscal policy

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

<table>
<thead>
<tr>
<th>Condition</th>
<th>Required annual fiscal adjustment</th>
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<tbody>
<tr>
<td></td>
<td>Debt ≤ 60% and no sustainability risk</td>
</tr>
<tr>
<td>Exceptionally bad times</td>
<td></td>
</tr>
<tr>
<td>Real growth &lt;0 or output gap &lt; -4</td>
<td>No adjustment needed</td>
</tr>
<tr>
<td>Very bad times</td>
<td></td>
</tr>
<tr>
<td>-4 ≤ output gap &lt; -3</td>
<td>0</td>
</tr>
<tr>
<td>Bad times</td>
<td></td>
</tr>
<tr>
<td>-3 ≤ output gap &lt; -1.5</td>
<td>0 if growth below potential, 0.25 if growth above potential</td>
</tr>
<tr>
<td>Normal times</td>
<td></td>
</tr>
<tr>
<td>-1.5 ≤ output gap &lt; 1.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Good times</td>
<td></td>
</tr>
<tr>
<td>output gap ≥ 1.5</td>
<td>&gt; 0.5 if growth below potential, ≥ 0.75 if growth above potential</td>
</tr>
</tbody>
</table>
Illustration: Member States’ distance to their MTO (2019)
Illustration: BE under the preventive arm

% of GDP


Legend:
- Blue: Headline balance
- Orange: Structural balance
- Black: 3% deficit limit
- Black Squares: MTO
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

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Year $t$</th>
<th>Average (Year $t$ and $t-1$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deviation SB</td>
<td>0.5%</td>
<td>0.25%</td>
</tr>
<tr>
<td>Deviation EB</td>
<td>0.5%</td>
<td>0.25%</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>Aim</th>
<th>Correct gross policy errors (“excessive deficits”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal basis</td>
<td>Art. 126 TFEU and Protocol 12 Regulation 1467/97</td>
</tr>
</tbody>
</table>
| 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 |

27
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 years
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

<table>
<thead>
<tr>
<th>When?</th>
<th>What?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening of the EDP</td>
<td>Non-interest-bearing deposit</td>
</tr>
<tr>
<td></td>
<td>0.2% of GDP</td>
</tr>
<tr>
<td>Failure to take effective action to correct the</td>
<td>Fine</td>
</tr>
<tr>
<td>excessive deficit</td>
<td>0.2% of GDP</td>
</tr>
<tr>
<td>Repeated failure to take effective action to</td>
<td>Fine</td>
</tr>
<tr>
<td>correct the excessive deficit</td>
<td>0.2% of GDP + variable component</td>
</tr>
</tbody>
</table>

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 temporarily to depart from the adjustment path towards the medium-term budgetary objective, 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 revised fiscal trajectory.”
More reading

SGP legislation


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

More reading

Preventive arm page

Excessive deficit procedure

Stability or convergence programmes

Draft budgetary plans
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

<table>
<thead>
<tr>
<th>Aim</th>
<th>Member States run prudent fiscal policies over the medium run</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal basis</td>
<td>Art. 121 TFEU, Regulation 1466/97</td>
</tr>
<tr>
<td>Objective</td>
<td>&quot;Close to balance or in surplus&quot;</td>
</tr>
<tr>
<td>Operationalization</td>
<td>Medium-term budgetary objectives (MTO)</td>
</tr>
<tr>
<td>Requirement</td>
<td>At the MTO or on the path towards it</td>
</tr>
<tr>
<td>Assessment</td>
<td>Structural budget balance + Expenditure benchmark</td>
</tr>
<tr>
<td>Process</td>
<td>European Semester; SCPs</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Significant deviation procedure</td>
</tr>
</tbody>
</table>
Illustration: Cyclical conditions

Modulation of the fiscal effort according to the economic cycle

- Normal times
- Good times
- Bad times
- Very Bad times
- Exceptionally bad times
Working of the preventive arm: 
*The structural balance*

- Central concept: *structural budget balance*

  \[ \Delta SB = \text{budget balance excluding the impact of the economic cycle and the impact of one-off factors} \]

  \[
  \begin{align*}
  \text{IF } \Delta SB > 0 & \implies \text{Fiscal position is improving} \\
  \text{IF } \Delta SB < 0 & \implies \text{Fiscal position is deteriorating}
  \end{align*}
  \]
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

**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

**Trigger:**
- Deficit > 3% of GDP
- Debt > 60% of GDP and not diminishing at a satisfactory pace
The excessive deficit procedure

- **Step 4**: Commission assessment
  - **EFFECTIVE ACTION**
    - Targets are **met**
    - Targets are **not met**

- **Step 5**: Council input
  - **Council** takes note
  - **Council** proposes EDP abrogation
  - **Council** takes final decision

- **Step 6**: EDP CLOSED
  - Council may issue revised recommendations and extend deadline
  - Back to **step 3**

44
The excessive deficit procedure

Step 4: Commission assessment
- Targets are met: EFFECTIVE ACTION
- Targets are not met: Council may issue revised recommendations and extend deadline

Step 5: Council input
- Council takes note
- Commission proposes EDP abrogation
- Council takes final decision

Step 6: Council takes final decision
- EDP CLOSED

Closure

- Step 3
- Back to step 3
The excessive deficit procedure

Step 4
Commission assessment

NO EFFECTIVE ACTION

Type of MS
Non-euro area MS

Council gives new recommendation, deadline, targets

Back to step 3

Council gives new recommendation, deadline, targets

Back to step 3

Council gives new recommendation, deadline, targets

Back to step 3

Council gives new recommendation, deadline, targets

Back to step 3

No effective action continues

Euro area MS

SANCTIONS

SANCTIONS

SANCTIONS

SANCTIONS

€

MS does not take action repeatedly, Council gives notice, detailed requirements
Step 4
Commission assessment

Type of MS
Non-euro area MS

Council input
Council gives new recommendation, deadline, targets

Back to step 3

No effective action continues

Euro area MS
Council gives notice, detailed requirements SANCTIONS

Back to step 3

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."
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 revised Draft Budgetary Plan** (in case of particularly serious non-compliance with SGP)
Number of countries in excessive deficit procedure

% of GDP