

## How could the Stability and Growth Pact be simplified?

*This note provides a summary of three external papers requested by the ECON Committee in the context of the Parliament scrutiny activities of the Euro area. The main objective of these papers is to elaborate on how the fiscal rules of the Stability and Growth Pact could be simplified, in order to enhance its credibility, transparency and enforceability, while allowing some room for flexibility. Several EU institutions have recognised the complexity of the SGP and the consequent need for simplification: some of these positions are mentioned in this note as well.*



**Carlo Cottarelli** (Director, Observatory on Public Accounts Cattolica University) argues in his [paper](#) that the complexity of the SGP, which may have contributed to its limited effectiveness, reflects largely the conflict between the need to make the original SGP rules more stringent and the desire to allow flexibility with respect to various country circumstances. Now that the effects of the largest economic shock since the 1930s are fading away, a major simplification of the system could be achieved by removing some margins of flexibility, without changes in the legislation. Other solutions would require legal changes, including relaxing some of the SGP long-term parameters or reconsidering the coexistence of the MTO rule and the expenditure benchmark. A more radical approach would be shifting to a single rule in which an “operational target” responds to deviations of public debt from its long-term objective.

**Friedrich Heinemann** (Centre for European Economic Research, ZEW, Mannheim and University of Heidelberg) acknowledges in his [paper](#) that past reforms of the SGP have improved its economic rationale, but this progress has come at the expense of simplicity, transparency and, possibly, enforceability.

His study evaluates reform models that could reduce complexity without compromising the SGP’s indispensable flexibility. From a holistic perspective, the greatest potential for simplification will result from a shift of discretionary power to an independent fiscal institution. Independence is a substitute for complexity.

With a narrower focus on the potential streamlining of the SGP and a reduction of excess complexity, first, the preventive and corrective arms could be integrated into one procedure. Second, this integrated procedure should be centred on a net expenditure rule that is combined with a debt feedback mechanism and a memory for expenditure overruns. Third, further fiscal indicators that are currently treated as parallel targets (headline deficit rule and structural balance) could be downgraded to non-binding reference values. And fourth, the planned transposition of the Fiscal Compact into European law should follow SGP reforms, in order to promote consistency between European and national fiscal rules.

**George Kopits** (Woodrow Wilson Center and Portuguese Public Finance Council) states in his [paper](#) that an assessment of the present SGP fiscal rules reveals a significant deterioration in simplicity,



undermining their effectiveness. In fact, in both design and process, they have become the most complex framework worldwide.

Three options for future reform are offered by him to correct this deficiency. Under the first, the structural balance and the debt convergence targets are replaced with a debt-stabilizing or -reducing primary surplus target, while retaining the expenditure benchmark. The second consolidates all current rules into a single operational debt rule by setting a limit on the discretionary budget deficit, derived from the debt reduction target. The third option consists of a market-based approach, which implies essentially an autonomous regime of rules, in contrast to coordinated or centralized regimes.

### Recent positions taken in the public domain

- After the [Eurogroup meeting](#) of December 2017, its President concluded: *“As regards fiscal governance, there was broad agreement that the credibility of our fiscal framework should be enhanced by making it more effective, less complex, and by increasing shared ownership while some have been advocating a stronger reliance on developing market-based fiscal discipline mechanisms. In my view, a possible way forward, which could merit further discussions, could be to ask a high-level working group of independent experts to provide advice along those criteria.”*
- The [“Further step towards completing the EMU: a roadmap”](#), published by the **Commission** on 6 December 2017, reads: *“Finally, the need to capture the diversity of economic circumstances, which was particularly pronounced during the crisis years, has brought more sophisticated but also more complex fiscal rules at EU level over time. At times, this can play against national ownership of reforms and effective implementation. Stronger economic, fiscal and financial integration, together with market discipline, should pave the way for a review of the EU fiscal rules in the longer term, with the aim of a substantial simplification by 2025.”*
- The [European Fiscal Board Annual Report 2017](#) includes the following recommendations:
  - Under the corrective arm of the SGP, allow for updating EDP recommendations in the event of an unexpected improvement of economic conditions. This would enhance the symmetry of rules and prevent a recurring practice to replace structural adjustments with budgetary windfalls.
  - Under the preventive arm of the SGP, require Member States to compensate for past deviations from the adjustment path towards the medium-term budgetary objective (MTO). This would prevent Member States from systematically planning deviations within the allowed margins.
  - Broaden and simplify the use of macroeconomic conditionality in the EU budget in order to strengthen the enforcement of the rules and safeguard the effectiveness of EU finances.
  - Introduce in the SGP a link to the Macroeconomic Imbalance Procedure (MIP) by regulating the speed of adjustment towards the MTO in relation to Member States' macroeconomic imbalances. This would address the risks that imbalances may pose to fiscal sustainability.
  - Reduce the complexity of the SGP, while introducing well defined escape clauses to be triggered and applied with the involvement of independent judgement. This would serve the triple aim of simplifying rules, safeguarding flexibility and enhancing transparency.

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