

An overview of the Stability and Growth Pact - September 2019

The Stability and Growth Pact (SGP) is the legal framework (based on primary and secondary EU law) that seeks to ensure sustainable public finances in the interest of the stability of the Economic and Monetary Union (EMU). It consists of two main building blocks: the preventive arm and the corrective arm. Stylised overviews, including on flexibility provisions (endorsed by the Council) within the existing rules of the SGP, are provided in the annexes.

The main sources used in this briefing are primary Union law (Articles 121 and 126 of the Treaty on the Functioning of the European Union), secondary Union law (the amended Regulations (EC) 1466/97 and 1467/97 as well as the Regulation (EU) No 1173/2011), the Code of Conduction on the implementation of the SGP and the Commission Communication entitled 'Making the best use of flexibility within the existing rules of the SGP'.

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 \(SGP\)](#). In particular, these provisions stipulate that each Member State must have a differentiated **medium-term objective (MTO)** for its budgetary position. The MTO is a budget balance in structural terms (see Box 1) which has to fulfil the following criteria:

- *it should be close to balance or in surplus;*
- *it shall provide a safety margin with respect to the 3 % of GDP government deficit ratio;*
- *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 must be revised every 3 years and may be further revised in the event of a new structural reform with a major impact on the sustainability of public finances.*

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](#); currently, only Denmark belongs to the ERM II) must be

Box 1: Structural budget balance

The structural budget balance is the main indicator used for assessing progress towards MTOs under the preventive arm and effective action under the corrective arm of the SGP. Within the methodology used in the SGP, it corresponds to a **nominal budget balance adjusted by the cyclical component and excluding one-off and temporary policy measures**. The cyclical component is calculated as the product of the output gap (difference between actual and potential GDP as % of potential GDP) and a parameter reflecting the automatic reaction of the government balance to an output gap change.

For more details on the definition, see pp 8/9 of the 2019 [Vademecum on the SGP](#).

As it is based on estimates of the potential output, the structural balance is vulnerable to uncertainty and revisions (see separate [EGOV note](#)).



specified within a defined range between -1% of GDP and balance or surplus (see Box 2).

Member States which have not yet achieved their MTO should **improve their structural balance by 0.5% of GDP per year as a benchmark** (more in the 'good times' and less in the 'bad times'). The Commission judgment whether a '**significant deviation**' exists is based on an "*overall assessment with the structural balance as the reference, including an analysis of the expenditure net of discretionary revenue measures*" which proves that the deviation (from the MTO or from its adjustment path) amounts to 0.5% of GDP in 1 year or cumulatively over 2 years. In case the Commission establishes the existence of such a deviation, it triggers a **Significant Deviation Procedure** (SDP), which starts with a Commission warning to the Member State in question and can lead - if the Member State concerned belongs to the euro area - to an interest-bearing deposit (see below section on sanctions).

Box 2: Difference between the balanced budget rules in the SGP and the Fiscal Compact

The allowed ranges in which the country-specific MTOs are 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).

In February 2016, the ECOFIN Council endorsed - on the basis of a Commission Communication of January 2015 entitled '[Making the best use of flexibility within the existing rules of the SGP](#)' - a "**commonly agreed position on flexibility within the SGP: Flexibility for cyclical conditions, structural reforms and investment**" which was subsequently annexed to the [code of conduct on the implementation of the SGP](#) (latest update: February 2017); the new elements of the position agreed by the Council include: (a) a matrix specifying the 'good times' and 'bad times' and the corresponding appropriate fiscal adjustments; (b) specifications on the "structural reform clause" and the "investment clause" allowing temporary deviations from the adjustment path towards the MTO; for each of both clauses the allowed temporary deviation does not exceed 0.5 % of GDP and the cumulative temporary deviation granted under the both clauses shall not exceed 0.75 % of GDP.

In accordance with the regulation on the preventive arm and the above specifications on the structural reform and investment clauses, **temporary deviations from the MTO** or the adjustment path towards it may be allowed in the following cases:

A) Major structural reforms (e.g. pension reforms) which have a verifiable long-term (positive) impact on the public finances including by raising potential sustainable growth. The following conditions for granting the clause must also be met: the deviation from the MTO or the adjustment path does not exceed 0.5% of the GDP, the MTO is reached within the four-year programme period and an appropriate safety margin is continuously preserved so that the deviation from the MTO or the agreed adjustment path does not lead to deficit greater than the 3 % GDP reference value; furthermore, the reforms must be implemented, adopted or presented in a medium-term structural reform plan which is comprehensive and detailed.

Certain **public investments** are also considered as '*structural reforms*' that would allow Member States to deviate temporarily from their MTO or adjustment path towards it under the following conditions: GDP growth is negative or GDP remains well below its potential; the deviation does not lead to a deficit greater than the 3 % 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 under this so-called "investment clause" include 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.¹ The Commission stated in its 2015 Communication on flexibility that it will apply the ‘investment clause’ without the previously existing condition of a large negative output gap in the euro area or EU as a whole.

The following two clauses allow temporary deviations from the MTO, they do not endanger fiscal sustainability in the medium term.

B) An unusual event outside the control of the Member State concerned which has a major impact on the financial position of the government.

C) Periods of severe economic downturn for the euro area or the Union as a whole. A severe economic downturn is defined as a negative real growth of GDP or as an accumulated loss of output during a protracted period of very low real growth of GDP relative to its potential.

Each set of country-specific recommendations (CSRs) adopted annually by the Council includes a recommendation (‘fiscal effort in structural terms’²) 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 the possibility of [sanctions](#) for euro area Member States.

The current SGP rules also include an **expenditure benchmark**, according to which growth of public expenditure (net annual public expenditure growth corrected - inter alia - for discretionary revenue measures, revenue measures mandated by law and one-offs) shall not exceed medium-term potential GDP growth; for Member States that have not yet reached MTO, net expenditure growth shall not exceed a rate **below** the medium-term rate of 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 current version of the [‘Code of Conduct’ on the SGP implementation](#) contains two opinions - of November 2016 - of the Economic and Financial Committee (EFC), which put a stronger focus on the expenditure benchmark, while the structural balance indicator remains an essential part of the fiscal surveillance framework.

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 account³.

If the Council decides, on the basis of a Commission recommendation, that a deficit is excessive, the Council issues a 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**

¹ However, the Council’s Legal Service stated in a non-public opinion (Ref. 7739/15) that it is ‘*legally not feasible to establish ex-ante on the basis of rough presumptions, as the Communication does, that all co-financing expenditure by Member States in those projects amounts to structural reforms [...] and that ‘a case-by-case examination, where consideration is given to whether the [...] project in question aims at [...] the implementation of structural reforms, should be made in order for the flexibility clause to be applied’.*

² However, the required fiscal effort in the preventive arm is not clearly specified in numerical terms in the respective CSRs.

³ 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 should make sufficient progress towards compliance with the benchmark.

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 of January 2015 entitled '[Making the best use of flexibility within the existing rules of the SGP](#)', the Commission stated that intends to 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.⁴ These Commission considerations have however not been fully taken up by the Council:

- The Council's Legal Service has taken a slightly stricter view than the Commission on "dedicated structural reform plans".⁵ The so-called 'investment clause' which is place in the preventive arm of the SGP (see above), is not applicable in the corrective arm of the SGP.
- The current version of the '[Code of Conduct](#)' on the SGP implementation , adopted by the Member States in the ECOFIN Council in May 2017 does **not mention that structural reforms (including investments) are relevant in the context of the EDP**. However, It contains an annex (adopted by the Economic and Financial Committee on 29 November 2016 and endorsed by the ECOFIN in November 2016) called "improving the assessment of effective action in the context of the EDP - a specification of the methodology" which focuses on the introduction/implementation of the expenditure benchmark in the EDP; in that context it **contains implicitly structural reforms, namely on the revenue side**, which can increase the amount of allowed government expenditure: *"For a government action to be considered as a discretionary revenue measure with a permanent effect, it should be: (i) an **autonomous intervention by the government**; (ii) **enacted or credibly announced in sufficient detail**; and (iii) **with a direct budgetary impact**. On the contrary, commitments or targets (e.g. deficit targets, deficit rules) which are not underpinned by specific measures to achieve them should not be considered discretionary revenue measures."*

The Council may decide, on the basis of 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:

- 'effective action' has been taken by the Member State owing to unexpected adverse economic events with major unfavourable consequences for government finances
- 'severe economic downturn in the 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 the possibility of [sanctions](#) for euro area Member States and in the case of repeated failure to take effective action to correct the excessive deficit even for all EU Member States. According to the above mentioned Communication, the Commission considers it an aggravating relevant factor, if agreed reforms are not implemented.

⁴ This argument had already been applied in February 2015, when the Commission proposed extending the deadline for France in order for it to correct its excessive deficit by two instead of one year (the latter is the rule), given that France had previously published a reform agenda (for further information on this case, see separate [EGOV note](#)).

⁵ A non-public opinion (Ref. 7739/15) from the Council's Legal Service provides some limitations by stating that major structural reforms would qualify as a relevant factor when deciding about the opening of an EDP or about the deadline for the correction 'as long as they were adopted by the national authorities through provisions of binding force [...]'. In the view of the Council's Legal Service, a plan announcing upcoming reforms, as a simple manifestation of political intentions or of wishes, would not fulfil the application of Article 5(1) of Council Regulation (EC) No 1467/97.

⁶ The February 2015 Commission assessment of effective action under the EDP in the case of France only covered the years 2013 and 2014 instead of the entire correction period (2013-2015) as specified in the Council recommendation of 21 June 2013. For 2015, the Council recommendation for France does not include an assessment of effective action. Furthermore, the extension of the deadline for correction was based on the assessment by the Commission services

Box 3: Assessment of ‘effective action’

In the corrective arm, progress by Member States is measured on the basis of ‘fiscal effort’ in structural terms¹. 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. whether ‘effective action’ has been taken or not) has several steps:

First, the annual change in the structural budget balance is assessed to see if it is in line with the required fiscal effort (a ‘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 in 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 this regard, the [Code of Conduct on the SGP implementation](#) as adopted by Member States in the EFC (see page 45 of the Code of Conduct) in May 2017, states **“If the Member States fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, or both, a careful analysis of the reasons of the shortfall will be undertaken. The careful analysis is, therefore, a centrepiece in the assessment of effective action. The careful analysis first uses the expenditure benchmark to assess fiscal effort. All in all, the aim of the careful analysis is to provide an adequate estimation of the extent of policy actions, to evaluate whether the Member State concerned has delivered on its policy commitments as set in the EDP recommendation (...). If the expenditure benchmark is not met, there is a presumption the Member State has not delivered on its policy commitments. The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments.”**

Furthermore, the [Code of Conduct on the SGP implementation](#) includes that:

- 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;
- with respect to multi-annual EDPs, the Commission examines whether the **overall fiscal effort over the EDP correction period** is delivered in order to balance – at least partially – the asymmetry in the assessment. However, or can be noted that this approach has not always been applied⁶.

Possible sanctions in the preventive and corrective arms

It should be noted that the first three sanctions in the table below (i.e. those applicable to euro area members only) 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 the end of 2013) implies, both for euro area and non-euro area Member States, possible suspensions of up to five European structural and investment funds in the event of failure or repeated failure to take effective action under the SGP.

that ‘the available evidence does not allow to conclude on no effective action’. This implies that the Commission de facto interprets that ‘effective action’ has taken place as it proposed an extension to the deadline for correction.

When?	What?
Adjustment towards the MTO/expenditure rule not respected (preventive arm)	Interest-bearing deposit [euro area members] 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 [euro area members] 0.2% of GDP
Failure to take effective action to correct the excessive deficit	Fine [euro area members] 0.2% of GDP deficit
Repeated failure to take effective action to correct the excessive deficit	Fine [EU members] 0.2% of GDP + variable component

Reports on the application of the current rules

The regulations governing both arms of the Pact⁷ contain the following review clause:

"1. By 14 December 2014 and every 5 years thereafter, the Commission shall publish a report on the application of this Regulation. That report shall evaluate, inter alia:

(a) the effectiveness of this Regulation, particularly whether the provisions governing decision-making have proved sufficiently robust;

(b) the progress in ensuring closer coordination of economic policies and sustained convergence of economic performances of the Member States in accordance with the TFEU.

2. Where appropriate, this report shall be accompanied by a proposal for amendments to this Regulation, including to the decision-making procedures.

3. The report shall be forwarded to the European Parliament and the Council".

The Commission (in February 2019) has informed ECON that it *"intends to use the opportunity of the reviews for a comprehensive and holistic assessment of the economic and fiscal rules"*. On the basis of the academic debate on the SGP, such a holistic assessment could inter alia cover the following elements:

- The effectiveness of the Stability and Growth Pact, including the role of the European Parliament vis a vis the European Fiscal Board, which is responsible, inter alia, for providing its views on the euro area fiscal stance;
- The complexity of the rules;
- Issues linked to measurement (especially potential output and the output gap);
- Pro-cyclical elements of national fiscal economic policies and the limitations of the European fiscal framework to address them;
- The possibility to take better into account productive/sustainable investments (also in the context of the implementation of EFSI / InvestEU programme);
- Other ways to smoothing the economic cycles with a specific budget for the euro area and/or national fiscal buffers.

⁷ See: Regulation (EC) No 1466/97 (preventive arm) and No 1467/97 (corrective arm).

For further information:

- [2019 Commission guide on the SGP](#)
- [2018 Commission guide on the SGP](#) (more comprehensive than the 2019 version)
- Communication "[Making the best use of flexibility within the existing rules of the SGP](#)"
- [Code of Conduct on the SGP implementation, as adopted by the Council](#)
- [Regularly updated EGOV briefing on implementation of the SGP](#)
- [Regularly updated EGOV briefing on structural balances](#)
- [EGOV factsheet "The EU framework for fiscal policies"](#)

Annexes:

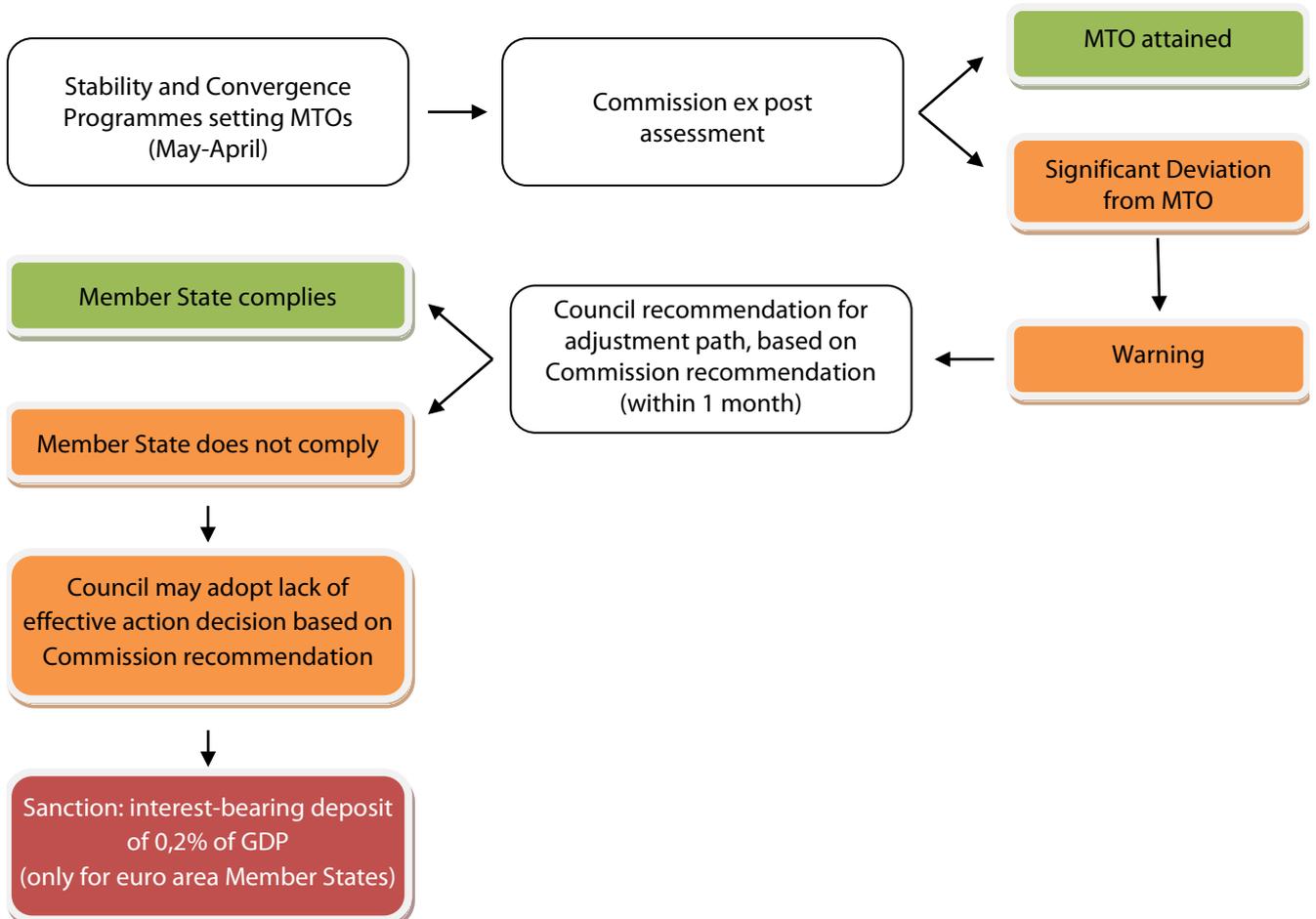
- Annex 1 - Steps under the preventive arm of the SGP
- Annex 2 - Steps under the corrective arm of the SGP
- Annex 3 - Preventive arm of the SGP: "flexibility" elements
- Annex 4 - Corrective arm of the SGP: "flexibility" elements

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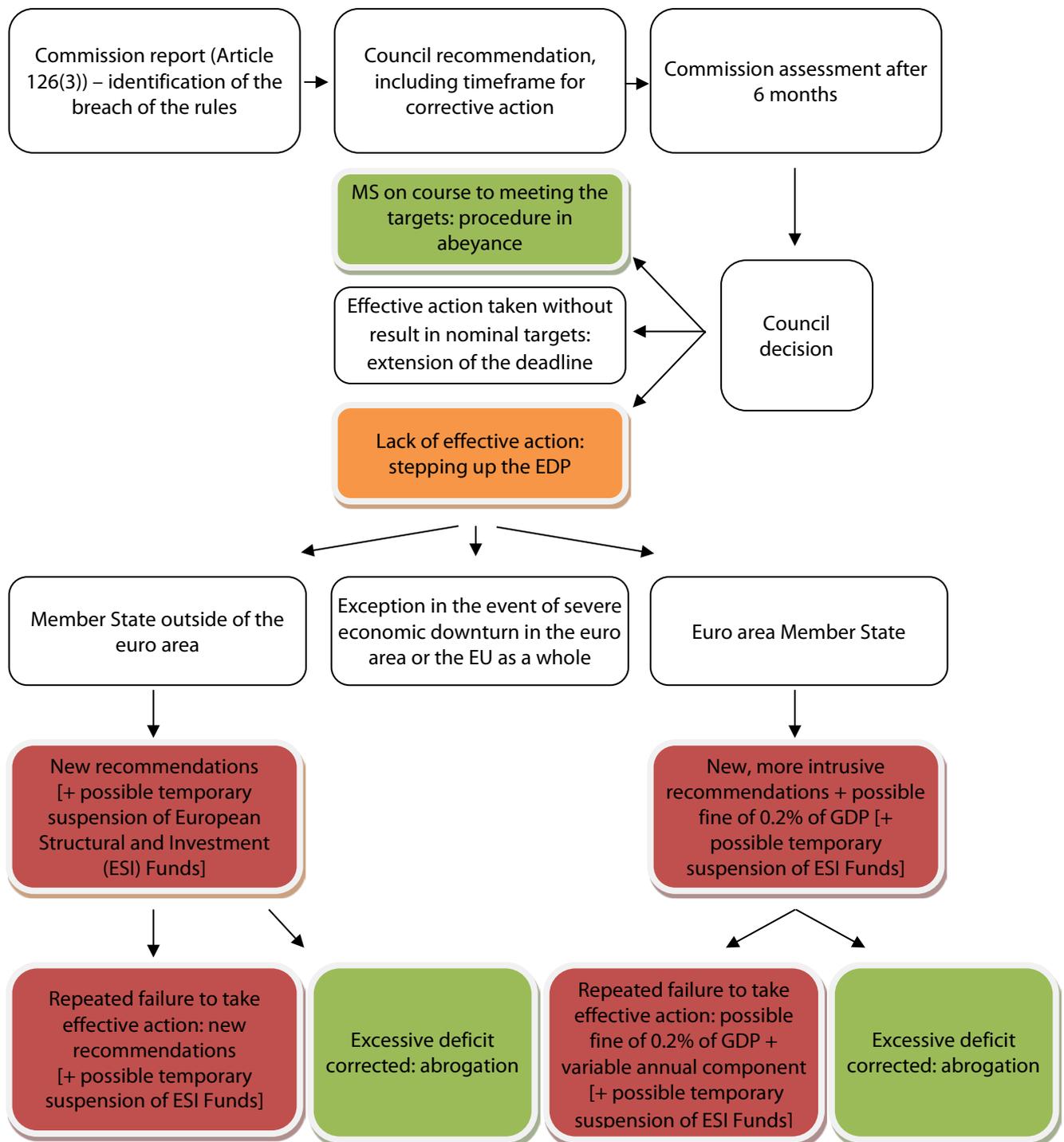
Contact: egov@ep.europa.eu

This document is available on the internet at: www.europarl.europa.eu/supporting-analyses

Annex 1: Steps under the preventive arm of the SGP

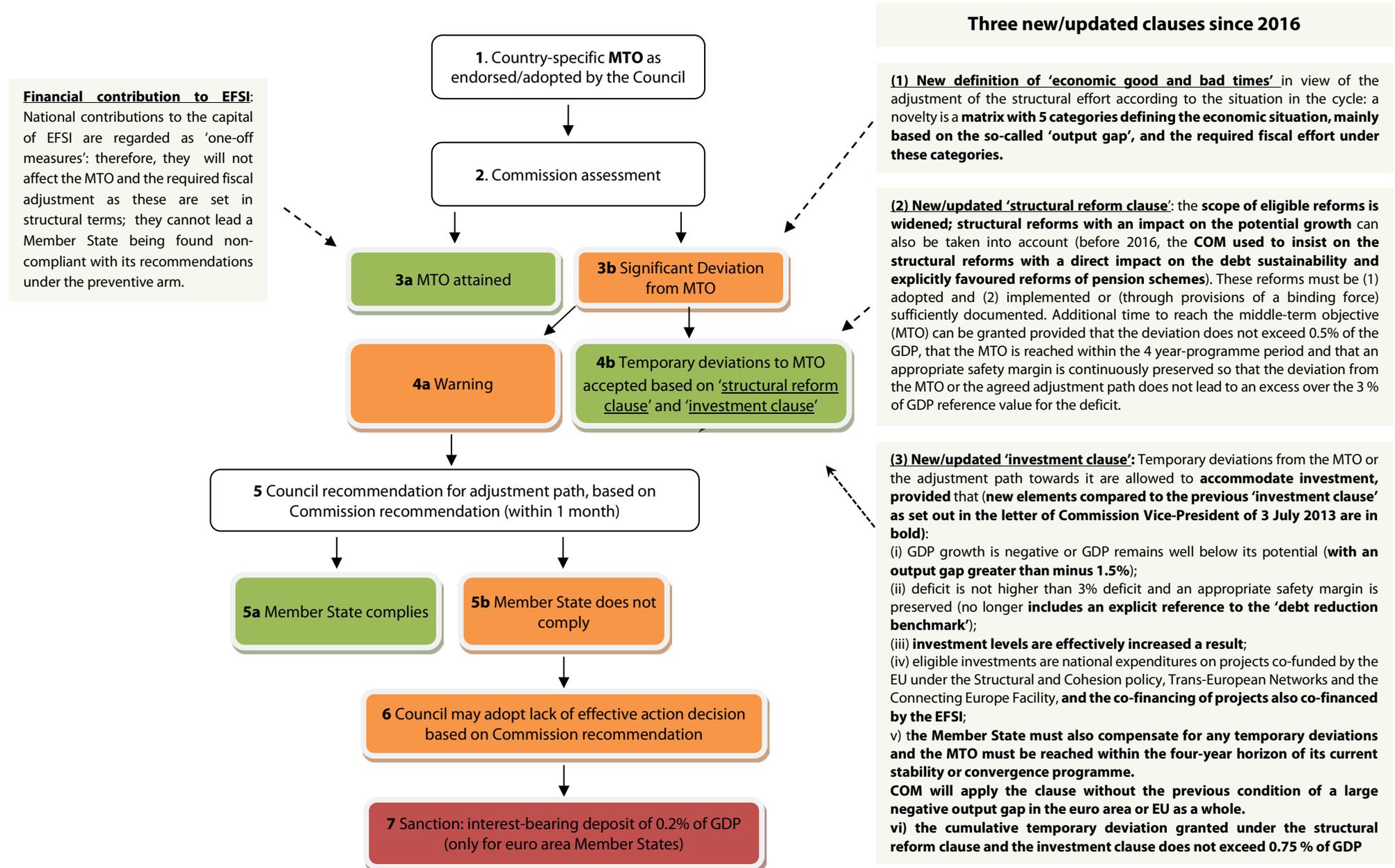


Annex 2: Steps under the corrective arm of the SGP

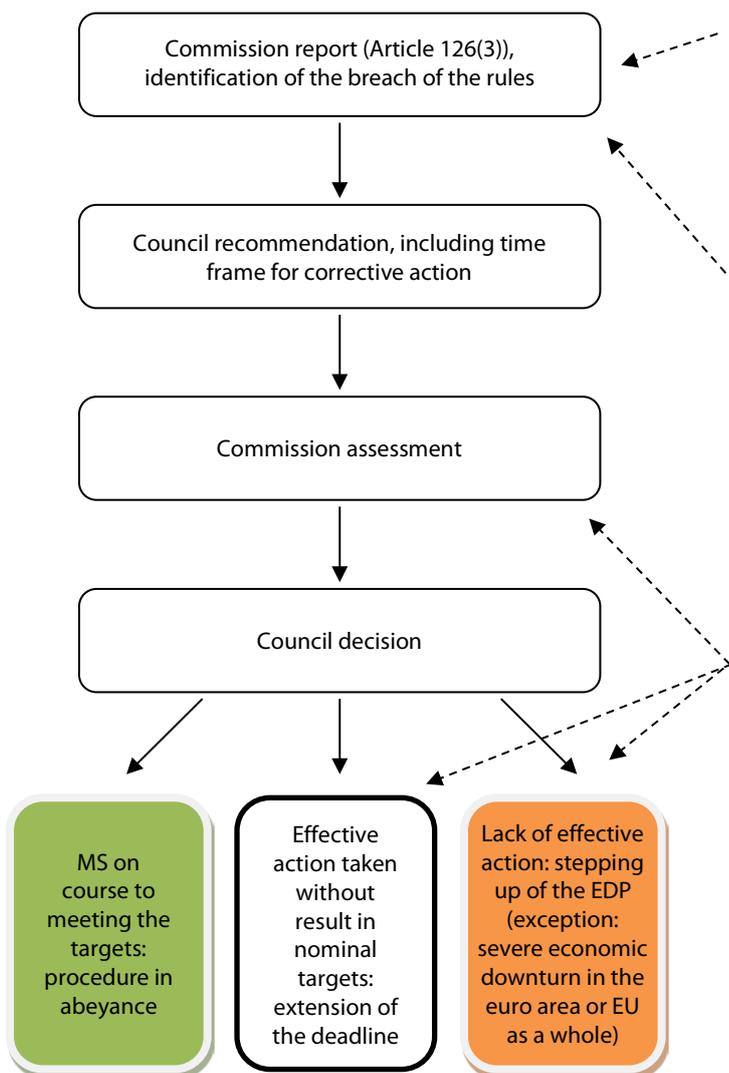


Note: The possible suspensions of up to five ESI funds are in square brackets, since they are formally not belonging to the SGP but to the so-called regulation on macro-economic conditionality of 5 European Structural and Investment Funds [[Regulation \(EU\) No 1303/2013](#)]

Annex 3: Preventive arm of the SGP: ‘flexibility’ elements (as endorsed by the Council in 2016)



Annex 4: Corrective arm of the SGP: 'flexibility' elements (as endorsed by the Council in 2016)



National Contributions to EFSI: a) In case of a non-respect of the deficit or debt reference values, the Council and the Commission will consider the contributions to the capital of EFSI to be a 'relevant factor' in line with Article 2(3) of Regulation (EC) No 1467/97 → An EDP will not be launched if this non-respect is due to the contribution and if the excess over the reference value is small and is expected to be temporary. b) Like in the preventive arm, national contributions to EFSI can be calculated as one-off expenditures, so that compliance with the fiscal adjustment effort (measured in structural terms) recommended by the Council would not be affected. A contribution to the EFSI should therefore not lead to a Member State being found non-compliant with its EDP recommendation.

The following elements of the Commission communication on flexibility of 2015 **has not been included in the flexibility provisions endorsed by the Council in 2016:** a) the Commission will take into account **structural reforms** or well documented plans for such reforms as relevant factors when opening or not an EDP and when setting the timeline for the correction; b) the **scope of eligible reforms is widened, given that structural reforms with an impact on the potential growth** can also be taken into account (before 2016, the COM used to insist on the structural reforms with direct long-term positive budgetary effects and explicitly favoured reforms such as for pension

The following elements of the Commission communication on flexibility of 2015 **have not been included in the flexibility provisions endorsed by the Council in 2016:**

- The Commission will take into account **structural reforms or well documented plans** for such reforms as relevant factors when proposing the extension the deadline of an ongoing EDP, if effective action has been taken by the Member State concerned.

- If agreed reforms are not implemented, the Commission will consider it **an aggravating relevant factor** when assessing effective action in response to the EDP recommendation and when setting a deadline for the correction of the excessive deficit.