BRIEFING

Stability and Growth Pact – An Overview of the Rules

*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. The main new or updated elements introduced by the Commission Communication entitled '**Making the best use of flexibility within the existing rules of the SGP**' are summarised in overviews provided in the annexes.*

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 (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 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.*

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 full potential.

In line with the methodology used in the EU fiscal framework, the cyclical component of the budget is subtracted from the actual budget balance. 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 budget 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

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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)) must be specified within a defined range between -1% of GDP and balance or surplus.

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 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).

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 has specified in its Communication of January 2015 entitled 'Making the best use of flexibility within the existing rules of the SGP' that it will apply a matrix specifying the 'good times' and 'bad times' and the corresponding appropriate fiscal adjustments. In the event 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 give an 'early warning'.

Temporary deviations from the MTO or the adjustment path towards it may be allowed in cases where:

(1) ***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 provided that the 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. In its Communication entitled 'Making the best use of flexibility within the existing rules of the SGP', the Commission specified that the reforms must be implemented, adopted or presented in a medium-term structural reform plan which is comprehensive and detailed.[1]

It also stated in the abovementioned Communication that it will regard certain ***public investments*** *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

[1] On this issue, the Council's Legal Service stated in a non-public opinion (Ref. 7739/15) that '*both the Regulation 1466/97 and the (...) Code of Conduct presuppose a form of implementation of the major structural reform in question (...). This would require their adoption by the national authorities through provisions of a binding force (...). 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 Regulation 1466/97, as interpreted by the Code of Conduct.*'

the Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Fund for Strategic Investments.[2] The Commission stated in the Communication 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.

(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 deficit is provided.

Each set of country-specific recommendations (CSRs) adopted annually by the Council includes a recommendation ('fiscal effort in structural terms'[3]) 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 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[4].

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

[2] 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*'.
[3] However, the required fiscal effort in the preventive arm is not clearly specified in numerical terms in the respective CSRs.
[4] 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.

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 of January 2015 entitled '*Making the best use of flexibility within the existing rules of the SGP*' the Commission announced that it 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.[5] The Council's Legal Service has taken a slightly stricter view on this.[6] 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 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:

(i) '*effective action*' has been taken by the Member State owing to unexpected adverse economic events with major unfavourable consequences for government finances

(ii) '*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. According to the above mentioned Communication, the Commission will consider it an aggravating relevant factor, if agreed reforms are not implemented.

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[7]. 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.

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[5] 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).

[6] 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.

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

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 the '***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. With respect to multi-annual EDPs, the terms of reference stipulate that '*in forthcoming assessments of effective action, the Commission will examine whether the overall fiscal effort over the EDP correction period is delivered in order to balance – at least partially – the asymmetry in the assessment'* (page 18 of the document 10945/1/14 REV 1 ADD belonging to the terms of reference). While the Commission reiterated this approach in its Report on Public Finances in the EMU 2014 (page 39), 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 Commission draft recommendation and the revised Council recommendation (March 2015) for France do not include an assessment of effective action. Furthermore, the extension of the deadline for correction was based on the assessment by the Commission services 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. This is the first time the Commission based its recommendation on such a premise, thus establishing a precedent for future assessments of effective action under the provisions of the SGP. In particular, this may have consequences for the assessment of effective action under the preventive arm of the SGP, as the variables (notably the 'output gaps') against which fiscal effort is measured are non-observerable.

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

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 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.

Report on the application of the current rules

As required by the regulations governing both arms of the Pact[8], at the end of 2014, the Commission published a report on the application of the rules and forwarded it to 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 Member States concerned have attained or have 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 the 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.

For further information:

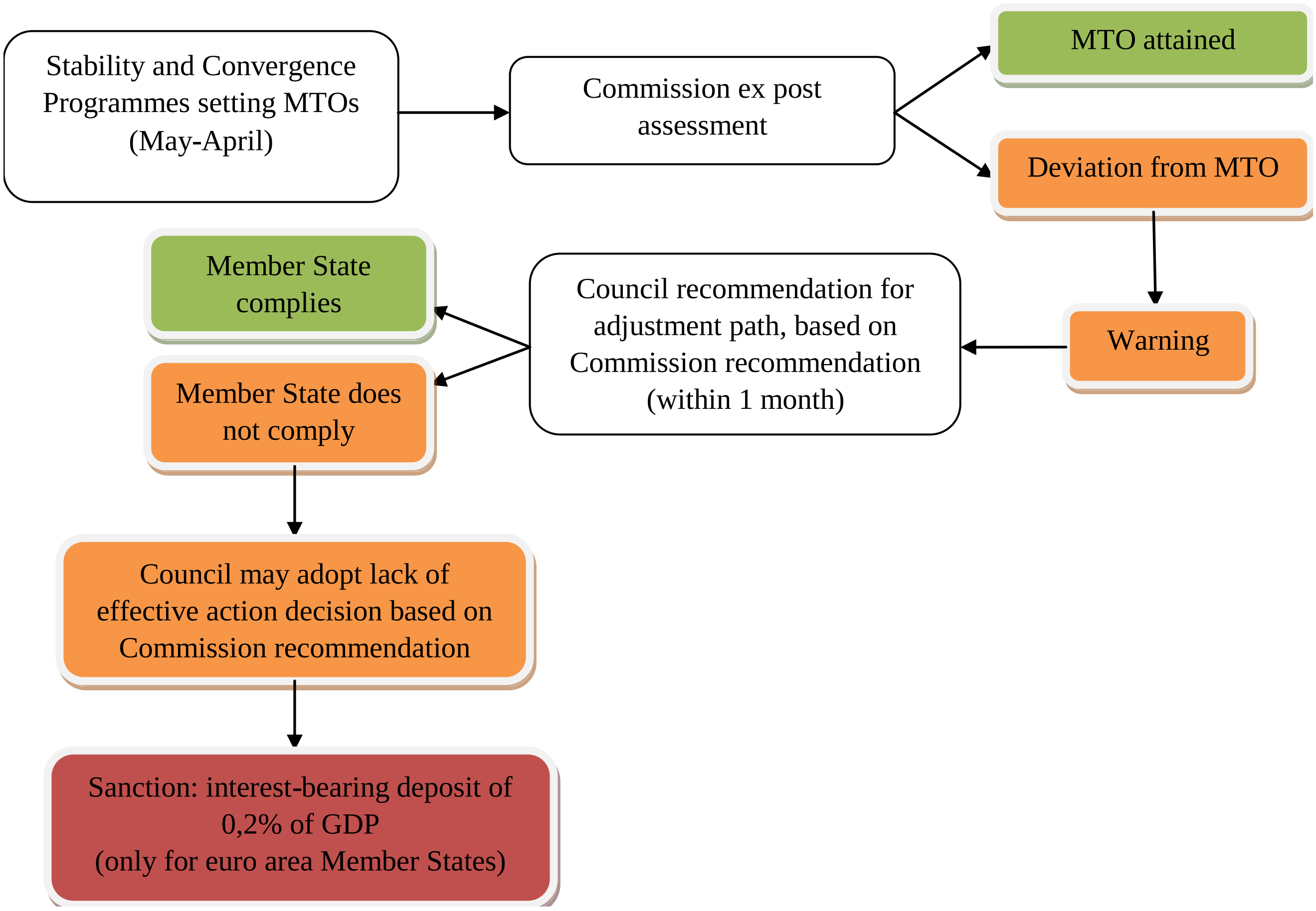
- *Communication "Making the best use of flexibility within the existing rules of the SGP":* http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
- *Code of Conduct as adopted by the Council:* http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf
- *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

Annexes:

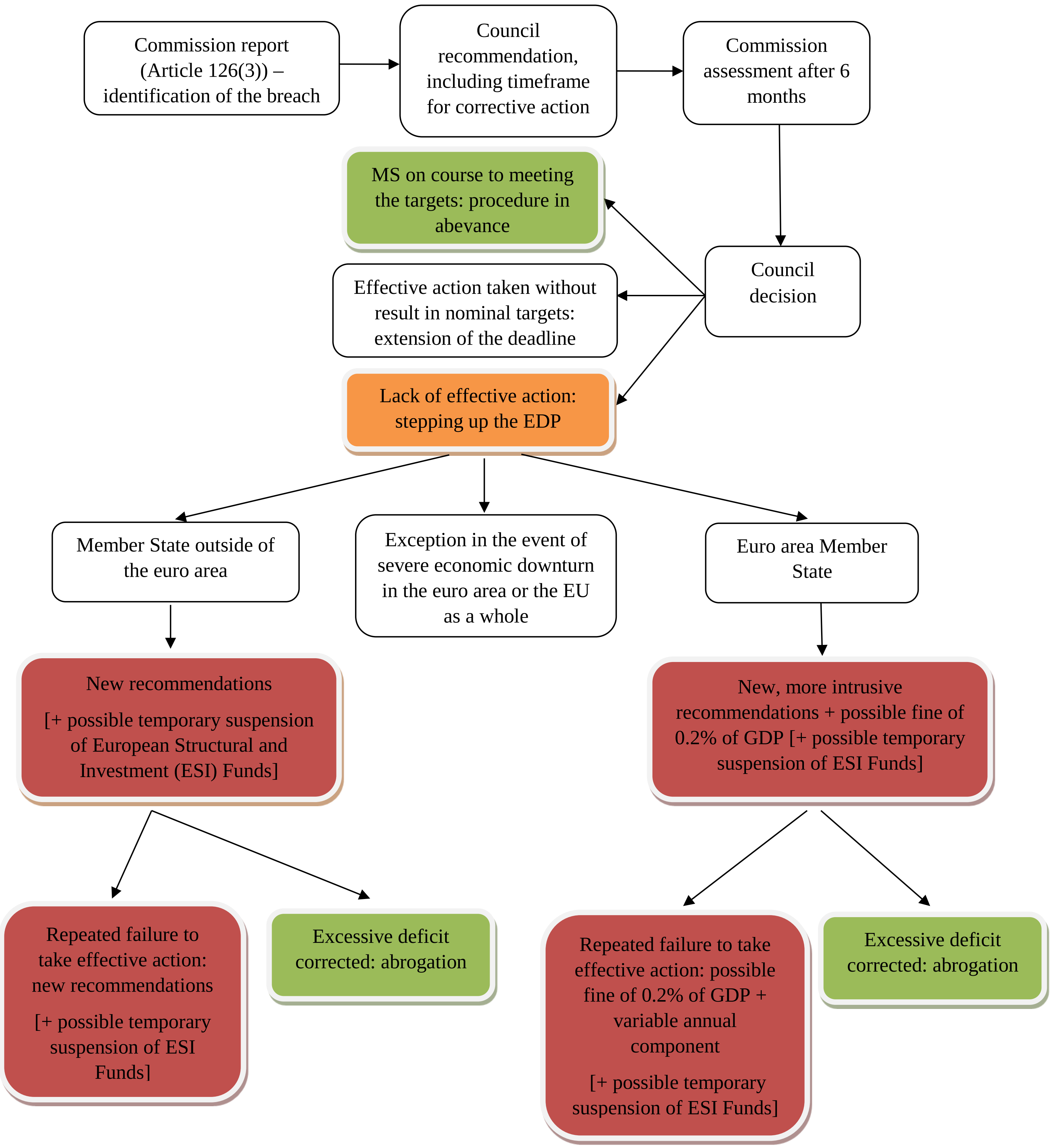
- Annex 1 - Steps under the preventive arm of the SGP
- Annex 2 - Steps under the corrective arm of the SGP
- Annex 3 - Preventive arm of the SGP: New/updated "flexibility" elements
- Annex 4 - Corrective arm of the SGP: New/updated "flexibility" elements

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

Annex 1 - Steps under the preventive arm of the SGP



Annex 2 - Steps under the corrective arm of the SGP

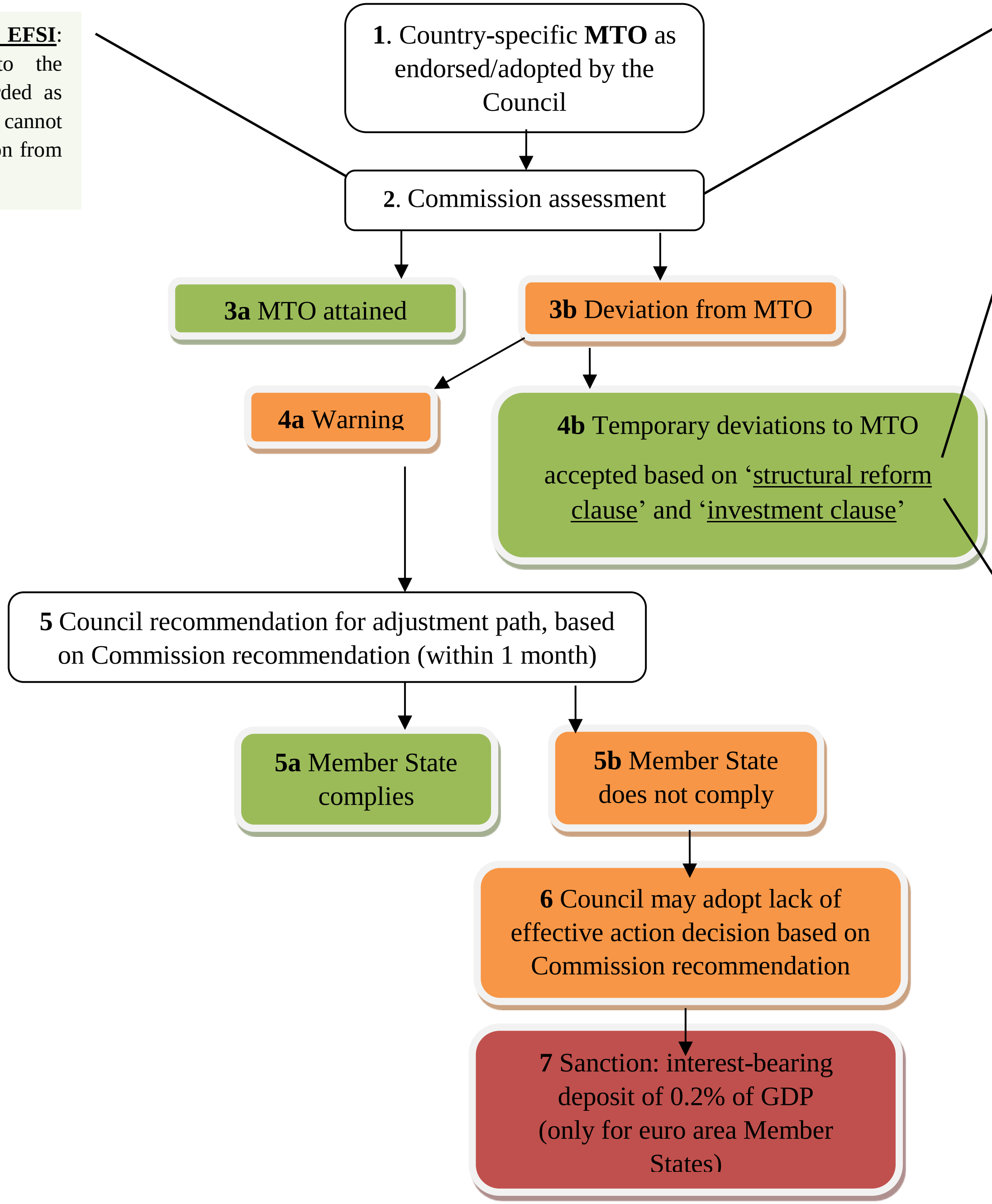


Note: The possible suspensions of up to five ESI funds are in square brackets, since they are formally not belonging to the SGP but to the so-called regulation on macro-economic conditionality of 5 European Structural and Investment Funds [Regulation (EU) No 1303/2013]

Annex 3: Preventive arm of the SGP: New/updated 'flexibility' elements

Three new/updated clauses
(which might be cumulative)
Note: New elements are in bold below

__Financial contribution to EFSI__: National contributions to the capital of EFSI are regarded as 'one-off measures': they cannot therefore lead to a deviation from MTO.



__(1) New definition of 'economic good and bad times'__ in view of the adjustment of the structural effort according to the situation in the cycle: a novelty is a **matrix with 5 categories defining the economic situation, mainly based on the so-called 'output gap', and the required fiscal effort under these categories.**

__(2) New/updated 'structural reform clause__': the **scope of eligible reforms is widened; structural reforms with an impact on the potential growth** can also be taken into account (**until now COM used to insist on the structural reforms with a direct impact on the debt sustainability and explicitly favoured reforms of pension schemes**). These reforms must be (1) adopted and (2) implemented or (through provisions of a binding force) sufficiently documented. Additional time to reach the middle-term objective (MTO) can be granted provided that the deviation does not exceed 0.5% of the GDP, that the MTO is reached within the 4 year-programme period and that an appropriate safety margin is continuously preserved so that the deviation from the MTO or the agreed adjustment path does not lead to an excess over the 3 % of GDP reference value for the deficit.

__(3) New/updated 'investment clause'__: Temporary deviations from the MTO or the adjustment path towards it are allowed to **accommodate investment, provided** that (**new elements compared to the previous 'investment clause' as set out in the letter of Commission Vice-President of 3 July 2013 are in bold)**:

(i) GDP growth is negative or GDP remains well below its potential (**with an output gap greater than minus 1.5%**);

(ii) deficit is not higher than 3% deficit and an appropriate safety margin is preserved (no longer **includes an explicit reference to the 'debt reduction benchmark'**);

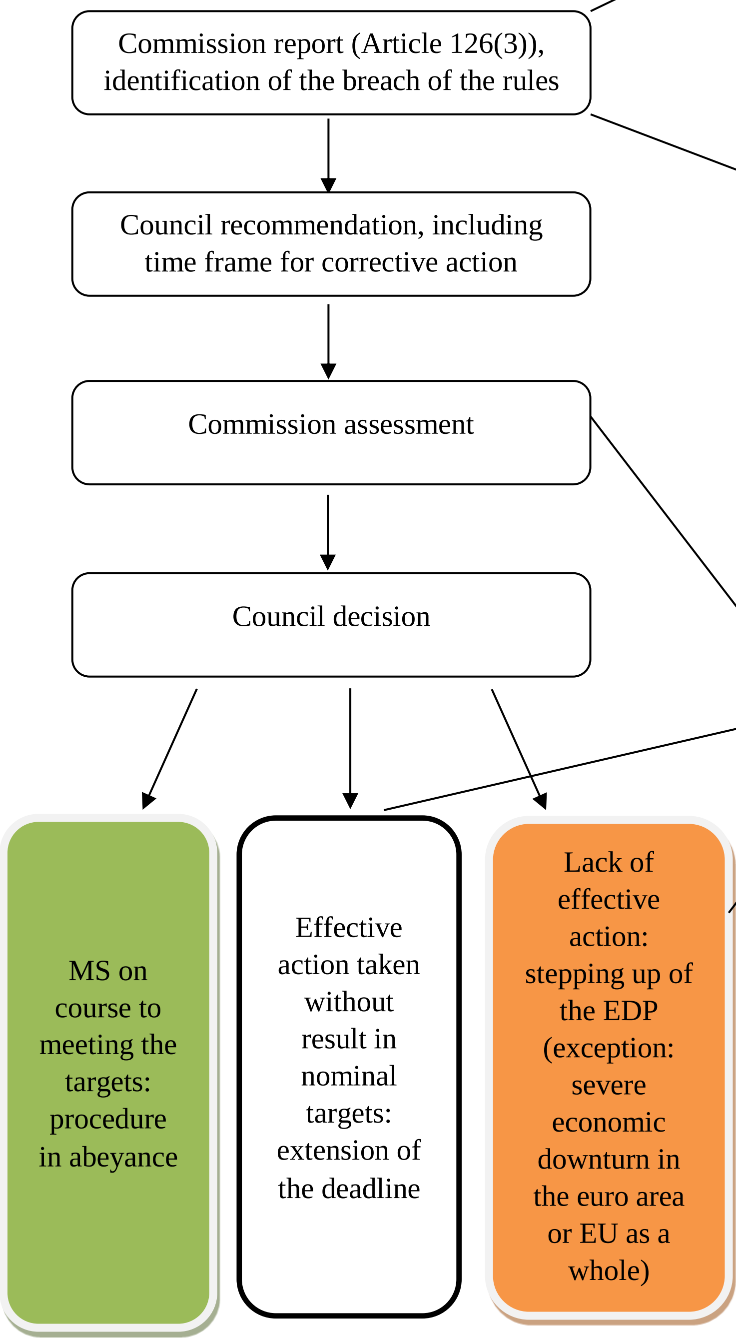
(iii) **investment levels are effectively increased a result**;

(iv) 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, **and the co-financing of projects also co-financed by the EFSI**;

v) **the Member State must also compensate for any temporary deviations and the MTO must be reached within the four-year horizon of its current stability or convergence programme.**

COM will apply the clause without the previous condition of a large negative output gap in the euro area or EU as a whole.

Annex 4: Corrective arm of the SGP: New/updated 'flexibility' elements



National Contributions to EFSI: In case of a non-respect of the deficit or debt reference values, 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

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. The **scope of eligible reforms is widened, given that structural reforms with an impact on the potential growth** can also be taken into account (until now COM used to insist on the structural reforms with direct long-term positive budgetary effects and explicitly favoured reforms such as for pension schemes). If agreed reforms are not implemented, the Commission will consider it **an aggravating relevant factor**.

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.