BRIEFING

Stability and Growth Pact - An Overview

The Stability and Growth Pact (SGP) is a legal framework (based on primary and secondary EU law) that seeks to ensure sustainable public finances so as to contribute to the stability of the Economic and Monetary Union (EMU). It consists of two main building blocks: the preventive arm and the corrective arm.

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).

These provisions stipulate notably that each Member State shall 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 which is adjusted by the cyclical component and net of one-off and temporary measures);
- 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; exceptions to this rule are allowed, if a safety margin with respect to the nominal 3% of GDP government is provided.
- it shall be revised every 3 years and may be further revised in case 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) shall be specified within a defined range between -1% of GDP and balance or surplus.

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<th>Box 1: Balanced budget rule(s)</th>
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<td>The allowed ranges in which the country-specific MTOs have to be set differ between the preventive arm of the SGP (EU law) and the &quot;Fiscal Compact&quot; (intergovernmental treaty): While the upper limit (&quot;surplus&quot;) is (unspecified and) identical in both frameworks, the lower limit (&quot;close to balance&quot;) is specified differently: It is more stringent in the Fiscal Compact (structural deficit of 0.5% of GDP) than in the preventive arm (structural deficit of 1% of GDP), if the debt-to-GDP ratio is higher than 60%. 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).</td>
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Member States which have not yet reached their MTO should improve their structural balance by at least 0.5% of GDP per year. In case of a "significant deviation" (= 0.5% of GDP in 1 year or cumulatively over 2 year) from the MTO or from its adjustment path, the Commission can express an "early warning".
Temporary deviations from the MTO or the adjustment path may be allowed in the cases of (1) major structural reforms (e.g. pension reforms) which have a verifiable long term (positive) impact on the public finances, (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.

The Country Specific Recommendations (CSR) as adopted annually by the Council for each Member State include for each Member State a recommendation on progress towards the MTO.

Non-compliance with the warnings and recommendations may trigger further steps in the procedures, including for euro area Member States the possibility of sanctions.

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 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 a 3 years period). For Member States that were subject to an EDP on 8 November 2011, the debt reduction benchmark is applied after a transition period of 3 years after the correction of the excessive deficit.

If the Council decides (on the basis of a Commission recommendation) that a deficit is excessive, the Council issues 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 budgetary targets 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 (like in the preventive arm) as a benchmark, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation.

The Council may decide, on 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 Stat + unexpected adverse economic events with major unfavourable consequences for government finances

(ii) severe economic downturn in 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 for euro area Member States the possibility of sanctions.

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**Box 2: "Effective action" in the preventive and corrective arms of the SGP**

Both in the preventive and corrective arm, progress is measured on the basis of "fiscal effort" in structural terms. 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. of whether "effective action" has been taken or not) is twofold:

First, COM and Council assess whether the annual change in the structural budget balance is in line with the required fiscal effort ("**Top down approach**")

Secondly, COM carries out a careful analysis which covers the following elements:

(a) revisions of potential output growth compared to that assumed at the time of the recommendations;
(b) the impact of revisions on the composition of economic growth (tax richness) or of other windfalls/shortfalls on revenue;
(c) quantification of measures taken ("**Bottom up approach**").

In June 2014, the Council endorsed "**terms of reference**" following a review of the methodology used under the EU's excessive deficit procedure for assessing "effective action" taken by Member States in response to Council recommendations. Improvements have sought, amongst other things, to improve transparency. 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 in the context of the excessive deficit procedure. Furthermore, the "terms of reference" specify in detail the top down and bottom up approaches.
**Possible sanctions in the preventive and corrective arms of the SGP**

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<th>When</th>
<th>What</th>
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<td>Adjustment towards the MTO/expenditure rule not respected (preventive arm)</td>
<td>Interest-bearing deposit 0.2% of GDP</td>
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<tr>
<td>Opening of the EDP (if the country was already sanctioned under the preventive arm or if the breach of the threshold is particularly serious)</td>
<td>Non-interest-bearing deposit 0.2% of GDP</td>
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<tr>
<td>Failure to take effective action to correct the excessive deficit</td>
<td>Fine 0.2% of GDP</td>
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<tr>
<td>Repeated failure to take effective action to correct the excessive deficit</td>
<td>Fine 0.2% of GDP + variable component</td>
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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.

**Report on the application of the rules**

The regulations governing both arms of the Pact stipulate that the Commission shall publish by 14 December 2014 and every five years thereafter, a report on the application of the rules and that the report shall be forwarded to the European Parliament and to the Council. See: amended regulations (EC) No 1466/97 (preventive arm) and 1467/97 (corrective arm).

**For more detailed information**

- **A Guide to the SGP:**
- **A Vademecum on the SGP:**
- **The code of conduct on the implementation of the SGP:**