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 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 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.

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 potential.

The EU fiscal framework consists in subtracting from the actual budget balance the cyclical component of the budget. 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 balance, including the output gap. For more detailed information:
- European Central Bank: Monthly bulletin (box 6, page 85) - 9/2014
- International Monetary Fund: Online overview - 8/2014

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.
Member States which have not yet reached their MTO should improve their structural balance by at 0.5% of GDP per year as a benchmark (more in “good times”, less in “bad times”). In case 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 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. Temporary deviations from the adjustment path are allowed, if a safety margin with respect to the nominal 3% of GDP government is provided.

Each set of Country Specific Recommendations (CSRs) adopted annually by the Council includes a recommendation 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 for euro area Member States the possibility of sanctions.

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

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 "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).

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.

A graphical overview of the steps under the preventive arm is provided in annex 1.
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. 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 shall make sufficient progress towards compliance with the benchmark.

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 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 State + 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.

| 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. 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;

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1 A similar method is applied in the preventive arm; one difference is that the assessment in the preventive arm also takes account of the compliance with the expenditure benchmark.
(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
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. Furthermore, the "terms
of reference" specify in detail the “top down” and “bottom up” approaches.

A graphical overview of the steps under the corrective arm is provided in annex 2.

Possible sanctions in the preventive and corrective arms of the SGP

<table>
<thead>
<tr>
<th>When?</th>
<th>What?</th>
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<tbody>
<tr>
<td>Adjustment towards the MTO/expenditure rule not respected (preventive arm)</td>
<td>Interest-bearing deposit 0.2% of GDP</td>
</tr>
<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>
</tr>
<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. Furthermore, the so-called *macro-economic conditionality* (in force since end 2013)
implies, both for euro area and non euro area Member States, possible suspensions of up to
five European structural and investment funds in case of failure or repeated failure to take
effective action to correct the excessive deficit.

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:

Annexes:

Annex 1 - Steps under the preventive arm of the SGP

Annex 2 - Steps under the corrective arm of the SGP
Annex 1 - Steps under the preventive arm of the SGP

Stability and Convergence Programmes setting MTOs (May-April)

Commission ex post assessment

MTO attained

Deviation from MTO

Warning

Member State complies

Council recommendation for adjustment path, based on Commission recommendation (within 1 month)

Member State does not comply

Council may adopt lack of effective action decision based on Commission recommendation

Sanction: interest-bearing deposit of 0.2% of GDP (only for euro area Member States)
Annex 2 - Steps under the corrective arm of the SGP

- Commission report (Article 126(3)), identification of the breach
- Council recommendation, including time frame for corrective action
- Commission assessment after 6 months
- MS on course to meeting the targets: procedure in abeyance
- Effective action taken without result in nominal targets: extension of the deadline
- Lack of effective action: stepping up the EDP
  - Member State outside of the euro area
    - New recommendations [+ possible temporary suspension of European Structural and Investment (ESI) Funds]
      - Repeated failure to take effective action: new recommendations [+ possible temporary suspension of ESI Funds]
      - Excessive deficit corrected: abrogation
  - Exception in case of severe economic downturn in the euro area or the EU as a whole
    - New, more intrusive recommendations + possible fine of 0.2% of GDP [+ possible temporary suspension of ESI Funds]
      - Repeated failure to take effective action: possible fine of 0.2% of GDP + variable annual component [+ possible temporary suspension of ESI Funds]
      - Excessive deficit corrected: abrogation
  - Euro area Member State
    - New recommendations [+ possible temporary suspension of ESI Funds]
      - Repeated failure to take effective action: new recommendations [+ possible temporary suspension of ESI Funds]
      - Excessive deficit corrected: abrogation

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

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