The EU’s Stability and Growth Pact

Fiscal Governance for Sustainable Growth and Development in Asia and Pacific Region

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Anton MANGOV
DG ECFIN, Fiscal Policy and Surveillance Unit (C1)
OUTLINE

1. Introduction

2. Preventive and Corrective Arms of SGP

3. Who does what?

4. Does the framework work in practice?
Fiscal policy in the EU context

- EMU as unique model of economic integration
  - Common monetary policy & decentralised fiscal policies

- Common monetary policy
  - Price stability
  - Macroeconomic stabilisation: dealing with common shocks

- Fiscal policy at national level
  - Sustainability: avoiding deficit bias
  - Macroeconomic stabilisation: dealing with country-specific shocks

- Common fiscal rules
  - Overcoming disincentives created by monetary union and spillovers
  - (More recently) Avoiding sovereign debt crises and monetary bail-outs
The Stability and Growth Pact

- Rule-based framework within which Member States make their budgetary decisions
  - Member States are responsible for fiscal policy
  - But must be compatible with the rules

- Two reference values (enshrined in the Treaty on the Functioning of the European Union)
  - 3% of GDP for government deficit
  - 60% of GDP for government debt

- Two arms, set up to be consistent
  - Preventive arm aims to ensure prudent fiscal policy
  - Corrective arm (a.k.a. Excessive Deficit Procedure) corrects gross policy errors (= breach of reference values)
What’s the goal of the Preventive Arm?

Prudent fiscal policy

- Structurally sound
  - Builds buffers against too high debt
  - Builds buffers against future liabilities
  - Controls expenditure dynamics
  - Builds buffers against bad times
How to ensure prudent fiscal policy?

The Medium-Term Objective (MTO)

Country-specific value for the Structural Balance

Requirements

(i) Safety margin with respect to the 3% → BAD TIMES
(ii) Sustainability of public finances → DEBT and FUTURE LIABILITIES
(iii) Allow room for stabilization over the cycle → STRUCTURAL

Limits

• Euro area and ERMII: -1.0%
• Fiscal Compact: -0.5% (unless debt ↓↓ 60% and ↓sustainability risks)

Process

• MS chose their MTOs in the Stability and Convergence Programmes
• Commission checks that they comply with above requirements
What should Member States do?

- If Member State at MTO at the start of the year:
  - Remain at MTO

- If Member State NOT at MTO at the start of the year:
  - Adjust towards the MTO
  - Required adjustment: 0.5% of GDP as a reference, less in bad times, more in good times + if high debt and/or sustainability concerns

- Effort modulated according to cyclical conditions, debt level and sustainability risks
- Structural reform clause
- Investment clause
How does the EDP work?

Trigger

- **Deficit > 3%** of GDP and/or
- **Debt > 60%** of GDP and not diminishing at a satisfactory pace

Step 1

- **Commission report** on the reasons behind the breach

Step 2

- **Council decision** on opening EDP based on Commission opinion
  - Provides recommendations, deadlines, targets

Step 3

- MS has 3-6 months to comply with recommendations

Step 4

- Commission assesses 'effective action' and informs the Council
How does the EDP work?

1. **Commission assessment**
   - **Distance from targets**
     - Targets are **met**
     - Targets are **not met**

2. **Council input**
   - Council takes note
   - Council proposes EDP abrogation

3. **Step 5**
   - Commission proposes EDP abrogation
   - Council may issue revised recommendations and extend deadline
   - Back to step 3

4. **Step 6**
   - Council takes final decision

5. **Closure**
   - EDP CLOSED

**EFFECTIVE ACTION**

- Targets are met
- Targets are not met

*Step 6 Closure*
How does the EDP work?

Step 4
Commission assessment

Type of MS
Non-euro area MS

Council input
Council gives new recommendation, deadline, targets

Back to step 3
Back to step 3

No effective action continues

Euro area MS

Council gives notice, detailed requirements
SANCTIONS

Back to step 3
Back to step 3

MS does not take action repeatedly, Council gives notice, detailed requirements
SANCTIONS

No effective action continues

NO EFFECTIVE ACTION

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Fiscal policy in EMU: Who does what?

**Member States**
- Decide on tax and spending levels – which drive borrowing and debt
- But must be compatible with the SGP
- NEW(ish) Fiscal Compact: National rules

**The European Commission**
- Implements the SGP: are Member States compliant with its provisions?
- Prepares the analysis to guide the Council
- NEW(ish) Two-pack: Opinions on Draft Budgets

**The Council of Ministers**
- Take the decisions on the application of the SGP
European legislation on NFFs

- EU Directive on budgetary frameworks (2011) sets minimum requirements for:
  - Accounting & statistics
  - Forecasts
  - Numerical Fiscal Rules (NFRs)
  - Medium-Term Budgetary Frameworks (MTBFs)
  - Transparency

- Intergovernmental Fiscal Compact (2012) calls for:
  - National balanced budget rule in structural terms (-0.5/-1% of GDP)
  - Automatic correction mechanism in case of deviation
  - Independent monitoring institution

- EU Regulation on monitoring of budgetary plans (2013) defines:
  - Features of independent bodies monitoring national fiscal rules
  - Principle of independent production/endorsement of macroeconomic forecasts
Deficits have substantially decreased
Debt developments are less benign...
… and pro-cyclicality has not been avoided
The increasing number of IFIs in the EU