Stability and Growth Pact set for another makeover

The European Commission proposed a new reform of the Stability and Growth Pact, putting the emphasis on a more tailor-made medium-term budget consolidation. While there might still be some tinkering on the detail, we believe that the proposal will eventually be adopted

The never-ending reform

Remember the time that the then president of the European Commission, Romano Prodi, called the Stability and Growth Pact “stupid” because it was too rigid? That was in 2002. Since then, an almost countless number of reform proposals have been advanced and a significantly lower number of actual changes have been made to finetune the pact. Over the last 20 years, there has been a never-ending debate on rules vs discretion, how to implement and enforce the rules, how to ensure sustainable government debt and how to keep the rules ‘breathing’, ie how to avoid pro-cyclical tightening.

As regards the avoidance of pro-cyclical fiscal tightening, the so-called ‘escape clause’ was introduced as part of the ‘Six-Pack' reform of the Stability and Growth Pact in 2011. This ‘escape clause’ allows for a temporary deviation from the normal fiscal surveillance in a situation of “general crisis caused by a severe economic downturn of the euro area or the EU as a whole”. At the start of the pandemic, the European Commission activated this general escape clause for the period 2020-2023. This basically put the Stability and Growth Pact on hold, but there was an agreement that from 2024 onwards, some form of fiscal discipline should be reintroduced to guarantee the stability of the monetary union. The European Commission seized the occasion to come up with a proposal to reform the SGP once again.

In essence, the European Commission this week proposed reforms, which aim to transform the SGP into a more risk-based surveillance framework that puts public debt sustainability at its core while promoting sustainable and inclusive growth. Important to notice is that the medium-term plans, which will be key, are tailor-made to take into account differences that exist between the different member states. Government expenditure becomes the single most important policy driver. But the hardline number watchers don't have to worry: the 3% norm for budget deficits and 60% for the debt-to-GDP ratio will still be there!

How will this work in practice?

At the start of the process, member states will have to design and present plans setting out their fiscal targets, measures to address macroeconomic imbalances and priority reforms and investments over a period of at least four years. These plans will be assessed by the Commission and endorsed by the Council based on common EU criteria. In fact, these national programmes simply bring together already existing plans like the stability programmes, national reform programmes and the latest national plans to apply for funds from the European Recovery Fund.

Member states' plans will have to set out their fiscal adjustment paths. These will be formulated in terms of multi-year expenditure targets, which will be the single operational indicator for fiscal surveillance.

For countries with a government deficit above 3% of GDP or public debt above 60% of GDP, the ratio of public debt to GDP will have to be lower at the end of the period covered by the plan than at the start of that period; and a minimum fiscal adjustment of 0.5% of GDP per year as a benchmark will have to be implemented so long as the deficit remains above 3% of GDP. A more gradual fiscal adjustment path, extending the adjustment period up to seven years, is possible if a country commits to specific reform and investments.

Interestingly, the European Commission also proposed a revision to the so-called excessive deficit procedure (EDP); the instrument to enforce compliance with the Stability and Growth Pact. The EDP applies to both the deficit and the debt criteria, even though it has never been triggered by excessive government debt. Why? Because in that case, highly indebted countries would have been under strict fiscal surveillance forever. The European Commission's proposals keep the rules for government deficit breaches of the 3% of GDP reference value broadly unchanged, while the excessive deficit procedure for public debt breaches of the 60% of GDP reference value is strengthened for both activation and abrogation. It will focus on departures from the net expenditure path that the member state has committed itself to and which was endorsed by the Council under the preventive arm of the Stability and Growth Pact. For a country that faces substantial public debt challenges, a deviation from the agreed net expenditure path will by default lead to the opening of an EDP.

Next steps

The European Commission aims for the legislative proposal of the new EU fiscal framework to be approved by the European Parliament and the Council by the end of 2023, so that member states and the Commission may discuss draft plans in the first quarter of 2024. 2023 will likely be a transitory year when the existing Stability and Growth Pact legislation still applies, but the fiscal country-specific recommendations for 2024 will already consider some elements of the proposed reform.

The aim of the proposals is clear: it is an attempt to combine the almost impossible: investing, reforming economies and still keeping public finances sustainable. The proposals also give the European Commission even more influence and power vis-a-vis the individual countries and capitals. The option to more easily start excessive-deficit procedures on debt can be regarded as a giveaway to the fiscal conservatives.

The fact that the European Commission already presented fully written out legislative acts for new regulations will make it harder for member states to make significant changes. To be sure, the Commission has had extensive discussions with member states since presenting its reform orientations in November 2022. These discussions had already resulted in a consensus emerging on some core elements of the reform orientations, adopted by the Council on 14 March and endorsed by EU leaders on 23 March.

It could very well be that the discussion now will be an “all or nothing” discussion at the Eurogroup and European Council levels. Interestingly, there hasn’t been a full refusal of the proposals by any member state, yet. It is hard to predict how the discussion will evolve. While some small changes are still possible, we think that eventually the proposal to change the SGP will be adopted.

An end to the escape clause and reinstatement of the SGP, be it in its existing or modified form, means that the budgets that have to be drafted this year for 2024 will need to foster some budget consolidation. As budget deficits for the eurozone as a whole are still likely to hover around 3.5% of GDP for 2023, fiscal policy will at least become less expansionary or even slightly contractionary in 2024. Which, in combination with a tight monetary policy, is a recipe for subdued growth next year.

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