

# Rethinking EU economic governance: The Stability and Growth Pact

**Francesco De Angelis**

Junior Policy Analyst  
European Policy Centre

**Frederico Mollet**

Policy Analyst  
European Policy Centre

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In February 2020, the European Commission launched a review of the Stability and Growth Pact (SGP), the EU's framework for fiscal and macroeconomic surveillance. It was intended to address broad dissatisfaction with the framework and respond to the challenges posed by an environment of prolonged low-interest rates, missed inflation targets and low growth. However, it was soon put on hold as, in March 2020, the fiscal rules were suspended due to the unprecedented COVID-19 crisis.

On 19 October 2021, the review restarted in a drastically different world. Not only has government debt increased significantly, but regional, economic and social divides are exacerbated, policymakers face inflationary pressures for the first time in decades, and the Recovery and Resilience Facility (RRF) and accompanying EU-level bond issuance fundamentally changed the EU's economic architecture. In parallel, there is a widespread acknowledgement that averting, as well as adapting to, the climate crisis requires a steep increase in public investment.

The Commission's review will not only have to address pre-existing concerns but also post-COVID-19 challenges. Against this background, in early 2021, the European Policy Centre (EPC) set up the Rethinking EU Economic Governance Task Force, convening experts, academics and policymakers. Drawing on the Task Force's insights, this first Policy Brief in a series of EPC publications outlines how the SGP debate has evolved and the range of reform options that have surfaced. The contents of the paper and views expressed are entirely the work of the authors and should not be interpreted as representing the views of any Task Force member.

## BACKGROUND

### *Fiscal rules and the Economic and Monetary Union*

The Economic and Monetary Union's (EMU) architecture is characterised by tightly integrated economies, decentralised fiscal and economic policy, and centralised monetary policy within the euro area. To manage this combination, the Maastricht Treaty requires deficit and debt GDP ratios to be kept below **3%** and **60%** respectively, forming the key reference values in the fiscal rules. In 1997, the SGP operationalised the relevant provisions. It has undergone significant reform over the years and has been supplemented by official interpretative guidance from the European Commission and Council.<sup>1</sup> The current structure of the rules is as follows.

The **preventative arm** is intended to ensure sound public finances. It sets a Medium-Term Budgetary Objective (MTO) for each member state, which they must make progress to at a yearly rate determined by their respective debt levels and macroeconomic conditions. The MTO is set in terms of the structural balance – in other words, the deficit adjusted for cyclical economic fluctuations. As a general rule, member states' MTO is a structural deficit-to-GDP ratio of 0.5%.<sup>2</sup> In addition, a net expenditure rule is meant to constrain the growth of net government expenditure relative to the economy's growth rate.

The **corrective arm** concerns those countries exceeding the Treaty's reference values and not reducing debt at a 'satisfactory pace', defined as a reduction of 1/20<sup>th</sup> of that part exceeding 60%. If a country is found to be in excessive deficit or debt, it can be placed in the Excessive Deficit Procedure, entailing enhanced surveillance, binding

recommendations for fiscal adjustment and potential sanctions (although they have never been used). Member state compliance with their MTO is considered a relevant factor when assessing their compliance with the 60% debt GDP benchmark and 'satisfactory pace' requirement.

The SGP also includes a complex system of multilateral surveillance, and requirements for national fiscal frameworks and institutions. Several exemptions and a broad margin of discretion when assessing compliance permit flexibility and temporary derogations from the headline rules, which were often introduced to balance sustainability with macroeconomic stabilisation needs.

*How effective have the fiscal rules been?*

The SGP is generally considered to have constrained national fiscal policy. However, the EPC Task Force and the wider literature have identified the additional flaws:<sup>5</sup>

- ▶ Many high-debt countries have not succeeded in reducing their debt ratios following the 2010 European debt crisis. This is despite their compliance with deficit and expenditure criteria improving substantially (although these improvements had started to reverse somewhat pre- COVID-19).
- ▶ Non-compliance is as common as compliance and prevalent in high-debt countries. However, analysis has shown that the rules do change behaviour, with the deficit and expenditure objectives acting as 'anchors'.
- ▶ The reference values are not grounded in economic criteria, and the one-size-fits-all approach to debt reduction is considered increasingly difficult given diverging debt burdens.
- ▶ The rules' complexity is viewed as undermining their credibility and transparency and contributing to weak enforcement. However, the complexity is widely acknowledged as the result of attempts to address concerns over procyclicality and allow macroeconomic stabilisation.
- ▶ The rules have led to procyclical behaviour (i.e. the failure to build up fiscal buffers during times of economic growth; procyclical fiscal consolidation during the European debt crisis).
- ▶ Given the lack of central fiscal capacity and centralised monetary policy, countries with higher debt burdens may not have the fiscal space to respond to country-specific shocks.
- ▶ The structural balance rule is criticised for its practical complexity and reliance on the estimated output gap – a non-observable concept subject to major uncertainty and revision. The expenditure rule increases complexity, as the two indicators are often at odds when assessing compliance.
- ▶ Fiscal policy coordination lacks effectiveness. Although the rules are intended to curb excessive deficits and debt, they cannot control the EU's aggregate fiscal stance.

For example, if countries in a strong fiscal position consolidate during a downturn, procyclicality can spill over to the rest of the EMU.

- ▶ Public investment (including social investment) suffered during the European debt crisis, slashed to preserve current spending and to the detriment of long-term growth.

## STATE OF PLAY

*Changes in the macroeconomic environment*

The EU's macroeconomic context has changed significantly since the fiscal rules were introduced. Before COVID-19, Europe faced a decade of low-interest rates, below-target inflation and reduced growth prospects. Higher debt levels became sustainable, and fiscal policy a necessary complement to monetary policy given low-interest rates.<sup>4</sup> Even putting aside the uncertain impacts of COVID-19 (see below), how long this environment will hold is unclear and disputed. Therefore, an effective and coherent set of fiscal rules promoting fiscal sustainability is still seen as essential.

*The COVID-19 impact*

In March 2020, the European Commission activated the General Escape Clause to allow member states to respond to the unprecedented health and economic crisis. When countries with higher debt burdens saw a jump in borrowing costs, the European Central Bank (ECB) responded forcefully via its Pandemic Emergency Purchase Programme, allowing the necessary fiscal space to act. Nevertheless, the experience highlighted the continuing vulnerability of countries with high levels of debt to shocks.

COVID-19 also triggered the creation of novel instruments with deep implications for the EU's economic architecture. The RRF, funded by central EU borrowing, directs investment into the worst-impacted regions to propel their recovery. Meanwhile, the European instrument for temporary support to mitigate Unemployment Risks in an Emergency (SURE) provides low-cost loans to national unemployment schemes. These responses managed to shield the EU economy, which, thanks also to projected robust growth in Q3 2021, is virtually back to the pre-pandemic output level.<sup>5</sup>

However, the extraordinary fiscal measures caused a surge in public deficit and debt. Countries with already high debt burdens were impacted disproportionately. According to the latest estimates, this year's EU27 deficit-to-GDP ratio will be -7.1%, whereas the EU's overall debt will attain 92.1% of GDP (100% in the euro area).<sup>6</sup>

*Post-COVID-19 challenges*

There will be serious and long-lasting social impacts from the pandemic. These include the differentiated impact across member states, regions and social groups. Looking ahead, the EU faces the challenge of the twin digital and green transitions. The latter in particular requires an

increase in annual public investment of 0.5% to 1% of GDP on top of the current EU rate of around 3.5% of GDP, or €100 billion per year.<sup>7</sup> The RRF will allow substantial public investment, but only temporarily – so concerns over the composition of public spending will return as distributions taper past 2024.

The EPC Task Force broadly agreed that should the fiscal rules be reactivated (expected in 2023) without amendments (or without very flexible interpretations), they would likely be politically, socially and economically untenable in countries with high debt levels. Given the rise in debt burdens in the most impacted countries, a one-size-fits-all approach to debt reduction would be unrealistic.

The multitude of pandemic shocks is also creating inflationary pressures for the first time in a decade. Although still widely viewed as transitory,<sup>8</sup> policymakers are worried, especially in Germany.<sup>9</sup> Beyond these shocks, other structural trends related to energy bottlenecks and the ambiguous macroeconomic impacts of the green transition may create a challenging macroeconomic environment.<sup>10</sup>

## PROSPECTS

### *Reform options*

The debates over SGP reform have traditionally been split between advocates for greater flexibility and those who view adherence to the current numerical criteria as necessary to ensure responsible fiscal practices. These fault lines re-emerged once again after a period of unified fiscal responses to the pandemic.<sup>11</sup> The EPC Task Force recognised that the debate must move beyond this framing, particularly since unrealistic rules would inevitably lead to their circumvention and undermine fiscal governance.

On some points, there is a broad consensus between the different camps, such as the complexity of the current framework. The strong and coordinated reaction to the pandemic also demonstrated the framework's existing flexibility to respond to macroeconomic shocks. The RRF implementation will test whether a public investment drive can lift the growth trajectory of member states with high debt levels and ultimately improve fiscal sustainability.

However, there are likely two key areas of contention. The first is over the pace of fiscal consolidation. Many have argued that any consolidation must be gradual and realistic, protect and promote public investment, and avoid a procyclical consolidation like that undertaken in 2011-2013, which triggered a second recession and saw public investment slashed. Others emphasise the need to repair fragile public finances and make use of the improving economy to reduce debt burdens.

The second concerns how to fund the significant investments required by the green transition. This combines substantial investment needs with ambiguous (and potentially negative in the medium term) effects on growth, creating tension with any debt reduction objectives.

The consequences of the transition are also likely to be socially regressive if not paired with additional measures. In addition, green investment requirements are also extensive across richer member states, potentially moving away from the redistributive logic of many post-eurozone crisis debates.

Considering the EPC Task Force's discussions, the wider literature and public debate, five broad categories of reform proposals emerge:

1. **Interpretative flexibility:** The current rules allow for a significant level of flexibility over interpretation and technical methodologies. This is often perceived as requiring less political capital to reach member state consensus, and the Commission has some unilateral leeway. In particular, this approach is suggested as a way to smooth fiscal adjustment paths and potentially place less emphasis on problematic indicators, such as the structural balance, when assessing compliance. However, if interpretations depart further from the letter of the existing rules, the credibility of the overall economic governance framework could be undermined, complexity increased, and uncertainty will emerge over how long a consensus would hold. Furthermore, there are limits to what can be done via interpretation alone, and it is thus unclear whether it could accommodate a surge in green public investment.<sup>12</sup>
2. **Moderate non-treaty reforms:** Although amending the Treaties is viewed as highly unlikely, several moderate reforms to the implementing regulations have been proposed. Common proposals include variations of removing the structural balance rule in favour of a single net expenditure rule, and/or changing the 1/20<sup>th</sup> debt reduction benchmark with more realistic and country-specific medium-term debt reduction benchmarks. Such reforms have a high level of expert support on the grounds of reducing complexity and procyclicality and increasing enforceability. However, many potentially contentious details remain to be debated, such as the stringency of any new debt reduction benchmarks or the level of flexibility maintained for economic stabilisation. The impact on green investment is also unclear.
3. **The golden rule:** This proposal would exempt some public investments from the rules. Proponents are split over whether all pro-growth public investment (e.g. social investment)<sup>13</sup> or just green investments should be excluded. Although a popular proposal, it also gives rise to strong objections. There are concerns over investment definitions, the authority that would sign them off and the potential for abuse. Others are concerned about the impact on overall debt sustainability. Countries with high levels of debt would rely on macroeconomic conditions to make use of the exemption. This would raise complicated questions should macroeconomic conditions change when the RRF ends and the ECB tapers its support, while significant frontloaded green investments are still required.

4. **Central fiscal capacity:** Some form of EU fiscal capacity based on the RRF is a popular idea in the EPC Task Force. Fiscal capacity is often proposed primarily for macroeconomic stabilisation.<sup>14</sup> Another rationale voiced in the Task Force and elsewhere is to use central fiscal capacity only for green (or other) investments and European public goods. This would be more in line with the current RRF structure, which is for long-term investments rather than short-term stabilisation. The RRF's structure is highlighted as an advantage because it simultaneously gives countries ownership while allowing EU level supervision, with agreed milestones and reform commitments. The possibility that national debt consolidation could be structured on the RRF model was even raised during Task Force discussions. However, the *legal* basis for a permanent or long-term RRF-style structure would have to be examined.
5. **Off-balance-sheet investments:** Public investment could be increased using an off-balance-sheet investment vehicle, where debt does not qualify as general government debt. This notion emerged recently in German national debates over the constitutional 'debt brake' but was barely discussed in the EPC Task Force and is not a mainstay of SGP debates. Its implications for the EU-level debates remain underexplored, and it is still unclear what financial and legal structure would permit it to function under existing rules.

In addition, the Task Force and other quarters highlighted that strengthening the role of **independent fiscal institutions** (IFIs) is critical to improving the governance of any reformed framework.

#### *Prospects for consensus*

The EU is far from reaching a political consensus. Within the EPC Task Force, some fear that a real debate will not start until after the 2022 French presidential election, notwithstanding member states having to submit their three-year fiscal plans in April.

There remains serious debate over the technocratic design of the rules and even over some macroeconomic fundamentals guiding fiscal policy. However, the challenges of trust and effective supervision must also be addressed. Whatever their technocratic merits, proposals to create flexibility for investment or ease adjustment paths must address concerns over evasion and wasteful public spending that could ultimately create liabilities for other member states.

The institutional and political mechanisms that govern the application of the rules must reflect this. The RRF structure could be a source of inspiration. It combines nationally designed investment plans with EU-level input, implementation supervision and oversight, as

well as a link to national reforms. Given the challenges outlined above, the most elegant solution would be using EU-level borrowing and the RRF governance structure for green investments.

However, other proposals, like a golden rule, could also use this structure to ensure effective supervision of spending and guard against abuse. The suggestion that it could be applied to debt consolidation pathways should also be explored with, for example, slower adjustments conditional on reform and investment milestones. These solutions could be augmented by a strengthened role for IFIs and democratic institutions. The EPC's coming work will further explore and develop such institutional proposals.

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- <sup>1</sup> See European Commission (2019), [Vade Mecum on the Stability & Growth Pact: 2019 Edition](#), Institutional Paper 101, Brussels.
- <sup>2</sup> Countries with a debt level below 60% of GDP can run a deficit of -1% of GDP.
- <sup>3</sup> See e.g. European Fiscal Board (2019), [Assessment of EU fiscal rules with a focus on the six and two-pack legislation](#), Brussels: European Commission.
- <sup>4</sup> European Central Bank (2021), [Monetary-fiscal policy interactions in the euro area](#), Occasional Paper Series 273, Frankfurt.
- <sup>5</sup> European Commission (2021), [European Economic Forecast: Autumn 2021](#), Institutional Paper 160, Brussels.
- <sup>6</sup> *Ibid.*
- <sup>7</sup> Darvas, Zsolt and Guntram B. Wolff (2021), [A green fiscal pact: climate investment in times of budget consolidation](#), Brussels: Bruegel.
- <sup>8</sup> Schnabel, Isabel, "Welcome address by Isabel Schnabel, Member of the Executive Board of the ECB, at the ECB and Federal Reserve Bank of Cleveland's Inflation: Drivers and Dynamics Conference 2021", Frankfurt am Main, 07 October 2021.
- <sup>9</sup> Giles, Chris and Colby Smith, "IMF warns of need to be 'very, very vigilant' over rising inflation risks", *Financial Times*, 12 October 2021.
- <sup>10</sup> Pisani-Ferry, Jean (2021), "Climate policy is macroeconomic policy and the implications will be significant", Washington DC: Peterson Institute for International Economics.
- <sup>11</sup> Speciale, Alessandro and Alessandra Migliaccio, "Draghi Insists Euro-Area Fiscal Pact Must Change After Pandemic", *Bloomberg*, 23 June 2021; Smith-Meyer, Bjarke, "Hopes of EU fiscal reform on the rocks after pushback from eight capitals", *Politico*, 09 September 2021.
- <sup>12</sup> Claeys, Grégory, "The European Green Deal needs a reformed fiscal framework", *Bruegel*, 10 December 2019.
- <sup>13</sup> Zuleeg, Fabian and Jan David Schneider (2015), "What role for social investment in the new economic governance", Brussels: European Policy Centre.
- <sup>14</sup> See e.g. Buti, Marco and Nicolas Carnot, "The case for a central fiscal capacity in EMU", *VoxEU*, 07 December 2018.