

The case of the disappearing Fiscal Compact

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At the peak of the euro crisis, Germany made its financial support for the euro rescue operations de facto contingent on the other countries accepting an even tighter fiscal discipline than the one foreseen by the Stability and Growth Pact (SGP). This new Fiscal Compact, formally known as the Treaty on Stability, Coordination and Governance was signed in March 2012 by 25 of the 27 EU member states¹ and by the end of the year, it was ratified by enough euro area member states to enter into force on 1 January 2013.² The treaty contains two main provisions:

- 1) The annual structural balance of the general government must respect the country-specific medium-term objective as defined in the SGP, with a lower limit of a 'structural deficit' of 0.5% of GDP.
- 2) If a contracting party fails to comply with the recommendations, a procedure may be launched with the Court of Justice of the European Union (CJEU).

Moreover, member states had to incorporate the provision on budgetary discipline and the automatic correction mechanism into their national legal systems, preferably at constitutional level. This has been done by most countries.

Formally we thus have the tight rules of the Fiscal Compact written into the constitutions of most member states and enforceable via the CJEU. But all this legal apparatus seems to have had little impact on actual fiscal policy-making.

A powerful example of this ineffectiveness is provided by the recent cases of the 2015 budgets of France and Italy. Both countries are clearly out of line with the Fiscal Compact, and their budgets break previous commitments on deficit reductions.

The Stability Pact is at least formally adhered to in the sense that the Commission at first rejected the 2015 budgets of France and Italy as incompatible with the basic rules of the Stability Pact, which require an improvement in the cyclically adjusted deficit of at least 0.5%

¹ The United Kingdom and the Czech Republic opted not to sign the treaty, which is not mandatory for EU countries as it is not part of the EU treaties.

² The Treaty is legally binding as an international agreement (the result of an intergovernmental initiative). According to Art. 16, its substance will be incorporated into the existing EU treaties within five years from the entry into force.

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of GDP each year. In response to the observations by the Commission, both countries offered only 'cosmetic' adjustments, worth about 0.2% of their GDP. This was deemed sufficient by the Commission to accept the new plans, which remain clearly insufficient to meet the targets. At least formally, however, the procedures foreseen by the Stability Pact were adhered to.

By contrast, no debate is taking place around the Fiscal Compact, although the new data just published by the European Commission in its autumn forecast³ show that only five euro-area countries (Germany, Greece, Luxembourg, Cyprus and the Netherlands) exhibit a fiscal balance better than the 0.5% of GDP deficit allowed by the Fiscal Compact.⁴

Moreover, very few countries have complied with the reduction in the deficit, which is mandatory under the Fiscal Compact, which foresees in its Article 1(e):

[I]n the event of a significant observed deviation from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically.

Why has the Fiscal Compact been so ineffective? One key reason is that the concept of 'structural budget', which is central in this framework, is at best uncertain. It is not observable and calculations are subject to revisions over time, some of which are also of substantial magnitude. In practice, this may limit considerably the firmness and certainty of this simple rule.

The structural deficit is defined as the actual deficit adjusted for the impact of the economic cycle plus any once-off special measures. This approach has an economic rationale: the adjustment of fiscal balances for the output cycle is crucial for correctly assessing fiscal sustainability, whereas headline numbers (nominal targets) can be misleading.

However, the problem is that there is no single universally agreed method for adjusting fiscal balances. An appropriate adjustment needs to take several country-specific factors into consideration, for estimating revenue and expenditure elasticities, measuring the output gap and deviations from the 'normal' asset or commodity price level.⁵

The fact that no unique definition of the cyclical adjustment exists implies that a certain degree of uncertainty cannot be removed and there is room for different estimates and possibly disputes. This problem becomes particularly acute when inflation is low and unemployment widespread, since the estimate of the cyclical position is based in turn on an estimate of the 'non-accelerating wage natural rate of unemployment' (NAWRU). This is a non-observable variable that is very difficult to estimate in practice and different estimates might yield quite different results depending on the econometric and other methods used.⁶

³ European Economic Forecast: Autumn 2014, *European Economy*, No. 7, European Commission, 2014 (http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee7_en.pdf).

⁴ For 2015, only three countries - Germany, Greece and Luxembourg - complied with the treaty requirements.

⁵ For example, a cyclical upswing based on higher exports yields much less revenues than one based on domestic demand, given that exports are exempted from VAT. Moreover, as forcefully argued by Borio (2013), the financial cycle can exert a more profound and longer-term influence on the economy than the shorter cycles, which are supposedly captured by the cyclically-adjusted balances.

⁶ The NAWRU becomes particularly difficult to estimate when wage inflation hits the zero bound since wage flexibility is limited downwards and there are few observations available to estimate the degree of this downwards rigidity.

The revisions in the estimates can be quite significant and are mainly driven by a revision in the estimates of the cyclical component of the GDP. Real-time data show that revisions (e.g. between the forecast made in 2008 for 2009 and the revision of it made in 2009) can be even larger than 1 percentage point of GDP at turning points of the economic cycle, when uncertainty is highest.

Giving the Commission the competence to determine the size of the cyclical adjustment cannot change this problem since the Commission has to change its own numbers every six months as new information changes the estimates of the cycle. Moreover, member states have a tendency to produce studies that show a different cyclical adjustment, indirectly suggesting that the cyclical adjustment estimated by the Commission is not large enough.

The disappearance of the Fiscal Compact from the policy debate shows that it is not possible to put fiscal policy in a legal straight jacket. The tight rules enshrined in a new Treaty and in national constitutions are being violated as soon as they become politically inconvenient.⁷

References

Borio, C. (2013), "The financial cycle and macroeconomics: What have we learnt?", BIS Working Paper No. 395, Bank of International Settlements, Basel, December.

Gros, D. (2012), "The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (aka Fiscal Compact)", CEPS Commentary, CEPS, Brussels, March (www.ceps.eu/book/treaty-stability-coordination-and-governance-economic-and-monetary-union-aka-fiscal-compact).

⁷ This conclusion supports our initial appraisal of the Fiscal Compact when it was first signed into law: "Once the initial excitement is over ... and national fiscal rules have been put in place, this Treaty will quietly be forgotten" (Gros, 2012).