Abstract: The Fiscal Compact seeks to strengthen budgetary discipline in the European Union. The Compact stipulates an upper limit on the cyclically-adjusted budget deficit and includes a strict enforcement regime in case of breaches. This paper discusses the contents of the Fiscal Compact and some challenges concerning its efficacy. Government financing crises typically have a number of causes, including factors other than excessive accumulation of explicit government liabilities, so the Fiscal Compact is no guarantee against future crises. Previous experiences with fiscal policy rules are mixed, but the results in large part hinge on institutional and political factors. It is argued the deficit ceiling may be difficult to implement due to its complexity and the resulting large forecasting uncertainty. The uncertainty and the fact that the stipulated deficit limit is open for interpretation and negotiation suggest that the Fiscal Compact will also be difficult to enforce. The upshot is that the Fiscal Compact may have limited impact on fiscal policy performance in the European Union due to its challenging implementation and enforcement.
1. Introduction

On 2 March 2012 the Fiscal Compact was adopted as an intergovernmental treaty by a majority of the member countries of the European Union (EU). All member countries except the Czech Republic and the United Kingdom signed up and thereby obliged themselves to adopt the Compact and implement its rules in domestic legislation and fiscal policy implementation. The Compact is scheduled to start operating by 1 January 2013.

The Fiscal Compact supplements the Stability and Growth Pact (SGP) and the six pack measures that seek to strengthen the SGP. The main innovation of the Fiscal Compact is an explicit fiscal deficit target expressed in cyclically-adjusted terms combined with a strict enforcement regime in case the target would be violated. The application of a cyclically-adjusted deficit target is meant to reduce the risk of pro-cyclical fiscal policy which may result from a target based on the headline deficit.

The global financial crisis and the ensuing recession led to deteriorating budget balances and strained borrowing possibilities in many EU countries. The financing problems have led governments in numerous EU countries to request support from the IMF, the European Union and sometimes individual countries. By July 2012 Hungary, Latvia, Romania, Greece, Ireland, Portugal, Cyprus and Spain had received bailouts in various forms. The debt crisis revealed a noticeable dichotomy in the European Union; numerous countries in the periphery faced severe financing problems, while the Northern European core countries experienced very low interest rates on government debt, sometimes even negative nominal rates.

The issues of fiscal governance within the European Union and/or the eurozone gained much attention from 2009 when it became clear that the government financing problems were not separate incidents in a number of EU countries from Central and Eastern Europe, but rather problems affecting a large number of countries across the European Union. The result was a host of measures meant to revise and strengthen the macroeconomic governance in the European Union. The Fiscal Compact is one of these new governance measures with the explicit goal of reducing the likelihood of government financing crises in future. The goal is to ensure that the budget is roughly in balance or exhibits a surplus over time so that the debt stock in percent of GDP would decrease over time. The use of the cyclically adjusted balance as an operational target is also meant to reduce the risk of pro-cyclical fiscal policies.

This paper provides a discussion of the Fiscal Compact and some challenges concerning the efficacy and implementation of the Compact. The paper draws on results from existing studies in order to assess the likely impact of the Fiscal Compact in short and medium term. The discussion centres on the causes of the financing problems experienced by EU countries since 2008, the effectiveness of constraints on fiscal policy in other cases and, finally, the possibilities of enforcing the regulation of the Fiscal Compact in practice. The paper concludes that there are many challenges associated with the implementation and enforcement of the Fiscal Compact. Moreover, the diverse background for the many financing crises in the EU suggests that the Fiscal Compact must be complemented by other measures if it is to reduce the number of government financing crises in future.

Macroeconomic governance issues gained much attention in connection with the introduction of the single currency and the introduction of the Stability and Growth Pact. Eichengreen et al. (1998) provides a clear-sighted assessment by highlighting the linkages between possible government financing crises and banking sector problems. It was also argued that the SGP
would make policy-makers focus on improvement of the fiscal balance and ignore structural issues and also. Buti et al. (1998) argues that the most challenging part of the SGP would occur in the early stages after its implementation when countries would transition to a balanced budget. Time would show that the fiscal consolidation expected and worried about by Eichengreen et al. (1998), Buti et al. (1998) and others never materialised to any larger extent.

The aims of reforming and extending the Stability and Growth Pact after the European debt crisis have been discussed by Schuknecht et al. (2011) in an Occasional Paper from the European Central Bank. A number of additional measures are proposed mostly to improve the implementation and enforcement of measures already in force, e.g. a commitment to correct past fiscal slippages through a so-called debt brake, fines and sanctions must be fully automatic and independent fiscal councils should be established in all EU countries.

The Fiscal Compact has been discussed in a number of commentaries. Kullas et al. (2012) argue that the focus on the cyclically adjusted fiscal balance and other measures of the Pact are a step in the right direction, but also that the coercive components of the Pact are too limited to ensure its full implementation and enforcement. The European Central Bank provides an overview and detailed assessment of the Fiscal Compact in article in the May issues of its Monthly Bulletin (ECB 2012). The European Central Bank sees the Fiscal Compact as a welcome strengthening of the fiscal governance framework, but it is stressed that it is important that the individual EU countries attain a perception of ownership of the Compact. Implementation and enforcement are seen as the Achilles heel.

The Fiscal Compact is also discussed in more or less detail in many of the contributions in the ebook Austerity: too much of a good thing edited by Giancarlo Corsetti (Corsetti 2012). The striking feature is the array of views presented. Some authors argue that the Fiscal Compact is simply an instrument to force through fiscal austerity across the EU countries which threatens to reduce growth and exacerbate the European debt crisis. Others argue that the broad fiscal targets in the Fiscal Compact and the SGP disregard important features such as the composition of fiscal restraint and the composition of fiscal spending. Others again argue that the Fiscal Compact might be effective because it obliges countries to take increased responsibility for fiscal management.

The contribution of this paper is that it incorporates economic, political-economy and administrative issues in the discussion of the efficacy, implementation and enforcement of the Fiscal Compact. The paper brings together studies within a diverse range of fields in order to produce a qualitative assessment of the Fiscal Compact.

The rest of the paper is organised as follows. Section 2 outlines the contents of the Fiscal Compact and ties it together with measures to strengthen the Stability and Growth Pact. Section 3 brings up possible factors behind the government financing crises experienced in many EU countries. Section 4 reviews the empirical literature on the effectiveness of constraints on fiscal outcomes. Section 5 discusses some challenges stemming from implementation and enforcement issues of the Fiscal Compact. Finally, Section 6 concludes.

2. The contents of the Fiscal Compact

The Fiscal Compact does not replace the Stability and Growth Pact, but supplements it. The SGP entered into force in 1997 and sets out both short-term and medium-term goals (Annett
The annual general government deficit cannot exceed 3 percent of GDP and that the general government debt cannot exceed 60 percent of GDP or must be approaching this value “at a satisfactory pace”. In addition, in the medium term countries should aim for a fiscal balance “close-to-balance or in surplus”, which is seen as a cyclically adjusted deficit not larger than 0.5 percent of GDP. Violation obliges the European Commission to initiate an Excessive Deficit Procedure (EDF) against the country in question; the EDF would compel the country to present a plan for restoring the compliance to the SGP. In practice EDFs have only been initiated against countries in breach of the deficit criterion.

The SGP was revised in 2005 (European Council 2005). The revision entailed more emphasis on the medium-term fiscal targets and less emphasis on short-term developments. It became easier for countries to avoid an EDF by referring to country-specific features such as severe economic downturns or “other relevant factors”. The definition of the medium-term objective similarly was made more adaptable to country-specific features and it was stipulated that the cyclically adjusted deficit could at most be 1 percent of GDP. The greater flexibility and discretion made the SGP more adaptable to country-specific features and might thus have enhanced enforceability (Morris et al. 2006). In practice, however, the immediate outcome of the SGP revision was that all ongoing EDFs were ceased.

The six pack measures entered into force in December 2011. The six pack measures aim to strengthen budgetary surveillance and macroeconomic governance within the EU and several of the six components seek to enhance the Stability and Growth Pact. The main features are that impermissible deviations from the medium-term target are now expressed in quantitative terms and that the EDP may also be initiated if the debt criterion is violated. For the euro area it is stipulated that financial sanctions can be applied in a step-wise fashion and that they are to be decided in the Council of Ministers by reverse qualified majority voting, i.e. a financial sanction proposed by the European Commission can only be stopped by a qualified majority voting against.

The Fiscal Compact is the core of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which was signed at a Council of Ministers meeting on 2 March 2012 and is scheduled to enter into force on 1 January 2013 (European Council 2012). The Fiscal Compact is meant to complement the Stability and Growth Pact (including the six pack reinforcement) as well as other pieces of EU legislation. ECB (2012) provides a detailed account of the Fiscal Compact and compares the balanced budget rules of the Fiscal Compact with the rules of the reinforced SGP.

The Fiscal Compact stipulates that the budgetary position of the general government must be “balanced or in surplus” (European Council 2012, p. 12). This is interpreted as each participating countries must specify a medium-term MTO that entails a cyclically adjusted deficit of at most 0.5 percent of GDP, albeit the MTO may be 1.0 percent of GDP in case the government debt is below 60 percent of GDP and there is no doubt about the sustainability of public finances.

Participating countries can “temporarily deviate from their respective medium-term objective or the adjustment path towards it only in exceptional circumstances”. For countries which are not on an adjustment path towards their MTO and which are not affected by exceptional circumstances the cyclically adjusted balance must in principle be 0.5 percent of GDP (or 1 percent of GDP for countries with low debt). In the case of deviations from the MTO, the country in question must ensure rapid convergence to the target.
The goal of keeping the cyclically-adjusted balance at or above 0.5 percent of GDP is clearly restrictive given that various shocks can affect the budget balance significantly. For that purpose the Fiscal Compact allows deviation in case of exceptional circumstances. An exceptional circumstance “refers to the case of an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact…” (European Council 2012, p. 13). An additional escape clause is included in the specification of the enforcement as deviations from the MTO or the adjustment path towards it must be significant in order for the automatic correction mechanism to be triggered. It is noticeable that the automatic correction mechanism is not specified in the treaty but is scheduled to be proposed by the European Commission.

The main innovation in the Fiscal Compact is the requirement that the balanced budget rule and its implementation through a MTO with regard to the cyclically adjusted balance must be included in national legislation. This must take place “at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes” (European Council 2012, p. 13). This requirement also applies to the automatic correction mechanism proposed by the European Commission. Countries that do not adopt the balanced budget rule can be subjected to penalties of up to 0.1% of GDP.

In summary, the Fiscal Compact represents and at most an incremental change from the SGP reinforced by the six pack. The explicit target on the cyclically adjusted fiscal balance dates back to the original SGP but it was loosened in the revision undertaken in 2005. Still, the Fiscal Compact lowers the acceptable cyclically adjusted deficit to 0.5 percent of GDP for countries with weak public finances, while it is 1 percent in the reinforced SGP. The stipulation of a rapid return to MTO and, hence, only short-lived deviations from the balanced budget rule, suggests that cyclically adjusted budget balance must attain a greater role in short-term policy-making. Finally, the requirement that the balanced budget rule be enshrined in domestic legislation may also change the political assessment and potential ownership of the rule.

3. What causes fiscal crises?

The impetus to strengthen fiscal coordination within the EU came from the financing problems experienced by several European governments after the outbreak of the global financial crisis in the autumn of 2008. At the time of writing in July 2012, a total of eighth EU countries had sought external help. This raises, of course, the issue whether there is a link from the cyclically adjusted balance or other fiscal variables to government financing crises.

It is outside the scope of this paper to provide a detailed account of theories of debt crises. As other types of financial crises, a crisis can be attributed to fundamental factors or to self-fulfilling expectations (“sun spots”). Contagion may be a factor in both types of government financing crises as defaults or restructuring of government debt in one country may affect fundamental variables as well as expectations in other countries.

Manasse et al. (2003) use a dataset comprising 47 market economies for the period 1970-2002 and seek to identify factors that have predictive power vis-à-vis government debt crises. They find that the government debt stock is of importance, while other fiscal variables have little
explanatory power. They also find that a range of macroeconomic variables matter such as the level of foreign debt, the level of short-term foreign debt, low rates of economic growth, current account imbalances and low trade openness help explain the outbreak of government debt crises.

Bandiera et al. (2010) use Bayesian model averaging on a sample of 46 emerging market economies over the period 1980-2004. They find that the level of debt is the only predictor of a government debt crisis that is robust across different sample partitions. For countries with high levels of debt, also macroeconomic stability appears to reduce the likelihood of a crisis. (Bandiera et al. (2010) also provide a comprehensive survey of different empirical studies of sovereign default.)

Reinhart & Rogoff (2011) examine a large number of financial crises during the last 200 years based on a newly compiled database. They find that public borrowing often increases markedly in the period before the outbreak of the debt crisis. Moreover, domestic banking crises or banking crises in international financial centres often precede government debt crises.

Turning to the European debt crisis, the financing problems first emerged in the EU member countries from Central and Eastern Europe, but soon moved to the EU members from Western Europe.\(^1\) Table 1 shows the fiscal balance (BAL), the cyclically adjusted fiscal balance (CAB) and the gross debt (DEBT), all for the consolidated general government and in percent of GDP.

\(^1\) Hungary and Latvia received financial support in 2008, Romania in 2009, Ireland and Greece in 2010, Portugal in 2011 and Cyprus and Spain in 2012.
Table 1: General government fiscal balance, cyclically adjusted fiscal balance and gross debt, percent of GDP

<table>
<thead>
<tr>
<th></th>
<th>BAL</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
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<td>1.7</td>
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<td>0.1</td>
<td>-7.3</td>
<td>-14.0</td>
<td>-31.2</td>
</tr>
<tr>
<td></td>
<td>CAB</td>
<td>1.4</td>
<td>2.2</td>
<td>0.8</td>
<td>-1.5</td>
<td>-7.3</td>
<td>-11.7</td>
<td>-29.2</td>
</tr>
<tr>
<td></td>
<td>DEBT</td>
<td>27.2</td>
<td>24.5</td>
<td>24.8</td>
<td>44.2</td>
<td>65.1</td>
<td>92.5</td>
<td>108.2</td>
</tr>
<tr>
<td>Greece</td>
<td>BAL</td>
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<td>-5.2</td>
<td>-5.7</td>
<td>-6.5</td>
<td>-9.8</td>
<td>-15.6</td>
<td>-10.3</td>
</tr>
<tr>
<td></td>
<td>CAB</td>
<td>-5.5</td>
<td>-6.9</td>
<td>-6.1</td>
<td>-8.0</td>
<td>-10.7</td>
<td>-15.0</td>
<td>-8.7</td>
</tr>
<tr>
<td></td>
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<td>113.0</td>
<td>129.4</td>
<td>145.0</td>
<td>165.3</td>
</tr>
<tr>
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<td>-8.5</td>
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<td>1.7</td>
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<td>1.2</td>
<td>-4.6</td>
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<td>-7.4</td>
</tr>
<tr>
<td></td>
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<td>39.7</td>
<td>36.3</td>
<td>40.2</td>
<td>53.9</td>
<td>61.2</td>
<td>68.5</td>
</tr>
<tr>
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<td>-5.3</td>
<td>-6.3</td>
</tr>
<tr>
<td></td>
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<td>-1.2</td>
<td>-3.7</td>
<td>2.7</td>
<td>-0.2</td>
<td>-5.9</td>
<td>-5.0</td>
</tr>
<tr>
<td></td>
<td>DEBT</td>
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<td>64.7</td>
<td>58.8</td>
<td>48.9</td>
<td>58.5</td>
<td>61.5</td>
<td>71.6</td>
</tr>
<tr>
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<td>BAL</td>
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<td>-0.5</td>
<td>-0.4</td>
<td>-4.2</td>
<td>-9.8</td>
<td>-8.2</td>
<td>-3.5</td>
</tr>
<tr>
<td></td>
<td>CAB</td>
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<td>-3.0</td>
<td>-1.9</td>
<td>-4.3</td>
<td>-6.5</td>
<td>-6.9</td>
<td>-5.6</td>
</tr>
<tr>
<td></td>
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<td>12.5</td>
<td>10.7</td>
<td>9.0</td>
<td>19.8</td>
<td>36.7</td>
<td>44.7</td>
<td>42.6</td>
</tr>
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<td>Hungary</td>
<td>BAL</td>
<td>-7.9</td>
<td>-9.4</td>
<td>-5.1</td>
<td>-3.7</td>
<td>-4.6</td>
<td>-4.2</td>
<td>4.3</td>
</tr>
<tr>
<td></td>
<td>CAB</td>
<td>-9.3</td>
<td>-11.4</td>
<td>-9.0</td>
<td>-6.4</td>
<td>-4.8</td>
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<tr>
<td></td>
<td>DEBT</td>
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<td>65.9</td>
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</tr>
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<td>BAL</td>
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<td>6.5</td>
<td>6.1</td>
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<td>3.6</td>
</tr>
<tr>
<td></td>
<td>CAB</td>
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<td>-4.3</td>
<td>-3.5</td>
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<td>-8.9</td>
<td>-9.1</td>
<td>-4.3</td>
</tr>
<tr>
<td></td>
<td>DEBT</td>
<td>67.7</td>
<td>69.3</td>
<td>68.3</td>
<td>71.6</td>
<td>83.1</td>
<td>93.3</td>
<td>107.8</td>
</tr>
<tr>
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<td>BAL</td>
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<td>-2.2</td>
<td>-2.9</td>
<td>-5.7</td>
<td>-9.0</td>
<td>-6.8</td>
<td>-5.2</td>
</tr>
<tr>
<td></td>
<td>CAB</td>
<td>-2.2</td>
<td>-4.3</td>
<td>-5.3</td>
<td>-8.8</td>
<td>-9.1</td>
<td>-5.9</td>
<td>-2.2</td>
</tr>
<tr>
<td></td>
<td>DEBT</td>
<td>15.8</td>
<td>12.4</td>
<td>12.8</td>
<td>13.4</td>
<td>23.6</td>
<td>30.5</td>
<td>33.3</td>
</tr>
</tbody>
</table>

Sources: Ameco (2012).

The striking feature is how different the fiscal position of the eight countries was prior to the outbreak of the global financial crisis and the government financing crisis. Countries such as Latvia, Romania, Ireland and Spain had low or relative low levels of debt before the onset of the crises, while other countries such as Hungary, Greece, Portugal and Cyprus had higher debt levels. Some countries such Hungary, Greece and Romania had cyclically adjusted balances with very substantial deficits before the crisis, while Ireland and Spain had surpluses and Latvia only small deficits.

One of the factors explaining that countries with so different fiscal starting points ended up having to seek financial support is the emergence of banking crises. Latvia, Ireland and Spain all experienced severe banking crises that required injection of public funds. The possibilities of governments borrowing large amounts in private markets for injection into the banking sectors were severely circumscribed after the outbreak of the global financial crisis. For many countries affected by the European debt crisis, banking and other forms of financial crises were important contributors to the government financing problems (Candelon & Palm 2010).

We continue by a simple empirical exercise to assess whether the measures of fiscal performance in Table 1 provide any predictive power vis-à-vis the occurrence of government debt cri-
ses in the EU. The dependent variable is a dummy. If no crisis has occurred, the dummy variable takes the value 0. If a country has received international support, the dummy variable takes the value 1 in the year of support and missing values in the year or years thereafter. The explanatory variables are the general government balance, the cyclically adjusted balance (CAB) and the debt stock, all in percent of GDP and lagged one year. The estimations are panel data estimations on the sample 2008-2012 undertaken using OLS. Qualitatively similar results are obtained if the panel is estimated using logit. Table 2 shows the results.

<table>
<thead>
<tr>
<th></th>
<th>(2.1)</th>
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<th>(2.3)</th>
<th>(2.4)</th>
<th>(2.5)</th>
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<tr>
<td>Balance(-1)</td>
<td>-0.0202***</td>
<td>-0.0283***</td>
<td></td>
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<td>0.0121</td>
</tr>
<tr>
<td></td>
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<td>(0.0064)</td>
<td></td>
<td>(0.0136)</td>
<td>(0.0132)</td>
</tr>
<tr>
<td>CAB(-1)</td>
<td></td>
<td></td>
<td>-0.0404***</td>
<td>-0.0407***</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.0151)</td>
<td>(0.0150)</td>
</tr>
<tr>
<td>Debt(-1)</td>
<td></td>
<td></td>
<td>0.0006</td>
<td>-0.0008</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.0008)</td>
<td></td>
</tr>
<tr>
<td>R²</td>
<td>0.095</td>
<td>0.142</td>
<td>0.004</td>
<td>0.156</td>
<td>0.095</td>
</tr>
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<td>Observations</td>
<td>119</td>
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<td>119</td>
<td>119</td>
<td>119</td>
</tr>
</tbody>
</table>

Notes: Robust standard errors are shown in brackets below the coefficient estimate. Superscript *** denotes that the coefficient estimate is statistically different from 0 at the 1 percent level of significance. A constant term is included in all estimations but not shown.

The estimations in Table 2 suggest that the debt stock does not help explain whether or not an EU country received a bailout in the period 2008-2012. This result is in contrast to the main result in the literature, but is reasonable given that several of crisis countries had very low debt levels prior to the crisis (Table 1). The fiscal balance or the cyclically adjusted fiscal balance has, however, some explanatory power. In both cases the sign is as expected; a larger deficit increases the risk of a crisis. Interestingly, the cyclically adjusted balance seems to exhibit more explanatory power than the overall budget balance. This result might, however, be the result of an idiosyncrasy: a government debt crisis often leads to an economic downturn and this will typically lead potential output before the crisis to be revised upwards, which again causes the cyclically adjusted balance to be revised downwards. The resulting “automatic” link between the cyclically adjusted balance and the incidence of crises could be removed by using real time data (see Section 5). The results in Table 2 are generally robust to other lag structures in the explanatory variables, e.g. two year lags or moving averages across several years.

The empirical literature suggests that a large stock of debt and/or rapid government borrowing are important factors for government crises. A number of macroeconomic and institutional variables also play a role, but it is difficult to attain robust results. In the European debt crisis, rapid borrowing prior to the crisis seems to be one factor explaining why private investors lost confidence, while the debt stock is of less importance. In several cases the rapid borrowing coincided with or was a direct result of banking crises. Overall these results are broadly in line with the historical pattern depicted in Reinhart & Rogoff (2011). The result gives some support to the idea that the fiscal balance should be a concern and measures to avoid large government borrowing may reduce the risk of future crises. At the same time, complex linkages between the financial sector, macroeconomic developments and public finances suggest that such measures cannot be seen in isolation.
4. The effect of constraints on fiscal outcomes

Another means to learn about the possible efficacy of the Fiscal Compact is to consider previous experiences in which fiscal rules have been in place. The seminal study in this field is Kopits & Symansky (1998) which summarise experiences of fiscal rules across developed and developing countries and across different levels of government. They arrive at the following eight almost tautological requirements for a well-designed and effectual fiscal rule. They rule must well-define, transparent, simple, flexible, adequate, enforceable, consistent and efficient. The list is arguably so extensive that no rule would satisfy all requirements, but it does highlight that a fiscal rule must address many issues and that the prospect for its implementation and enforcement must be taken into account.

Most states in the USA employ fiscal rules and constraints and the effect of these has been examined in a number of papers. Bohn & Inman (1996) find that the fiscal rules are only effective when they are enshrined in the constitution of the state and enforced by an independently supreme court. The results underscore the importance of the enforcement of fiscal rules. Poterba (1995) provides a survey of a large number of studies of fiscal rules in US states. Although most studies show that states with a balanced budget rule have more prudent fiscal policy, then question is whether this is the result of the rule or the results of the preferences of the electorate and/or policy-makers in the state. Poterba (1995) concludes based on studies in which controls are included for political preferences that balanced budget rules probably have a separate effect. Fatas & Mihov (2006) show that fiscal rules are associated with less use of discretionary fiscal policy and also reduces the sensitivity of fiscal policy to business cycle movements.

Turning to the European Union, Buti & Giudice (2002) evaluate the effect of the debt and deficit criteria of the Maastricht Treaty and find that criteria were effective in the sense that deficits were brought. The paper takes a cautious approach to the effectiveness of the SGP and questions whether it will be possible to retain the political momentum resulting from the Maastricht criteria.

Annett (2006) evaluates the early experiences (1999-2004) with the Stability and Growth Pact. While the cyclically-adjusted balance seemed to improve for most of the small euro area countries and Spain, it deteriorated markedly for the large countries, Germany, France and Italy. Annett (2006, p. 13) conclude that a “key failing of the SGP in its early years was its inability to prompt countries to adjust during the periods of high growth”. (Fiscal profligacy in the form of increasing headline fiscal deficits in Greece and Portugal was also pointed out.) Some changes in the relative importance of budgetary institutions and political factors were also noted, but the time span in which the SGP had been operating was rather short.

Marneffe et al. (2011) show that an index of fiscal rules decided and enforced domestically is statistically significant in panel data estimations for the euro area countries. More comprehensive rules are associated with an improved budget balance. The effectiveness of such domestic rules appears, however, to vary somewhat across countries. It should be underscored that since the study considers domestic rules, the result may also be attributed to differences in underlying preferences across the euro area countries. Only three countries in the euro area had no domestic fiscal rule in 2008, namely Greece, Cyprus and Malta.

The improved (headline) fiscal performance when countries sought to satisfy the Maastricht Treaty and after the introduction of the euro may partly be attributed to “creative accounting”. 
Milesi-Ferretti et al. (2004) examine the former period and conclude that in some cases where the gross debt stock was declining, the gross liabilities were increasing, so that the net consolidation was very modest. For the latter period von Hagen & Wolff (2006) find that some countries engaged in stock-flow adjustments keeping down deficits. This practice has been particularly prevalent during recessions when the risk of hitting the 3 percent deficit ceiling was largest.

A number of studies discuss the governance and political economy issues in detail. Schuknecht (2004) points out the political economy dimension of centrally imposed fiscal rules in the EU. There may be a trade-off between the complexity of rules and the ability to enforce them, especially in countries with limited institutional capacity. Given the political nature of the European Union, it is unlikely that strict enforcement can be imposed, which makes it very important that the national governments attain ownership of the rules. Tallberg (2002) argues that the institutional and administrative capacity of the national governments in the EU is a binding constraint vis-à-vis implementation of regulation and rules. The upshot is that improved enforcement might have little effect and countries should instead receive support to institutional development and capacity building.

This brief review of the empirical literature has made clear that fiscal rules cannot be seen in isolation. Their effectiveness will depend on the institutional and political structures in the countries subjected (or subjecting themselves) to such rules. The experiences in the EU from the mid-1990s illustrate this insight. The fiscal consolidations undertaken by EU countries as they sought to satisfy the fiscal criteria of the Maastricht Treaty suggested that simple fiscal rules can be effective if the rules can relatively easily be enforced and the sanctions in case of non-compliance are sufficiently severe. After the introduction of the euro, fiscal slippages became more widespread, arguably reflecting a more complex background for their implantation and a slackened enforcement.

5. Implementation and enforcement of the Fiscal Compact

Section 2 argued that the main implication of the Fiscal Compact is that the medium-term objective regarding the cyclically adjusted budget balance has moved from its previous relatively subordinate position to a position as a short-term operational target. This section discusses the some challenges of using the cyclically adjusted budget balance as an operational target. The emphasis will be on issues related to the implementation by the individual country and the surveillance and enforcement at the European level. The literature review in Section 4 suggests that the effectiveness of fiscal rules in large part hinge on the implement and enforcement opportunities.

The cyclically adjusted fiscal balance (CAB) is computed from the head balance (BAL) by subtracting the component which can be attributed to the business cycle stance of the economy. The business cycle stance is typically captured by the either the rate of economic growth or the output gap; the European Commission uses the latter methodology. The output gap (YGAP) is found as actual output minus potential output, where potential output is computed using the production function method (Larch & Turrini 2009). If the sensitivity of the budget balance to the output gap is labelled $\alpha$, the cyclically adjusted budget balance can be expressed as follows:

$$ \text{CAB} = \text{BAL} - \alpha \cdot \text{YGAP} $$
A positive sensitivity $\alpha$ would suggest that the fiscal balance exhibits counter-cyclical behaviour.

Larch & Turrini (2009) provide a thorough assessment of the use of the cyclically adjusted budget balance in the budgetary surveillance of the European Commission. It is concluded that it was “love” at first sight but numerous weaknesses and problems emerged over time, and the end results is a mature relationship with some every-day disenchantments.

The sensitivity estimates used by the European Commission to compute the cyclically adjusted balance vary substantially across the 27 countries, but the estimates generally appear reasonable. The welfare states in Northern Europe have sensitivities in the interval 0.5-0.6, while some of the pro-market EU countries from Central and Eastern Europe have sensitivities around 0.3.

The sensitivities are based on fairly complex estimation methods developed by the OECD (Larch & Turrini 2009, OECD 2001). The estimated sensitivities exhibit model uncertainty as well as statistical uncertainty, but no quantitative measures of this uncertainty have been reported in publicly available material from the European Commission. Moreover, the methods use historical data and since the underlying relationship may change over time due to e.g. structural changes, the estimated sensitivities may be some distance from the present sensitivities.

Another and arguably larger problem is the uncertainties associated with estimation of the output gap (Larch & Turrini 2009, Marcellino & Musso 2010). The output gap is computed as the actual output minus potential output. Statistics on actual output is available from statistics authorities, but forecasts of the output gap entail the need for forecasts of output. Such forecasts are evidently uncertain even within a time horizon of one year.

The potential output is computed using the production function method, which basically uses estimates of the availability, utilisation and productivity of the different production factors as well as estimates of total factor productivity. The computation of potential output contains several sources of uncertainty. First, the computation will typically entail model uncertainty, including structural breaks, as well as uncertainty stemming from the estimation of the coefficients of the production function. Second, the estimates of factor utilisation and total factor productivity will to some extent depend on the cyclical position of the economy. This implies typically that production and unemployment forecasts are needed, at least for the year for which the potential output is calculated. Sometimes, forecasts for further years ahead are also included as they provide useful information on e.g. the utilisation of the capital stock. The upshot is that ex post estimates of the potential output might be very different from ex ante estimates or, phrased differently, forecasts of potential output even within a short horizon are sui generis very uncertain.\footnote{Marcellino & Musso (2010, p. 5) conclude succinctly with respect to monetary policy: “Despite their appealing characteristics as a relatively clear summary measure of overall slack in the economy, output gap estimates are problematic and represent a potentially misleading input in monetary policy analysis”.

The uncertainties regarding the computation of potential output come on top of the usual uncertainties in the statistics of fiscal variables. Much information is only available with a lag and preliminary estimates are often applied. The result is the revisions in fiscal variables can
be substantial. Some of the uncertainties and possible biases might, however, be associated with the institutional and political features of the individual country (Cimadomo 2011).

An additional source of uncertainty stems from shocks which affect the budget balance, but which are captured by the changes in the output gap. This could for instance be revenue shocks related to changes in the composition of consumption or spending shocks due to natural disasters, security tensions etc. Such shocks would affect the headline balance and, hence, the cyclically adjusted balance.

The discussion above suggest that forecasts of the cyclically adjusted balance one year ahead or even within the year are subject to very large uncertainty. This point can be illustrated by considering the estimates of the cyclically adjusted balance of Latvia published by the European Commission. In the Autumn Forecast 2007, i.e. at the time when the preparation of next year’s budget was in its final stages, the cyclically adjusted balance for 2008 was estimated to be positive and equal to 0.5 percent of GDP. In later forecasts the cyclically adjusted balance for 2008 was adjusted down. In the Spring Forecast 2012 the cyclically adjusted balance for 2008 was reported as -6.5 percent of GDP (European Commission 2007, 2012). The example is extreme, but revisions of one or more percentage points are not unusual.

The uncertainty regarding forecasts of the cyclically adjusted balance complicates the implementation of a policy seeking to satisfy the target in the Fiscal Compact of a cyclically adjusted deficit of at most 0.5 percent of GDP (or 1 percent of GDP). Fiscal policy formulation typically starts 6-9 months before the start of the fiscal year and with such a horizon the forecasts of cyclically adjusted balance stance the next year would be very uncertain due to uncertainty regarding the output gap, other shocks to the fiscal balance as well as statistical errors. It is complex to quantify the resulting uncertainty on the cyclically adjusted balance, but it is bound to be substantial as illustrated by the case of Latvia. The prudent response to such uncertainty would of course be to operate with a large expected surplus on the cyclically adjusted balance in order to ensure that the probability of breach to criterion in the Fiscal Compact is small.

The uncertainties arguably complicate surveillance and enforcement even more. A country which is found to have a cyclically adjusted deficit in excess of 0.5 percent of GDP (or 1 percent of GDP) may argue that the deficit was below target ex ante but that the realisation of various sources of uncertainty led to the result that the MTO was not satisfied ex post. It may thus claim that it was merely a coincidence that the ex post cyclically adjusted deficit was above the target so that this would not count as a breach of the MTO in terms of the Fiscal Compact.

The uncertainties surrounding the budget sensitivities could be seen to have only theoretical interest as long as the sensitivities are published in advance and accepted by the relevant EU countries. However, a country breaching the criterion may argue that the sensitivity used in the calculations of the cyclically adjusted balance does not reflect the “true” current sensitivity and therefore has to be revised. This may for instance apply during a boom in which the output gap is positive; a lower sensitivity would be tantamount to an improved in the cyclically adjusted balance. Such an argument may be dismissed due to formalities, but will be difficult to dismiss based on economic arguments. It is noticeable that the Fiscal Compact already opens for some discretionary adjustment in exceptional circumstances related to unusual shocks or severe recessions, which suggests that the Compact opens for questioning of the model used to compute the cyclically adjusted balance.
Finally, countries may refer to exceptional circumstance. This is particularly alluring when the cyclically adjusted balance target becomes an operational imperative that should be satisfied on a year-to-year basis. Various shocks will undoubtedly affect the fiscal balance and hence the cyclically adjusted fiscal balance. It is challenging to delineate the types of shocks that reflect exceptional circumstances and shocks that fall outside this category.

In summary; the Fiscal Compact turns the MTO of the cyclically adjusted balance into an operational target so that the fiscal policy-making must ensure that the likelihood of the objective being breached is small. The use of the cyclically adjusted balance as an operational target has the advantage of reducing the risk of pro-cyclical fiscal policies. The target, however, has several disadvantages mainly stemming from the uncertainties of the calculation and forecast of the cyclically adjusted balance. The uncertainties complicate the implementation of the MTO as an operational target. The uncertainties in connection with institutional aspects of the Fiscal Compact may have an even greater effect on the enforcement.

A critical view would assert that an operational target regarding the cyclically adjusted balance is rather questionable; the cyclically adjusted balance is unobservable and it is computed from the output gap which is another unobservable variable and a sensitivity coefficient which is estimated very imprecisely. Enforcing such a bendable target could be very difficult and would at the minimum require substantial benevolence by countries facing a potential shortfall.

6. Final comments

The fiscal compact was agreed upon in beginning of 2012 after substantial political wrangling and with two EU countries, the Czech Republic and United Kingdom, refusing to participate. The Fiscal Compact brings the cyclically adjusted balance to the forefront of macroeconomic governance in the EU and the MTO effectively becomes a short-term target. This paper discusses the Fiscal Compact and its role in macroeconomic governance in the EU.

Two striking features of the Fiscal Compact stand out. First, the Fiscal Compact represents only incremental changes in the existing overall framework for macroeconomic governance in the EU, in particular the SGP after the implementation of the “six pack”. There is substantial overlap between the Fiscal Compact and the SGP with the “six pack”, so that the main difference in many areas is only whether all or a subset of EU countries participate. It would arguably have been preferable to amend existing treaties, but this would have been made difficult by the different participation of EU countries in different pieces of legislation.

Second, the Fiscal Compact may have added to an already extensive and complex body of treaties and legislation regarding macroeconomic governance in the EU. The many detailed preventive and corrective measures may on the one hand be seen to address a very important and complex set of issues that are of great importance for the functioning of the European Union and the Eurozone. They complex framework may on the other hand be seen to hamper implementation and enforcement and also to limit public appreciation of the objectives.

It is difficult to assess the efficacy of the Fiscal Compact in avoiding the outbreak of government financing crises in individual EU countries with possible spillover effects on other EU members. It is important to underscore, however, that fiscal crises have many causes. Gov-
Government financing crises occur when countries which seek to issue government debt cannot borrow at reasonable costs due to lack of confidence in financial markets. Sentiment shifts may occur because of developments in economic fundamentals such as the fiscal position of the government, but possibly also other developments such as growth prospects. Experience has shown that developments in the banking sector and financial markets in general can change fast with possible negative consequences on the fiscal position of a country. Finally, crises may occur due to sentiment shifts in financial markets that are largely unrelated to economic fundamentals. These considerations suggest that the FC and its focus on the cyclically adjusted budget balance will at most be one factor contributing to increased fiscal sustainability in the EU.

It was argued that the implementation and enforcement of the FC will be challenging. The implementing challenges for individual countries are partly the result forecasts of the cyclically adjusted fiscal balance being very imprecise and even subject to substantial revisions several years after the year in question. The imprecise forecasts stems largely from the forecast of the output gap and the impact of various shocks.

It was also argued that the same uncertainties make it very difficult to enforce the Fiscal Compact. Countries which are about to breach or have breached the MTO target may simply refer to the uncertainty with which the cyclically adjusted balance is computed. It will be possible for national authorities to produce different estimates of the cyclically adjusted balance based on other assumptions regarding the output gap and the sensitivity of the budget balance to the output gap. The national authorities may also be able to refer to extraordinary circumstances as a means to avoid being sanctioned.

The potentially greatest weakness of the Fiscal Compact is its combination of a strict enforcement regime and a quantitative target, the fulfilment of which is uncertain and open for interpretation. The outcome of the limited enforceability may be that countries expect to be able to avoid paying monetary fines in case of breaches of the target. This raises some questions regarding the efficacy of the Compact.

It is beyond the scope of this paper to discuss alternative or supplemental measures to the Fiscal Compact. It suffices to state that the European Union and the eurozone are rather unique institutions insofar as they are built on a large body of legislative agreements that on the one hand tie countries together, but on the other hand are relatively difficult to enforce. The Fiscal Compact may be seen as yet another measure to address the inherent conflict between decentralised policy-making and mutual interdependence. The Fiscal Compact and its results may thus be...

Opinions regarding the future of Europe are mixed. Increased fiscal integration may be one avenue that may – at least partly – address the implementation and enforcement problems of the Fiscal Compact. An alternative would be more decentralisation and decoupling of the economies in the EU countries so that debt financing problems will have limited spillover effects, but such measures will arguably run counter to the ideals of the European Union of ever increasing integration. Irrespective of the path chosen, it is of paramount importance that the national authorities in charge of fiscal policy take responsibility for and gain ownership of the sustainability of public finances. The European debt crisis is not all in vain if it can lead to greater awareness and understanding of the need to ensure sound fiscal policy-making at the national level.
Literature


