As part of ECFR's ‘Reinvention of Europe’ project, Sebastian Dullien examines the Fiscal Compact that lies at the heart of the growing debate over austerity and growth.

From the Fiscal Compact and austerity to a Growth Compact and Prosperity

Less than half a year ago the Fiscal Compact was being hailed by European leaders as the silver bullet which could permanently end the problem of government profligacy in the euro area, and which would help bring market confidence back to sovereign bond markets. Now, this same treaty has come under heavy attack. While countries such as Spain have passed harsh austerity budgets, the euro area has slid back into recession and employment conditions in crisis countries have taken another turn for the worse. The French Socialist François Hollande has scored points in the presidential campaign by demanding a renegotiation of the treaty and inclusion of elements to encourage growth. Ratification elsewhere might also be in jeopardy: some governments have scheduled referendums on the issue, while others have toppled over their austerity programmes.

Is the Fiscal Compact really to blame for bringing about overly harsh austerity? To answer this it is necessary to examine the fiscal rules currently in place in Europe, along with the austerity that they will imply in coming years and an evaluation of what this means for economic growth. Against this background what can be done to make austerity in the euro area less brutal, preferably without the complications involved in renegotiating the entire Fiscal Compact?

The Fiscal Compact: Only one element among many

Although the Fiscal Compact is currently the popular embodiment of austerity, it is not responsible for actually shaping fiscal policy and austerity in the euro area at present. Indeed, the Fiscal Compact Treaty (or “Treaty on Stability, Coordination and Governance in the Economic and Monetary Union”) includes a number of points which build directly on other European legislation already in place.

Specifically, the new rules of the Fiscal Compact are:

- **National “debt brakes”/”golden rules”:** The member states have committed once again to a budgetary position in “balance or in surplus”. They further commit to pass a national law or an amendment of the national constitution that limits the structural budget deficit to 0.5% of GDP, from which a deviation is only allowed in “exceptional circumstances” or deep recessions. The treaty allows for a transition period, the length of which, however, is not specified. For countries with a debt-to-GDP ratio “significantly below 60% of GDP”, the structural budget deficit may be as high as 1% of GDP.

- **European Court of Justice:** A member state can now bring another member state before the European Court of Justice if it believes that the other state has not fulfilled the provisions of
passing a national “debt brake” into national law. The ECJ can impose a fine of up to 0.1% of GDP.¹

- **The 1/20 rule**: This allows for an excessive deficit procedure to be opened (as defined in the old stability and growth pact) if countries with a debt-to-GDP ratio of more than 60% do not bring that ratio down sufficiently quickly. The requirement is defined as an annual reduction of the debt ratio by 1/20 of the difference between the actual debt-to-GDP ratio and the 60% threshold. This rule is applied over a three-year-average. In addition, countries are given a three-year grace period after the correction of their current deficit below the 3% target before the 1/20 rule would come into effect. Here, the treaty reiterates a similar rule which has been included already in the so-called “Six-Pack”, a package of secondary EU law for fiscal and macroeconomic coordination passed in December 2011.

- **Reverse qualified majority**: The treaty allows for reverse qualified majority voting in the excessive deficit procedure, also in cases where this had not yet been introduced under old European legislation.

It quickly becomes obvious that the treaty refers to and builds on existing European rules of fiscal policy making, especially the original Stability and Growth Pact (SGP) with its Excessive Deficit Procedure, and the “Six Pack” with the 1/20 rule.

The first interesting point to note is that none of the Fiscal Compact rules would make a direct impact on fiscal policy for probably at least half a decade: the compact itself does not specify how much time countries are given before their budget balance has to reach the threshold of 0.5%. When Germany passed its own “Schuldenbremse” (“Debt Brake”) in 2009, the law provided for a transition period until 2020 to bring down the deficit gently. One expects that countries passing their own debt brake would follow that model. Any gradual adjustment in such a debt brake would be much less harsh than the austerity programmes actually decided upon, and so would not really tighten the current path of austerity.

As noted above, the 1/20 rule only starts to be binding four years after a country has brought its deficit below the threshold of 3% of GDP. As all euro countries except Estonia, Luxembourg and Finland are in an excessive deficit procedure (and these three tiny countries have low debt-to-GDP ratios), the earliest of which are set to end in 2012, the 1/20 rule will not have any impact before 2016.

Instead, the current austerity comes from the original rules of the Stability and Growth Pact (SGP) and the tightening already passed with the Six Pack. As a reminder, the SGP contained the following provisions:

- Countries committed to aim for a medium term budget balance “close to balance or in surplus”.

- Countries committed to keeping their debt-to-GDP ratio below 60%, or to try to bring the debt-to-GDP level down to that threshold with "sufficient" speed.

¹ Note that this is a fine if a country fails to write the golden rule into its law, not a reoccurring fine if the rule is violated in the future.
If the current budget deficit is above 3% of GDP (and there was no deep economic downturn accounting for it), an excessive deficit procedure can be opened. Within this excessive deficit procedure, a path for budget adjustment is defined. If countries do not follow the path, fines of up to 0.2% of GDP can be levied.

These provisions were tightened with the Six Pack, as there had been growing consensus that enforcement – especially of the debt-to-GDP ratio and the medium term budget balance – had been too weak. The details of the Six Pack are:

- **Reverse Qualified Majority:** This tightens the excessive deficit procedure by introducing reverse qualified majority on certain types of sanctions provided for in the SGP.

- **The 1/20 rule:** This rule is reiterated in the Fiscal Compact (see above).

- **Medium-Term-Budget Objectives:** The package defines the provision of bringing the public budgets in the medium term “close to balance or in surplus”, and allows for opening an excessive deficit procedure if countries do not comply. For each country, a medium-term-budget objective (MBO) is defined (which ranges between minus 0.5 and plus 0.5% of GDP). As long as this MBO is not reached, the rate of public expenditure growth is limited. If this provision is violated, again, an excessive deficit procedure can be initiated.

- **European Semester:** Member states have to inform the EU institutions about their budget plans early on. These are then reviewed. The intention is to detect emerging budget imbalances early.

**The old rules drive current austerity in the euro area**

Together, the Stability and Growth Pact and the Six Pack (rather than the Fiscal Compact) determine the current fiscal stance we see in Europe. The severe adjustment programmes in Spain and Italy are all part of the normal working of these legislative acts. Within their respective excessive deficit procedures, countries such as Spain, France and Italy have promised to reach certain deficit targets and to bring down their deficit below 3% of GDP over a (usually rather short) predetermined time period. This is why Spain is trying to bring down its deficit from more than 8% in 2011 to 3% by 2013, and why the Netherlands was obliged to pass the significant budget cuts that led to the downfall of their government.

Until the majority of countries have brought down their deficits from an average of 6% of GDP in 2010 to below the threshold of 3%, the main driver for austerity in Europe will remain the SGP and the enhanced enforcement mechanisms prescribed in the Six Pack. The SGP will therefore be the main legal determinant of fiscal policy until at least the end of 2013.

Even without the Fiscal Compact, fiscal policy would remain constrained far beyond 2013, as the Six Pack already prescribes two strongly binding rules: the 1/20 rule to bring down the debt-to-GDP ratio by a predetermined rate, and the limitation of expenditure growth for all countries which have a debt-to-GDP ratio of more than 60% (which again will apply to almost all relevant euro area countries

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2 For space constraint, this paper does not cover the procedure for the prevention and correction of macroeconomic imbalances, but only that for fiscal imbalances.
over the coming decade or so). ECFR calculations\(^3\) indicate that many countries (including Italy and Spain), especially when faced with low economic growth rates, would not be able to run deficits beyond those prescribed in the Fiscal Compact even if its rules were never enacted, as they would otherwise quickly come into conflict with the 1/20 rule.

**So, what does the Fiscal Compact materially change?**

Some commentators (especially in Germany) hope that a multilateral treaty will force compliance more than EU legislation. However this assumption is questionable. There is no procedure to truly enforce a multilateral treaty, and, beyond the possibility of a (relatively small) fine for not passing a “national debt brake” through the European Court of Justice, there are no enforcement provisions in the Fiscal Compact. In contrast, European law might be bent by powerful national governments, but at least there are clear procedures for enforcing rules. It is therefore not at all clear whether the Fiscal Compact will be de facto more binding than the Six Pack, should national governments later decide that they do not want to follow it. The whole situation is complicated by the legal construction of the treaty, which refers to EU institutions, yet remains outside the EU treaty and will likely have different signatories. Materially, the impact of the Fiscal Compact might therefore be much less than hoped for by many fiscal hawks.

**Austerity stifles growth**

How much is austerity stifling the euro zone? My answer is ‘very much indeed’. ECFR calculations indicate that for the euro area as a whole, planned consolidation for 2012 amounts to almost 1.5% of euro area GDP, and another 1% for 2013. This, of course, is distributed extremely unevenly: planned budget cuts in countries such as Spain reach almost 3% of GDP in a single year, while Germany will not have any (or only negligible) budget cuts.

As this tightening is done in a situation where monetary policy cannot be expected to react with large interest rate cuts (given that liquidity conditions are already very loose), and that several countries are now embarking on coordinated austerity policies that amplify the effect of national budget cuts, one can expect the current ‘fiscal multiplier’ to be at least one. This means that GDP growth is dampened by at least as much as the deficit is cut.\(^4\) This then means that austerity measures alone would translate into a dampening effect on GDP growth of at least 1.5% this year, and of at least 1% in 2012 (distributed very unevenly as noted above). This reasoning suggests that austerity alone explains a large part of the current European recession, and indicates that any recovery into 2012 might be extremely weak if consolidation plans are left unaltered. Austerity is also increasingly seen as self-defeating as it reduces the absolute level of GDP, thereby increasing the debt burden as measured in debt-to-GDP-ratios.\(^5\)

If consolidation goes according to plan, the negative impact on growth will recede somewhat after 2013, when countries have reached the 3%-of-GDP threshold for their deficits. After this point, it can be expected that further progress towards the medium-term-budget objective of close to balance

\(^3\) From an internal working paper.

\(^4\) There is a large economic literature on the empirical size of this multiplier with estimates between 0.4 and almost 2. However, the recent experience in the European periphery hints, that under current institutional and historical circumstances, estimates in the mid- to higher range are more realistic.

will be pursued in a slower manner. This might still dampen GDP growth in Europe by a few percentage points, but it will be much less dramatic than the impact in 2012/3.

Another important question is whether the target of a (almost) balanced budget is too tight. Traditional golden rules usually call for a balanced budget over the cycle, excluding capital expenditure. The logic here is that investment yields return in the future, helping to service debt, and therefore should be treated differently from public transfers or public consumption. The EU rules do not make such a differentiation, and so can be seen as prescribing an overly tight fiscal policy that leaves insufficient room for investment.

Empirical evidence from (especially large-scale) previous austerity drives shows that there are cuts to public investment, education and research and development, which may then also have a negative effect on long-term growth potential. There is a large risk of this being repeated by the EU’s current attempts to reach its own fiscal targets.

This all suggests that there is validity in François Hollande’s criticisms of current austerity as harmful for economic growth, although the problem is not only (and not even primarily) the Fiscal Compact. The fiscal framework passed into law last year prescribes extremely harsh austerity in the near future and strongly constrained fiscal policy at least until the middle of the next decade. However, as these have already become law, it does make sense to ask for a renegotiation of the Fiscal Compact if one wants to change something in the current stance of euro area fiscal policy.

Elements of a Growth Compact

Given the limited material impact noted above, and the diplomatic complications caused by the passage of the Fiscal Compact outside the EU treaties, one might think that simply scrapping it was the easiest option. However it is not clear how such a move would now be perceived by financial markets. Before the first round of the French elections, spreads on French government bonds rose as François Hollande’s prospects improved in the polls. Pulling out of the Fiscal Compact altogether might cause a new capital flight. In addition, attempts to reopen the Fiscal Compact will be resisted, especially in Germany. As the compact is Chancellor Merkel’s trademark policy in the fight against the euro crisis (and has been widely applauded in German media), the current government cannot be expected to step back from the already agreed treaty.

A more promising solution would perhaps be to add a “Growth Compact” to the Fiscal Compact, as proposed by ECB president Mario Draghi. However, while the label coined by Mr Draghi is ideal, his proposals would be insufficient to alleviate the growth-inhibiting impact of current austerity. These proposals – for better and more focused use of existing EU funds, along with structural, growth-enhancing reforms – would bring in little that is new, relative to current conditions in IMF programmes. The existing EU funds would be too small to make a real impact, particularly in larger economies, and structural reforms usually take years before their positive impact can be seen.

An appropriate Growth Compact would therefore have to do more, getting relevant funds of a suitable magnitude moving again in Europe.

In addition to whatever can be done to activate dormant funds from cohesion funds and other EU budget lines, three main elements would be needed, all of which could be enacted without altering the Fiscal Compact:
1. **Allow for a longer adjustment period:** Crisis countries with large deficits (such as Spain) should be given more time to get back to the deficit-threshold of 3% of GDP. This could help break the downward spiral of contracting GDP, rising unemployment and rising deficits, by allowing the countries to exit recession before more austerity is applied.

2. **Reorganise the financing of public investment in Europe:** To make sure that public investment is not reduced beyond any sensible level, the financing of public investment could be taken out of the national budgets (and hence the measured deficit). One possibility would be to give the European Investment Bank a central role in public investment financing. Under such a scheme, national governments could lease new infrastructure investment from the EIB. The EIB would borrow the necessary funds in the market and pay for construction, while the national governments would, over the time of their use, pay the EIB a user fee that covers interest rates and depreciation. Under such a scheme, national governments could bring down their national budget deficits and debt-to-GDP-levels without having to cut investments into the future.

3. **Relieve crisis countries from excessive interest rate burdens:** One current critical problem is that crisis countries have to pay stiflingly high interest rates, which then impact private sector companies in those countries as their financing costs are often linked to their sovereign’s interest rates. A move towards euro-bonds or the introduction of a European debt redemption fund (as recommended by the German Council of Economic Advisors) would significantly lower these interest rates, and so help the countries back towards the path of economic growth.

Adding such a meaningful Growth Compact to the Fiscal Compact might provide the best way out of the current stalemate. Countries such as Germany may be willing to sign up for it as the price for ratifying the Fiscal Compact. For their part, countries sceptical of the current austerity stance might be willing to accept the Fiscal Compact if they see that the overall package is better than the status quo (especially as the Fiscal Compact is unlikely to have as large an impact as they fear). For Europe, this would be a large step forward, potentially helping to end the current down-turn and return the world’s largest currency area back to economic growth.

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