The Economics of the Fiscal Compact
Policy Institute

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Fiscal Governance

- Costs of excessive public debt
- Costs of fiscal pro-cyclicality
- “Commitment” versus “Discretion”
- role of a formal fiscal framework (plus political will)
- first line of defence: domestic
- second line of defence: EU level (fiscal spillovers)
Fiscal Compact: A “Gateway” Reform

- helpful in facilitating ECB role in bond market stabilisation
- condition for ESM funds
- necessary for joint bond issuance
- European-level “banking union”
  - (Bruegel: 2 percent of GDP)
- European-level fiscal initiatives
Domestic Fiscal Reform

- Fiscal Responsibility Bill (now Q2 2012)
- Oireachtas Committee Report (November 2010)
- DF report (March 2011)
- IFAC report (January 2012)
EU Economic Governance Reforms

- **November 16**: “Six Pack”
  - Three fiscal regulations and one fiscal directive
  - Two regulations on “excessive imbalances procedure” (EIP)
- **November 23**: Two further proposed regulations by European Commission to strengthen fiscal governance (also green paper on stability bonds)
- **December 9**: “Fiscal Compact” proposed
- **January**: Fiscal Compact Treaty published
Fiscal Compact

- Very high level statement of principles
- Fiscal elements of “six pack” - more detailed guidance
- Article 3: structural budget balance
  - meets country-specific medium-term budget objective (MTBO)
  - floor of 0.5 percent
  - floor of 1 percent for ‘low risk’ countries
  - convergence towards MTBO if initially away from MTBO (0.5 percent annual improvement a reference point)
  - **Automatic correction mechanism** if deviation from MTBO or adjustment path
- Article 4: debt reduction commitment if debt above 60 percent [“one twentieth” rule]
Country-specific; reset every 3 years

MTBO - fiscal sustainability (including demographics), other economic targets (growth, ..)

‘Optimal’ MTBO?
- target level of public debt
- more restrictive MTBO for high-debt countries
- key focus for political debate

MTBO framework consistent with any target for public spending share in GDP
Structural Budget Balance

- Cyclical adjustment - automatic stabilisers
- One-off and temporary measures
- Six pack - broad view (including public investment exceptions)
- “Activist counter-cyclical” measures possible: The Council and the Commission shall take into account whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times. In particular, revenue windfalls and shortfalls shall be taken into account.
  - reinforces importance of actively building up surpluses in good times
  - coherent with “excessive imbalances procedure” - fiscal action to address credit cycle, current account cycle, competitiveness cycle
- Measurement - broad range of estimates; pragmatic implementation (?)
Ex Post Correction Mechanism

- Absent from DF report: “Bygones are bygones”
- Clawback policy to avoid debt drift
  - “control” account
  - German and Swiss examples
Debt Reduction

- “One Twentieth” Rule implies debt target in year $t$
  
  $b_t^* = 0.60 + \left(\frac{1}{3}\right)0.95(b_{t-1} - 0.60) + \left(\frac{1}{3}\right)0.95^2(b_{t-2} - 0.60) + \left(\frac{1}{3}\right)0.95^3(b_{t-3} - 0.60)$

- Debt reduction target more robust than a (cyclically-adjusted) primary surplus target (DF report)
  
  debt reduction associated with a given primary surplus depends on growth rate and interest rate
Independent Medium-Term Macroeconomic/Fiscal Forecasts

- A reference point in “six pack”, along with European Commission forecast
- Required in November 23 proposed regulation
  - European Commission?
  - Irish CPB?
  - Irish OBR?
  - ESRI?
  - Central Bank?
  - IFAC Mark II?
- More formal analysis of medium-term path for Ireland a priority
Final Remarks

- Fiscal Compact - last crisis or next crisis?
- Sequencing of reforms
- Fiscal frameworks: long-term effectiveness?