Automatic Austerity

10 things you need to know about 'the Fiscal Compact'

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On the 2nd of March 2012, 25 EU heads of state or government signed a new treaty[1], and if all goes as planned, it will enter into force early next year. The so called 'Fiscal Compact' was conceived in next to no time, and had a dramatic start when it was vetoed by the UK at a meeting of the European Council on 9 December, preventing a regular change to the EU treaty. Instead, governments opted to create a new legal vehicle – which can be adopted more quickly with less risk of annoying interference from democratic debate and the public; a separate EU-treaty that's not really an EU-treaty.

The treaty is about strengthening the rules to ensure signatory states apply strict budgetary policies. Notably, so called 'structural deficits' are to stay permanently below a limit of 0.5 % of GDP. News of the treaty was applauded by the business community, including the European employers' federation BusinessEurope, but trade unions denounced it emphatically, with the European Trade Union Confederation for the first time rejecting a new treaty outright.

Why now?

"This Treaty might reassure Kanzlerin [Chancellor] Merkel's political friends, but not the millions of unemployed, poor or precarious workers in Europe who are waiting for decisive support from EU institutions. This is why we are opposed to it," Bernadette Ségol, the secretary general of ETUC said[2].

Most analysts and commentators agree: the treaty is not about the current crisis. It will not change the course of the eurocrisis, and is not really intended to do so. It's about the future of economic policy, and the German electorate. Chancellor Angela Merkel needs to reassure the German public that she's being tough with the highly indebted countries to bolster her popularity and provide the government with the leeway to co-fund the new European Stability Mechanism – the fund to provide loans to member states in deep economic trouble. To do this she must ensure they stick to a tough austerity programme in return.

Three novelties

A quick scan of the new treaty might give the impression that we're dealing with a comprehensive set of new rules and mechanisms. The text appears to be full of intricate devices to steer member states' economic policies in a range of areas. But if you filter out the self-congratulatory words about past ‘achievements’, the repetition of benchmarks and objectives already covered by EU legislation, plus the wording on upcoming initiatives, what’s left is a pretty short list of three novelties: more formalised Eurozone summits, more swift action against countries with budget deficits, and last but not least the so called ‘debt brake’ – strong enforcement of rules to keep deficits down and the debt from growing.

Unpicking the intricacies is complicated, but the main features of the treaty can be described in 10 points.

1. It´s an ‘Austerity Treaty’

The most important feature of the treaty is the requirement that member states tighten their fiscal policies (ie. minimise or avoid budget deficits) to an even greater extent than currently required under existing EU rules.

Containing deficits is, of course, not new for the European Union. The stability and growth pact that underpins the Economic and Monetary Union requires member states to keep their budget deficit below 3% of GDP. And in the case of Eurozone countries, governments can be fined if they do not respect the limit. But first, they are given a programme to set them on course towards a balanced budget. The key element in this ‘adjustment programme’ is the reduction of the ‘structural deficit’ (see box), typically to reach a benchmark of 0.5% of GDP in several years[3]. Now, under the new treaty, this benchmark is no longer a benchmark – it’s to be the rule.

What is ‘the structural deficit’?

Structural deficit = Total deficit – Cyclical deficit – One-off measures

The structural deficit is supposed to reveal any medium term mismatch between government expenditure and revenue. To get to that number, two things have to be subtracted from the actual total deficit: the first is the effect of particular current circumstances, the ups and downs, of the economy, the so called ‘cyclical deficit’. The second are temporary expenses inflicted on the government - the so called ‘one-off measures’ – restricted to a list of legitimate expenses. This calculation gives you the number that is supposed to show whether the government should pull itself together and cut expenditure or raise taxes. This would restrain the debt and so a requirement to keep the structural deficit low is often called ‘a debt brake’.

Had the treaty been in force, the required cuts (or tax rises) would have been quite dramatic: at the moment only four EU countries have a deficit below the magic threshold (Luxembourg, Finland, Sweden and Estonia)[4]. In many countries, dramatic changes would be needed, as for example in Belgium where 4.0% of a total deficit of 4.6% is regarded as ‘structural deficit’ by the Commission. Under the treaty, Belgium would be given a new and much stronger ‘stability pact’ forcing the Belgian government to lower the deficit to 1,1 % of GDP – not the current 3%.

At first glance, signatory states do not appear to be directly coerced into taking specific measures such as cutting social expenditure. But bringing the structural deficit down requires specific measures. The Commission’s recommendations to member states which have an excessive deficit procedure – that's currently it's 23 (!) of the 27 member states – are clear that cutting social expenditure is the right way to bring down any structural deficit.[5] A 0.5% limit to the structural deficit will seriously restrict the options open to governments, eg. in times of crisis. It will impede the use of public investment as a crisis response, and it is biased against social expenditure.

Also, the focus in the treaty – as well as in current EU-rules and procedures, such as the stability pact, is on expenditure. This was confirmed and underlined with the adoption of the 'Europact' (or Europlus Pact) in March 2011 that stresses that the 'sustainability of public finances' should be reached by attacking pensions, health care expenditure and social expenditure[6].

In short: this is an Austerity Treaty.

2. It will be automatic

Should the 'debt brake' not be respected by the government during the 'national budgetary processes' (planning, adoption, implementation), mechanisms within the country's own legislation will trigger sanctions – serious enough to make the government get back on track.

That begs the question: who is to keep governments' policies in place and how? Who can sue the government and force it to change policies, or how will this work? We get a hint from the Treaty. It puts the responsibility for defining 'common principles' for the rules in the hands of the European Commission, including principles on "the independence of the institutions responsible at national level for monitoring the observance of the rules." In other words, independent bodies at member state level are to be set up, presumably consisting of economists and legal experts, to discipline member-state governments[7].

3. It will be forever

The tight budget policies are to be everlasting.

The text states that member states are to adopt "provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes". In other words, forever.

Germany prefers that signatory states implement this the same way as in Germany. Germany recently adopted a change to its constitution that will force future governments to stay below a 0.35% structural deficit. Now, Chancellor Merkel wants to see something similar in other member states. There is some flexibility, though. Other kinds of rules can be chosen, but they have to be 'permanent'. As Merkel said at the end of the negotiations:

"The debt brakes will be binding and valid forever. Never will you be able to change them through a parliamentary majority." [8]

The text does read that this "shall fully respect the prerogatives of national Parliaments", but in the context it looks like little more than an unintended insult.

In some countries changes to the constitution need to be submitted to a referendum, and that is a scenario governments are trying to avoid. One way of doing so inside the framework of this new EU-treaty that's not really an EU-treaty, might be to come up with a permanent constitution-like rule that's not really in the constitution.

4. If in doubt, the European Court of Justice will have the final word

What if one member state (or signatory state) thinks another member state has not adopted rules strong enough to uphold the principle? In that case, the annoyed member state can open a case against the culprit in the European Court of Justice. This might be slightly confusing, because it's the job of the European Court of Justice to uphold EU legislation, not to sort out differences between member states in general, nor to pass judgements on non-EU treaties. But in this case, the Court has been placed in a position to impose fines of 0.1% of GDP.

The European Court of Justice's key role may become important in the future. It will enable any member state to file a complaint at any point on the implementation of the treaty in another signatory state. In fact, though the Commission is not supposed to play a formal role in a non-EU treaty, the Commission is provided with a back door to a court case: if a report from the Commission concludes that implementation of the 'debt brake' has not been implemented sufficiently in a member state, then 'the matter will be brought to Court' one of the other signatory states (article 8, para 1).

5. Little or no flexibility

Will signatory governments have to bring their structural deficits down to 0.5% of GDP tomorrow?

No, but it does have to happen quickly. It's not clear how much time is allowed from the Commission's proposal. On their way to the target, signatory states can be allowed to deviate from the narrow path of austerity, provided they've experienced negative or very low growth and provided deviating doesn't endanger "fiscal sustainability in the medium term". The same exception applies when the target of a max. 0.5% deficit has been reached.

But the exception is not clear, and may even never be used. The only tangible flexibility is that signatory states with a low debt can run a deficit up to one per cent of GDP – an exception only few countries will be able to enjoy in the next few years[9]. But even when in a crisis, or when experiencing low growth, signatory states will encounter severe difficulties should they opt for an expansionary fiscal policy and for major public investment as a way out. This whole exercise is biased against the kind of Keynesian response to a crisis that history has proved effective: that it's actually sound economic policy to respond to a crisis with an expansionary policy, even if at the cost of a balanced budget.

"In good times we don't need it. In bad times it's the wrong policy. It's not a sign of bad politics to run a deficit in times of crisis," as the professor of economics Jesper Jespersen put it[10].

The treaty will carve the current response to the crisis in stone and make sure that when in crisis, the blame falls automatically on public spending – even if, as at present, the roots of the crisis lie in the private economy. Wrong diagnosis, wrong cure.

6. The calculation method is biased against social expenditure

The details of calculating the 'structural deficit' are too complicated to ever be comprehensible or transparent to the public. And in fact, there is no consensus internationally or even within the EU on the calculation method. The IMF, the OECD, The European Central Bank and the European Commission each use their own methods, and some EU member states also have their own approach.

But the method used is crucial. This figure – 0.5% – can determine the future of key social rights. And whether a government is running a structural deficit on the wrong side of this threshold is, to a large extent, determined by the way it's calculated.

For example: for 2011, the Commission calculated the structural deficit of Denmark to be three per cent. The Danish government, on the other hand, claims the structural deficit is about one per cent. If the Commission's calculation was to used, Denmark would have to cut back on expenses (or raise taxes), with double the costs to the country's early retirement scheme!

The Danish National Bank as well as the Denmark's Ministry of Finance claim to have developed a method that better reflects the Danish economy. They argue that the Commission's method is biased against countries with high levels of unemployment benefits. As a consequence the Danish government has insisted on being able to use its own methods. And because the Commission bases its calculations on a very short list of other expenses- the 'one-off measures' - that can be deducted from the total.[11].

If the desire for some flexibility on method is to be satisfied, it would require a change to the Treaty text. At the moment, the Commission is to draft the common principles to be adopted at a later date, and it's highly unlikely to suggest methods other than those it has developed and been using to assess member state budgets. Likewise, if the approach of a member state is to be judged by the European Court of Justice, it would be highly surprising if the court supported any other methods than those the European Commission has been using for many years.

In the long run, country- specific methods adapted to the economies of individual states are not likely to survive. The Commission loves harmonized calculation methods that allow it to gloss over specifics of local economies, and it's not likely to change tack at a moment when uniform fiscal discipline is the order of the day. More than anything, that will be the Commission's priority; a straight forward no-nonsense and no-discussion political tool.

7. It's a political tool - calculations are unreliable and dangerous

But actually, the Commission has nothing to brag about in its record in recent years. In fact, the Commission's calculations for member states structural deficits have sometimes been proven to be far off the mark. Ireland is a case in point. In late 2008, the Commission projected that the Irish economy would continue at its optimum level in 2009. Had the new treaty been in force, the budget would have been prepared based on this assumption. The Irish government would have expected a low structural deficit and allowed some leeway for expenditure. In the course of the year, however, the Irish government would have been forced into drastic and immediate cuts. For in fact, the Irish economy plunged, and the numbers had to be drastically revised. The calculations, in other words, gave far too rosy a picture of the structural deficit.

The opposite can also be the case. The Commission's assessment of the Irish growth rates – potential and actual rates – showed that the deep economic crisis had not significantly altered the gap between the actual growth rate and the potential growth rate. In other words: whether the Irish economy is in deep crisis or experiencing a boom does not really change anything. Ireland is close to optimum performance in either scenario[12]. This is not very realistic. And actually it is rather dangerous. A low 'performance gap' in times of crisis, suggests a large 'structural component' to the debt, and with the new treaty this would lead straight to massive immediate cuts.

This is not only because the Commission is not equipped with a crystal ball. Calculating the structural deficit goes through several steps which include guesstimates. In the method used by the Commission to determine the cyclical deficit, two estimates are multiplied with each other, and so – to put it bluntly – uncertainty is multiplied[13].

The use of the idea of a 'structural deficit' is not chosen for its remarkable ability to give a precise view of the state of the economy. It's elevated to its current status to serve as a political tool to blame budgets for the ills of the economy, and to reform member states' economic policies.

8. The Eurozone is in the driver's seat

Besides the 'debt brake', the treaty has two other important sections.

The first is the formal adoption of a decision from October to have at least two Eurozone summits a year. These are to be chaired by a new Eurozone Summit President to be "appointed by the Heads of State or Government of the Contracting Parties whose currency is the euro by simple majority at the same time the European Council elects its President and for the same term of office." This part of the treaty was controversial. A number of non-Eurozone country governments, spearheaded by Poland, were uncomfortable with being left out of the Euroclub, which they fear will start making the real decisions on behalf of the Union as a whole. The Eurozone commands a qualified majority. As a token of good will, the non-Eurozone signatory states can participate in discussions on particular subjects at Eurozone summits and in a separate annual meeting of the signatories to the new treaty.

9. Swift submission and fines for deficit countries

The second element concerns the rules about countries running a deficit, which is being changed again. Under the EU treaty, member states are obliged to respect a threshold of three per cent deficit on their state budgets. If they don't, a procedure can be initiated – the so called Excessive Deficit Procedure. The procedure entails a number of steps – first there's the decision to start it, then the government of the member state in question has to produce a report to show how it will fix the problem, then if it doesn't perform convincingly it can receive a warning, and in the end if it's a Eurozone country, it can be fined. In 2011 this procedure was tightened considerably with a decision to use a voting system in the Council called 'the reverse qualified majority vote'. That means that in order to repeal a proposal to move forward with the procedure, there has to be a qualified majority. This rule is now being used at every step of the procedure except one - the initiation.

But how can a non-EU treaty interfere with EU-regulation? Won't they have to ask the European Parliament and go through the other steps involved to change EU rules?

With the new treaty these procedures are circumvented by organising separate Eurozone votes. the basic decision is that before a vote in the Council, the Eurozone will make up its mind in a separate meeting. Since the Eurozone commands a qualified majority in the Council, they can pretty much run the show. So when the question comes up as to whether the Council will support a proposal from the Commission to start proceedings against a member state, there has to be a qualified majority against such a measure inside the euro group if it is to be rejected. If not, then the Eurozone will vote 'en bloc', ie. together, to support the commencement of the excessive deficit procedure. By deciding this procedure outside the framework of the EU, it will not formally change EU procedures, and so the European Parliament will not decide on the matter[14].

The loser here is France which in 2011 opposed the used of 'reverse qualified majority voting' in decisions on the launch of the procedure. Now it's there in the new treaty.

This will become increasingly important in years to come. At the moment, according to the latest figures from Eurostat[15], all EU countries except four[16] run deficits above the three per cent allowed, and only four EU member states are not going through the excessive deficit procedure.

10. It will become (real) EU law

The treaty is not an EU-treaty. Even so, it hands over new tasks and responsibilities to the Commission and entrusts the European Court of Justice with a new and formidable power. It's as close to an EU vehicle as you can get. Within five years, the treaty is to be integrated into the EU treaty, and considering the current state of the debate, this is a likely scenario. Only the Czech Republic and the UK are currently outside the treaty, and UK opposition was initially bitter and staunch. Since then, though, moods have calmed and due to existing arrangements, the UK could easily be exempt from the new provisions in the EU treaty.

A challenge to welfare and democracy

By then, it will probably not make much difference. The real change will happen in the short term. Only last year, rules on excessive budget deficits were strengthened considerably, with countries in deficit facing tougher deadlines, demands for quicker fixes, more intrusive reform demands with a preference for cuts in social expenditure, and higher fines. With the Euro pact (or Europlus pact) and the reforms dubbed 'the six pack' on economic governance, this trend has become stronger. The thumb screws are being tightened one more notch with this 'Austerity Treaty', which marks the next step in the build-up of a complex web of regulation to make austerity the overarching response to the crisis, and exert a serious blow to European welfare.

But this will hardly go down easily. The fact that 25 heads of state or government put their signature on the deal, does not mean it's all done. For a start, it will have to be ratified, and though the treaty was designed to avoid public votes, the Irish government has been forced to call for a referendum later this year. And even if ratified and implemented, the treaty is likely to meet with considerable resistance as it becomes clear what the consequences are.

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[1] The Fiscal Compact, or "The treaty, stability,. Coordination and governance in the Economic and Monetary Union", http://www.european-council.europa.eu/media/579087/treaty.pdf

[2] Press release from the ETUC, 31. January 2012, http://etuc.org/a/9605

[3] Regulation 1466/97, article 5, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF

[4] Eurostat statistics, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb080&plugin=1

[5] European Economy, Occassional Papers 65, 2010, http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp65_en.pdf

[6] The Europlus Pact, page 19 in the Council conclusions, 24-25. March 2011, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf

[7] A strong role for independent bodies has been debated for a while in the EU institutions and new legislation seems to be coming up.

[8]The Guardian, 30 January 2012, http://www.guardian.co.uk/business/2012/jan/30/eu-summit-eurozone-treaty-deal?newsfeed=true

[9] Eurostat Newsrelease, 6. February 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-06022012-AP/EN/2-06022012-AP-EN.PDF

[10] Professor Jesper Jespersen, interview, 24th of February.

[11] European Commission, European Economy no 3, 2006, http://ec.europa.eu/economy_finance/publications/publication423_en.pdf

[12] Examples from Pat McArcle; "The Euro Crisis: The 'Fiscal Compact' and Fiscal Policy", Working Paper 6, Institute of International and European Affairs, 2012, page 13. http://www.iiea.com/publications/the-euro-crisis-the-fiscal-compact-and-fiscal-policy

[13] A thorough critique of the method of the Commission has been carried out by the Danish National Bank (Economic Department): Ann-Louise Winther; "Konjunkturudsving og offentlige finanser", Kvartalsoversigt, 1. Kvartal 2011 del 1, Danmarks Nationalbank, 2011, pp. 71- 91. https://www.nationalbanken.dk/C1256BE2005737D3/side/7E21A951977D9382C1257855004AE526/$file/konjunkturudsving.pdf

[14] In reality, though, it would hardly make a difference. A majority in the European Parliament would support this approach. That was clear from the debates in 2011 on the strengthening of the Stability and Growth Pact.

[15] Eurostat statistics; http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb080&plugin=1

[16] Sweden, Finland, Estonia, and Luxembourg, are the exceptions to the rule. See http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm