EUROPEAN FISCAL STABILITY TREATY – MARCH, 2012

ISSUE

The current status of fiscal legislation in the European Union (EU).

KEY POINTS

- The March 2, 2012 signing of a “fiscal agreement” between most members of the EU is a response to the precarious financial position of several eurozone countries.

- Its intent is to maintain confidence in the euro and restore confidence in the eurozone’s financially weaker members, notably Greece, Portugal, Ireland, Italy and Spain.

- The agreement outlines fiscal rules intended to limit government deficits and debt and outlines mechanisms to co-ordinate budget plan development among member countries.

- The agreement, if ratified by at least 12 euro-currency signatories, will come into force on January 1, 2013, and could, within 5 years, be part of the EU’s legal framework.

BACKGROUND

Current Status

The Treaty On Stability, Coordination And Governance In The Economic And Monetary Union has been signed, but not ratified, by 25 of the 27 EU members (the United Kingdom and the Czech Republic did not sign). All 17 eurozone countries were signatories.

- While it is called a “treaty”, it is, for all practical purposes, an intergovernmental agreement, as it is not yet integrated into the legal framework of the EU (Article 16).

The ratification phase is now underway and must be completed by January 1, 2013. It is reasonable to expect that at least some of the 17 eurozone countries will not ratify the agreement.

- Ireland, for example, will hold a referendum on ratification, putting the decision in the hands of voters who may vote on the basis of individual rather than international considerations.

- The agreement’s framers appear to have anticipated this by allowing up to 5 eurozone members to refuse ratification without nullifying the agreement.
Fiscal Rules

The agreement falls under the general class of laws commonly called “balanced budget legislation.” Such laws identify restrictions on the fiscal authority’s decision-making flexibility.

The major fiscal restrictions of this agreement are as follows.

- The lower limit of an annual structural budget balance is a deficit of 0.5 per cent of GDP, or 1.0 per cent of GDP if debt is less than 60 per cent of GDP (Article 3).
- If debt is over 60 per cent of GDP, it is to be reduced by one-twentieth per year (Article 4).
- Budgets and debt issuance plans must be reviewed ex-ante by EU bodies (Articles 5, 6).
- Non-compliance can result in a penalty of 0.1 per cent of GDP (Article 8).

Compliance Determination

Compliance with the agreement is partly determined by the concept of a “cyclically-adjusted budget balance” (CABB), net of “one-off” measures (Article 3(3)).

- CABBs attempt to partition an annual accounting balance measure into cyclical (temporary) and structural (permanent) components.
- CABBs require sophisticated economic models and estimated parameters to construct the economic cycle that is removed from the accounting-based budget balance.
- The complexity and variety of CABB methods, combined with the allowance for undefined “one-off” measures, leaves considerable room for interpretation and confusion.

Comparison to Previous Fiscal Treaties

The current agreement has similar import to the 1993 Maastricht Treaty (Protocol on the excessive deficit procedure) limiting deficits/debt to 3/60 per cent of GDP.

- Both documents share the characteristic of attempting to impose external rules on a sovereign government. During periods of fiscal stress, sovereign considerations dominate all others.
- The terms of the Maastricht Treaty were frequently ignored by many eurozone countries, including Germany and France, diminishing the credibility of the current one.

LEVEL OF CONFIDENTIALITY

Public information.