

## 8 The fiscal compact: the Commission's review and the way forward

**In response to the sovereign debt crisis, the fiscal compact was set up to foster budgetary discipline and increase national ownership of the fiscal governance framework.** This was to be achieved by anchoring in national legislation the principles of sound fiscal policies set out in the Stability and Growth Pact and by ensuring that institutions are in place to support a well-informed national political debate on these issues.

**To achieve these objectives, the fiscal compact<sup>32</sup> obliges participating countries to commit legally to a balanced budget rule and to set up institutions to monitor adherence to this rule.** The balanced budget rule, which should preferably be enshrined at the constitutional level, is deemed to be respected if a country's structural balance is in line with its country-specific medium-term objective (MTO).<sup>33</sup> Countries which have not yet achieved their MTO should ensure rapid convergence towards it. In the event of significant deviations from the rule, a correction mechanism at the national level should automatically be triggered. With respect to the latter, the Commission has proposed common principles, which, inter alia, specify the nature, size and time frame of the corrective action.<sup>34</sup> Regarding the institutional monitoring, the governments bound by the fiscal compact have committed to set up national independent fiscal institutions (referred to as fiscal councils) to monitor compliance with the rules. These institutions should also play a role in the activation of the correction mechanism in the event that countries deviate from the rule.<sup>35</sup> Moreover, in line with the common principles, national authorities should adhere to the "comply or explain" principle when responding to the assessments made by the fiscal councils, i.e. they should either follow the latter's advice or publicly explain why they are departing from it. The fiscal compact supplements other recent amendments to strengthen the fiscal governance framework at the national level, such as the directive on national budgetary frameworks and the "two-pack" regulations.<sup>36</sup>

**The European Commission published its review of the transposition of the fiscal compact into national legislation in February this year, three years after the transposition deadline (1 January 2014).**<sup>37</sup> The Commission's review is crucial, as, if a contracting party is found not to have complied with the transposition

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<sup>32</sup> The fiscal compact is part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG). The TSCG entered into force on 1 January 2013, with a one-year deadline for its transposition into national legislation. It is an intergovernmental treaty, signed by 25 countries (the "contracting parties") of which 22, namely the 19 euro area countries plus Bulgaria, Denmark and Romania, are formally bound by the fiscal compact.

<sup>33</sup> See also the article entitled "A fiscal compact for a stronger economic and monetary union", *Monthly Bulletin*, ECB, May 2012 and the box entitled "Main elements of the fiscal compact", *Monthly Bulletin*, ECB, March 2012.

<sup>34</sup> See the Commission's [communication on the common principles](#).

<sup>35</sup> In the "two-pack" regulations, the tasks of the independent fiscal institutions are further specified and include producing, or at least endorsing, the macroeconomic projections used for the budgetary plans.

<sup>36</sup> See the [directive on national budgetary frameworks](#) and the relevant "two-pack" [regulation](#).

<sup>37</sup> See the Commission's [review of the fiscal compact transposition](#).

requirements, the matter may be brought before the European Court of Justice. Moreover, a country could face a penalty payment of up to 0.1% of GDP if it does not respect the Court's judgement within a set period.

**According to the Commission's review, all countries have complied with the requirements.** However, in some cases the positive assessment is subject to the future adoption of complementary or amended provisions. The review focuses, for each country, on (i) the legal status of the provisions, (ii) the formulation of the balanced budget rule, (iii) the correction mechanism, and (iv) the set-up of the independent fiscal council. Regarding the legal status of the provisions and the formulation of the balanced budget rule, the Commission finds that "all contracting parties have significantly adapted their national fiscal frameworks as a result of the fiscal compact requirements", notwithstanding national differences. In particular, all contracting parties are found to have put in place a binding balanced budget rule (although only some at the constitutional level) and to have set the lower deficit limit at -0.5% of GDP. However, countries differ in how they aim to ensure rapid convergence towards their respective MTOs. In some countries the definitions of exceptional circumstances, which enable the application of escape clauses, seem broader than in the Stability and Growth Pact. The Commission's review also points to differences regarding the automaticity of the correction mechanism and the scope of the required corrective action. As regards the fiscal councils, the Commission confirmed that their mandate to monitor rule compliance and their institutional set-up were enshrined in legislation, although with varying degrees of detail.

**The Commission's overall positive assessment contrasts with the fact that the fiscal compact has been only partially transposed in many countries.** The Commission's assessment of "being compliant" is, for several countries, conditional on formal commitments by the national authorities either to implement remaining parts of the fiscal compact or to ensure that they will be fully complied with in the future. Commitments are, however, not an adequate substitute for legal provisions, as they are not enforceable. Formal commitments have been made with regard to the balanced budget rule by the authorities of Denmark, France, Cyprus, Lithuania, the Netherlands and Romania (see table). Moreover, a large number of countries, namely Belgium, Denmark, Greece, Spain, France, Italy, Luxembourg, Austria, Portugal and Slovakia, have not yet formally integrated an unconditional "comply or explain" principle into their legal frameworks. Instead, they have only promised to respect the principle or to amend their legal provisions. Furthermore, regarding the correction mechanism, France's provisions governing the substance of the mechanism and Latvia's definition of the escape clause allow for some scope for flexibility. Finally, the Commission concurred with the set-up and design of the monitoring institutions, although in some countries, namely Belgium, Denmark, Spain, France, Luxembourg and the Netherlands, their independence was not found to be fully ensured by national legislation.

## Table

Overview of the “conditioning factors” referred to in the Commission’s review of compliance with the fiscal compact

	balanced budget rule	correction mechanism	fiscal council	comply/explain principle
formal commitments	DK, FR, CY, LT, NL, RO	FR, LV	DK, ES, FR, LU, NL	DK, ES, FR, IT, LU, AT, PT, SK
clarifications		BE, DK, IT, LT, LU	LT, NL, PT	
legal amendments			BE	BE, GR
actions to be taken			SI	

Source: European Commission.

Notes: The “conditioning factors” (formal commitments, clarifications by the national authorities on the interpretation of certain legal provisions, promised legal amendments and actions to be taken) refer to those parts of the fiscal compact which have not yet been transposed into national legislation but which the national authorities have promised to fully comply with in the future. Since the publication of the review, Slovenia has taken action by appointing the members of the newly established monitoring institution.

**Overall, the slow and incomplete transposition of the fiscal compact is disappointing.** It signals a clear risk that the intended anchoring of sound fiscal policy rules at the national level may not materialise. In combination with an implementation of the EU fiscal framework which may be perceived as not sufficiently complete, this could contribute to undermining the credibility of sound fiscal policymaking.

**As a follow-up to the review, it will be important to closely monitor whether the authorities fulfil their commitments.** The Commission’s review focuses on the question of whether the main elements of the fiscal compact are sufficiently enshrined in national provisions. Neither their practical implementation nor their effectiveness are discussed. Looking ahead, it would be valuable to thoroughly assess the effectiveness of the fiscal compact.<sup>38</sup> Such effectiveness, realised in the form of better budgetary discipline, can only be ensured if and when countries fully adhere to the agreed commitments contained in the fiscal compact.

<sup>38</sup> This will also be important for the question of whether to integrate the main elements of the fiscal compact into EU legislation – an option foreseen in the TSCG.