

Box 12

MAIN ELEMENTS OF THE FISCAL COMPACT

The fiscal compact as enshrined in the new “Treaty on Stability, Coordination and Governance in the Economic and Monetary Union” was agreed at the EU summit of 30 January 2012 and signed on 2 March by the Heads of State or Government of all EU countries, with the exception of the United Kingdom and the Czech Republic. In addition to the fiscal compact, the new Treaty includes provisions to foster economic policy coordination and convergence and to strengthen the governance of the euro area. The fiscal compact is a step towards a true “fiscal stability union”, as it aims to strengthen the fiscal governance framework in the euro area and addresses some of the shortcomings of the recently reinforced Stability and Growth Pact.¹ It follows the agreement by the euro area Heads of State or Government on 9 December 2011 on the basic cornerstones of the fiscal compact. The new Treaty will enter into force after it has been ratified by at least 12 euro area countries. This box gives a brief overview of the main elements of the fiscal compact:

- 1. A mandatory balanced budget rule:** The signatory Member States commit themselves to implement in their legislation a fiscal rule which requires that the general government budget be balanced or in surplus. The fiscal rule is considered to be respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a deficit (in structural terms) of 0.5% of GDP. If the government debt ratio is significantly below 60% of GDP and risks to long-term fiscal sustainability are low, the medium-term objective can be set as low as a structural deficit of at most 1% of GDP.
 - **Rapid convergence towards the medium-term objective:** The fiscal compact states that countries with a structural balance not yet in line with the medium-term objective must ensure rapid convergence towards this objective. The concrete time frame for adjustment will be specified by the European Commission.
 - **Temporary deviations:** A country may temporarily deviate from its medium-term objective or adjustment path towards it only in exceptional circumstances, i.e. where there is an unusual event outside the control of the country concerned or a period of severe economic downturn as defined in the preventive arm of the reinforced Stability and Growth Pact.
 - **Automatic correction mechanism:** In the event that the structural balance of a country deviates significantly from the medium-term objective or the adjustment path towards it, a mechanism will be automatically triggered to correct these deviations. The cumulated impact of deviations on government debt dynamics should also be automatically corrected. The common principles regarding the nature, size and time frame of the corrective action to be undertaken, also in the case of exceptional circumstances, will be proposed by the European Commission. This proposal will also cover the role and independence of the national institutions responsible for monitoring observance of the rules.

¹ For an assessment of the reinforced Stability and Growth Pact that entered into force in December 2011, see the box entitled “Stronger EU economic governance framework comes into force”, *Monthly Bulletin*, ECB, December 2011.

- **Enforcement:** Member States are obliged to transpose the above elements of the balanced budget rule into national law, preferably at the constitutional level, within one year of the new Treaty entering into force. The European Commission will report on compliance with this transposition requirement. Any signatory Member State can call upon the European Court of Justice to verify the transposition of the rules into national law, and the latter can impose financial sanctions of up to 0.1% of GDP to ensure compliance with its judgements.
2. **Strengthening of the excessive deficit procedure:** The fiscal compact foresees that euro area countries commit themselves to support proposals or recommendations from the European Commission to the ECOFIN Council if a euro area country breaches the deficit criterion, unless this is opposed by a qualified majority of the other euro area countries. While fully respecting the requirements of the EU Treaties, this provision is expected to increase the automaticity of the excessive deficit procedure related to breaches of the deficit criterion. Moreover, Member States which are subject to an excessive deficit procedure are required to put in place a budgetary and economic partnership programme which should enable them to correct their excessive deficits in an effective and durable manner.
 3. **Benchmark for government debt reduction:** The fiscal compact includes the numerical benchmark for debt reduction for Member States with government debt exceeding the 60% of GDP reference value, as foreseen in the reinforced Stability and Growth Pact. It thereby lifts the benchmark, for signatory countries, to the level of primary law. In concrete terms, the difference between the government debt-to-GDP ratio and 60% of GDP needs to be reduced at an average rate of one-twentieth per year.
 4. **Public debt issuance plans:** Member States are asked to report ex ante on their public debt issuance plans. This should help to optimise the coordination of their financing plans.

Overall, the fiscal compact is a welcome step towards anchoring fiscal discipline in the euro area. If strictly implemented and enforced, the fiscal compact should strengthen the existing fiscal governance framework and foster its credibility. A more in-depth analysis of the fiscal compact will be featured in a forthcoming issue of the Monthly Bulletin.