Fiscal Policy in the EU – What Have We Learned from the Crisis?

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INTRODUCTION AND SUMMARY

The economic and financial crisis has demonstrated that the public finances of euro area member states were on an unsustainable path in the pre-crisis years. Many member states failed to take advantage of the favourable economic environment to consolidate public finances and hence were ill-prepared when the crisis struck. Nevertheless, most member states eased their fiscal policies in 2009 as part of a European initiative to counter the negative effects of the crisis on growth and employment. As a result, public finances deteriorated further, leading to a sovereign debt crisis in a number of euro area member states. In many member states, expansionary fiscal policy during the boom of the pre-crisis years has been replaced by significant consolidation. Consequently, fiscal policy has amplified rather than dampened cyclical fluctuations.

For a number of member states, the unsustainable state of public finances was both due to their failure to adequately comply with the fiscal discipline rules of the Stability and Growth Pact and insufficient enforcement. Other member states, although in large measure complying with the rules, saw a sharp deterioration in public finances during the crisis. These member states had accumulated major macroeconomic imbalances, which boosted public finances in the pre-crisis years, e.g. through revenue from rising asset prices. When the crisis erupted, it became clear that this revenue had been misinterpreted as structural. At the same time, the underlying potential output had been overestimated, causing the boom to be underestimated. Collectively, these factors meant that the underlying position of public finances – in terms of the structural balance – was estimated to be better than it actually was in the pre-crisis years. Viewed in this light, fiscal policy should have been less expansionary.

The crisis has exposed at least two fundamental weaknesses of economic governance in the EU. Firstly, the incentives for exercising budget-
ary discipline were insufficient. Secondly, the unilateral focus on fiscal policy was too narrow. Broader macroeconomic surveillance was needed to provide an overall picture of the member states' economic situation.

In recent years, EU member states have adopted a number of new regulations to address these weaknesses. Following the adoption of the Fiscal Compact, member states must run an annual structural deficit – i.e. the actual balance adjusted for temporary factors – of no more than 0.5 per cent of the gross domestic product, GDP. This strengthens fiscal discipline requirements, but reduces fiscal flexibility. EU member states have also adopted regulations for the surveillance of macroeconomic imbalances, entailing that the European Commission is to monitor whether a member state is accumulating excessive imbalances.

These new measures for strengthening economic governance represent an important step towards increased budgetary discipline and broader macroeconomic surveillance. However, the political will to ensure that the fiscal policy stance does not amplify cyclical fluctuations to the same extent as during the pre-crisis and crisis years remains crucial. In this context, it is essential that the EU member states do not base fiscal policy on unrealistic assumptions of growth, employment, etc., since this blurs the actual fiscal policy requirements.

The crisis has demonstrated a need to improve the calculation of the structural balance, including better adjustment for fluctuations in asset prices. It is also relevant to supplement changes in the member states' structural balances as a measure of the fiscal policy stance with a calculation of the impact of the member states' specific fiscal policy measures. This provides a better overall picture of their fiscal policies.

FISCAL POLICY COORDINATION IN THE EU BEFORE THE ECONOMIC AND FINANCIAL CRISIS – RULES AND COMPLIANCE

The Stability and Growth Pact before the crisis
The cornerstone of fiscal policy coordination in the EU is the Stability and Growth Pact, which elaborates on and clarifies the EU Treaty's fundamental provisions on ensuring budgetary discipline in the member states (avoiding "excessive deficits").

The Pact comprises two elements – a preventive and a corrective arm. The preventive arm sets out provisions for the EU member states' medium-term fiscal policies, including that, in the medium term, their public finances must be close to balance or in surplus. The idea is for member states to build a scope for the automatic stabilisers to operate freely during normal economic downturns without exceeding the 3-per cent limit on government deficits.
The corrective arm of the Pact takes effect if an EU member state exceeds the EU Treaty’s limits on government deficits and gross debt of 3 per cent and 60 per cent of GDP, respectively. In practice, only the deficit requirement has been enforced. The member state in question will receive a recommendation to correct the deficit within a given deadline, and euro area member states may ultimately be fined for failing to comply with the provisions of the Pact.

The Stability and Growth Pact was adopted in 1997 and revised in 2005. The corrective arm of the Pact was eased, while the preventive arm was tightened. The possibility of exempting member states from the excessive deficit procedure in the event of low economic growth was extended, and it became possible to set a deadline of several years for correcting excessive deficits. On the other hand, more specific requirements for fiscal consolidation were introduced in the preventive arm of the Pact for member states failing to comply with their medium-term objectives, MTOs. These member states were to ensure that, as a point of departure, their structural balance – i.e. the government balance adjusted for cyclical and other temporary factors – improved by 0.5 per cent of GDP per year, until the MTO was achieved. In addition, country-specific MTOs were introduced, which were differentiated according to government debt and potential growth. MTOs were also to be differentiated according to member states' fiscal sustainability.1 For euro area member states and members of the European Exchange Rate Mechanism, ERM2, MTOs were to be in the range from -1 per cent of GDP to balance or surplus.

The 2005 reform of the Stability and Growth Pact reflected the problems encountered by a number of euro area member states in complying with the provisions of the Stability and Growth Pact. In practice, the provisions had been applied more leniently, and to some extent the 2005 reform of the Pact represented adjustment to this reality. Critics noted that the reform would not solve the problems of implementing the Pact, but rather increase the risk of larger government budget deficits and higher debt ratios in the medium term (e.g. Deutsche Bundesbank (2005)).

Non-compliance with the Stability and Growth Pact before the crisis

As our point of departure for assessing which euro area member states were in compliance with the provisions of the Stability and Growth Pact in the pre-crisis years, we apply government deficits, debt levels and

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1 In 2009, MTOs were also differentiated according to the member states' fiscal sustainability. The new MTOs were implemented as part of the stability and convergence programmes for 2009-10.
structural balances measured in real time – i.e. the estimates of the levels of these factors in the years in question. For any given year, the real-time target for e.g. the government deficit will show the deficit as estimated in European Commission Economic Forecasts for that year.

In the pre-financial crisis years, the (real-time) government debts and deficits of many euro area member states exceeded the Pact's limits of 60 and 3 per cent of GDP, respectively, cf. Chart 1. In 2004 when the highest number of member states exceeded the limits, half of the euro area member states had deficits of more than 3 per cent of GDP, and in 7 of 12 euro area member states, government debt exceeded 60 per cent of GDP. For the euro area as a whole, the government deficit was 2.8 per cent of GDP, while the government debt was approximately 70 per cent of GDP. In the run-up to the crisis, the budget deficits and debt levels of several member states increased – despite favourable economic conditions.

In the autumn of 2008, in response to the crisis, the EU member states adopted the European Economic Recovery Plan with a coordinated fiscal stimulus package totalling 1.5 per cent of the EU’s GDP. As member states pursued active expansionary fiscal policies, allowed the automatic stabilisers to operate and implemented financial rescue packages, debts and deficits rose sharply in many member states after 2008.

Note: The Chart shows the member states' deficit and debt measured in real time. For a given year, a simple average of the European Commission’s spring and autumn forecast estimates of deficit and debt is applied.
Source: European Commission forecasts 2002-08.
The requirement of the Pact’s preventive arm for medium-term government budgets to be close to balance or in surplus was also exceeded to a large extent. In the pre-crisis years, the structural balance (in real
time) of just under half of the euro area member states showed a deficit of 2-4 per cent of GDP, cf. Chart 2. Germany and France were among the member states running large structural deficits for a number of years after the introduction of the euro. Other member states, such as Ireland and Spain, had small structural surpluses, which quickly turned into large deficits (8-10 per cent of GDP) during the crisis.

Although half of the euro area member states were in the excessive deficit procedure, and even more member states were running large structural deficits, fiscal consolidation in the euro area was modest in 2002-05, cf. Table 1. Fiscal consolidation apparently improved after 2005, when the new provisions established that member states in non-compliance with their MTOs or in the excessive deficit procedure, generally had to improve their structural balances by at least 0.5 per cent of GDP per year. Most member states improved their balances, although not all of them by 0.5 per cent of GDP. Data may be blurred by the boom of 2005-07 and rising asset prices, which made the structural balance improvement appear greater than reflected by the fiscal policy stance during those years.

Stability programmes and unrealised growth assumptions

In their annual stability programmes, the euro area member states specify their strategies for fiscal adjustment towards their MTOs and towards correcting any excessive deficits. In France, Italy, Portugal and Greece, among others, realised government budget deficits in the run-up to the crisis were generally larger than assumed in the programmes, cf. Chart 3. Other member states, such as Spain and Ireland, complied with the programme targets in the pre-crisis years. This should be seen in the context that, during those years, public finances of these two member states benefited from high revenue growth, especially from surging house prices, cf. ECB (2008).

A key reason why the member states' budget deficits did not develop as projected in the stability programmes was that the growth assumptions on which the programmes were based tended to be more optimistic than the realised growth rates, cf. Chart 4. In France, Italy, Portugal and, to some extent, Germany, the programmes built on the expectation that GDP growth would rise to 2.5-3 per cent in the course of a couple of years and subsequently remain at that level. Spain, Ireland and Greece, on the other hand, realised the projected growth. In other words, a number of member states had an optimistic view of potential growth. This was undoubtedly one of the reasons why they did not implement sufficient fiscal consolidation policies to brace themselves against sudden deterioration of their public finances.
Note: The yellow lines indicate the planned development in the actual balance as indicated in the member states’ stability programmes, SP, while the blue line indicates the realised development. 2009 saw a significant statistical revision of Greece’s budget deficit for the years illustrated by the Chart.

Source: European Commission spring forecast 2012, and the individual member states’ stability programmes 2002-08.
Note: The yellow lines indicate the expected GDP growth in the member states' stability programmes, SP, while the blue line indicates the realised development. 2009 saw a significant statistical revision of Greece's GDP for the years illustrated by the Chart.

Source: European Commission spring forecast 2012, and the individual member states' stability programmes 2002-08.
UNCERTAINTY ABOUT THE STRUCTURAL BALANCE AS A POLICY TARGET

Measuring fiscal consolidation (or lack of same) solely by calculating the change in the structural balance is subject to considerable uncertainty and does not necessarily provide a complete picture of the fiscal policy stance. The structural balance is calculated residually by deducting cyclical government revenue and expenditure (i.e. cyclical components such as higher expenditure on unemployment benefits during a recession) and other temporary factors from the actual budget balance, cf. Winther (2011). The calculation of the cyclically adjusted balance takes only cyclical factors into account.

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\text{Cyclically adjusted balance} = \text{Structural balance} = \text{Actual balance} - \text{Cyclical component} - \text{Temporary factors}
\]

Over- or underestimation of the structural balance is due to over- or underestimation of the actual balance, the cyclical component or temporary government revenue or expenditure.

Underestimation of the cyclical position in the pre-crisis years

The cyclical component of the government budget balance is calculated based on an assessment of the cyclical position of the economy measured by the output gap. In the years prior to the financial crisis, the output gaps of a number of member states were negative, calculated in real time. Hence, there were indications that the member states were in recession. But during the same years, calculated in 2012, a number of member states had large positive output gaps, cf. Chart 5. In other words, their economies were booming. For several member states, this underestimation of output gaps amounted to up to 3-4 per cent of GDP, reflecting that these gaps are difficult to calculate at cyclical turning points, cf. Andersen and Rasmussen (2011).

The underestimation of euro area member states' output gaps, and thus their cyclical position, also caused the cyclical component of the budget balance to be underestimated. Viewed in isolation, this meant that, in general, the structural balance was estimated to be better than it actually was, cf. Chart 6. On the other hand, the actual balance – with the exception of that of Greece – was underestimated at the same time. Consequently, the overall overestimation of the structural balance was smaller than the direct contribution from the underestimation of the cyclical position.
**ESTIMATION OF OUTPUT GAP, 2005-07**

Chart 5

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**Per cent of GDP**

- Output gap, calculated in real time
- Output gap, calculated in 2012
- Underestimation of output gap

Source: European Commission forecasts 2005-12.

**OVERESTIMATION OF CYCLICALLY ADJUSTED BALANCE, 2005-07**

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**Per cent of GDP**

- Underestimation of cyclical component
- Overestimation of actual balance
- Overestimation of cyclically adjusted balance

Note: In the Chart, the cyclically adjusted balance is applied for member states, since European Commission data is not available for 2012 estimates of the structural balance in 2005-07.

Source: European Commission forecasts 2005-12.
Structural revenues turned out to be temporary in nature

In the calculation of the structural balance, other temporary factors are deducted besides the cyclical component, e.g. privatisation revenue, expenses related to natural disasters, etc. If such temporary revenues (or expenses) are not deducted, they will be misinterpreted as structural.

But a number of temporary revenues are not deducted in the Commission's calculation of the structural balance, including, in particular, supernormal tax revenues from temporary and abnormal increases in asset prices, such as house and equity prices. Kanda (2010) calculates the structural balance for Ireland using an approach that adjusts for the budgetary effect of the housing bubble. His conclusion is that the structural balance had been negative in the pre-crisis years, and that Ireland had a structural deficit of 7 per cent of GDP in 2007. The latest Commission figure for the structural deficit in 2007 was 1.8 per cent of GDP, and in real time the structural balance was estimated to be in surplus by 1.5 per cent of GDP.

The sharp declines in the structural balances of Ireland and Spain in 2007-09, cf. Chart 2, illustrate the difficulty of estimating the structural balance in real time. In these two member states, the balance deteriorated by approximately 10 per cent of GDP as a result of the crisis. These decreases were not attributable to discretionary fiscal easing, but rather to misinterpretation of the structural levels of government revenue and expenditure.

Consolidation in terms of specific fiscal policy measures

The uncertainty when it comes to measuring the structural balance means that it does not necessarily provide a complete picture of the fiscal policy stance. An alternative approach to assessing fiscal policy by measuring the change in the structural balance ("top-down") is to quantify the budgetary effect of specific discretionary fiscal policy measures ("bottom-up"). The euro area member states' stability programmes present the specific measures and the Commission assesses the effect of these measures across the EU member states on an ongoing basis. In principle, the effect of the actual measures is a more ideal approach to assessing the fiscal policy stance, but this approach requires member states to report very detailed as well as true and fair information on their fiscal policy measures, and to provide an accurate assessment of their effects. However, the problems of assessing the level of the structural balance are not addressed simply by assessing the specific measures and, at any rate, the level depends on an assessment of member states' output gaps.
The discretionary measures provide a different picture of the fiscal policy stance in the euro area in the run-up to the crisis than the one indicated by the change in the structural balance. In Ireland and Spain, for example, the measures show that fiscal policy was eased by approximately 1 per cent of GDP per year in the period 2005-08, cf. Chart 7. In comparison, the changes in the structural balance were slightly positive, indicating some fiscal consolidation during those years, cf. Table 1. The expansionary measures should be seen in the context of strong economic growth in both member states in the pre-crisis years. At the time, growth was estimated to reflect structural rather than cyclical factors. This is illustrated by the significantly underestimated output gaps in the two member states during those years, cf. Chart 5. Therefore, the perception was that there was scope for easing fiscal policy.

The opposite is the case for Italy and, to some extent, Portugal. Discretionary measures for Italy e.g. indicate fiscal policy tightening of approximately 1 per cent of GDP annually in 2005-07. Although these member states tightened their fiscal policies in the pre-crisis years, their structural balances did not improve until 2006-07 and the tightening was insufficient to ensure that public finances were sufficiently robust when the crisis struck. A possible explanation why the structural balance did not improve could be weak potential growth, leading to a
worsening of the underlying position of public finances in these particular member states. For Germany and France, both approaches show that their fiscal policies were more or less neutral in 2005-07.

The cumulative effect of fiscal policy measures over time for the two calculation methods shows that during the period 2004-08, Ireland and Spain eased fiscal policy by the equivalent of 4-6 per cent of GDP, calculated by summing up direct discretionary measures, while the cumulative change in the structural balance was largely flat, cf. Chart 8.

Note: The yellow line indicates the cumulative change in the structural balance (in real time), while the blue line indicates the cumulative discretionary fiscal policy measures (bottom-up). Discretionary fiscal policy measures have been calculated by adding up the budgetary effects of the specific fiscal policy measures specified in the European Commission's annual assessments of the member states' stability programmes. 
Source: European Commission's annual publication, Public finances in EMU, and Commission forecasts.
When the crisis hit Ireland and Spain, this was reflected in sharp declines in their structural balances, and already in 2009 the cumulative change in the structural balance was greater than the cumulative change in discretionary measures. The marked deterioration in structural balances in 2009-10 – despite extensive fiscal consolidation in Ireland and broadly neutral fiscal policy in Spain – probably reflects the drying-up of a number of temporary revenue sources which were perceived as structural in the run-up to the crisis.

As already mentioned, the EU member states in late 2008 agreed on a coordinated fiscal stimulus package equivalent to a total of 1.5 per cent of the EU’s GDP. Therefore, discretionary fiscal policy measures in 2009 show that fiscal policy was eased substantially in most member states, although Ireland, among others, tightened its fiscal policy significantly. In 2010, when the financial crisis evolved into a sovereign debt crisis in a number of euro area member states, it became clear that several of these member states had not had sufficient fiscal scope. In the wake of the significant discretionary fiscal expansion in 2009, member states had to tighten fiscal policy considerably in 2010, cf. Chart 7. Spain and Portugal, in particular, had to make massive government spending cuts. Against this backdrop, the coordinated fiscal stimulus in the EU should have been more differentiated across member states.

Fiscal tightening has continued in the euro area in 2011 and 2012, and substantial fiscal consolidation is also planned for the coming years. In many euro area member states, expansionary fiscal policy during the boom of the pre-crisis years has been replaced by significant consolidation. In other words, fiscal policy has reinforced both the boom and the subsequent recession.

STRENGTHENING THE EU’s ECONOMIC GOVERNANCE RULES

The crisis exposed at least two fundamental weaknesses of economic governance in the EU. Firstly, there has not been sufficient incentive for member states to consolidate public finances and create fiscal space to counter the effects of a major economic downturn. The provisions of the Stability and Growth Pact were not adequately enforced, and because of weak market discipline, the markets failed to punish member states with unsustainable public finances.

Secondly, the unilateral focus on fiscal policy was too narrow. Although the provisions of the Pact were complied with, member states such as Spain and Ireland managed to build up substantial macroeconomic imbalances, and, as mentioned earlier, the crisis therefore took a particularly heavy toll on these member states. Consequently, broader
macroeconomic surveillance of the EU member states was required in order to form an overall picture of their economic situation.

Hence, the crisis demonstrated that the fiscal framework needed to be strengthened and that economic governance in the EU needed to be extended. This time around the need to restore confidence in the long-term sustainability of public finances and stabilise the financial markets generated broad political support in the EU for strengthening the rules. Initially, the Stability and Growth Pact was reformed and surveillance of macroeconomic imbalances was introduced – the "Six Pack" from 2011.¹

**Stability and Growth Pact reform**

The reform of the Stability and Growth Pact builds on the existing rules so as to tighten the rules and strengthen enforcement. One of the most important changes to the *preventive arm* of the Pact is that, in future, the assessment of the adjustment towards the MTO is to be based on an overall assessment, using the structural balance as a reference. Furthermore, member states with government debt exceeding 60 per cent of GDP must accelerate adjustment towards the MTO. Additionally, in future, an EU member state may become subject to a recommendation if it deviates significantly from the adjustment path. In the *corrective arm* of the Pact, the most significant change is that the debt criterion is operationalised. In future, EU member states with government debt exceeding 60 per cent of GDP must, as a main rule, reduce the difference between the current debt level and the 60 per cent of GDP by an annual rate of one twentieth (average over three years). Member states that fail to comply with this rule could become subject to the excessive deficit procedure although their actual deficit does not exceed 3 per cent of GDP.

For the euro area member states, the enforcement mechanisms are reinforced – both for the preventive and the corrective arms of the Pact. At the same time, more automatic action is introduced, and hence more efficiency in the adoption of sanctions as future decisions on economic sanctions will be made via "reverse qualified majority voting", making it more difficult to adopt exemptions to sanctions. This strengthens the Pact and increases the probability that sanctions are applied.

**Surveillance of macroeconomic imbalances**

As part of the effort to broaden macroeconomic surveillance, the EU member states adopted a new procedure for the surveillance of macroeconomic imbalances. Under the new procedure, based on a number of

¹ For an in-depth review of the elements of the Six Pack, see Gade and Thuesen (2010).
indicators – such as house prices, current account balance, external debt, private sector credit flow and debt – the Commission is to monitor whether an EU member state is accumulating excessive macroeconomic imbalances. A member state may ultimately become subject to a Council recommendation to correct the imbalances, and euro area member states may be fined for failing to comply with a recommendation.

The broadening of macroeconomic surveillance is an important supplement to fiscal surveillance, since macroeconomic imbalances are far from always reflected in a timely manner in government balances and debt. Imbalances may as well originate from the private sector and translate into e.g. unsustainable house price rises, weakened competitiveness, large current-account deficits and accumulation of external debt. Since significant uncertainty is associated with the calculation of the structural balance, unilateral focus on structural balances entails a risk that the planning of fiscal policy is inexpedient. If fiscal policy is based on annual assessments of the structural balance as a reference, there is a risk that member states will pursue policies which are inappropriate given the cyclical situation.

Fiscal Compact

During the autumn of 2011, the sovereign debt crisis escalated, and it became clear – despite the strengthening of the Stability and Growth Pact, etc. – that the financial markets still doubted the political efforts to ensure sustainable public finances, especially in certain euro area member states. As a result, in early December 2011, the euro area member states entered into an intergovernmental agreement to strengthen fiscal policy coordination – the Fiscal Compact – with a possibility for non-euro area member states also to adopt the agreement.1 Many of the elements of the Fiscal Compact correspond to fundamental elements of the Stability and Growth Pact, but the Fiscal Compact strengthens a number of provisions and also adds new initiatives.

The cornerstone of the Fiscal Compact is the fiscal rule that the budgetary position of the general government shall be balanced or in surplus. This rule is deemed to be respected if the annual structural balance is at the country-specific MTO, which must not exceed a deficit of 0.5 per cent of GDP (1 per cent of GDP for member states with low debt and low challenges in terms of fiscal sustainability). This rule is in line with the provisions of the preventive arm of the Stability and Growth Pact, but the provision that the annual structural balance must not ex-

1 All EU member states with the exception of the UK and the Czech Republic participate in the Fiscal Compact. It will take effect when ratified by at least 12 euro area member states.
ceed the MTO constitutes a strengthening. This rule tightens fiscal discipline requirements, but reduces fiscal flexibility. A new aspect is that the balanced budget rule must be transposed into national legislation, preferably at constitutional level, and the European Court of Justice may be asked to verify the implementation of these rules at national level, representing a clear strengthening.

The requirements for the calculation of the structural balance are reinforced by the Fiscal Compact requirement of annual compliance with the MTO. Consequently, member states should aim at a structural balance better than the lower limit of a structural deficit of 0.5 per cent of GDP. This should prevent calculation uncertainties from leading to inappropriate fiscal policy.

The fiscal rule is to be supplemented by a correction mechanism that is triggered automatically in the event of deviations from the rule. The objective is to make fiscal consolidation more automatic than is the case with the Stability and Growth Pact. The specific elements are currently not known, since the Commission has yet to make proposals for the implementation of the correction mechanism. One risk is that the mechanism will contain a number of exemptions that will, in practice, dilute the new balanced budget rule and hence weaken fiscal discipline.

Another new element is that the euro area member states commit to support proposals or recommendations submitted by the Commission regarding euro area member states in the excessive deficit procedure, unless a qualified majority is opposed. As previously mentioned, this voting rule was introduced by the reform of the Stability and Growth Pact, but it is extended and strengthened by the Fiscal Compact.
LITERATURE


