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"The TSCG and Irish Fiscal Policy"

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The TSCG and Irish Fiscal Policy: Opening Statement to Oireachtas Sub-Committee on the Intergovernmental Treaty

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The Treaty on Stability, Convergence and Growth (TSCG) is an important element in the reform of the European system of economic governance. In particular, the fiscal clauses in the TSCG (the 'Fiscal Compact' articles) will provide a new framework for the conduct for national fiscal policies. Crucially, the Fiscal Compact should be interpreted in conjunction with the already-agreed set of economic and fiscal governance procedures that are spelled out in the 2011 "six pack" set of reforms. In particular, the high-level principles expressed in the Fiscal Compact will be implemented according to the detailed guidelines described in the six pack reforms.

Taken together, this set of reforms provides a coherent vision of how fiscal policy should be conducted in the future. The key principle is that fiscal policy can only be effectively used for macroeconomic stabilisation if the underlying medium-term fiscal position is sustainable. Otherwise, running deficits during downturns can be destabilising, if investors fear that higher debt will increase the likelihood of default and charge higher risk premia to a country's government, banks and firms. For sustainability, a country should maintain the stock of public debt at a prudent level, while also ensuring that the underlying cyclically-adjusted ('structural') budget is not too far from balanced.

The role of fiscal policy in national macroeconomic stabilisation is especially important

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for the euro area, since the alternative policy options of running an expansionary monetary policy or currency devaluation are not available to individual member countries. In addition, an unsustainable fiscal policy at national level has negative spillover effects on the rest of the euro area, through contagion mechanisms and the deployment of bailout funds. Accordingly, Ireland has a self interest in promoting area-wide fiscal sustainability.

If fiscal sustainability is so important, it is natural to ask why governments would not simply maintain a sustainable position even in the absence of a legislative mandate. There are two main barriers to effective fiscal management.[1] First, the historical evidence is that many governments have suffered from a "debt bias" by which short-term electoral incentives encourage excessive recourse to borrowing in the financing of public spending - the benefits of deficit financing tend to be immediate, whereas the full costs are incurred over the long-term.

Second, many governments find it difficult to run the scale of sufficiently-large surpluses during cyclical upturns that would facilitate aggressive deficit financing during cyclical downturns while still preserving fiscal sustainability. In the absence of a legislative commitment to a structural fiscal target, the political pressure to raise spending and/or cut taxes during revenue booms may be overwhelming. While a government may succeed in running a small overall budget surplus during a boom, this may mask an underlying structural deficit and will not provide a sufficient margin of adjustment in the event of an adverse macroeconomic shock.

Accordingly, in order to mitigate these two distortions, the twin pillars of the Fiscal Compact are that domestic legislative mandates can help governments to take determined action to reduce public debt ratios to a safe level (that is, below 60 percent of GDP) and run balanced budget positions over the medium run.

The budget balance concept is expressed in terms of a country-specific medium-term objective for the structural balance. The objective will be updated every three years, in line with changes in the macroeconomic and fiscal environment facing each country.

It is economically appropriate to focus on the structural balance. The alternative is to specify a target for the overall balance. However, this would imply a destabilising pro-cyclical fiscal pattern, since a target for the overall balance would be more difficult to achieve during bad times and easier to achieve during good times, forcing expenditure cuts and tax hikes during recessions and fuelling booms through expenditure growth and tax

[1] More detailed explanations are provided by Lane (2010a, 2010b).

cuts during expansionary periods.

Granted, the estimation of the underlying structural balance is a difficult task, since it requires analysts to take a stand on the relative contributions of trend factors and cyclical factors in driving overall macroeconomic performance. Inevitably, such estimates will turn out to contain errors (forecasting is an inexact process, in view of the inherent uncertainties embedded in macroeconomic dynamics), with the structural balance overstated in some years and understated in other years.

This calls for two important steps. First, each country must invest the modest resources required to build the analytical capacity to best estimate the structural balance. In line with the six-pack philosophy, a broad view of macroeconomic balance is required, taking into account developments in external imbalances, credit growth, house prices, inflation, competitiveness and trade shares as well as the level of output. For this analysis to be impartial and credible, it is best conducted by an agency that is independent of government.

Second, each country must have a correction plan in the event that the accumulated errors in forecasting the structural balance (or deviations in implementing announced fiscal measures) become significant in terms of a ratio to GDP. Otherwise, there could be a negative drift in public debt, which ultimately poses a sustainability risk. Article 3 of the TSCG specifies that such a correction mechanism must be introduced. In the German and Swiss fiscal regimes, a correction system is already in place that specifies that a fiscal correction must be gradually implemented if the cumulated errors exceed a threshold ratio to GDP.

As noted the target value for the structural balance will be country-specific and will vary over time. At the lower level, there is a floor of 0.5 percent of GDP for the structural deficit for those countries with debt ratios above 60 percent of GDP; the floor is 1.0 percent of GDP for countries with prudently-low debt ratios below 60 percent of GDP.

It is important to appreciate that a surplus target for the structural balance might be appropriate under a range of macroeconomic conditions. For instance, a country undergoing a sustained boom episode in which domestic spending levels are high, house prices and credit are growing strongly and competitiveness indicators are turning negative might opt to run a substantial structural surplus in order to cool down the economy and build an extra buffer that can be deployed in the event of a sharp reversal in the macroeconomic environment.

In addition, a country with a high initial level of debt could have a surplus target in

order to make sure that the debt ratio returns to a prudent level over time. Indeed, the importance of debt reduction is directly built into the TSCG through the "one twentieth" rule by which the gap between the current debt ratio and 60 percent of GDP is eliminated at an average rate of one-twentieth per year. This provides a benchmark target for highly-indebted countries - depending on the rate of growth of the economy and prevailing interest rates, this may imply a higher minimum for the structural budget balance than the 0.5 percent floor specified above. As is specified in the six-pack regulations, this debt-reduction rule should be interpreted on a cyclically-adjusted basis - deviations from this rule are permissible in line with cyclical conditions.

On its own terms, then, the TSCG provides a useful commitment framework that can help governments run sustainable fiscal positions and effectively promote macroeconomic stability through counter-cyclical fiscal measures. Importantly, the TSCG will work best if it is fully absorbed into the domestic political process, with the terms of the fiscal debate operating within the established domestic legislative framework. The TSCG does specify a "second line of defence" by which the European Commission and the other member governments can seek modifications to fiscal plans but, all going well, this scenario need not be realised for well-run economies during normal times.

Importantly, the TSCG is silent on the appropriate role of government in the economy and the appropriate level of government spending, which remain fundamental political questions. Rather, the constraint imposed by the TSCG is that the level of public spending should be broadly matched by the level of revenue collection over the medium term.

Taking a broader view of the future of the eurosystem, it is also vital to appreciate that the TSCG is a "gateway" reform, since responsible national-level fiscal policies are a prerequisite for other reforms that require mutual financial commitments. As is already incorporated into the TSCG, this includes access to bail-out funds (the European Stability Mechanism). In addition, it is widely agreed that a European-level banking system can do much to stabilise the eurosystem by breaking the "diabolic loop" by which a weak domestic banking system damages the sovereign fiscal position and, in the other direction, a risky sovereign position disproportionately threatens domestic banking stability.[2] However, the European sharing of banking-sector risk is only feasible if fiscal positions are sufficiently robust that they do not tempt national governments to indirectly seek funding or resources from its local banks.

[2]See Allen et al (2011) and Brunnermeier et al (2011).

Going further, the issuance of eurobonds on the basis of "joint and several" liability is only feasible if each participating government can be trusted to refrain from overborrowing. Similarly, more ambitious levels of fiscal federalism (such as European-level sharing of some tax revenues or European-level financing of unemployment benefits) also require prudential fiscal behaviour at the national level in order to be sustainable.

In summary, the TSCG should be especially welcome in Ireland, in view of the importance of effective counter-cyclical policies for small, open economies that are more exposed to large macroeconomic fluctuations. Certainly, it is only one element in the broader reform of the eurosystem and, over time, Ireland should also press for the deeper systemic reforms that are required.

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