Information Note on the EU Fiscal Compact Treaty

May 2012
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This is the first in a series of occasional Information Notes produced by staff of the Nevin Economic Research Institute (NERI). The purpose of these Information Notes is to provide information about a particular topic or matter of public concern. This particular Information Note focusses on a number of questions arising from the European Union Fiscal Compact Treaty (2012).

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Executive Summary

The forthcoming referendum on the EU Fiscal Compact Treaty in the Republic of Ireland offers an opportunity for voters to consider various aspects of the Treaty and its implication for the political economy of Europe and Ireland. The Treaty for those member states who have signed up is based on the implementation of rules and sanctions with regard to public debt and fiscal policies. Fiscal policy is about how governments spend and raise revenue. A key part of the Treaty is the implementation of rules on (i) what is referred to as government ‘structural deficits’ and (ii) total government debt (referred to as the ‘debt brake’). Contracting member states who fail to comply with those rules are liable to sanctions and penalties through the European legal system.

This Note focusses, narrowly, on the following three questions:

- How is the concept of a public ‘structural deficit’ estimated in practice?
- What is the ‘debt brake’ and how is it measured?
- What options might arise in the future in regard to funding and borrowing by the Irish Government with or without endorsement by the people of the Treaty on 31 May 2012.

The measurement of the ‘structural deficit’ is a highly contested and uncertain area. Various agencies estimate that, in 2015, Ireland will have a structural deficit as a proportion of Gross Domestic Product (GDP) of between 2.5% (International Monetary Fund, 2012b) and 3.5% (Department of Finance, 2012). A further fiscal adjustment of approximately 3% of GDP would be required after 2015 to reach the 0.5% target. Unless the economy of Ireland is growing significantly it will be hard to reach this target and any further fiscal contraction required could be very damaging. A further complication is that the economy could be growing (actual GDP) but the estimate of the structural deficit is not shifted because estimated ‘potential GDP’ is not growing as fast.

The coordination of fiscal austerity through new debt brake and balanced budget rules may very well reinforce recession across Europe if the German Macroeconomic Policy Institute (IMK, 2012) forecasts cited later in this Note are borne out.

A significant challenge to Ireland in 2014 will be the requirement to continue access to funding internationally whether through a second bail-out or a re-entry to the capital
markets. At the moment it appears that future access to funds through the European Stability Mechanism is directly tied to ratification of the Fiscal Compact and ESM Treaties leaving Ireland potentially and dangerously exposed to a costly alternative funding arrangement in 2014 if such were available.

It should be noted that this Note does not address all the political and legal aspects of the Treaty and its implementation in Irish law. Neither does this Note seek to draw definitive conclusions in relation to the likely course of future events. Moreover, the larger European political context together with legal challenges to the Treaty in various parts of Europe is an evolving one at the time this Note has been prepared. Finally, this Note does not advocate how voters in the Republic of Ireland should vote on 31st May 2012.
1 Overview of the Treaty

The Fiscal Compact Treaty, or the ‘Stability, Coordination and Governance in the Economic and Monetary Union’, to give it its full title, is the subject of intense debate across Europe.

Many believe that the Fiscal Compact Treaty is essential to restore confidence and stability in the European financial and fiscal scene. Moreover, closer fiscal integration is viewed by many as essential to save the European currency if not the entire European Union project. Some of the ‘core’ EU member states (e.g. Austria, Finland, Germany and France) want to see stricter ‘fiscal discipline’ across Europe. The weak financial position of certain ‘peripheral’ or troubled EU economies such as Ireland, Portugal, Greece and now Spain is seen as a threat to the stability and survival of the Euro. The Treaty signed in March 2012 and which is still to be ratified by many countries sets out to reinforce some existing fiscal rules and impose new ones along with more effective sanctions underpinned by primary legislation at the national level. It follows months of turbulence and uncertainty on international bond markets as well as growing political tensions across Europe. The existing political and institutional architecture of the European Union has been found significantly wanting as the effects of the worst economic crisis since the 1930s have been seen across all member states including those perceived as ‘core’ or relatively stable in terms of public finances.

On the other side of the argument many have expressed concerns both about these particular fiscal rules as well as the practicalities of implementing such rules based on concepts that are difficult, if not impossible, to measure. There is, also, concern about the way in which a Fiscal Compact would constrain domestic fiscal policy and possibly reinforce current fiscal austerity over a long period – especially as it seems inevitable that fiscal austerity would be coordinated at the same time across the major EU member states. It is not obvious that having rules such as those contained in the Treaty would have averted the economic crisis which erupted and spread across much of Europe in 2007-2011. While ‘fiscal indiscipline’ was a problem and source of instability in some European countries (of which Ireland was not one) the problems of government debt finance reflects a much wider set of global problems and imbalances as trade, capital, and public and private savings markets have been subject to large

\[1\] The Treaty was signed on 2 March 2012 by 25 Heads of Government. The full text of the Treaty may be downloaded online here.
shocks and a build-up of unsustainable patterns of trade and capital flows. The recession which hit industrialised nations in 2007-2008 was temporarily curbed by the introduction of counter-cyclical stimulus measures in some countries – notably the USA, UK, Germany and France. However, a trend towards greater fiscal austerity in Europe – including Ireland from the very outset of the crisis – has compounded the problem of sluggish aggregate demand and associated problems of unemployment, stagnant or falling output and cumulative public and private sector debt.

The debate about the Fiscal Compact in Ireland has been overshadowed by concerns in relation to the possible or likely implications of a 'No' vote. These concerns extend to options for funding to cover day-to-day spending by government as well as the long-term reputation and attractiveness of Ireland as a location for investment and as a full partner in an evolving and more closely politically integrated Europe. At the same time, there have been concerns about the medium to long-term implications of a 'yes' vote in terms of continuing fiscal adjustment which could impact on jobs and living standards.

On 31st May, 2012, voters in the Republic of Ireland will be asked to approve the insertion of the following subsection after subsection 9° of article 29.4 of the Constitution.

*The State may ratify the Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union done at Brussels on the 2nd day of March 2012. No provision of this Constitution invalidates laws enacted, acts done or measures adopted by the State that are necessitated by the obligations of the State under that Treaty or prevents laws enacted, acts done or measures adopted by bodies competent under that Treaty from having the force of law in the State.*

The Fiscal Compact is not a European Union treaty. Two European member states, the Czech Republic and the United Kingdom did not sign the Treaty and it cannot therefore become EU law at this time. It takes the form of a separate non-EU inter-governmental Treaty. This means that it sits outside the scope of EU law though, controversially, it alters the way in which EU policy and institutions operate.

It is a binding and permanent agreement freely entered into by contracting States. Although the Treaty sits outside the European Union legal architecture it introduces a new political and institutional dynamic following the rise of ‘inter-governmentalism’ which has characterised debate on the European response to the current economic
crisis. Some of these provisions were included in the ‘six-pack’ measure agreed in November 2011. These measures are now incorporated into a binding and permanent inter-governmental Treaty which gives a new, binding and lasting foundation to what was already agreed. This is the novelty of the current Treaty – it makes binding and lasting existing fiscal rules and tightens up existing rule on the public ‘structural deficit’. The existing rules – the Maastricht criteria – require member states to limit their total government deficit to 3% of GDP as well as limit total gross general government debt to 60% of GDP.

The new rule introduced in the present Treaty stipulates that the estimated government ‘structural deficit’ should not be greater than 0.5% of GDP for countries that have a debt-to-GDP ratio of over 60% (which includes Ireland\(^2\)). The government deficit is the difference between government spending and revenue. This deficit is very large in most European countries at the moment due to the impact of recession. Economists estimate that the deficit at any one point in time breaks down into two parts: a portion known as the ‘cyclical deficit’ which is explained by temporary factors arising from a recession and a separate portion known as the ‘structural deficit’. The ‘structural deficit’ is defined as the difference between total government revenue and spending adjusted for changes in the business cycle. Such an adjustment is estimated by economists and various public agencies using data over a period of time to identify the impact of the business cycle on the government deficit. Typically, deficits rise in recessions as public spending rises in response to higher unemployment and associated social payments while revenue falls off as people lose jobs or suffer loss of income. When economic conditions improve the deficit tends to fall. For example, Ireland maintained a balance of government spending and revenue for most years up to 2007. With the onset of recession in 2008 spending initially rose and revenue fell so that a large ‘cyclical’ deficit opened up.

The key provisions of Article 3 of the Treaty include a new structural deficit target of 0.5%; a restatement of the existing Stability and Growth Pact deficit target of 3% and debt target of 60% of GDP; a requirement for states who breach these targets to return to them rapidly; and an option for breaching these targets in ‘exceptional circumstances’. This means that the ability of any future government to borrow or run deficits is likely to be more curtailed than might otherwise have been the case. It is also

\(^2\) ‘Ireland’ in this paper refers to the Republic of Ireland.
possible that European member states with high structural deficits will continue to be severely challenged for many years to come as they struggle to reduce not only their ‘headline’ government deficit but the estimated structural deficit portion of the ‘headline’ deficit.

In the future, governments in Europe will be compelled to implement tighter fiscal adjustment. It is possible that this could entail even larger negative fiscal retrenchment than is now the case depending on what estimates of the structural deficit are agreed or imposed and depending on whether or not member states exercise their right to take other member states to the European Court of Justice. It is the case that the introduction and implementation of these rules will significantly limit the existing limited decision-making of governments in the future with respect to the size of the deficit, irrespective of the mandate they receive from the electorate. What is not known at this time is how much flexibility will be accorded to member states in the implementation of this balanced budget rule. The 0.5% (or 1.0%) limit is referred to as a Medium-Term Objective (MTO) which must be reached by ‘rapid convergence’ through a combination of credible fiscal measures in each contracting state. Article 3 states:

\[\text{The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks. Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact.}\]

Article 4 restates the existing Stability and Growth Pact requirement for states that breach the 60% debt ceiling to reduce the excess portion of that debt at an average rate of 5% annually.

The preamble to the treaty recalls the existing mechanism for enforcing the Stability and Growth Pact targets, known as the ‘excessive deficit procedure’. Article 5 of the treaty goes further and introduces new measures aimed at compelling member states in breach of the targets to take action deemed necessary by the Commission and Council. There is a new obligation to enter a ‘budgetary and economic partnership programme’ involving detailed structural reforms aimed at reducing debt and deficit levels. This is essentially a Eurozone version of the existing funding programmes for
certain member states that other member states will be legally obliged to accept when they breach the debt and deficit targets.

Articles 7 and 8 make three more changes. The first is that the excessive deficit procedure becomes automatic, requiring a qualified majority of the European Council to block it. The second is that member states can now take each other to the European Court of Justice if they believe that the debt and deficit rules are not being respected. The third is that the European Court of Justice can fine an errant member state for not complying with the rules, a fine being up to but not exceeding 0.1% of a member state's GDP, which in Ireland’s case would be approximately €155 billion based on 2011 GDP figures.

Article 12 creates a new parallel governance structure for the Eurozone, based on the existing Eurozone summit meetings but outside the framework of the existing euro governance framework. This will apply to all Eurozone countries irrespective of whether they ratify the treaty or not.

Article 16 states that the content of the austerity treaty will be incorporated into EU treaty law within five years of coming into force.

In March 2011 the European Council agreed to insert into Article 136 of the Treaty on the Functioning of the European Union the following the words:

The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.

In effect there are two Treaties: the Fiscal Compact and the ESM Treaty.

The preamble of the Fiscal Compact Treaty makes ratification a condition for accessing future EU bail-out funds from the European Stability Mechanism. The Treaty governing the ESM funds has also been amended. Currently, the adoption of both Treaties – Fiscal Compact and ESM – is the subject of challenges in the courts in a number of European States including Germany and Estonia.

In summary the Treaty reinforces or re-states existing rules on the government ‘structural deficit’ and the scope for reducing the amount of public debt as a proportion of GDP. The estimation of the government ‘structural deficit’ will therefore be a very
important dimension of fiscal policy in the coming years. In the next section this concept and its estimation is considered.
2 The Estimation of Government Structural Deficits

The Maastricht rules require European member states to aim for a Government deficit of no more than 3%. Yet, the latest estimates of General Government Balance (the headline deficit) for 2011 shows that 17 out of 27 member states were in excess of this figure.

![Chart 1. Total Government Deficit in EU Member States (% of GDP)](source)

Source: European Commission (2012b)

In the case of Ireland, in 2011, the ‘headline’ government deficit was recently estimated to be 13.1% in 2011 (which includes ‘bank recapitalisation’ spending by the government in 2011).

According to the latest data provided by the Department of Finance (April, 2012) the ‘structural’ deficit is projected to fall from its 2011 level of 7.9% to 3.5% in 2015 (using a slightly different estimation to that published by the European Commission). The measurement of the ‘structural deficit’ is a contested area – conceptually and empirically. The margin of error for measuring the structural government deficit is very large. Estimates by various agencies including the IMF and EU are frequently at large variance from each other. Consequently, the fiscal policy implications of estimation error could be in billions of Euro. A rule of 0.5% implies great precision, greater than what can ever be achieved in practice. Indeed, in many cases retrospective revisions of the estimate for a given point in time shift the estimate by a considerable amount. In practice the European Commission continues to play a key
and decisive role in determining the estimate of such a deficit. Figure 1 provides a decomposition of the headline deficit using data published by the European Commission in spring 2012.

**Figure 1. Decomposing the Government Deficit**

<table>
<thead>
<tr>
<th>Year</th>
<th>Structural Government Deficit</th>
<th>Total Government Deficit</th>
<th>Cyclical Government Deficit</th>
<th>One-off Measures*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>-9.6</td>
<td>-31.2</td>
<td>-2.0</td>
<td>-19.6</td>
</tr>
<tr>
<td>2011</td>
<td>-8.4</td>
<td>-13.1</td>
<td>-0.9</td>
<td>-3.7</td>
</tr>
<tr>
<td>2012</td>
<td>-8.1</td>
<td>-8.3</td>
<td>-0.5</td>
<td>+0.3</td>
</tr>
<tr>
<td>2013</td>
<td>-7.9</td>
<td>-7.5</td>
<td>0.4</td>
<td>0</td>
</tr>
</tbody>
</table>

**Source:** European Economic Forecast, Spring 2012 (European Commission, 2012a)

**Note:** * One-off measures include, for example, bank recapitalisations in 2009, 2010 and 2011. These are estimated as residuals.

The calculation of the structural deficit is based on the estimated gap between ‘potential output’ in the economy (if it were working at full capacity) and the actual output. Potential output is estimated with reference to such factors as the degree of spare capacity in an economy, the level of technology in a country, the total stock of capital and the potential supply of labour. The measure of the potential supply of labour, and therefore the structural deficit, depends crucially on what economists refer to as the ‘non-accelerating wage rate of unemployment’ (NAWRU) – the level of unemployment for which wages do not accelerate. Currently, the estimate used by the European Commission for the NAWRU in Ireland is 12.2% in 2011 (European Commission, 2012b). In the case of data for Ireland in 2011 it is estimated by the Department of Finance that the output gap was -3.8%. In other words actual GDP was €156 billion but the potential level of GDP – if all factors of production were fully utilised – would be €162 billion. The Irish economy is said to be operating below full capacity as indicated by the estimate of potential GDP. The difference between actual and potential GDP is referred to as the ‘output gap’. The value of the output gap is
negative when potential GDP exceeds actual GDP. Economists use the estimated output gap to derive the estimated cyclical component of the Government deficit.

An indication of how problematic the estimation of the output gap used by the European commission and the Department of Finance, here, is that the gap is estimated to be positive in 2014 (in other words the economy is technically 'overheating') whereas all projections of unemployment are for rates in excess of 10% in 2014 (Department of Finance, 2012:53).

In 2011 the Government deficit was 13.1% of GDP. The estimated gap of -3.8% of GDP is multiplied by the estimate of 'fiscal elasticity'. The fiscal elasticity shows how sensitive government expenditure and revenue (and the difference between them) is to changes in the output gap. The Department of Finance uses an estimate of 0.4. The assumption underlying this point estimate is that as the negative output gap increases by 1% the budget deficit increases by 0.4%. Multiplying the output gap (-3.8%) by 0.4 gives a value of -1.5% in 2011. The figure of -1.5% is assumed to be the cyclical component of the total deficit of 13.1%. The remainder is one-off measures (-3.8%) and the 'structural deficit' (-7.9%). The structural deficit of 7.9% for 2011 is less than the IMF (2012b) estimate for the same year (8.3%) as well as that of the European Commission (8.4%).

In contrast to the figure of 0.4% used by the Department of Finance, the figure used by the EU Commission for Ireland is 0.38 (European Commission, 2011:11 and Girouard and André, 2005:22 ). If the estimated output gap were to increase by 1% of GDP it is estimated that the budget balance would worsen by 0.38% of GDP. If the EU estimate of potential output were an underestimate equal to 4% of GDP, for example, the estimated structural deficit would be over-estimated by 1.52% of GDP. In 2011 this would have equated to a €2.4 billion fiscal adjustment. The paper by Girouard and André does not fully account for asset-price based taxes. Such taxes formed a large proportion of revenue in Ireland during the property boom. This helps to explain why the Irish elasticity of 0.38 is less than the Euro Area average of 0.48 (as estimated in 2005).

The Department of Finance has commented (Department of Finance, 2011:24):

On the basis of this approach, a significant part of the 2012 deficit would appear to be structural in nature. While this would accord with the general view that a large
part of the deficit will not be eliminated with economic recovery, the exact size of
the structural element is, of course, highly uncertain. Moreover, further out the
forecast horizon, the production function methodology implies a positive output
gap – that overheating pressures are emerging, which does not appear realistic.
This, in turn, has implications for estimates of the size of the structural deficit in
later years, and warrants caution in the interpretation of the figures.

D’Auria et al. (2010:4) state:

the measurement of potential output is the subject of contentious and sustained
research interest.

while OECD economists Cotis, Emleskov and Mourougane, 2003) stress that

Whatever method is used, it is necessary to make a critical and a non-mechanical
use of it (in particular, it is important to bear in mind its underlying assumptions
and its shortcomings).

Various agencies project that, in 2015, Ireland will have a structural deficit of between
2.5% (IMF, 2012b) and 3.5% (Department of Finance, 2012). The European
Commission (2012a) estimate that Ireland’s structural deficit in 2011 was 8.4%. A key
variable in the period following 2014 is how economic growth compares with growth
in estimated ‘potential output’. If – as is assumed or projected by the Department of
Finance (2012) – the estimated output gap is positive in 2015 and the structural deficit
is -3.5% of GDP (a full 3.0 % points above the target of -0.5%) then further fiscal
consolidation equivalent to 3.0% of GDP would be required.

It is sometimes claimed that economic growth after 2014 will reduce the structural
deficit automatically. This is not necessarily the case as the estimated structural deficit
is a function of the estimated output gap which in turn is related to growth in
estimated potential GDP. Given that, according to EU and Department of Finance
estimates, the Irish economy is technically ‘overheating’ in 2014 and later years it is
possible to conceive of an outcome where the structural deficit is still high and
economic growth has been restored. An example of this is the projections prepared
recently by the IMF which go out to 2017 (Table A in the appendix). Ireland, according
to IMF projections, will continue to experience high unemployment (more than 10% of
the labour force), continuing high structural deficits (more than 2% of GDP) and

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3 The IMF publishes figures of the structural balance divided by potential GDP, whereas the EU
Commission publishes the structural balance divided by actual GDP. Hence, it is necessary to make a
minor adjustment to IMF figures to compare like with like in this paper.
modest economic growth following a recovery (2-3% per annum in real terms from 2013 onwards).

To achieve a net improvement of €5 billion in the fiscal deficit a gross adjustment in excess of this amount would be required given fiscal drag\(^4\). Unless the economy of Ireland is growing significantly and estimates of the output gap are radically changed it will be hard to reach this target and any further fiscal contraction required could be very damaging. To compound the problem in Ireland, the planned coordination of fiscal austerity through a continuation of the debt brake and balanced budget rules may very well reinforce recession across Europe if the German Macroeconomic Policy Institute (IMK, 2012) forecasts are borne out.

How do European states compare with regard to the estimate of the ‘structural deficit’ as provided by the European Commission? Chart 2 provides the latest estimate of the government structural deficits as a % of GDP for each EU member state. The comparison indicates that, according to EU Commission estimates, only six member states out of 27 were compliant with the fiscal deficit rule of 0.5% of GDP (or 1% in the case of Bulgaria which had a debt-to-GDP ratio of less than 60%). Ireland leads with the highest structural deficit followed by Spain and the UK. Greece is in fifth place.

\(^4\) To achieve a net reduction of €5 billion in the deficit through spending cuts/tax increases a greater adjustment in gross terms is needed because the impact of some spending cuts will be cancelled out by loss in revenue.
Chart 3 shows the different estimates by the EU Commission and IMF of the structural deficit. As can be seen, using the latest methodology, and even with the benefit of hindsight, the EU Commission estimates that in 2006 the structural balance was 2.2% (an upward revision from 1.7% which was estimated at the time). Given the structural deficit permitted is 0.5%, this suggests (even with the latest methodology and with the benefit of hindsight) it might have been possible for Ireland to have spent an additional 2.7% in GDP, or €4.8 billion (or reduce taxes accordingly).

It is useful to compare historical and cross-agency performance on estimation of the structural deficit. The IMF (2012b) has estimated that Ireland had a ‘structural’ budget deficit of 4.3% of GDP in 2006, whereas the EU Commission (2012a, b) has estimated that it had a ‘structural’ surplus of 2.2% in the same year [Chart 3]. For that year the difference in estimates was 6.5% of GDP, equivalent to €11.5 billion. At the very least, targeting a structural deficit of 0.5% requires an ability to measure to an accuracy greater than 0.5%. However, on average the difference in estimate between the EU and

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5 As the EU Commission does not publish estimates for 'one-off and other temporary measures' it is necessary to infer them from the European Economic Forecasts, 2007 to 2012. The European Commission revised estimates of one off measures for the years 2005 and 2010. The most recent available estimate is used in all cases.
IMF was over 3%. The margin of error is at its largest at times of economic imbalance, precisely the time when an accurate measure would be most needed.

**Chart 3. Estimates of Structural Deficit in Ireland as % of GDP – IMF and EU**

Ireland’s performance, in comparison to Germany’s can be seen in Chart 4. The EU Commission estimates that, while Ireland maintained a structural balance during the construction boom, Germany has consistently not been compliant, with a structural balance consistently worse than that which will be permitted by the new fiscal pact.

**Chart 4. EU Commission Estimates of Structural Deficit**

Source: European Commission (2012a), European Commission (2012b)
The IMF frequently revises its estimate of the government structural deficit as can be seen in Chart 5.

![Chart 5. IMF Estimates of Structural Deficit 2000-07 for Ireland as a % GDP](image)

**Source:** IMF World Economic Outlook, various editions.

The IMK (2012) in Germany show simulations from the Oxford Economics model. It indicates that the consolidation based on debt would severely impair economic activity in EU countries such as Italy and Belgium, which have high debt ratios, and would dampen economic growth in the EU as a whole for many years. The IMK (2012) projects that European growth rates will be cut as a result of applying the Fiscal Compact rules. The lowering in GDP growth varies for each country but could be highest in the case of France and Italy. The IMK projections for Ireland envisage a cut in GDP growth in 2015 and later years. For example, in 2017 growth is projected to be 2.7% instead of 3.3% according to the IMF.

One assumption of a simulation undertaken by IMK is that the maximum structural deficit of 0.5% of GDP is to be reached by 2016. To achieve this Ireland would require a total annual consolidation requirement of 2% of GDP in 2013 (about €3.2 billion). The synchronised austerity policies would result in a stagnating GDP across Europe according to the IMK (2012).

Although it is exceptionally difficult to measure the past structural deficit (and IMF and EU estimates are contradictory), what is relevant to policy makers are expectations of
the future structural deficit. Both the EU and IMF provide forecasts for future structural deficits. Refer to the data Tables in the Annex.

The evidence and experience with regards to recent structural deficit estimation exercises suggests very large uncertainty and instability with regards to the appropriate measure. This will have consequences for how any agreed estimates are interpreted and implemented across member states especially those that are in recession.
3  Measuring the Debt Brake

The Fiscal Treaty includes a further rule that requires member states to reduce their debt-to-GDP ratio by an annual average of one twentieth of the difference between their present debt-to-GDP ratio and the 60% target every year. The latest EU estimate of this ratio for Ireland in 2011 is 108.2 (Eurostat, 2012). By way of example, if the debt-to-GDP ratio is given as 117.4% for Ireland in 2015 (Department of Finance, 2012:27), then it would be necessary to reduce the gap of 57.4 percentage points (the excess over the threshold of 60%) by an average of one twentieth each year. This could be achieved by a combination of real economic growth, inflation, or fiscal adjustment.

Whelan (2012) has shown the 0.5% structural deficit rule could be consistent with a long term debt/GDP ratio of just 25% while the German Macroeconomic Policy Institute (IMK, 2012) suggests it could be as low as 14%. IMK highlights the problems of a debt ratio that is too low, as banks and pension funds are required by law to hold a proportion of their reserves in public securities.


The specific rules for complying with the debt brake are laid out in the European Commission’s code of conduct (European Commission, 2012b). The European Commission will examine if states comply with the debt brake rule over a three-year period. The debt brake rule is fulfilled if a country reduced its debt by an average of one-twentieth over the past three years, or is expect to comply over the next three years (Council Regulation (EU) No 1177/2011).

The equation for calculating the three year average is given as

\[
bb_t = 0.95 \left( \frac{1}{3} (b_{t-1} - 60\%) + \frac{0.95^2}{3} (b_{t-2} - 60\%) + \frac{0.95^3}{3} (b_{t-3} - 60\%) \right)
\]

where \( bb_t \) stands for the benchmark debt ratio in year \( t \) and \( b_t \) stands for the debt-to-GDP ratio in year \( t \).

The evolution of the debt-to-GDP ratio in the future will depend on growth rate in GDP, the rate of price inflation and the average rate of interest on loans. Normally, under conditions of growth and moderate price inflation this ratio can decline significantly over a number of years as it did in the case of Ireland in the 1990s. However, with little or no real growth (at annual rates of no more than 1-2% per annum) allied to moderate price inflation and the prospect of elevated interest rates on a large stock of debt which exceeds the size of annual GDP it is not expected that the debt-to-GDP will decline rapidly before significant growth is restored to the economy. It is also possible that some restructuring of debt along with some write-down in the value of the Anglo-Irish/INBS Promissory Notes could assist in cutting the debt ratio in the future.

It should be noted that long-period time series of debt-to-GDP in the USA and UK reveal very high levels of public indebtedness over protracted periods of history. Natural processes of economic growth and price inflation helped bring down the ratio over time\(^6\).

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\(^6\) Refer to online data sources for the US public deficit over a century [here](#) as well as for UK public debt [here](#).
4 Possible Future Borrowing Options

Currently, the State is in receipt of funds under the ‘bail-out’ funding programme. This involves borrowing from external agencies as part of the ‘Troika’ agreement signed in November 2010 and amended subsequently. The programme runs to 2014. A question that arises in relation to the current Fiscal Treaty is how access to funds would be made in the event of a ‘Yes’ vote or a ‘No’ vote. In the preamble to the Treaty it is stated that:

STRESSING the importance of the Treaty establishing the European Stability Mechanism as an element of the global strategy to strengthen the economic and monetary union and POINTING OUT that the granting of financial assistance in the framework of new programmes under the European Stability Mechanism will be conditional, as of 1 March 2013, on the ratification of this Treaty by the Contracting Party concerned and, as soon as the transposition period referred to in Article 3(2) of this Treaty has expired, on compliance with the requirements of that Article.

In other words, assuming that both the Fiscal Compact and ESM Treaties are fully ratified in their current state, access to funds in the future, upon expiry of the current Troika bail-out funding programme, is conditional on ratification of the Treaty by the Irish people.

It is not possible, with certainty, to predict what national or European authorities would do or not do given a sharp and unexpected turn in economic and political events. The architecture of the European currency area was so designed as to prevent any Euro area member state bailing out another member state or to prevent the European Central Bank or national central banks from financing governments. Both of these provisions have been overridden many times recently. All member states were expected to operate within the Maastricht criteria on debt and deficits – yet many countries flouted these rules without sanction. In this section of the paper a number of possible scenarios are presented.

4.1 Borrowing options following ratification of the Treaties by Ireland

Based on the existing Treaty documentation and subject to any further possible changes to it, Ireland will have access to the European Stability Mechanism – should
the need arise in the future – subject to the rules, sanctions and agreements inherent in the Fiscal Compact Treaty as well as other agreements involving Ireland and other member states at the time such funding may be required. Access to make an application does not guarantee funding and is subject to conditions and approval by all countries (European Central Bank, 2011).

4.2 Borrowing options following non-ratification of the Treaty by Ireland on 31 May

It is not known at this time with any certainty what options may exist for future borrowing by government at the end of the current Troika Agreement. Governments borrow from a number of sources:

- Domestic savings by households and corporations
- International capital markets
- Special bilateral or multi-lateral lending arrangements involving agencies such as the European Union and the International Monetary Fund as well as other countries (e.g. the UK, Denmark and Sweden in the case of the 2010 bail-out for Ireland).

At this time, Ireland, is largely excluded from international capital markets. Access to domestic savings is limited but not negligible. From the 2010 annual report of the National Treasury Management Agency, the amount outstanding in 'State Savings' (ie prize bonds, post office accounts etc.) was €12.7 billion, while €3.4 billion was raised in 2010. It should be noted that the overall level of domestic savings (household and corporate combined) is currently very high. Net lending/borrowing with ‘the rest of the world’ is very low as net public borrowing is roughly offset by net private savings (Nevin Economic Research Institute, 2012:4).

Ireland is mainly reliant on outside sources of funding to bridge the gap between government revenue and expenditure. The current agreement with the Troika is in place until the end of 2013. The 12th review of the Troika is scheduled for 15th Nov 2013 (IMF, 2012b). The aim of the Troika plan was to return Ireland to the debt markets.
With or without a further bail-out involving the existing Troika, it is expected that
Ireland will borrow money internationally in 2014. According to NTMA\(^7\) and IMF
(2012a) estimates of outflows in 2014 will comprise:

- €9.4 billion to roll over debt
- €9.9 billion in interest payments
- €54.1 billion in non-interest current spending
- €4.3 billion capital spending

The IMF project a revenue flow in 2014 of €59.8 billion. Total government debt in
2013 is estimated to be €22.5 billion to the IMF and €45 billion to the EU. So debt to
these official creditors will be roughly a third of our total projected debt of €194.1
billion (IMF, 2012:29). It should be noted that the projected General Government
deficit in 2014, according to the Department of Finance (2012) is €8.2 billion. Total
projected interest on public debt in 2014 is €9.5 billion indicating a projected ‘primary
surplus’ of €1.3 billion.

*The International Monetary Fund*

The International Monetary Fund has been cited as a possible source of backstop
funding in 2014. However, there are a number of difficulties in accessing additional
IMF funding – not least political given its role as a partner with European authorities
as well as the fact that Ireland is currently well above quota in terms of sums lent.

*The European Financial Stability Fund\(^8\)*

It is possible for countries, including Ireland, to apply for funding from this source up
to July 2013 (European Central Bank, 2011)\(^9\). Access to the money is reliant on a
decision from the European Council, so another country could decide not to accede to
an application for funding.

There appears to be a strong case for continuing support under the EFSF until Ireland
regains access to capital markets based on a statement of the Heads of Government in
July 2011:

*We are determined to continue to provide support to countries under programmes
until they have regained market access, provided they successfully implement those*

\(^7\) http://www.ntma.ie/GovernmentDebt/maturityProfile.php
\(^8\) http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm
\(^9\) http://www.ecb.int/pub/pdf/other/art2_mb201107en_pp71-84en.pdf
programmes. We welcome Ireland and Portugal’s resolve to strictly implement their programmes and reiterate our strong commitment to the success of these programmes.

A second assurance was issued on 30th January 2012 after the Fiscal Compact was agreed and after the ESM clause was inserted into the Preamble of same:

We welcome the latest positive reviews of the Irish and Portuguese programmes which concluded that quantitative performance criteria and structural benchmarks have been met. We will continue to provide support to countries under a programme until they have regained market access, provided they successfully implement their programmes.10

This could be interpreted to mean that the current funding programme can be extended and financed under the ESM itself – because it would not be regarded as ‘new’. It is merely a continuation of support – support that the EU leaders have already guaranteed.

It must be acknowledged that any continuation of support through any of the options mentioned above would be accompanied by exacting financial terms and policy conditions. While it may be viewed as improbable that Ireland would be left unfunded from external sources in 2014 it is not known for sure at this time what options exist for continuing funding and what price would be paid in terms of interest owed and policy conditions imposed on Ireland over and above those already foreseen under existing funding arrangements.

Notwithstanding the recent approved Greek default, it may be claimed that the EU would not be willing to allow Ireland default and so would lend to Ireland no matter what. However, the outcome of any given strategy or option is not certain as political and economic developments will dictate what is, ultimately, negotiated or implemented.

Voters must assess these risks and weigh them against possible (and unknown) long-term risks attached to adherence to the existing fiscal rules (Maastricht, six-plus and now the draft Treaties).

5 Conclusion

The biggest challenge to European member states is continuing and rising levels of unemployment especially among young people. This is undermining social cohesion, well-being and the long-term sustainability of economies. The surest and safest way to stabilise public finances is to grow the economy through timely and coordinated demand-led growth across European economies (refer to the investment proposal made by NERI – Nevin Economic Research Institute, 2012). Following a number of years of fiscal austerity in many European countries there is a need for a new departure and reversal of existing fiscal policy. The timing, content and genesis of the Fiscal Compact leave much to be desired.

In this paper some significant conceptual and measurement problems have been signalled in relation to key components of the Treaty. At the same time, the challenge in the case of Ireland of gaining access to funds internationally on a continuing basis has been noted. A number of options have been presented. However, none of these options are secure or certain and the lending terms and policy conditions attached to any future funding arrangement are unknown at this time.

At least three large unknowns characterise the current situation in Ireland in regard to the Fiscal Compact:

1. The extent of possible or likely further fiscal consolidation after 2015 when – according to Department of Finance estimates the government structural deficit will be 3.5 percentage points of GDP in excess of the 0.5% target;
2. The terms and conditions on which Ireland might be able to continue accessing funds internationally in 2014 (ESM or otherwise) and later years regardless of the outcome of the referendum; and
3. The outcome of various political, legal and economic developments at this time.

Ultimately, the outcome of current debates and negotiations across Europe may be shaped or significantly modified by political forces pressing for growth and recovery through investment. In the immediate term voters in Ireland bear a heavy and unique responsibility to make a wise choice that will secure a better future for Europe and Ireland.
References


Department of Finance (2011) Economic and Fiscal Outlook, Dublin.


European Commission (2012b) AMECO online database (update 11 May 2012)

European Commission (2012c) Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes Available.


## Appendix

Table A. IMF Forecasts for Structural Deficit as % of Nominal GDP

<table>
<thead>
<tr>
<th></th>
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</table>

**Source:** IMF WEO (April 2012).

**Notes:** Data for Estonia unavailable. As the IMF publishes an estimate of the structural deficit as a percentage of potential GDP, it is necessary to make an adjustment to ensure comparability with EU figures.
Table B. EU Forecasts for Structural Deficit as % of Nominal GDP

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Source: European Commission (2012a)
Notes: * indicates compliance with fiscal rule