

Social Justice Ireland

The Fiscal Compact – Intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

**Briefing for Joint Oireachtas Committee
on European Union Affairs**

Introduction

Social Justice Ireland welcomes the opportunity to address the Joint Oireachtas Committee on European Union Affairs on the Intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (referred to as the Fiscal Compact from hereon) and its implications for Ireland. We do so because this Compact is very relevant to *Social Justice Ireland's* core objective of building a just society where human rights are respected, human dignity is protected, human development is facilitated and the environment is respected and protected. The Compact is likely to have major implications for those who are the worst off in society and so has implications for the development of a just society in Ireland.

In making these observations on the Fiscal Compact we focus on a few key questions we believe are critically important.

Why has this Fiscal Compact been developed?

The Fiscal Compact has been presented as the means to achieve two key outcomes:

1. Ensuring there will be no repetition of the crisis that hit in 2008 and that still continues;
2. Playing a key role in the strategy to save the euro.

It proposes to do this by putting in place a much more stringent approach towards budgetary policy across the Eurozone countries.

Should there be Budget oversight and monitoring

Social Justice Ireland welcomes the general principle of providing more oversight of the budget process. We have for some time called for greater monitoring of budgetary policy. For example, on several occasions in recent years we have challenged Governments when they have reduced the information available in budget documentation. Likewise we have pointed out that there were very serious questions concerning forecasts contained within Budget and Budget-related documentation. These questions remained unanswered.

We believe there is an obvious need for enhanced national and international monitoring of annual budgets. Nationally this could be done by giving a greater role to the Oireachtas to consider and debate budget proposals which ideally would occur over a series of weeks in advance of the enactment of a Budget. Internationally monitoring could be done via a sophisticated European monitoring mechanism which externally assessed the stability and sustainability of budgetary/fiscal policies. Such assessment, however, would have to be based on objective evidence and not on the political ideologies of those who are powerful at the EU level at any particular moment in time. It would also have to be open to challenge and adjustment – also on the basis of evidence and not of power. Sophisticated oversight of Budget policy is long-overdue and if properly structured would be very welcome.

Will the Fiscal Compact prevent a repetition of the 2008 crisis?

Much of the analysis underpinning the Fiscal Compact is flawed. This analysis understands the crisis to have been caused by Governments over-spending and running up huge debts. Failures in Budgetary policy at the national level are seen as the key problem. However, only in the case of Greece, which did have serious fiscal issues, was this the case.

The real causes of the crisis were much deeper. In order to increase profitability the financial world began more than a decade ago to invest surplus funds in the financial world itself and in property. A whole range of new financial ‘products’ were created that could be bought and sold. Interest rates were lowered to facilitate this process. The increasing resources available for purchasing property led to huge increases in the price of property. Mortgage companies became more aggressive in marketing their products introducing innovations such as 100 per cent mortgages, ‘interest only’ mortgages and 40-year mortgages. House prices soared. Lending standards were lowered. Many of these mortgages were held by people who could not afford to repay on the agreed terms i.e. these were ‘subprime’ mortgages.

A further problem was created as these mortgages were included with other assets in new derivative products called ‘collateralised debt obligations’ (CDOs). These products were sold to banks and financial institutions that were not aware of what these products really contained. As interest rates rose it became apparent that many of these products were not worth their face value. The total value of these products is not known but is estimated to run into trillions of dollars.

In 2007 this situation began to unravel. Companies such as Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac and Bear Stearns in the USA and others across the world were simply overwhelmed by these products as their reserves could not meet the losses being faced. Some collapsed. Others were bought out. The major international insurance company AIG (American International Group) was brought down by its huge exposure in the area of ‘credit default swaps’ which are derivatives that make it possible for investors to bet on the possibility that companies will default on repaying loans. George Soros the well known investor estimated that €45 trillion were invested in a market on these swaps – a market that was totally unregulated. The seriousness of this situation was further exacerbated by the broad adoption of a policy of light-touch regulation for financial markets.

In the Eurozone the crisis was exacerbated by the fact that the euro is an incomplete currency union. It is vulnerable to destabilising financial flows, regional credit bubbles and sovereign defaults. It also failed to take any account of the fact that different countries in the Eurozone were always likely to be at different points in the economic cycle at any given time. This in practice meant that the European Central Bank’s core interest rate while being very appropriate for some countries was always likely to be inappropriate for others.

As the situation deteriorated institutions such as the European Central Bank were adamant that no bank should be allowed to default; otherwise they believed there could be serious ‘contamination’ and other banks might fall. Countries such as Ireland were pressurised by some international institutions to ‘socialise’ their debt i.e. to agree that Government would take full responsibility to repay all the debts accumulated by private banks. In practice this would move responsibility for repaying these debts from the banks to the State. Those who had gambled their money and lost would, as a result, be repaid in full. The repayments would be funded by increased taxes and cuts in public expenditure. In practice, this would mean a programme of austerity would have to be imposed. Poor and vulnerable people and ordinary taxpayers would pay for debts they had no hand, act or part in accumulating. There is something profoundly unjust, unfair and immoral about this approach. Yet it was enforced particularly by German and French political leaders.

Would the Fiscal Compact have prevented the 2008 crisis emerging in Ireland? For the most part Ireland’s annual budget was in surplus in the decade prior to 2008 and would have met the Fiscal Compact’s conditions with ease. Likewise, if the Fiscal Compact had been in

place in those years it would have made no difference to the way banks and financial institutions generally operated.

That crisis was caused in Ireland by a combination of factors. Some of these were firmly rooted in Ireland itself. Others were caused by external forces. Those already identified above played a profound part in Ireland's implosion. Other contributing causes are well known:

- From 2001 onwards Ireland developed a huge property 'bubble' which was financed by money available at interest rates that were too low.
- Much of this money came from banks and financial institutions in Germany, France and beyond who were getting higher interest rates for these loans because of the risky nature of their investment.
- Light-touch regulation was the order of the day and promoted across the EU.
- The tax-base was narrowed.
- There was a widely-held conviction among politicians and key Government Departments that infrastructure and social services at an EU-average level could be delivered in Ireland with one of the lowest total tax-takes in the EU.
- Having one of the lowest tax-takes in the EU was seen as very desirable.

Ireland also:

- Failed to appropriately regulate the banking and financial services sector;
- Failed to take action to broaden the tax base;
- Failed to promote tax equity by for example, introducing Refundable Tax Credits;
- Failed to overcome infrastructure deficiencies, such as broadband, public transport, primary health care, water, energy and waste;
- Failed to adequately address high energy costs;
- Failed to address high local authority charges on business;
- Failed to promote competition in sheltered sectors of the economy, such as professions;
- Failed to manage the growth of personnel numbers in the public service.

As a result, Ireland was very poorly placed to address the crisis that arrived in 2008.

Would the Fiscal Compact have made a substantive difference to Ireland's situation if it had been in place since the year 2000? Clearly, the answer to that question is No.

Social Justice Ireland believes that many changes are needed to resolve the causes of the crises of recent years. From an EU perspective a number of initiatives are required. We highlight two:

- **Addressing the problems created by different countries being at different points in the economic cycle at any one time.** Of particular concern here is the interest rate issue. Ireland had very low interest rates for much of the last decade. These were dictated by the large EU economies which, unlike Ireland, were experiencing very low growth levels. Interest rates were reduced to very low levels to encourage investment in those countries. The same rates applied in Ireland, however, which was at the opposite end of the economic cycle. *The new Fiscal Compact does not address this issue.*
- **Addressing the moral hazard that protects banks.** Moral hazard is the situation in which an individual or institution is insulated from risk while others pay the negative consequences of the risk. In such a situation those insulated from risk have a tendency or an incentive to behave inappropriately. This is what happened to banks and financial institutions in Ireland, Germany, France and beyond in the years prior to 2008. The same is likely to happen again unless much more stringent institutional safeguards are put into place. Governments in wealthy countries have built up large liabilities because they have provided implicit guarantees to their banks and financial institutions. This contributes to the development of moral hazard in lending around the world. The new Fiscal Compact will not stop this trend. The real structural challenge is to design an effective mechanism to address the moral hazard of banks and financial institutions. Such a mechanism must include a provision ensuring that bondholders can be held responsible for losses when their gambling fails. Unless this challenge is addressed effectively we can be assured that banks and financial institutions will return to their wayward ways, reprise their reckless activity of the past decade and produce similar consequences. *The new Fiscal Compact does not address this issue.*

Would the Fiscal Compact play a key role in saving the euro?

The euro is a flawed and incomplete currency union. It remains vulnerable to destabilising financial flows, regional credit bubbles and sovereign defaults, given the unwillingness to re-engineer the Eurozone as a proper monetary union.

The weaknesses which could spark a renewed crisis sometime in the future have not been addressed in the Fiscal Compact and the pretence is maintained that Europe's problems derive entirely from budgetary excess.

What would be the Fiscal Compact's impact on Ireland's Budget process?

There are four key issues *Social Justice Ireland* wishes to highlight here. These are:

- The Budget must be balanced and Ireland's Government was well on the way to doing this before the Bailout Agreement.
- National debt must be reduced to 60 per cent of Gross Domestic Product (GDP)
- The structural deficit must not exceed 0.5 per cent of GDP.
- The Fiscal Compact has serious implications for economic policy and how a country decides to improve its infrastructure, social services and jobs, implications that flow from the three points listed above which are contained in the Fiscal Compact.

On the Budget balance

Following more than a decade of balanced budgets and a dramatic reduction in the Debt/GDP ratio Ireland saw its fiscal situation collapse in 2008. A huge drop in Exchequer revenue led to a corresponding rise in Exchequer borrowing to cover public expenditure and the rescue of banks. Government moved to address the issue with a series of expenditure cuts and tax increases. As well as the annual Budget there were adjustments in July 2008 and February/March 2009 followed by a Supplementary Budget in 2009.

The point to note here is that the Irish Government had chosen to close the Budget gap long before the Bailout Agreement with the EU, ECB and IMF was signed. Ireland needed budgetary correction and acted accordingly. Even if Ireland had avoided a Bailout

arrangement dramatic Budget adjustments could not have been avoided. The scale of the debt taken aboard by the Government following on the Bank Guarantee is adding dramatically to the austerity Ireland is currently experiencing. But the Budget would have had to be balanced and Ireland would have had to make the necessary adjustments to ensure it paid its way.

On reducing the national debt to 60 per cent of GDP

Ireland's current Debt/GDP ratio is close to twice the limit set out in the Fiscal Compact. The Fiscal Compact will expect us to reduce it gradually until it reaches 60 per cent of GDP. The target as set out in the Fiscal Compact has been in place since 1992. Most countries in the EU have debt levels above the limit set in the Fiscal Compact.

In Ireland it would be a great help to most people if the Government presented its debt figures and its annual Budget expenditure figures in a manner that shows clearly and honestly how much of the national debt and how much of the Government's annual expenditure is accounted for by the costs flowing from the rescue of banks and financial institutions.

On keeping the structural deficit below 0.5 per cent of GDP

It is important to note that the Fiscal Compact continues to allow countries to have an overall deficit of 3 per cent of GDP but within that countries will now be forced to target a structural deficit below 0.5 per cent as well. The structural balance is the balance once the transitory effect of the business cycle and once-off budgetary measures have been removed. The structural balance is very difficult to measure and there is much disagreement among economists on the issue. With reference to Ireland this issue is well addressed by Dr Jim O'Leary in his article '*External Surveillance of Irish Fiscal Policy during the Boom*', published on the Irish Economy website in July 2010. There is much argument on how to calculate the effect of the business cycle on the budget balance. Some have concluded that the Compact's 3%/0.5%/60% limits lack internal consistency.

In this context it is worth noting the Department of Finance's comments in the Budget 2012 documents on this. In its Economic and Fiscal Outlook document the Department states:

“A frequently used tool in the analysis of fiscal policy is the structural budget balance – the balance that would prevail if transitory elements in the headline balance owing to economic fluctuations are removed. Unfortunately, decomposing the headline General Government Balance (GGB) into its temporary and permanent components is subject to considerable uncertainty, as neither component can be directly measured and must be estimated.

This is problematic as the approaches available for this purpose are all subject to some limitations. For open economies such as Ireland’s, these limitations are particularly marked, while the very significant structural shocks that the Irish economy has experienced in recent years are a further complicating factor.”

Having reviewed the relevant table (table 14, p. D. 23) the Department of Finance concludes:

“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.”

The Department of Finance had previously voiced this view in Annex 4 of the Stability Programme Update published on April 11, 2011. On page 46 it claims that the applicability of this approach to Ireland “is a question that merits particularly close scrutiny”. Having reviewed a number of approaches to measuring the structural deficit it concludes:

“...issues arising out of the current methodological framework have resulted in substantially reduced potential output figures for Ireland, with the knock on effect that the output gap for 2015 is positive at around 4½ per cent of GDP. Given that this figure would suggest a rapidly overheating economy with resulting inflationary pressures; this result is not viewed as plausible.”

The Compact’s provision on the structural deficit raises serious questions for Ireland. The Department of Finance’s conclusions highlight serious problems in using this methodology to estimate output gaps, potential GDP and ultimately the structural balance. It is neither

acceptable nor appropriate that Budget policy be built on such a basis. It seems strange that a target of this nature is included in the Fiscal Compact together with actionable consequences when it appears the target cannot be measured.

On the timely availability of statistics and the Fiscal Compact

In the context of applying the Fiscal Compact it is important to note that there is quite a time-lag in the production of statistics. While estimated national income data is available there is quite a delay before the actual real outcomes are available. This means that accurate estimates (if these were possible) of the various parameters would not be possible until finalised national income figures, tax take figures and related other data were available. In many cases these data are not available for many months after a Budget. Indeed at the extreme the Revenue Commissioners do not publish final tax return figures for a few years! It is not acceptable that a Budget would have to be developed on the basis of targets produced on the basis of incomplete data.

On the Fiscal Compact's implications for economic policy

Social Justice Ireland believes the Fiscal Compact has serious implications for Ireland's economic policy in the years ahead, implications that fly in the face of decades of good practice and good outcomes across the developed world. If the Fiscal Compact is implemented then it will be impossible for a country to follow the approach advocated by John Maynard Keynes, an approach that has served Europe, the USA and other OECD countries well for almost eighty years. Is this wise?

There is ample evidence to suggest that Keynes got it right in 1937 when he argued that "the boom, not the slump, is the right time for austerity at the Treasury". Keynes believed that Governments should operate counter-cyclical policies, running deficits to boost flagging economies and cutting spending to cool over-heating economies. Since 1937 many Governments have proved Keynes right by trying austerity during a slump and failing to rejuvenate their economies. In effect that is what is happening in the EU since the crisis of 2007/2008 with little or no success. It will become the permanent approach of Eurozone countries if the Fiscal Compact is followed in the years ahead.

Currently we are in the middle of the worst economic crisis since 1929. How the USA got out of that depression holds lessons for today's world. Following the crash of 1929 severe austerity was imposed by the US Government between 1929 and 1933. Government, for example, responded to reduced tax revenue caused by declining economic activity by cutting its own expenditure by similar amounts. Average incomes went down from over \$11,000 to less than \$8,000—a loss of more than 25 per cent. Unemployment went up to 20 per cent and, on that issue, the Great Depression was worse than what we're going through now.

In 1933, Franklin D. Roosevelt was elected President of the US and his Government started spending money to stimulate the economy. He called it “priming the pump.” Years later Keynesian economists would call it “stimulating aggregate demand.” Whatever you call it, Roosevelt took what, at the time, looked like big action, spending money trying to help people, to get the economy moving again. And he had several years of success.

However, following his re-election he came under severe pressure to balance his budget and returned to austerity measures which led to economic decline and a return to high unemployment.

In 1941 the Japanese bombed Pearl Harbour. The United States entered World War II. Roosevelt immediately reversed his approach, abandoned budget-balancing as his priority and the depression ended virtually overnight.

But a war isn't needed to stimulate the economy. There are alternatives to austerity: Government could start spending money. It could spend on essential economic and social infrastructure such as schools, bridges, public transport, telecommunications, or on services to help the vulnerable through a basic income guarantee or other measures.

Keynesians would argue that Governments need to spend money to help people in the present crisis. Once that door is open they argue that the possibilities are great. But until then, they argue that Governments are practicing austerity against the lessons of history.

This however is not the ‘dominant view’ in the EU at present. Nobel laureate Paul Krugman has noted that:

“The belief that one should slash spending even in a depressed economy, and that this would actually promote growth because it would have positive effects on confidence, spread like wildfire in 2010. There were some economic studies used to justify the

doctrine of expansionary austerity – studies that quickly collapsed under scrutiny. But really, the studies became popular because they suited the prejudices of politicians, prejudices that would have been totally familiar to Herbert Hoover or Heinrich Brüning.”

Even if people don't believe in the approach of John Maynard Keynes, is it wise to lock the Eurozone into one specific approach? Is it wise to adopt one approach, put it into law and refuse even to consider that it might be wrong? These are very serious questions thrown up by the Fiscal Compact.

What would the Fiscal Compact's impact be on Ireland's access to the permanent EU bailout fund?

A modification to an EU treaty on February 2, 2012 introduced the condition that only countries which adopt the Fiscal Compact will have access to the permanent EU bailout fund, the European Stability Mechanism (ESM). This provision is not part of the Compact; it was not discussed in Ireland; but it was signed by the Irish Government.

Will Ireland need this facility after 2013? Government is adamant that all will be well and Ireland will have access to the financial markets as outlined in the timeframe set out in the current Bailout Agreement. However, the economy is not performing at anywhere close to the levels envisaged when that Agreement was originally signed.

The European Commission recently published its *Winter 2011 Review of the Economic Adjustment Programme for Ireland*. The Review has revised down Ireland's growth rate for 2012 to 0.5% as a result of falling domestic demand and the growth slowdown in Ireland's main trading partners, especially in the Euro area where there is a danger of some of these countries sliding into recession.

Projections for domestic demand show there will be no real improvement until 2014. The report also highlights some of the risks to Ireland's growth noting that a further drop in Irish exports will impact on budget performance and on Ireland's overall growth.

Without some major adjustment to Ireland's debt (e.g. reducing Ireland's liability for the Anglo promissory notes) Ireland may well need access to the ESM after 2013.

Conclusions

- The general principle of enhanced oversight is a good one and we need more of this domestically and internationally.
- The execution of that principle is a problem in the Fiscal Compact. It proposes an impossible to measure and too restrictive approach which has the ability to undermine the role of Government to respond to economic shocks.
- The Fiscal Compact is unlikely to achieve either of the two key outcomes for which it was created i.e. (i) ensuring there will be no repetition of the crisis that hit in 2008 and (ii) playing a key role in the strategy to save the euro.
- On the other hand two of its targets i.e. reducing Government debt and balancing the Budget are desirable outcomes.
- Its third target (on the structural deficit) is based on a concept the understanding of which is seriously contested.
- Countries that do not sign the Fiscal Compact will not have access to the ESM. Without major adjustment to Ireland's debt (via action to reduce the impact of the Anglo promissory notes, for example) Ireland may well need access to substantial funding after 2013.
- The Fiscal Compact would lock the EU into one specific approach to economic development, an approach that cannot guarantee a positive outcome.
- The best recommendation would be to redesign the Fiscal Compact but the situation seems to be beyond that at this stage and that is a major problem.