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Restoring balance in public finance in Europe in the light of Fiscal Compact

1. Introduction

In the days before the outbreak of the Great Depression, so in a period when the concepts of classical economics were dominant, state budget policies were often related to a budgetary policy of a family. Even Adam Smith - the father of classical economics – noted: "*What is prudence in the private life of every family, there may perhaps not be madness in the life of a great kingdom*"[Smith, 1985 p. 47]. State financial responsibility was associated fundamentally with the determinants of the family well-being. Saving was a virtue, which was reflected in the view that the state budget should be at least balanced, if no surplus, and the deficit was allowed only in exceptional circumstances. Serious and persistent deficit was considered a sign of fiscal insanity [Buchanan, Burton and Wagner, 1978]. Indeed, until the thirties of last century it was commonly believed, that the balance between expenditures and state revenues is normal and the lack of such a balance - the budget deficit - an abnormal condition [see. Cossa, 1884][2]. Balancing the budget was certainly a good rule of fiscal policy, simple and completely captivating the problem. This did not mean that governments had not got into debt. On the contrary – the public debt often reached considerable size. For example, in the UK in 1820 it amounted to 132% of GDP [Rzońca 2008, p. 17]. However, the states usually did not increase debt in good times. Public debt appeared during wars, when public spending rose dramatically or in times of disasters such as e.g. floods, pestilence, drought, etc., when tax revenues were rapidly falling. Deficits were also caused by difficulties in creating an adequate revenue base for growing - amid the rapid progress of civilization – expenditure's needs [Wernik 2011, p. 178]. Despite the widespread recognition, the rule expressed in a balanced budget was broken in the thirties of the twentieth century. The economists began to see the budget deficit as an instrument that could stimulate the economy in times of recession. An excellent

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[2] However, it should be added that the same expression was used by the author to the budget surplus.

participation in the prevalence of such a perception of deficit had an English economist John Maynard Keynes – unavoidably one of the greatest economists of the twentieth century, but also his supporters and apologists afterwards. However, an important postulate in his theory was also that he advocated for increasing the deficit only in times of recession, because he was aware that during the cyclical recovery, which always takes place after the recession, higher public spending will result in an increase in prices and will crowd out private spending [Keynes, 1985, p.151]. Hence, the budget was to record a budget surplus when aggregate demand was excessive in relation to the state of full employment, leading to economic imbalances. As economic history shows, Keynesian recommendations were firmly ignored.

Irresponsible fiscal policies, pursued by governments in Europe before the crisis for purposes other than stabilizing the economy, constitute a good example of the above. The levels of debt and deficit in many countries exceeded acceptable limits, recorded in the Treaty on the Functioning of the European Union (TFUE) and in the Stability and Growth Pact (SGP)[3]. Further deepening of the fiscal imbalances, caused by the recent crisis, led the most indebted countries even on the brink of bankruptcy. In the face of the explosion of public debt, but also gradually progressive aging of the population, the need to bring continued fiscal discipline became clear. It should avoid duplication of past mistakes when during high economic growth (particularly in years 2006-2007) the public finance was not even balanced, while the surplus should be a natural state which de facto Keynes himself advocated, reiterating that "*…a boom is the time for the severity of the Treasury*" [in Skidelsky, 2012, p. 161].

The experience of financial and economic crisis, which then turned into a sovereign debt crisis, forced the European leaders to adopt solutions aimed at the establishment of a sustainable fiscal discipline in the Member States. In December 2011 a package of six legal acts strengthening economic governance in the EU was adopted, the so-called Six-Pack that reforms the Stability and Growth Pact of 1997 and in 2012, 25[4] Member States signed The Treaty on Stability, Coordination and Governance in EMU - TSCG, so-called Fiscal Compact. One of the main provisions of the Treaty says that the budgetary position of the general government shall be balanced or in surplus. This rule

[3] In years 1999-2009, Member States violated the deficit rule 74 times and the debt rule 93 times. This simply means that the system of fiscal discipline adopted in the EU did not work.
[4] The United Kingdom and Czech Republic were not among the signatories of the Treaty.

refers to the annual structural balance of the general government at its country-specific medium-term budgetary objective (MTO) as defined in the revised Stability and Growth Pact. The reformed Stability and Growth Pact and the Fiscal Compact represent the foundations of a new European economic governance system. These several years since the rules came into effect encourage to evaluate the adopted solutions in terms of restoring balance in public finance in Europe.

Therefore, the main aim of the article is to assess the extent to which Member States have achieved their medium-term budgetary objectives (MTO) and the benchmark for government debt reduction in the light of the Fiscal Compact's provisions along with identifying the risks involved in this process. The specific purpose of the paper is to present recommendations from legislative acts reforming the Stability and Growth Pact and the Fiscal Compact whose principal objective is to more effectively safeguard against the risk of irresponsible fiscal policy conduct and to prove that the outbreak of financial and economic crisis which then turned into a sovereign debt crisis is the final evidence of the need to return to the concept of maintaining a continued fiscal discipline.

The methodology focuses on the author analysis and assessment using research and professional experience. First of all, the analysis relies on the literature studies, research, available analytical reports as well as data and statistical analysis. The methodology assumed in the article is based on the well-correlated reports of the European Commission, OECD, IMF. The paper uses a literature research method to solve defined problems and achieve set goals. In addition, the subject of research required to use deductive and inductive methods, analysis and synthesis methods, and comparative analysis to the necessary extent to achieve the objectives of the paper.

2. Persistence of deficits

Persistence of indebtedness phenomena by governments all over the world is confirmed by fiscal statistics. The data fully proves that recommendations of Keynes's theory have been ignored. Fiscal data concerning OECD countries indicate that 45 out of 46 years in the period of 1970-2015 were characterized by the occurrence of the budget deficit[5], while in Europe in the period of 1995-2016 the budget surplus occurred only once.

A striking example of irresponsible fiscal policies pursued by governments in Europe for purposes other than stabilizing the economy were the years before the outbreak of recent financial and economic crisis in 2008. The levels of debt and deficit in many countries exceeded acceptable limits, recorded in the Treaty on the Functioning of the European Union (TFUE) and in the Stability and Growth Pact (SGP).

Structural weaknesses in public finance were covered by very high budgetary revenues fostered by favorable phase of the business cycle, and in some countries by transactions in the asset market, especially in real estate market, driven by the increase in debt of the private sector. Such circumstances were not conducive to making reform efforts by governments consisting in removing swollen structural problems of public finance. They emerged with full force when the financial and economic crisis had led to a strong decrease in budget revenues. In addition, the need to stimulate economies and support the financial sector during the world's biggest economic downturn since the Great Depression of the 1930s was so strong that many countries, including the richest, decided to introduce fiscal packages on a large scale. As a result, there has been a sharp increase in deficit-to-GDP and debt-to-GDP ratios (see Fig. 1.; right axis refers to general government balance; values in % of GDP).

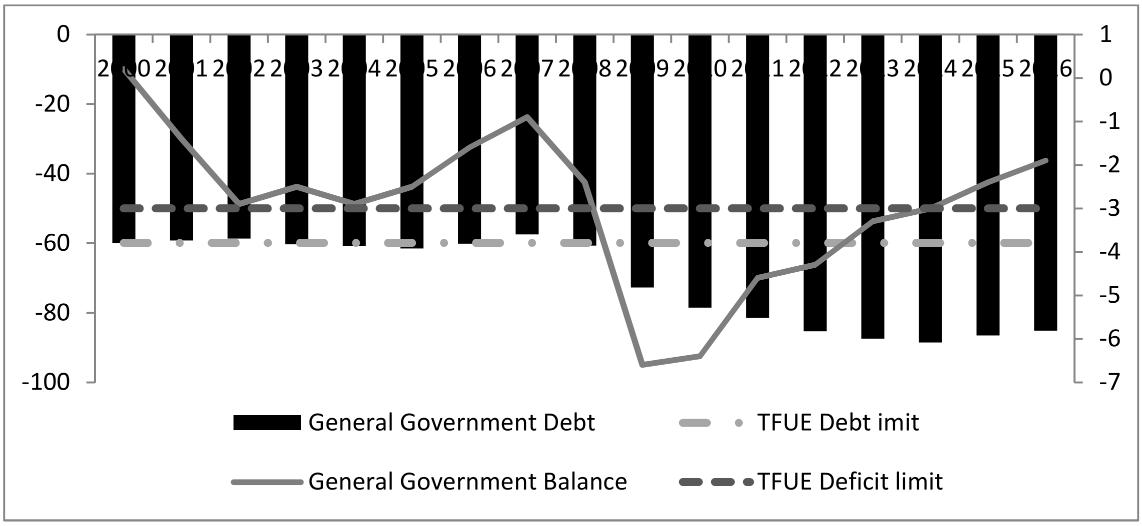

Fig. 1. General Government debt and deficit in Europe in years 2000-2016 in % of GDP.

Source: AMECO database; European Commission.

[5] OECD Statistics database.

Further deepening of the fiscal imbalances, caused by crisis, led the most indebted countries on the brink of bankruptcy. It is to note that in years 2008-2015 the debt-to-GDP ratio in Europe increased by 26 pp.! Only fiscal consolidation undertaken by governments led gradually to a slowdown in the growth of debt in relation to GDP and already in 2015 the debt-to-GDP ratio has been put on a downward path.

3. Institutional reforms in Europe

The Stability and Growth Pact of 1997 indicates the fiscal criteria to which each Member State is bound. The size of -3% of GDP is the threshold for the annual nominal balance of the planned or real general government sector beyond which the Member State is threatened by the European Council's to impose on the request of European Commission the Excessive Deficit Procedure (EDP). Essentially, an excessive deficit should be corrected in the year following its identification unless exceptional circumstances occur. In addition to the deficit criterion, there is also the general government debt criterion, according to which, the general government debt should not exceed 60% of GDP. The experience of financial and economic crisis, which then turned into a sovereign debt crisis, forced the European leaders to adopt solutions aimed at the establishment of a sustainable fiscal discipline in the Member States. In January 2012 a package of six legal acts (one Directive and five Regulations) strengthening economic governance in the EU came into force. The so-called Six-Pack that reforms the Stability and Growth Pact of 1997 sets requirements for budgetary frameworks indicating that Member States should have fiscal rules with clearly defined objectives and with mechanisms for effective and timely monitoring. It recommends that the fiscal rules should relate to the deficit and debt calculated according to the EU methodology and relate to the entire general government sector. Member States should also set escape clauses and consequences of non-compliance. By applying rules in the annual budgeting process and in multi-annual budget planning, the Member States are to avoid pursuing pro-cyclical fiscal policies.

The provisions of the six-pack were grounded in the Treaty on Stability, Coordination and Governance in the EMU - TSCG, the so-called Fiscal Compact agreed in March 2012 at European Union Summit[6]. The Treaty specifies requirements for fiscal rules in the countries that are subject to the provisions of the Treaty. The provisions of the

[6] The United Kingdom and Czech Republic were not among the signatories of the Treaty.

Treaty oblige the signatory States to introduce fiscal rules into national law in the form of legally binding and permanent norms set forth either in the Constitution or in any other form that guarantees their compliance. The two main elements of the Fiscal Compact are:

1. A mandatory balanced budget rule[7]

The signatory Member States commit themselves to implement in their legislation a fiscal rule which requires that the general government budget be balanced or in surplus. The fiscal rule is considered to be respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a deficit (in structural terms) of 0.5% of GDP. If the government debt ratio is significantly below 60% of GDP and risks to long-term fiscal sustainability are low, the medium-term objective can be set as low as a structural deficit of at most 1% of GDP. In the event that the structural balance of a country deviates significantly from the medium-term objective or the adjustment path towards it, a mechanism will be automatically triggered to correct these deviations.

2. Benchmark for government debt reduction

The Fiscal Compact includes the numerical benchmark for debt reduction for Member States with government debt exceeding the 60% of GDP reference value, as foreseen in the reinforced Stability and Growth Pact. A Member State with general government debt above 60% of GDP is obliged to reduce the "surplus of debt" (so the debt above 60% of GDP) by one-twentieth annually. Countries that do not adhere to those rules may be subject to fines up to 0.1% of GDP.

The reformed Stability and Growth Pact and the Fiscal Compact represent the foundations of a new European economic governance system. New regulations should

[7] It should be added that the medium-term budget balance rule has been in force since 1998 under the Stability and Growth Pact, which states that the lower limit of the structural budget balance must be in the range of between 1% and 0% of GDP. This means that the Fiscal Compact's requirement to reduce the structural deficit to 0.5% of GDP does not bring anything new in practice, especially that in Member States with low level of debt the deficit can be increased up to 1% of GDP. These rules were not respected though.

heavily increase the chances of changing the irresponsible fiscal policies pursued by governments before the recent crisis.

4. Medium-term Objective (MTO) – general overview

One of the basic instruments for coordinating the fiscal policies of the Economic and Monetary Union countries, as defined in the Maastricht Treaty, is the condition that the general government deficit does not exceed 3% of GDP. The practice has shown, however, that in many countries this criterion proved difficult to be met, especially in times of economic slowdown. Consequently, Member States in the Stability and Growth Pact have committed themselves to achieving and respecting the so-called Medium-term budgetary objective (MTO), which [European Commission, 2016, p. 17]:

(i) provides a safety margin with respect to the 3% of GDP deficit limit. For each Member State this safety margin is estimated in the form of a minimum benchmark that takes past output volatility and the budgetary sensitivity to output fluctuations into account.

(ii) ensures sustainability or rapid progress towards sustainability. This is assessed against the need to ensure the convergence of debt ratios towards prudent levels with due consideration to the economic and budgetary impact of ageing populations.

(iii) in compliance with (i) and (ii), allows room for budgetary maneuver, in particular taking into account the needs for public investment.

The Medium-Term Objective (MTO) is at the core of the preventive arm of the Stability and Growth Pact. The budgetary targets are set in structural terms, i.e. cyclically adjusted and net of one-off and other temporary measures to ensure that the underlying fiscal position of Member States is conducive to medium-term sustainability, while allowing for the free operation of the automatic stabilizers.

To set an MTO, firstly, a safety margin is calculated for each Member State. The cyclical part of the budget is estimated by multiplying the output gap that would have been observed during very low economic growth by an average sensitivity of the nominal general government balance to cyclical fluctuations. Subsequently, the absolute value of the cyclical portion is subtracted from the number 3[8], resulting in a structural balance [European Commission, 2016 p. 26-31].

The European Commission provides lower bound (minimum) MTOs, taking into account Member States' respective debt levels, the country-specific sustainability challenge posed by the costs of ageing population and the specific dynamics of the automatic stabilizers every three years. In addition, countries undertaking structural reforms with a major impact on the sustainability of the public finances can also have their minimum MTOs revised on a case-by-case basis, in agreement with the European Commission. In particular, the carrying out a major pension reform, that has an impact on long term fiscal sustainability, could result in a revision of the minimum MTO. Euro area and ERM2 Member States must have an MTO that corresponds to at least -1% of GDP. In addition to the requirements set by the minimum MTOs, the signatories to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union in EMU - TSCG, namely all Euro area Member States plus Bulgaria, Denmark and Romania, have further committed themselves to MTOs of at least -0.5% of GDP, unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low.

As part of the assessment of the adjustment path, the EU Council and the Commission examine whether the country is implementing the annual adjustment of the structural balance required to achieve the MTO, accounting for 0,5% of GDP for Euro area countries and countries participating in ERM II as a benchmark for this adjustment. For all Member States with debt levels in excess of 60% of GDP or with significant long-term debt service risk, the Council and the Commission examine whether the annual adjustment of the structural balance exceeds 0.5% of GDP. Correction should be higher in good times and lower in bad times.

From a theoretical point of view, the structural balance rule is a useful tool in limiting fiscal discretion. Basing the rule on the structural balance requires isolating from the nominal balance a value representing the hypothetical balance, assuming no cyclical and one-off factors. Since cyclical factors are considered as independent on the government and one-off factors in their nature do not affect the shape of long-term fiscal policy, the structural balance is that part of the nominal balance that is under

[8] from 3% of reference value of general government balance in relation to GDP.

control of the government. It is assumed that the structural balance reflects the fiscal policy conducted and changes in this category should, in principle, result from discretionary government action. Another advantage of using the structural balance is that it motivates to adopt a medium-term perspective when planning fiscal policy. This approach, in turn, is conducive to greater anti-cyclicality of the policy by the action of automatic stabilizers, since the rule based on structural balance (when the output gap is positive) automatically forces a more restrictive policy and, in the long run, allows for a more expansive one than it would be the case if the rule was based on the nominal balance. It is important that the value of the MTO for the vast majority of Member States was set below zero. The zero target of the structural balance would be too ambitious for countries whose economies have only been striving for an average EU level. Until this level is reached, GDP growth is expected to be higher than the European average. At the same time it can be shown that, in the long run, public debt in relation to GDP roughly converges to the ratio of the nominal fiscal deficit expressed in % GDP and nominal GDP growth rate. For example, with a deficit maintained at 1% of GDP and with a nominal GDP growth rate at 3%, the debt would go down to 33% of GDP (assuming stable relation of deficit to GDP and nominal GDP growth). This means that a country whose GDP grows faster can reach correspondingly higher deficits and still maintain a debt-to-GDP ratio at the same level as a country with a lower GDP growth.

5. Implementation of the Fiscal Compact

5.1. Mandatory balanced budget rule – performance

In 2010-2016 the scale of the average fiscal adjustment in Europe should be considered as high. The general government deficit was reduced on average by 4.5 percentage points (from 6.4 to 1.9 % of GDP), however, the debt-to-GDP ratio increased meanwhile by 6,6 pp. and only since 2015 has been put on the downward path. The continued reduction of the deficit and its stabilization at the level consistent with the medium-term objective (MTO) turned out, however, to be a challenge for most Member States. Fig. 2 demonstrates the level of structural balance achieved in 2016 against required MTOs nominated for Member States in 2016. In total, eleven Member States met their MTOs.

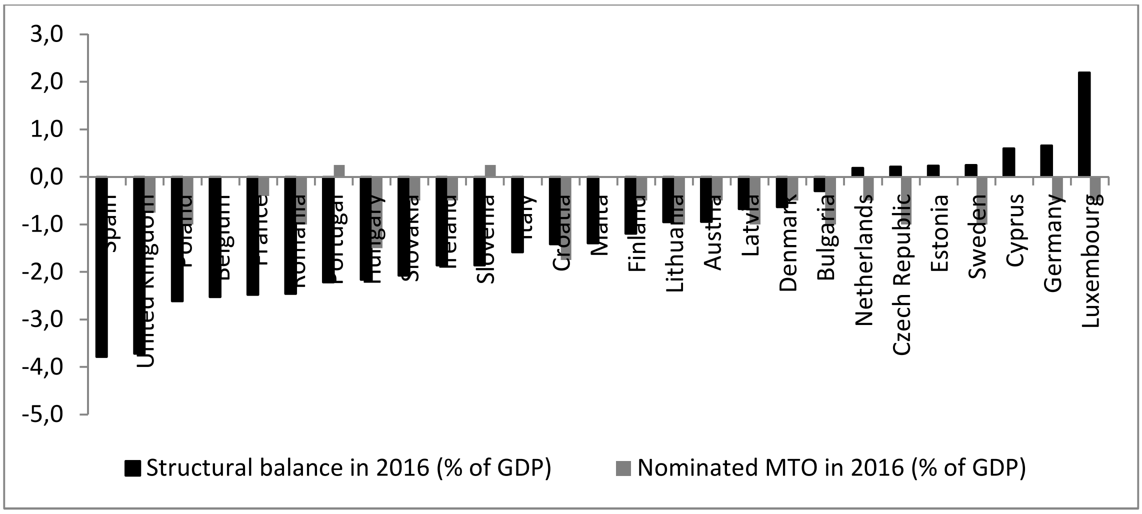

Fig. 2. Structural balance against medium-term budgetary objectives in 2016 in Europe in % of GDP.

Source: AMECO database; European Commission.

Restoring budget balance in recent years proved to be a difficult task mainly due to weak growth prospects. These weak prospects were related both to high levels of private and public sector debt and the need to reduce it but also to the persistently high levels of unemployment and uncertainty as for the further development of the labor market situation. On the other hand, efforts to accelerate economic growth with fiscal stimulus were limited by the high level of debt and consolidation efforts undertaken by the most indebted countries.

In general, changes in fiscal policy have two main effects on the economy. On the one hand, they directly affect aggregate demand, on the other - they have an impact on trust and expectations about the future. Over the first three years of fiscal consolidation, Member States tightened their belts, assuming that the second effect would overlap the first. However, since 2014 there has been a change in direction. Even though many Member States are far from stabilizing the debt-to-GDP ratio, the scale of fiscal savings has been limited. Fig. 3 illustrates that clearly (right axis refers to the average changes in structural balance as % of GDP in Europe).

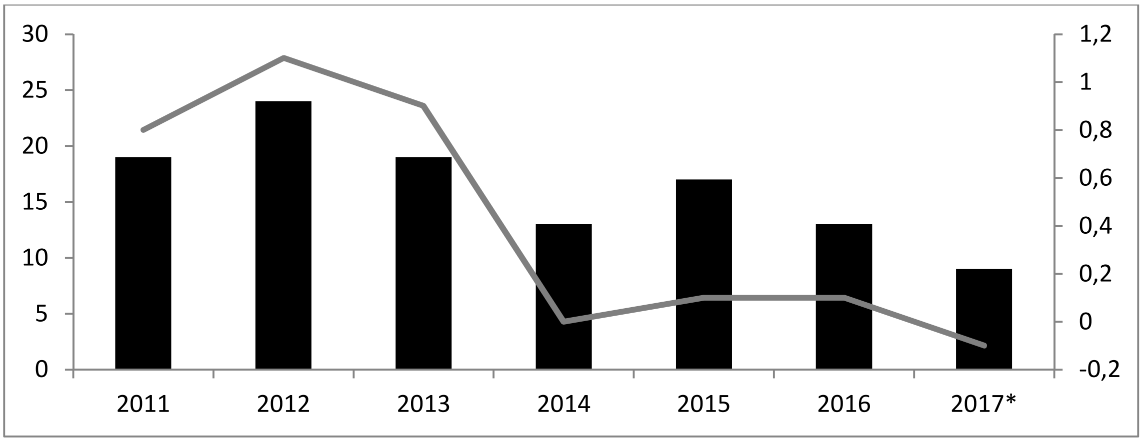

Fig. 3. Number of countries improving their structural balance and average changes in structural balance as % of GDP in Europe.

Source: AMECO database; *European Economic Forecast, Winter 2017, European Economy, Institutional Paper 048, February 2017, European Commission.

Since 2014 noticeably fewer countries have managed to improve their structural balance which is the key variable for assessing fiscal stance in the light of the Stability and Growth Pact and the Fiscal Compact. As a result, the scale of fiscal consolidation in structural terms have been considerably reduced as well. Furthermore, based on the most up-to-date European Commission forecast [European Commission, 2017], the year 2017 will be the first year when the structural balance worsens. In turn, Fig. 4 shows the same forecast according to which in years 2016-2018 Europe, as a whole, will not improve its structural balance but worsens it. In only eight countries the structural balance is expected to be improved.

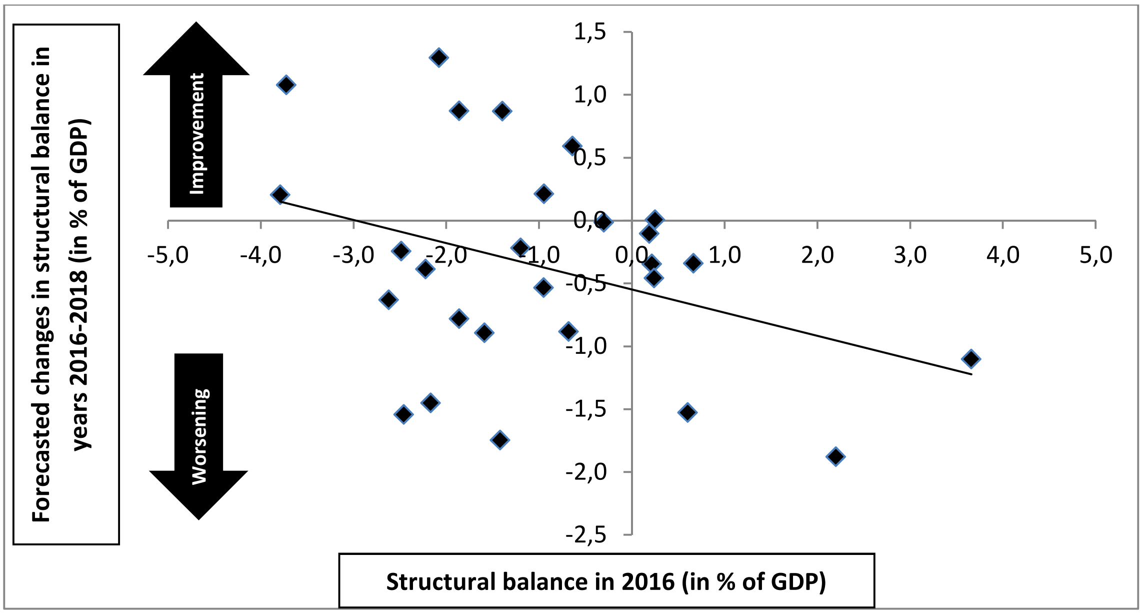

Fig. 4. Changes in structural balance in years 2016-2018 as % of GDP in Europe.

Source: AMECO database; European Commission and European Economic Forecast, Winter 2017, European Economy, Institutional Paper 048, February 2017, European Commission.

Fig. 5 demonstrates the reason for the change in fiscal policy in recent years: countries with the highest fiscal savings size in structural terms have experienced on average the highest increase in debt-to-GDP ratio in Europe (vertical axis refers to the changes in debt-to-GDP ratio; values in % of GDP).

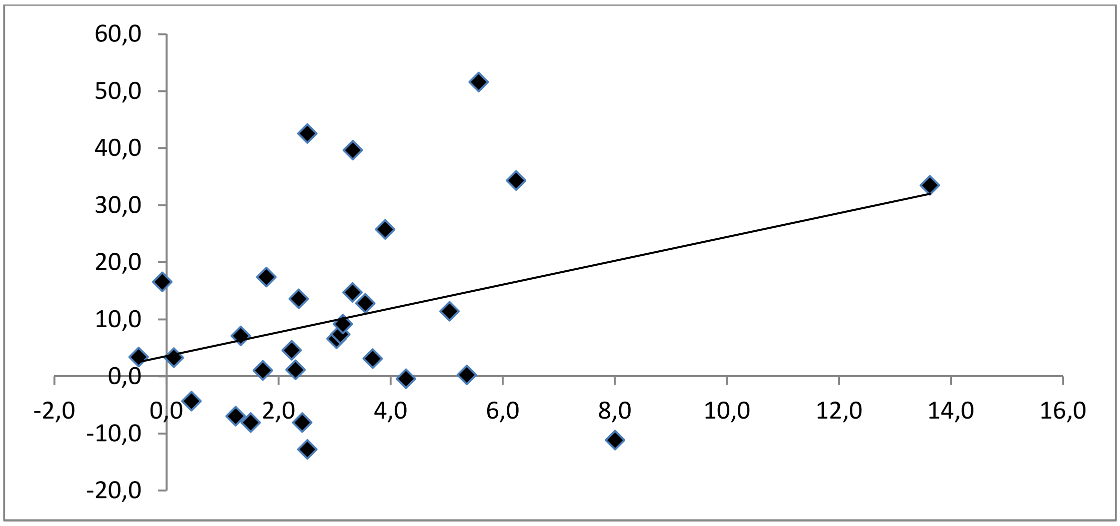

Fig. 5. Changes in structural balance and in debt-to-GDP ratio in years 2010-2016 as % of GDP in Europe.

Source: AMECO database; European Commission.

Certainly, the relationship between these variables can only be apparent but it seems to point out that savings so drastically suppress the demand that the resulting effect of low economic growth prevents further reduction of debt. It is to note that the halt to savings takes place when the largest and most indebted Euro area countries (France, Italy and Spain[9]) have been still far from stabilizing their debts (see Table 1: Current scenario).

5.2. Benchmark for government debt reduction - performance

Even though there is no formula that allows a clean additive decomposition of changes in the debt ratio into the most interesting underlying factors, such as interest rates, inflation, fiscal adjustment, etc., the following equation, however, comes close to it [Escolano, 2010 p. 6]:

[9] In terms of size of GDP, France, Italy and Spain are respectively the third, fourth and fifth European economies.

$$d_t - d_{t-1} = \frac{i_t}{1+y_t}\ d_{t-1} - \frac{y_t}{1+y_t}\ d_{t-1} + p_t$$

d_t = Debt at the end of period *t*, as a ratio to GDP at *t*.
d_{t-1}= Debt at the end of period *t-1*, as a ratio to GDP at *t-1*.
i_t = Nominal interest rate in period *t*; paid in period *t* on the debt stock outstanding at the end of *t* – 1.
y_t = Nominal GDP growth rate between t – 1and t.
p_t = Primary fiscal deficit[10] in *t*, as a ratio to GDP at *t*.

This equation indicates that the change in the debt ratio equals the impact of interest (positive) and nominal GDP growth (negative), plus the contribution of the primary deficit. After simplification[11]:

$$d_t - d_{t-1} = p_t + d_{t-1}[\frac{i_t - y_t}{1+y_t}] \quad [1]$$

The equation [1] shows that the change in debt-to-GDP ratio is a sum of primary fiscal deficit and so called snow ball effect which expresses the combined effect of the interest rate of government bonds and the growth rate of nominal GDP on debt-to-GDP ratio. Maintaining a constant debt-to-GDP ratio requires that left side of equation [1] must equal zero. The condition to stabilize the debt-to-GDP ratio at a specified debt level is to ensure that:

$$-p_t = d_{t-1}[\frac{i_t - y_t}{1+y_t}] \quad [2]$$

Equation [2] indicates that the condition for stability of the debt-to-GDP ratio requires that the relation of primary deficit to GDP equals the snow ball effect. Indeed, the public debt does not grow, if the primary deficit is compensated by the surplus of growth of nominal GDP above the average nominal interest of debt. In other words, the debt ratio will increase indefinitely if nominal interest rate exceeds the growth rate of nominal GDP, unless the primary budget is in sufficient surplus to compensate for that. Very often, in order to stop the process of increasing debt, not only a primary balance shall be achieved, but also a primary surplus. This is the case many European countries are experiencing now. Hence, crucial for the debt dynamic is a sign of expression (i_t - y_t).

According to equation [2] the value of structural primary balance needs to equal its right side in order to stabilize the debt-to-GDP ratio. However, with high and positive value

[10]In this equation the primary balance is expressed in structural terms.
[11] It was assumed that the impact of so-called stock-flow adjustment factor equals zero in this equation.

of expression (i_t - y_t) stabilizing the debt-to-GDP ratio requires to maintain not only a primary balance but also a sufficient primary surplus. Currently, France, Italy and Spain have been still aiming to achieve a structural primary balance and their medium-term budgetary objectives (MTOs). In this respect, in years 2010-2016 the progress has been relatively noticeable and has been a result of conducting a fiscal consolidation, however, the value of structural primary deficit is still not sufficient to start the decrease in debt-to-GDP ratio. Table 1, apart from the current situation, presents a sustainability of general government debt in those three countries including two sensitivity scenarios in order to illustrate better the changes in relation to the required level of structural primary balance in accordance with equation [2].

Table 1. Sustainability of general government debt in France, Italy and Spain

Countries	**Structural primary balance as % of GDP**		**Threshold of structural primary balance beyond which the debt starts to fall (% of GDP)**		
	2010	**2016**	**Current* scenario**	**Scenario 1****	**Scenario 2*****
France	**-5,8**	**-2,5**	**-1,4**	**0,2**	**-3,6**
Italy	**-3,4**	**-1,6**	**-0,3**	**2,3**	**-3,0**
Spain	**-7,1**	**-3,8**	**-2,2**	**-0,3**	**-4,1**

Source: *own calculation based on AMECO database, European Commission. Level of debt stems since 2015 and long-term interests since 2016.
** Scenario 1 reflects lower inflation and real GDP rates by 1.0 pp. compared to Forecast 2017.
*** Scenario 2 reflects higher inflation and real GDP rates by 1.0 pp. compared to Forecast 2017.
Based on European Economic Forecast, Winter 2017, European Economy, Institutional Paper 048, February 2017, European Commission.

Scenario 1 assumes lower inflation and real GDP rates by 1.0 pp. compared to the forecast for 2017. In this case, the value of primary balance beyond which the debt starts to fall increases significantly causing that in France and notably in Italy a structural primary surplus is required. In turn, scenario 2 assumes higher inflation and real GDP rates by 1.0 pp. compared to the forecast for 2017. In this case, the value of primary balance beyond which the debt starts to fall decreases considerably allowing even for some relaxation in fiscal policy stance. The analysis in the table 1 only confirms that the sign and value of structural primary balance in accordance with equation [2] is highly sensitive about the sign and value of expression (i_t - y_t). At present, the low nominal GDP growth (y_t) - as it affects the rate of increase or decrease of debt - makes it difficult to reduce debt. On the other hand, highly expansive monetary policy conducted by European Central Bank enables to keep the interest rates (i_t) at very low level which contributes to low cost of debt service.

In turn, the progress towards the second main element of the Treaty on Stability, Coordination and Governance in EMU - TSCG - benchmark for government debt reduction which in concrete terms means that the difference between the government debt-to-GDP ratio and 60% of GDP needs to be reduced at an average rate of one-twentieth per year has also not been in line with the Fiscal Compact's provision. Table 2 demonstrates two paths of debt-to-GDP ratio development: the actual one and the one required by provision of Fiscal Compact.

Table 2. Paths of debt-to-GDP ratio in Europe in years 2014-2016.

in % of GDP		**Path of debt-to-GDP ratio required by Fiscal Compact**			**Actual path of debt-to-GDP ratio**		
Countries	2013	2014	2015	**2016**	2014	2015	**2016**
Spain	95,4	93,6	91,9	**90,3**	100,4	99,8	**99,7**
France	92,3	90,7	89,2	**87,7**	95,3	96,2	**96,4**
Italy	129,0	125,6	122,3	**119,2**	131,9	132,3	**132,8**

Source: own calculation based on AMECO database, European Commission.

Since the adoption of the Fiscal Compact only Spain has managed to slightly reduce debt-to-GDP ratio while the ratio in France and Italy has been still on upward path. If these countries had respected the provisions of the Treaty, the debt ratio would have amounted to on average 10 pp. less than at present. Overall, in years 2012-2016 less than half of Member States managed to reduce their indebtedness.

The European Commission, after the financial crisis, demanded that the Member States take vigorous corrective measures as a response to the outbreak of the financial crisis which then turned into a sovereign debt crisis. Furthermore, both the Stability and Growth Pact and the Fiscal Compact provide for penalties for breaking the rules. However, due to concern about slowdown of economic growth, EU institutions have not used these tools and countries with budgetary problems: France, Portugal, Italy and Spain have been granted a prolongation for introducing the necessary corrective measures several times. This is due to fears that stronger fiscal tightening would lead in countries whose economy have been at the edge of recession for years, to both another economic slowdown and a heightened level of radical sentiment. A change in the attitudes of the European Union's authorities to fiscal problems can be seen in the draft of the European Parliament's "Implementation of the Stability and Growth Pact" of February 2017 [European Parliament, 2017] on the basis of decisions and recommendations of the European Commission. There is no announcement of taking action to discipline countries that do not fulfill the objectives, and even countries where debt levels have been growing deserve a positive rating.

Conclusions

Putting constraints on fiscal policy in the form of different rules is nothing new in the European economic governance system. The Stability and Growth Pact of 1997 included already permissible limits of general government deficit and debt which, however, were violated many times and without consequences. The adoption of the reformed Stability and Growth Pact and the Fiscal Compact aims to break this practice permanently. The introduction of adopted solutions should avoid duplication of past mistakes when, in times of high economic growth (especially in years 2006-2007), the budget deficit has not even reached the medium-term budgetary objective (MTO) while the budget surplus should be a natural state.

These several years since the rules came into effect demonstrate that the process of restoring balance in public finance in Europe has been relatively slow. Less than half of Member States have managed to meet the requirements imposed by Fiscal Compact both in terms of achieving their MTOs and the benchmark of debt reduction. One of the reasons is the impact of fiscal consolidation on economic growth. Austerity measures undertaken so drastically have suppressed the aggregate demand that the resulting effect of low economic growth prevents further reduction of general government debt.

Due to fears that stronger fiscal tightening would lead in countries whose economy have been at the edge of recession for years, to both another economic slowdown and a heightened level of radical sentiment, EU institutions have granted several times a prolongation for introducing the necessary corrective measures resulting from the Fiscal Compact. It is to note, however, that the halt to savings takes place when the largest and most indebted Euro area countries (France, Italy and Spain) have been still far from stabilizing their debts. The analysis conducted in the article confirms that.

Nevertheless, the Fiscal Compact was a welcome step towards anchoring fiscal discipline in the Euro area and those non-euro area signatories that have declared themselves bound by the provisions of the Fiscal Compact (Denmark, Bulgaria and Romania). If strictly implemented and enforced, the fiscal compact should strengthen the existing fiscal governance framework and foster its credibility in the future. On the other hand, the resolutions enacted are nothing more than an attempt to return to the unspoken principle of a balanced budget and to treat the public finance deficit as at most temporary, and certainly not normal state, as it was practiced since the Great Depression of the twentieth century until the outbreak of the financial crisis in 2008, which later turned into a sovereign debt crisis. Ultimately, the adoption of these solutions is an attempt to return to a continued fiscal discipline.

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