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**Research Report**

## The fiscal compact and government debt: One law, multiple statistics

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# The Fiscal Compact and Government Debt: One Law, Multiple Statistics

Policy Letter No. 22

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# The Fiscal Compact and Government Debt:

## One Law, Multiple Statistics

*Iñaki Aldasoro and Ester Faia*

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*“Facts are stubborn things,  
but statistics are more pliable”  
- Mark Twain*

In the aftermath of the recent financial crisis, a major manifestation (and consequence) of the deterioration in the financial position of the public sector has been a dramatic surge in government debt. This is true throughout the world, but particularly for Europe. Not even pre-crisis poster examples of fiscal rectitude were exempt from this affliction, which speaks to the importance of including potential and implicit liabilities in the assessment of the soundness and sustainability of public finances.

In many cases, the dire situation of public finances calls into question the very soundness of sovereigns and prompts corrective actions with far-reaching consequences. In this context, European authorities responded with several measures on different fronts. The one that concerns us here is the “Treaty on Stability, Coordination and Governance in the Economic and Monetary Union”, or “Fiscal Compact” for short, which entered into force on January 1, 2013<sup>1</sup>. This treaty, in particular its Title III, builds on the rules and penalties already in place since the enactment of the Stability and Growth Pact. It includes stricter provisions, however, in order to better deal with the post-crisis reality. Of critical importance in this framework is the assessment of a country’s situation by way of statistical measures, in order to take corrective actions when called for according to the letter of the law.

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<sup>1</sup> See [http://european-council.europa.eu/media/639235/st00tscg26\\_en12.pdf](http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf)

While it is true that “to measure is to know”, it is not always clear whether measurement truly reflects the nature of the problem. Therefore, when basing decisions on statistics, the foundations of knowledge are rather shaky. This is especially problematic when penalties are uniform but measurement is not complete.

The measurement of government debt is a case in point. Unlike other macroeconomic indicators such as GDP or the Consumer Price Index, which are built on the basis of international standards followed by many countries, the measurement of government debt presents a different picture. This is not due to an absence of international guidelines<sup>2</sup>, but rather to a failure to observe them.

Divergences in reportings of public sector debt statistics can derive from deviations in several underlying dimensions, often with users being unaware of the reporting details: institutional coverage, instrument coverage, cash vs accrual reporting, gross vs net debt, consolidation vs non-consolidation of intra-government holdings, and market vs nominal valuation of debt instruments<sup>3</sup>. Additionally, there is the critical issue of implicit government debt.

Let us focus on the two most important items of divergence: instrument coverage and implicit government debt. “Instrument coverage” refers to the type of debt instruments considered in the accounting of public debt: debt securities and loans, special drawing rights, currency and deposits, other accounts payable, and insurance, pension and standardized guarantee schemes. Coverage can also be expanded to cover other types of contingent liabilities. “Maastricht Debt” refers to the first item in this list, since it covers currency and deposits, securities other than shares, and loans; coverage is here homogenous and in that sense it allows for comparability. That said, the expansion of instrument coverage may not be

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<sup>2</sup> See the [Public Sector Debt Statistics Guide](#).

<sup>3</sup> For an insightful overview see the [IMF Staff Discussion Note 12/09](#).

important for some countries, but may be critical for others<sup>4</sup>. Hence, not including them might result in an important bias when applying the law.

Implicit government debt refers to the uncovered future government expenditures related to promised pensions, health care and related expenditures. A number of admittedly arbitrary assumptions go into the calculation of such figures, yet the issue remains that the sustainability of public finances is much more compromised on this ground in some countries than in others<sup>5</sup>. For instance, countries that have tackled pension reform head on, imposing hardship in their population in the process, but also improving the sustainability of their pension system, stand in the same footing in terms of current law as countries which did not. Failure to account for this introduces another important bias.

The deteriorated fiscal situation throughout Europe is a stubborn fact. For a proper assessment of fiscal soundness, public debt sustainability and the adequacy of penalties if thresholds set by law are breached, a level playing field in terms of the triggering statistics is of the utmost importance. Also critical is an assessment based on uniform and proper instrument coverage and implicit liabilities. Otherwise, there is a risk of imposing draconian measures on countries that do not really need it.

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<sup>4</sup> See also the [IMF Staff Discussion Note 12/09](#) for some examples.

<sup>5</sup> See, for instance, Bernd Raffelhüschen and Stefan Moog, economists at Freiburg University, in *Stiftung Marktwirtschaft*, December 2013 ([http://www.stiftung-marktwirtschaft.de/fileadmin/user\\_upload/Generationenbilanz/Summary\\_Honorable-States\\_2013.pdf](http://www.stiftung-marktwirtschaft.de/fileadmin/user_upload/Generationenbilanz/Summary_Honorable-States_2013.pdf)). Société Générale, among others, have calculated numbers for implicit debt (see charts here: <http://riskandreturn.net/index.php/2011/11/08/ignore-egan-jones-at-your-peril/>.) While figures differ among studies, the overall message that implicit debt is critical in a holistic assessment of public finance sustainability remains unaltered.