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Euro-area Fiscal Governance: A Guide for the Perplexed at Times of Crisis (ARI)

Luis Guirola[*]

Theme[1]**:** Fiscal governance in the Euro-zone is fatally flawed and it would be preferable to have a more integrated framework based on permanent institutions rather than rules.

Summary: The fiscal governance of the Euro-area is subject to debate and this paper aims to it identify key insights and propose potential solutions. It first describes the theoretical rationale for fiscal discipline, then turns to a brief description of the evolution of the EMU's fiscal institutional framework and afterwards assesses the debate as well as current reform proposals. The upshot of the analysis is that, as some authors have suggested, fiscal governance based on compulsory and automatic rules is unlikely either to lead to sound fiscal policy or to be enforceable in an intergovernmental setting. Therefore a more integrated framework based on permanent institutions rather than rules is proposed and briefly sketched.

Analysis: The main idea behind the design of the EMU was that having a single monetary policy was perfectly compatible with preserving a plurality of economic sovereignties. While the interest rate was centrally fixed in Frankfurt, there was no need for a similar degree of integration in other areas. Financial regulation was managed according to the subsidiarity principle, and growth policies (structural reform) and fiscal policy could be handled in a decentralised, intergovernmental fashion.

The advent of the crisis has questioned the soundness of this arrangement. Although European countries live in an 'ever closer union', have very interdependent economies and integrated financial systems, the response to the early crisis appeared to be largely insufficient and uncoordinated. Governments proved to be unable to coordinate themselves in a single fiscal stimulus and one could even perceive a real risk of protectionist measures that would endanger the sacrosanct principle of the free movement of goods in the EU.

In retrospect, the real problem does not appear to be the uncoordinated character of the response, but the previous incapacity to prevent fiscal and current account imbalances. There is therefore clearly a case for examining the institutional framework in order to identify potential improvements in the current framework.

The goal of this paper is to revisit the debate about the fiscal governance of the Eurozone with the aim of identifying key insights and potential solutions. Since the subject is vast, it

[*] *Bank of Spain.*
[1] Any opinions that might be inferred from this article represent only those of its author and do not necessarily express the views of his employer.

will concentrate on the issue of fiscal imbalances. The paper is structured as follows: after presenting the possible justification for fiscal discipline in a monetary union and –briefly– how the policy framework has evolved, it then evaluates how the current framework could be repaired. It assesses current proposals and argues that the approach based on automatic rules and sanctions is likely to fail. It therefore suggests that the way forward for fiscal policy could be to abandon rigid rules and instead adopt flexible institutions, as occurred in the past with monetary policy.

Possible Rationales for Constraints on National Fiscal Policies

There are mainly two rationales for setting some minimum constraints on national fiscal policies. The first one is from the field of political economy and is based on the idea that since national governments are prone to fiscal misbehaviour –that is, accumulating too much debt– there is therefore much to be gained from a set of rules or institutions that put a constraint on fiscal action. This might happen due to weak or decentralised governments being unable to strike a deal of fiscal consolidation, or to voters who suffer from some form of fiscal illusion and fail to punish a government with a lax fiscal stance. In this context, the EU framework can be a useful commitment device to lead to sound policy to correct government failures.

The second argument stresses the fact that fiscal discipline is an essential complement of a price-stability-oriented monetary policy. Although at first sight fiscal and monetary policy can seem to be separate and independent, this is only true as an institutional or legal construct. But, as a matter of fact –and as the current crisis has made clear–, fiscal and monetary policy have always been linked, since the monopoly that central banks have on issuing money is a source of revenue for the government.

In a monetary union, the costs of a bailout in the event of default –higher inflation– would be inevitably shared by all its members, but the benefits of irresponsible fiscal behaviour would only be enjoyed by one state. This justifies treating fiscal policy as a common problem. But although this is sufficient to justify a no-bail-out clause, it is difficult to see why more stringent measures are needed. The problem is that as states are big economic players, they are likely to be considered 'too big to fail' and therefore bail-out clauses are unlikely to be credible.

The SGP, its Critics and Evolution

Although these concerns might look like *ex post facto* rationales, they were already in the mind of the drafters of the Maastricht treaty, especially the German authorities. The fiscal framework that saw the birth of the euro can be briefly described as follows: (1) monetary policy was strictly separated from fiscal policy, first by a 'no-bail-out clause' written into the treaty and, secondly, by a strongly independent central bank, although the possibility of a sovereign default and the need for a mechanism to deal with it was not, however, even envisioned; and (2) a set of rules was designed to ensure sound fiscal behaviour, the most prominent of which was the Stability and Growth Pact (SGP).

The SGP consisted originally of two regulations with force of law that clarified the meaning of the Maastricht treaty provisions regarding excessive deficits. The arrangement had three arms: (1) the preventive arm, which was a system of multilateral surveillance in which member states submitted reports on their public finances to the ECOFIN scrutiny; (2) the corrective arm, which defined more clearly what was supposed to be considered a temporary deficit; and (3) the dissuasive arm, which established some rules for sanctions under the usual European arrangement, by which the Commission proposes while the ECOFIN rules.

The fiscal framework was harshly criticised by, arguably, a majority of the academic community. Summarising, the main critique suggested that the 3% ceiling was too automatic and largely inadequate since it was a bad proxy for sound fiscal policy. For example, if the debt to GDP ratio is to remain stable –in order to ensure fiscal sustainability– then the deficit should be, on average, roughly equal to the growth rate of the country –which differs from country to country–. But the SGP ignored this sort of consideration. Moreover, the SGP ignored many other factors, such as public investment, which should be treated separately, or 'implicit liabilities', such as pensions or health care expenditures, that are a large part of future expenditures. Additionally, the pact not only punished member states for their deficits, but failed to reward them for good fiscal behaviour in good times. Finally, the pact was criticised because it gave governments incentives to focus on the wrong objective: fiscal consolidation instead of structural, growth-enhancing reforms.

Overall, the consensus suggested that there was a need for a more comprehensive and flexible approach to fiscal discipline. This consensus permeated the reform of the pact when, in 2002, several member states breached it and the ECOFIN decided to suspend it instead of sanctioning deviators. The reform approved in 2005 by the European Council adopted a more flexible approach, abandoning the one-size-fits-all policy, taking more into account the importance of national differences and also the effort put into reforming their productive models. The idea was that if countries could ensure high growth rates after structural reform, then the ratio of debt to GDP would fall.

In retrospect this approach can be regarded as a failure. Many apparently healthy public finances according to debt and deficit measures actually were not. Structural reform was no better enforced after the pact was made more flexible, but arguably the opposite happened. Moreover, many threats that materialised ex post, such as sovereign insolvency, were not even taken into account. Therefore, a new approach becomes necessary.

The failure of the SGP was recognised by member states when the fiscal crisis became evident and therefore a reform was suggested. The European Commission drafted a proposal during the last month of 2010. In its proposal, countries could be put under the Excessive Deficit Procedure when their general government gross debt was greater than 60% of GDP and not declining 'satisfactorily'. Moreover, countries could be penalised when their structural deficit –that is, once corrected for the cycle effect– 'deviates significantly from the adjustment path foreseen in the SGP'. Additionally, the procedure of mutual surveillance would be strengthened by the proposal to create a 'European semester' during the first six months of each year, where monitoring of national policies would be intensified and member states would be required to present their national Stability and Convergence programmes. Finally, it reformed the implementation mechanism: sanctions would be automatically imposed but a qualified majority of the council could reject them.

The Pact reached by the European Council of March 2011 essentially builds on this approach. Fiscal consolidation is coupled with the importance of structural reform. The initial one-size-fits-all 3% limit is now completely relinquished and only taken as part of a large set of indicators. These indicators include both implicit and explicit liabilities, taking into account healthcare, pension liabilities and demographic factors. The main innovation is perhaps the reform of the enforcement mechanism. Individual countries commit to reform national fiscal institutions by translating the SGP into national legislation, which must take the form of 'hard law' –such as a constitutional clause or a framework law–. Although the details of the reform should be spelled out by individual countries, the Pact explicitly mentions the importance of subnational levels of governments. All in all, however, the essence of the enforcement mechanism has not changed: governance remains an intergovernmental affair. Although sanctions are mentioned, the main forces that ensure compliance are the political mechanisms of peer pressure and 'naming and shaming'.

An Assessment of the Debate

There are, broadly speaking, two interrelated reasons why the former approach failed to achieve its objective. First, the fact that the targets it assigned to individual countries were badly designed and undermined the pact's legitimacy. Fiscal consolidations are frequently painful from a political point of view. Although politicians might often pursue policies that are painful but are considered necessary, the incentive to sacrifice their political capital in such a task may be much lower when the goal is considered inappropriate. Hence, this might explain why the former President of the European Commission Romano Prodi called the pact 'stupid'. Moreover, as shown by the current crisis, many countries that performed well under the criteria of the SGP –such as Ireland and Spain– hid a far less bright situation, that might have been captured by a broader set of indicators.

But, more generally, the main reason why the pact failed was arguably that it lacked any credible enforcement mechanism. Negotiations in the ECOFIN to impose sanctions were likely to be politically motivated –and therefore results reflected the relative political strength of individual member states–; hence, large member states were unlikely to respect it. More importantly, the pact's framework lacked any sort of enforcement mechanism to compel a country that was reluctant to do so. Such a mechanism would have been regarded as too intrusive in internal political affairs, but it appears, at least in retrospect, to have been necessary.

The underlying philosophy of the initial pact was that fiscal behaviour could only be enforced by political compromise and symbolic measures such as sanctions. The 'sanctions constraint' was never credible, as the pact was breached on many occasions and sanctions were never imposed. Moreover, intergovernmental methods of enforcement are both unfair and ineffective. While small countries had a lot to lose from international political shaming, large countries knew that their bargaining power was much greater; this resulted in an unfair asymmetric enforcement with the collateral effect of being a constant source of tension between member states.

From this perspective, the assessment of the current proposal for reform is mixed. On the one hand, it is clear that the reform goes in the right direction. The critique of the arbitrariness of the 3% has been largely overcome and the pact now includes a larger set of indicators, focusing on what really matters: debt sustainability. The enforcement mechanism has also been strengthened, giving more power to the European Commission, augmenting the automaticity of sanctions and giving more weight to national institutions. On the other hand, progress is insufficient and there are several risks still present.

Any credible reform of the SGP will face a trade-off between independence and automaticity. The idea is as follows. In retrospect, the main problem of the SGP's enforcement mechanism was that it was operated by the same states who were supposed to be penalised. The mechanism encouraged collusion between states and bullying of smaller states by larger ones. The initial arrangement that was supposed to resolve the problem was to make the pact automatic: to rely as little as possible on the judgment of member states.

If this approach was to lead to sound fiscal policy, it would consist of a full specification of all contingencies that would make the pact perfectly enforceable, allowing for automatic enforcement while avoiding the 'one-size-fits-all' approach. However, this kind of complete drafting is for obvious reasons not possible. Therefore, the pact led to bad fiscal policy. The reforms that followed tried to solve the problem by relying on a more flexible and discretionary approach. However, flexibility always means that measures are likely to be disputable and easy to manipulate for political reasons. While the 3% threshold is hard to manipulate, an assessment of sustainability relies to a much greater extent on subjective judgment.

An additional disadvantage of a rule-based approach is that it might, paradoxically, relax discipline. Hagen[2] suggests that one of the risks of marginally strengthening the current pact is that if European authorities increase their intervention in national public finances this will create a perception among member states that they have the right to receive financial assistance if their public finances go wrong. The result will be more moral hazard. This suggests that mid-way solutions are likely to fail.

Therefore, if fiscal rules are to be sound they must be flexible, but flexibility will make them easy to manipulate and therefore hard to enforce. If, on the other hand, they are to be easily enforceable and automatic they are also likely to be 'stupid' like the initial SGP. This suggests a need for a completely new approach.

The alternative to fiscal rules that has been proposed by several authors[3] and endorsed by the ECB in at least one of its proposals[4] is fiscal committees. These institutions would produce independent, technically-based appraisals of fiscal policy. They would enjoy more flexibility but their independence would avoid the moral hazard problem. Instead of forcing governments to run deficits and surpluses according to an inflexible rule, an independent institution could evaluate the margin of manoeuvre of the government in each period in view of the medium-term goal of fiscal sustainability. Since, on the one hand, the goal of debt sustainability is not controversial and can be evaluated on technical grounds and, on the other, both the composition and size of taxes and expenditures could be set freely, the argument goes, there would be no real problem of political legitimacy. The analogy with central banks is clear: an independent agency, with an uncontroversial mandate (price stability or fiscal sustainability) whose action can be evaluated on technical grounds.

[2] Jürgen von Hagen (2010), 'The Sustainability of Public Finances and Fiscal Policy Coordination in the EMU', policy paper nr 412/2010, Case Network Studies and Analyses.
[3] There is an ample literature on fiscal councils. See the essays by Fatás & Mihov, Ubide, Lane and Wyplosz in Richard Baldwin, Daniel Gros and Luc Laeven (Eds.) (2010), *Completing the Eurozone Rescue: What More Needs to be Done*, VOX, or the many contributions by Wyplosz, such as Charles Wyplosz (2008), 'Fiscal Policy Councils: Unlovable or Just Unloved', *Swedish Economic Policy Review*, nr 15.
[4] ECB (2010), 'Reinforcing Economic Governance in the Euro Area', Brussels, 10/VI/2010.

The details of this approach diverge from one proposal to another depending on the role of fiscal councils in the budgetary procedure. In some, fiscal councils would only have 'soft power' and the government would just consult them. Fiscal councils would have the same role of the European Commission now. In the case of the EMU, our preferred design could arguably be as follows. In order to solve the enforcement puzzle, fiscal councils would be given the monopoly of issuing public debt –just as central banks have the monopoly of issuing money–. Their structure, governance and composition would be analogous to that of the ECB. It would have a federal structure, composed of a 'eurosystem' of national fiscal councils that would individually be governed according to some commonly set criteria of independence. This would allow a common coordinated fiscal policy, set according to technocratic criteria –just as monetary policy is–. Finally, the proposal could embody many of the suggestions for the creation of 'Eurobonds', for which all member states would be collectively responsible.

This sort of arrangement would fit well with another institution that could be considered necessary in view of the recent crisis: a permanent sovereign default mechanism. Such a mechanism was not envisioned by the treaties since the possibility of default was considered remote and the prevention framework sufficient. It has become apparent, however, that the Eurozone would have benefited from an insurance scheme instead of deciding as the financial turmoil developed. One proposal was initially made by Thomas Mayer & Daniel Gros,[5] who suggested the creation of a European Monetary Fund that would fulfil the role of lender of last resort and enforcer of fiscal discipline –just like the IMF at the international scale–. This arrangement would act as an insurer but prevent moral hazard by linking discipline and prevention to subsequent help. In our design, this EMF could be managed by the European fiscal council since it would act as an intermediary between debt-holders and member states.

In fact, the crisis has led to the creation of two lending facilities: the European Financial Stability Mechanism (EFSM), managed by the European Commission, and a more substantial but temporary one (that can set up new programmes only until the end of June 2013), the European Financial Stability Fund (EFSF), managed by member states. The declared purpose of these institutions is to provide liquidity to member states with financial difficulties in a context of market distress. Most commentators have, however, suggested that the principle is flawed since countries such as Greece and Ireland do not face liquidity but solvency problems. The fund has turned into a *de facto* substitute for what Gros & Mayer proposed: a mechanism that helps to reschedule debt and lending at low rates –something which is economically equivalent to partly defaulting or receiving some sort of fiscal transfer–. The fact that the aim the EFSM is supposed to fulfil is unclear has blurred the debate on its evaluation. However, most commentators[6] think that the fund is likely to be too small. Although it was recently increased, the official diagnosis remains that the problem is one of liquidity, that no default is likely to take place and that most countries are likely to repay their debts, something that most commentators find distressing.[7]

All in all, despite the efforts of European leaders, there are reasons to be pessimistic about the current governance framework. The experience of the last decades gives reason to think that fiscal governance based on politically-enforced rules is likely to fail or

[5] Thomas Mayer & Daniel Gross (2010), 'Towards a Euro(pean) Monetary Fund', Policy Brief nr 202, Centre for European Policy Studies (CEPS), Brussels, February.
[6] See, eg, Willem H. Buiter, Ebrahim Rahbari, Jürgen Michels & Giada Giani (2011), 'The Debt of Nations', Citigroup Report, January.
[7] Daniel Gros (2011), 'Pact for the Euro: Tough Talk, Soft Conditions?', VOX, 14/III/2011.

bring about division and political tension. Moreover, the current bankruptcy mechanism raises multiple doubts.

Conclusion

What Would a Proper Solution Look Like?
It has been shown that a solution should include an agreement on both fiscal policy and competitiveness. The current approach to fiscal governance is flawed as it lacks any credible enforcement mechanism and fiscal discipline is likely to be relaxed as soon as growth is resumed. There are still two issues to be dealt with: the problem of current account imbalances and that of political feasibility.

Some critics[8] have suggested that the emphasis on public indiscipline is misplaced since fiscal turmoil can be mainly attributed to the effect of the financial crisis. This is a serious criticism: issues of excessive private indebtedness and competitiveness are at the core of the current crisis. However, the analysis tends to neglect the fact that proper countercyclical fiscal policy could be used to reduce current account imbalances, as was recently suggested by Jean Claude Trichet.[9] In fact, the proper management of fiscal policy should be prudent enough and take into account the risk of a crisis causing fiscal distress by building the appropriate buffer. Therefore, while this critique attenuates the guilt of fiscal misbehaviour in the crisis, it hardly weakens the case for a revision of the EMU's fiscal framework.

How hard would such an agreement be to implement? Implementing a proper fiscal architecture, like the one proposed in this paper, would require a treaty revision which would need a long process of ratification. Moreover, fiscal policy is not considered a technical issue and delegating debt policy to an independent agency could be seen as an enormous renunciation of sovereignty which is likely to encounter resistance. On the other hand, there are several reasons to be optimistic. While countries are very reluctant to give up their sovereignty on fiscal issues, it is a fact that the current Stability and Growth Pact, if properly implemented, already implies a substantial renunciation of fiscal sovereignty. A fiscal council would only mean a credible commitment to a goal that is already considered to be desirable. The agreement could be part of a grand bargain to solve the whole crisis.[10]

Luis Guirola
Bank of Spain

[8] See, for instance, Paul De Grauwe (2010), 'Fighting the Wrong Enemy', *VoxEU.org*, 19/V/2010.
[9] http://www.ecb.europa.eu/press/key/date/2011/html/sp110216.en.html.
[10] Daniel Gros (2010), 'All Together Now? Arguments for a Big Bang Solution to Eurozone Problems', Centre for European Policy Studies (CEPS), Brussels, 6/XII/CEPS.