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Fiscal Rules in the Economic and Monetary Union

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Fiscal policies are at the core public policies. In the euro area, 98 per cent of government spending and almost 100 per cent of revenues are at the country-level. Fiscal policies encompass the allocation and the distribution of government revenue, the taxation system, the management of the budget and its deficit and the government debt. Fiscal policies therefore play a major role in national sovereign decision making, including notably decisions on social policies. Fiscal policies also play a significant role in the economic stabilisation of a country's business cycle. Member States of the European Union (EU) generally share the objectives of enhancing macroeconomic stability. In the case of Member States that are part of the euro area (EA), fiscal policies play an even more important role.

In a monetary union, Member States no longer have the power to implement country-specific monetary and exchange rate policies. Standard macroeconomic models like the Mundell-Fleming model predict that in fixed exchange rate systems, the impact of fiscal policy decisions on the macroeconomy becomes larger than in flexible exchange rate systems.

In a monetary union, national fiscal policies can also have numerous spill-over effects on other member countries.

One aspect concerns the consequences of unsustainable fiscal policies. Outside of a monetary union, a country that has run unsustainable fiscal policies can resort to its own central bank to prevent a nominal default. The consequence of a fiscal crisis solved with monetary means would typically be a weaker exchange rate and higher inflation. The government would therefore not nominally default but use the inflation tax to take care of its fiscal problems. In a monetary union, providing access to the central bank for a national fiscal authority would mean that a national fiscal problem would be solved with a supranational inflation tax. The cost of the fiscal policy would thus be socialised in the monetary union through higher inflation or at least jointly issued currency.

A second aspect concerns the impact of fiscal policies on inflation. In a recession, inflation is typically falling as demand is lower than supply. The fall of inflation expectations triggers a response of monetary policy but that monetary policy response affects the entire union. A recession in one major country of the monetary union therefore triggers monetary policy effects for the entire union. Since national fiscal policies are a part of domestic demand, national fiscal policies indirectly also affect the union's monetary policy.

Conversely, when monetary policy is constrained by the zero lower bound, that is, a situation in which it cannot lower the interest rate further and is therefore becoming less effective, fiscal policies become even more important. In particular, standard macroeconomic theory would suggest that fiscal policy needs to be more active in steering the macroeconomy and preventing a fall in inflation when monetary policy is in a liquidity trap or highly constrained. If fiscal spending and revenues are mostly at the national level, it will be the sum of the national fiscal policies that matter for the union as a whole.

Finally, fiscal policies also have an impact on the relative price and wage developments across countries and this becomes more relevant in a monetary union as the nominal exchange rate instrument is absent. There are various channels for this impact. One is often labelled 'fiscal devaluation' in the literature. It is a shift in taxes away from production factors towards consumption, for example a reduction in labour taxes and an increase in VAT taxes. Such a shift would make exporting easier as the cost of production could be lowered while the VAT tax is not applied to exports. It would directly affect the real exchange rate between members of the monetary union, while outside of it, its effects would be at least partially offset by a nominal exchange rate movement. Another channel concerns the macroeconomic channel of fiscal policy. A relatively contractionary policy in one Member State would lower its relative price and wage levels and thereby its real exchange rate vis-à-vis the other members of the monetary union.

Fiscal policies in a monetary union therefore interact strongly with fiscal and economic policies in other countries as well as with the common monetary policy. Every monetary union therefore has to make decisions on how to manage the relations between its fiscal and monetary policies. In this overview article, we will first present the fiscal framework of the Maastricht Treaty (1992). We will then discuss the changes to the fiscal rules and to the stability and growth Pact (SGP (1997)) over time. Finally, we will discuss the practice of implementation of the fiscal rules, before making a few suggestions for the future development of fiscal policies.

I. The Maastricht Setup

The European Union has decided to let the interaction of national fiscal policies and the common monetary policy be governed by a framework that is set out in the European treaties and that is often labelled the 'Maastricht consensus'. The framework was laid down in the Maastricht Treaty and is detailed in chapter 1 of the Treaty on the Functioning of the European Union (TFEU) on economic policy. It can be characterised as a framework based on rules. One of its major aims is to limit national discretions in that framework and is based on three major pillars:

(a) The first pillar is the so-called no monetary financing rule in article 123 and article 124. The articles are meant to limit the financing of public institutions, that is, governments, by central banks. The aim is to prevent access to the printing press of national governments or preventing the first spill-over explained above, namely the risk that unsustainable fiscal policy is socialised through an inflation tax on the entire euro area. The purpose is therefore to prevent excessive inflation as a result of unsustainable national fiscal policies.

(b) The second pillar is the so-called 'no bail out' clause in article 125 TFEU, which states that the Union or a Member State within the EU cannot pay for the debt of any of the Member States. As written in the article, it 'shall not be liable for or assume the commitments of' any public institution of 'any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project'.

(c) Finally, the third pillar refers to the set of fiscal rules set out in article 126 TFEU and the secondary legislation based on articles 121 and 126. They are the founding principles of the fiscal and budgetary surveillance in the EU and in the SGP. The first paragraph of article 126 is clear: 'Member States shall avoid excessive government deficits'.

The articles set thresholds for the government deficit – which shall not lie above the reference value of 3 per cent of the gross domestic product – and for the gross government debt – which shall not lie above the reference value of 60 per cent of the gross domestic product.

The SGP sets the operational side of the multilateral fiscal and budgetary surveillance. It defines the preventive and the corrective arms as well as the objectives that each Member State has to meet with respect to its specific fiscal and budgetary situation. As part of the 'preventive arm', the Member State needs to submit to the Commission a stability Programme, for EA countries, or a convergence Programme, for non-EA countries, in April of each year as well as a draft budget Plan (EA members only) in October. These must be in line with the Medium-Term Budgetary Objectives (MTOs) of the country concerned that are set in the SGP (following the reform in 2005). The 'corrective arm' sets the operational rules under the excessive deficit Procedure (EDP) and the sanctions that might be imposed on the country concerned. When a Member State is part of the 'corrective arm' of the SGP, it means that it has to meet additional targets to reduce its government excessive deficit. The main rationale of the SGP is thus to ensure sound budgetary policies on a permanent basis.

The articles as well as the accompanying regulations also establish the governance of the fiscal surveillance. The legal basis underlying the economic governance of the European Union are described by article 3 of the Treaty on European Union (TEU), articles 2–5, 119–144 and 282–284 TFEU. Moreover, article 126 and protocol No. 12 annexed to the Treaty describe the process that has to be followed to monitor governments' deficits. The European Commission is in charge of assessing the fiscal situation and making a recommendation to the Council. The Ecofin (*Economic and Financial Affairs Council*, made up of the economics and finance ministers from all Member States within the European Council) is in charge of taking the decision whether a Member State is in a situation of excessive deficit or not based on the recommendation of the European Commission. If the Council decides that a Member State is in a situation of excessive deficit, the latter enters the EDP that gives guidance on reducing the deficit. In case the Council considers the progress as not sufficient enough, it might start imposing sanctions on the country concerned.

A. Changes to the SGP Over Time

In 2005, the SGP was amended for the first time under the pressure of France and Germany. The 2005 modifications concerned the two arms and the economic governance. One of the major changes was related to the calculation of the MTOs. MTOs are part of the preventive

arm and are used as a benchmark for each country to give information on the budgetary situation. Each country has to compute its MTO as part of the stability (or convergence) Programme due in April of each year, as mentioned above. Prior to the 2005 SGP, the MTOs for structural budget balances were calculated according to a 'one-rule-fits-all' method. The 2005 framework allowed the MTOs to be country-specific and to take into account crucial economic differences across Member States, such as the risks associated to demographic changes. As explained in Biraschi, Cacciotti, Iacovoni et al (2010):

> MTO differentiation, in turn, had to consider the countries' government debt and implicit liabilities – especially those associated with rising age-related expenditure –, potential growth, and a safety margin minimizing chances of having budget deficits breaching the Maastricht 3 percent reference value (p 7).

MTOs rely on values according to the economic and budgetary position and sustainability risks of the Member States, based on current debt to GDP ratio and the concerned country's potential output growth. If a country's gross debt is higher than the reference value of 60 per cent of GDP, its MTO has to be strictly higher than the reference value of –0.5 per cent of GDP. Otherwise, it has to be higher than the reference value of –1 per cent of GDP. The structural budget balance (excluding effect of cycle and one-off measures) has to be higher than the MTO. In case of a lower structural budget balance, it has to increase by 0.5 per cent of GDP per year.

Over the last eight years, the European Union faced major economic challenges. The 2007–08 financial crises followed by the sovereign debt crisis in 2011 triggered some Member States' bailouts. The EU had to cope with an unexpected series of shocks that dramatically affected the Member States and led to an unstable economic environment. Financial stability became a source of worries and an issue to be solved at the EU-level. It is in this environment that the EU changed its fiscal governance substantially.

B. The 2011 Six-Pack

The Six-pack is a fiscal law package containing five regulations and one directive. The main objectives of this new series of amendments were to strengthen the procedure to avoid excessive deficits and to address the issue of macroeconomic imbalance, which refers to macroeconomic imbalances such as large current account deficits or surpluses, real estate bubble and others. The Six-pack ultimately aims to reinforce the fiscal and budgetary discipline among the EA Member States by threatening to impose prompt sanctions and introducing a 'reverse qualified majority' voting procedure (with the latter, the burden to find a qualified majority, so as a political decision can be reached, is reversed; that is, the Commission's proposal shall be automatically adopted unless a qualified majority of States that are against it arise within the Council).

Concerning the public debt criterion, the amendment defines the reference value for the debt-to-GDP ratio as 60 per cent of GDP and states that if a country exceeds that value, it will be put under EDP (even if its deficit does not exceed the 3 per cent reference value). Another change made was to provide more guidance for the Member States under the preventive arm of the SGP: the amendment determines a new expenditure benchmark to

help assess progress towards the MTOs. Note that, from 13 December 2013 onwards, a Member State can be asked to provide a new version of its draft budget Plan in case of non-compliance with the rules set under the preventive arm.

Finally, the 2011 Six-pack builds up a new surveillance framework called the macroeconomic imbalance Procedure (MIP). It aims at monitoring more closely the macroeconomic and financial stability and imbalances in Member States. According to the European Commission, the main goals of the MIP are to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances. It was created as a result of the financial crisis and the increasing need for more macroeconomic surveillance – especially in the EA in which countries are highly interdependent. Like the excessive deficit Procedure, the MIP is based on a series of reference values – called the MIP scoreboard – that aim at ranking and organising by category (five stages) the Member States according to their macroeconomic and financial situation (ie, the degree of their macroeconomic imbalances). The MIP scoreboard is organised in two categories of indicators: the external imbalances and competitiveness (current account balance, net international investment position, real effective exchange rate, export market shares, unit labour cost) and internal imbalances (consolidated private sector debt, private sector credit flow, change in deflated house prices, public sector debt, unemployment rate, change in total financial sector liabilities). Following an in-depth analysis, each country receives recommendations based on its MIP scoreboard and the stage it has been put under. The Six-pack in principle even foresees a sanction in case of Member States' non-compliance.

C. The 2013 Two-pack and the Fiscal Compact

The Two-pack consists of two new regulations that aim at strengthening the fiscal and budgetary discipline within the EA. It aims mainly at reinforcing the discipline among those EA countries that experienced – or are currently experiencing – financial stability issues. It concerns Member States that are under the EDP, the MIP and a financial assistance programme.

The European Fiscal compact – officially the Treaty on stability, coordination and governance in the Economic and Monetary Union – comprises a 'balanced budget rule', debt brake rule, the automatic correction mechanism, the economic partnership programme, the debt issuance coordination, the commitment always to support EDP recommendations and to embed the balance budget rule and the automatic correction mechanism into domestic law. It also foresees that the debt to GDP ratio needs to be reduced by 1/20 of the difference between the current level and 60 per cent of GDP per year. Finally it foresees the creation of the Euro summit at the level of heads of States and governments to discuss euro-area matters.

All of these reforms were intended to cope with the financial instability and the economic uncertainty prevailing in the European Union. The SGP and its extensions ended up being a very 'sophisticated' set of numerical rules that requires strong fiscal surveillance at the EU-level. They have become so sophisticated that many senior officials have admitted that they do not fully understand them.

D. The European Stability Mechanism and the Outright Monetary Transaction

In the course of the various bail-outs, the euro-area members eventually created a European Stability Mechanism (ESM), which provides financial assistance to EA Member States under strict conditionality. ESM financial assistance loans have been granted to a number of EA Member States (Pisani-Ferry, Sapir, Wolff (2013)). Despite the creation of these instruments, however, sovereign yields in the euro area diverged substantially. The argument made by Paul De Grauwe, that this divergence in yields reflects bad equilibria or self-fulfilling runs on countries, has been widely accepted. Yields only started to narrow when the European Central Bank (ECB) put in place its 'whatever it takes' programme, the OMT (*Outright Monetary Transaction*), a programme announced by the president of the ECB, Mario Draghi, on 6 September 2012, under which the ECB makes transactions in secondary sovereign bond markets within the Eurozone. Under the OMT programme, the ECB can buy sovereign bonds of a specific country as long as there is a valid ESM programme in place.

In fact, the euro area has therefore created a significant bail-out capacity. It has done so in a way that it intends to use it only to address problems of liquidity, which can be solved with the right set of national reforms. For cases of debt insolvencies, the ESM and OMT cannot be activated. This distinction is fundamental in theory but it is actually difficult to put in place in practice. The reason is that debt sustainability analysis is not an exact science. Moreover, those ultimately deciding on whether debt is solvent are not neutral players. It is this blurry line that is at the heart of the problem of whether or not the current EA institutional setup needs major or only minor reforms.

Next, we will analyse how the stability and growth Pact is currently performing in the EU.

II. In Practice

We presented the SGP as it is intended to be implemented in the EU. However, implementation de facto looks different from its original conception.

Table 1 shows the actual figures of general government deficit and gross debt in percentage of GDP in all countries of the EU during 2000–15. We use the two reference values to assess country-specific compliance with the headline numbers, namely 3 per cent for the deficit and 60 per cent for the gross debt. Figures 1 and 2 display respectively the general government deficit in percentage of GDP and the general government debt in percentage of GDP in the EU Member States over 2000–15. They show two data points (2000 and the latest available, 2015) and the increase to a peak – in other words the highest value reached for each country over the same period (highest value in the sense of the thresholds: for the deficit it is the lowest, meaning the largest deficit reached by the country, and for the gross debt it is the highest, meaning the largest level of gross debt reached by the country).

Table 1 General government debt and deficit as % of GDP per country

Country	GG variable	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Austria	deficit	−2,1	−0,7	−1,4	−1,8	−4,9	−2,6	−2,6	−1,4	−1,5	−5,4	−4,5	−2,6	−2,2	−1,4	−2,7	−1
	debt	65,9	66,5	66,5	65,7	65,1	68,6	67,3	65,1	68,8	80,1	82,8	82,6	82	81,3	84,4	85,5
Belgium	deficit	−0,1	0,2	0	−1,8	−0,2	−2,6	0,2	0,1	−1,1	−5,4	−4	−4,1	−4,2	−3	−3,1	−2,5
	debt	108,8	107,6	104,7	101,1	96,5	94,6	91	87	92,5	99,5	99,7	102,3	104,1	105,4	106,5	105,8
Bulgaria	deficit	−0,5	1,1	−1,2	−0,4	1,8	1	1,8	1,1	1,6	−4,1	−3,1	−2	−0,3	−0,4	−5,5	−1,7
	debt	71,2	65	51,4	43,7	36	26,8	21	16,3	13	13,7	15,3	15,2	16,7	17	27	26
Croatia	deficit	–	–	−3,5	−4,7	−5,2	−3,9	−3,4	−2,4	−2,8	−6	−6,2	−7,8	−5,3	−5,3	−5,4	−3,3
	debt			36,6	38,1	40,4	41,3	38,9	37,7	39,6	49	58,3	65,2	70,7	82,2	86,6	86,7
Cyprus	deficit	−2,2	−2,1	−4,1	−5,9	−3,7	−2,2	−1	3,2	0,9	−5,4	−4,7	−5,7	−5,8	−4,9	−8,8	−1,1
	debt	54,9	56,5	59,7	63,1	64,1	62,8	58,7	53,5	44,7	53,4	55,8	65,2	79,3	102,2	107,1	107,5
Czech Republic	deficit	−3,5	−5,3	−6,3	−6,4	−2,7	−3,1	−2,3	−0,7	−2,1	−5,5	−4,4	−2,7	−3,9	−1,2	−1,9	−0,6
	debt	17	22,8	25,9	28,1	28,5	28	27,9	27,8	28,7	34,1	38,2	39,8	44,5	44,9	42,2	40,3
Denmark	deficit	1,9	1,1	0	−0,1	2,1	5	5	5	3,2	−2,8	−2,7	−2,1	−3,5	−1,1	1,5	−1,7
	debt	52,4	48,5	49,1	46,2	44,2	37,4	31,5	27,3	33,4	40,4	42,9	46,4	45,2	44,7	44,8	40,4
Estonia	deficit	−0,1	0,2	0,4	1,8	2,4	1,1	2,9	2,7	−2,7	−2,2	0,2	1,2	−0,3	−0,2	0,7	0,1
	debt	5,1	4,8	5,7	5,6	5,1	4,5	4,4	3,7	4,5	7	6,6	6,1	9,7	10,2	10,7	10,1
Finland	deficit	6,9	5	4,1	2,4	2,2	2,6	3,9	5,1	4,2	−2,5	−2,6	−1	−2,2	−2,6	−3,2	−2,8
	debt	42,5	41	40,2	42,8	42,7	40	38,2	34	32,7	41,7	47,1	48,5	53,9	56,5	60,2	63,6
France	deficit	−1,3	−1,4	−3,1	−3,9	−3,5	−3,2	−2,3	−2,5	−3,2	−7,2	−6,8	−5,1	−4,8	−4	−4	−3,5
	debt	58,6	58,1	60	64,1	65,7	67,1	64,4	64,3	68	78,9	81,6	85,2	89,5	92,3	95,3	96,2

(continued)

Table 1 *(Continued)*

Country	GG variable	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Germany	deficit	0,9	−3,1	−3,9	−4,2	−3,7	−3,4	−1,7	0,2	−0,2	−3,2	−4,2	−1	0	−0,2	0,3	0,7
	debt	58,9	57,7	59,4	63,1	64,8	67	66,5	63,7	65,1	72,6	81	78,7	79,9	77,5	74,9	71,2
Greece	deficit	−4,1	−5,5	−6	−7,8	−8,8	−6,2	−5,9	−6,7	−10,2	−15,1	−11,2	−10,3	−8,8	−13,2	−3,6	−7,5
	debt	104,9	107,1	104,9	101,5	102,9	107,4	103,6	103,1	109,4	126,7	146,2	172,1	159,6	177,4	179,7	177,4
Hungary	deficit	−3	−4,1	−8,8	−7,1	−6,3	−7,8	−9,3	−5,1	−3,6	−4,6	−4,5	−5,5	−2,3	−2,6	−2,1	−1,6
	debt	55,1	51,7	55	57,6	58,5	60,5	64,6	65,6	71,6	77,8	80,5	80,7	78,2	76,6	75,7	74,7
Ireland	deficit	4,9	1	−0,3	0,4	1,3	1,6	2,8	0,3	−7	−13,8	−32,1	−12,6	−8	−5,7	−3,7	−1,9
	debt	36,1	33,2	30,6	29,9	28,2	26,1	23,6	23,9	42,4	61,7	86,3	109,6	119,5	119,5	105,2	78,6
Italy	deficit	−1,3	−3,4	−3,1	−3,4	−3,6	−4,2	−3,6	−1,5	−2,7	−5,3	−4,2	−3,7	−2,9	−2,7	−3	−2,6
	debt	105,1	104,7	101,9	100,5	100,1	101,9	102,6	99,8	102,4	112,5	115,4	116,5	123,3	129	131,9	132,3
Latvia	deficit	−2,7	−2	−2,2	−1,6	−1	−0,4	−0,6	−0,7	−4,1	−9,1	−8,5	−3,4	−0,8	−0,9	−1,6	−1,3
	debt	12,1	13,9	13,1	13,9	14,3	11,7	9,9	8,4	18,7	36,6	47,4	42,8	41,3	39	40,7	36,3
Lithuania	deficit	−3,2	−3,5	−1,9	−1,3	−1,4	−0,3	−0,3	−0,8	−3,1	−9,1	−6,9	−8,9	−3,1	−2,6	−0,7	−0,2
	debt	23,5	22,9	22,1	20,4	18,7	17,6	17,2	15,9	14,6	28	36,2	37,2	39,8	38,7	40,5	42,7
Luxembourg	deficit	5,9	6	2,5	0,2	−1,3	0,1	2	4,2	3,4	−0,7	−0,7	0,5	0,3	1	1,5	1,6
	debt	6,5	7	6,9	6,9	7,3	7,5	7,9	7,8	15,1	16	19,9	18,8	21,8	23,5	22,7	22,1
Malta	deficit	−5,5	−6,1	−5,4	−9,1	−4,4	−2,7	−2,6	−2,3	−4,2	−3,3	−3,2	−2,5	−3,6	−2,6	−2,1	−1,4
	debt	60,9	65,5	63,2	69,1	72	70,1	64,6	62,4	62,7	67,8	67,6	70	67,6	68,4	67	64
Netherlands	deficit	1,9	−0,3	−2,1	−3	−1,7	−0,3	0,2	0,2	0,2	−5,4	−5	−4,3	−3,9	−2,4	−2,3	−1,9
	debt	51,8	49,2	48,5	49,7	49,9	49,3	44,8	42,7	54,8	56,9	59,3	61,6	66,4	67,7	67,9	65,1
Poland	deficit	−3	−4,8	−4,8	−6,1	−5	−4	−3,6	−1,9	−3,6	−7,3	−7,3	−4,8	−3,7	−4,1	−3,4	−2,6

Country	GG variable	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	debt	36,5	37,3	41,8	46,6	45	46,4	46,9	44,2	46,3	49,4	53,1	54,1	53,7	55,7	50,2	51,1
Portugal	deficit	−3,2	−4,8	−3,3	−4,4	−6,2	−6,2	−4,3	−3	−3,8	−9,8	−11,2	−7,4	−5,7	−4,8	−7,2	−4,4
	debt	50,3	53,4	56,2	58,7	62	67,4	69,2	68,4	71,7	83,6	96,2	111,4	126,2	129	130,6	129
Romania	deficit	−4,6	−3,4	−1,9	−1,4	−1,1	−0,8	−2,1	−2,8	−5,5	−9,5	−6,9	−5,4	−3,7	−2,1	−0,8	−0,8
	debt	22,4	25,7	24,8	21,3	18,6	15,7	12,3	12,7	13,2	23,2	29,9	34,2	37,3	37,8	39,4	37,9
Slovakia	deficit	−12	−6,4	−8,1	−2,7	−2,3	−2,9	−3,6	−1,9	−2,4	−7,8	−7,5	−4,3	−4,3	−2,7	−2,7	−2,7
	debt	49,6	48,3	42,9	41,6	40,6	34,1	31	30,1	28,5	36,3	41,2	43,7	52,2	54,7	53,6	52,5
Slovenia	deficit	−3,6	−3,9	−2,4	−2,6	−2	−1,3	−1,2	−0,1	−1,4	−5,9	−5,6	−6,7	−4,1	−15	−5	−2,7
	debt	25,9	26,1	27,3	26,7	26,8	26,3	26	22,8	21,8	34,6	38,4	46,6	53,9	71	80,9	83,1
Spain	deficit	−1	−0,5	−0,4	−0,4	0	1,2	2,2	2	−4,4	−11	−9,4	−9,6	−10,5	−7	−6	−5,1
	debt	58	54,2	51,3	47,6	45,3	42,3	38,9	35,5	39,4	52,7	60,1	69,5	85,7	95,4	100,4	99,8
Sweden	deficit	3,2	1,4	−1,5	−1,3	0,3	1,8	2,2	3,3	1,9	−0,7	−0,1	−0,2	−1	−1,4	−1,6	0,2
	debt	50,7	52,1	50,2	49,7	48,7	48,9	43,7	39	37,5	41	38,3	37,5	37,8	40,4	45,2	43,9
United Kingdom	deficit	1,1	0,4	−2	−3,2	−3,4	−3,3	−2,7	−2,9	−4,9	−10,2	−9,6	−7,6	−8,3	−5,7	−5,7	−4,3
	debt	37,3	34,6	34,7	35,9	38,8	40,1	41	42	50,2	64,5	76	81,6	85,1	86,2	88,1	89,1

Source: Eurostat.

Figure 1 General government deficit in percentage of GDP: general government deficit/surplus is defined in the Maastricht Treaty as general government net lending (+)/net borrowing (−) according to the European system of accounts. The general government sector comprises central government, State government, local government, and social security funds

Source: Eurostat.

When we look at figure 1 and the development of the general government deficit/surplus in percent of GDP per Member State, we see that fiscal deficits were corrected after some countries reached really high deficits during the financial crisis and the sovereign debt crisis (Ireland, Greece). The latest data points (values for 2015) are much more encouraging in terms of complying with the fiscal headline numbers. The dashed horizontal line represents the 3 per cent threshold and we note that most of the EU countries are now complying with this threshold.

Only few Member States remain still above that threshold, meaning that their deficit is still too high according to the SGP and the fiscal rules in the EU. The countries that are concerned are: Greece, Portugal, Spain, France, Croatia and the UK, before its withdrawal from the EU (table 2).

Table 2 Overview of ongoing excessive deficit procedure

Country	Date of the Commission report	Council decision on existence of exessive deficit	Current deadline for correction
	(Art. 104.3/126.3)	(Art. 104.6/126.6)	
Croatia	15 November 2013	21 January 2014	2016
Portugal	7 October 2009	2 December 2009	2016
France	18 February 2009	27 April 2009	2017
Greece	18 February 2009	27 April 2009	2017[1]
Spain	18 February 2009	27 April 2009	2018
Un. Kingdom	11 June 2008	8 July 2008	Financial year 2016–17

[1] See the Council decision published on 20 August 2015 for Greece that states that the general government budget deficit will fall below 3% of GDP in 2017. The EC website indicates 2016.

Looking at the development of general government gross debt (figure 2) in the EU, the story is different. Overall, almost all the EU countries reached their maximum level of gross debt in 2015. For those with a current lower value, the progresses seem not to be that significant and encouraging except for Bulgaria or Ireland. General government debt seems to pose a serious problem in the EU, especially for EA countries. This story is in line with the events that occurred over the last years.

Table 3 summarises the situation over the time period 2000–15. As already mentioned above, the classification is only based on general government deficit and general government gross debt. Our goal is to provide an overview of the fiscal and budgetary situation through which the EU Member States have been over the last 15 years. Overall, the striking fact is that the situation seems to have gotten worse over time. The current framework seems not to allow countries to cope with periods of recession. As mentioned in the first part of the chapter, a proper budgetary and fiscal framework should allow the Member States to minimise budgetary troubles during periods of recession and maximise benefits during periods of growth/prosperity (cyclicality of fiscal rules). Moreover, it is clear that some countries have had difficulties going out of the crisis and improving their financial situation (Greece, Spain, and Portugal). While few countries managed to get out of the fiscal 'red zone' (Ireland and Italy for example), other countries have been struggling to improve their situation (Greece).

Figure 2 General government debt in percentage of Gross Domestic Product (GDP): for the purpose of the Excessive Deficit Procedure (EDP) in the Economic and monetary union, as well as for the growth and stability Pact, the current protocol 12, annexed to the 2012 consolidated version of the Treaty on the functioning of the European Union, defines government debt "as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government". The stock of government debt in the EDP is equal to the sum of liabilities, at the end of year, of all units classified within the general government sector (S.13) in the following categories: AF.2 (currency and deposits) + AF.3 (debt securities) + AF.4 (loans). Basic data are expressed in national currency, converted into euro using end-year exchange rates for the euro provided by the European Central Bank (ECB). The Macroeconomic Imbalance Procedure (MIP) headline indicator is calculated as: (Gross Government Debt/GDP)×100. The indicative threshold is 60% of GDP. The data are expressed in millions of units of national currency and in percentage of GDP

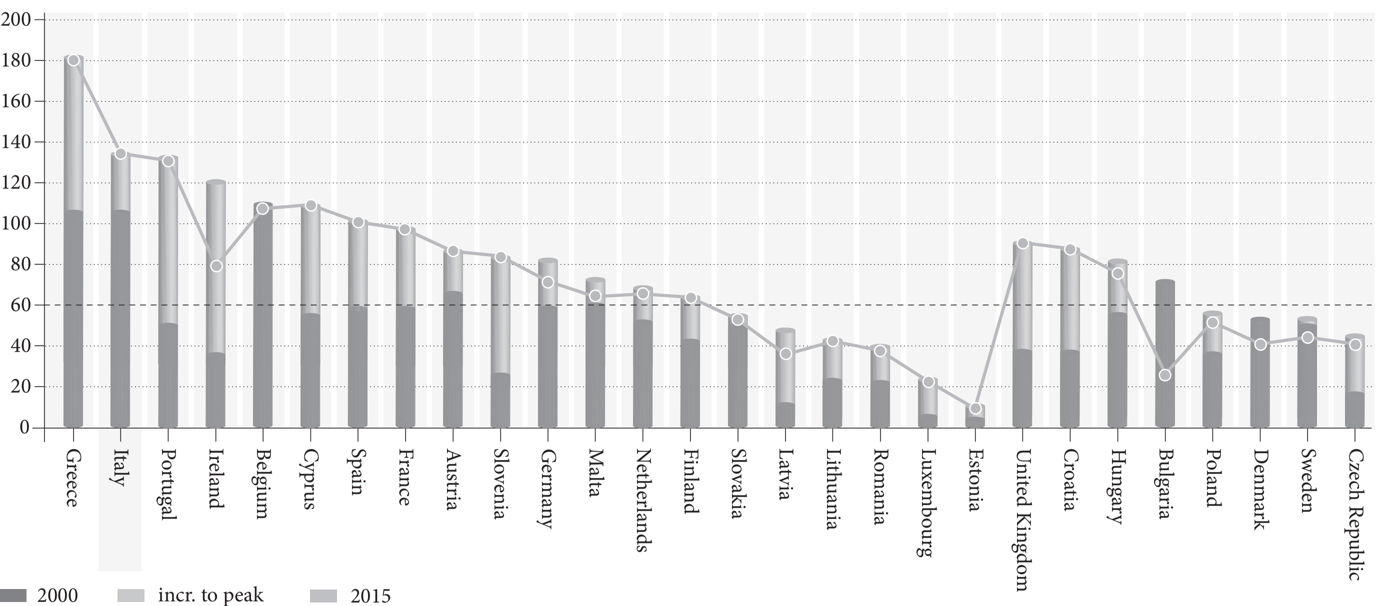


Table 3 Framework summary 2000–2015

Country	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Austria																
Belgium																
Bulgaria																
Croatia	–	–														
Cyprus																
Czech Republic																
Denmark																
Estonia																
Finland																
France																
Germany																
Greece																
Hungary																
Ireland																
Italy																
Latvia																
Lithuania																
Luxembourg																
Malta																
Netherlands																

(continued)

Table 3 ***(Continued)***

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Poland																
Portugal																
Romania																
Slovakia																
Slovenia																
Spain																
Sweeden																
United Kingdom																

Data used correspond to data in table 1.
Legend: High risk (above 3% deficit and 60% debt)
Medium risk (above 3% deficit or 60% debt)
Low risk (below 3% deficit or 60% debt)

Source: Eurosat.

A. Assessment of the Actual Number of Countries Under EDP

Table 2 shows the currently ongoing EDP along with the associated current deadline for correction. In 2016 there were six countries under an EDP: Croatia, Portugal, France, Greece, Spain and the United Kingdom. Four countries out of the six have been asked to correct their excessive deficit by the end of 2017, namely Greece, France, Croatia and Portugal. Spain will need to correct its deficit by the end of 2018, while the United Kingdom's deadline was the financial year 2016–17. All of the EA countries experienced an EDP over the last 20 years except Estonia. Therefore, the closed EDPs include procedures for: Austria, Belgium, Cyprus, Germany, Italy, Ireland, Finland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Slovenia and Slovakia. Among the countries that are currently under the EDP, four countries out of the six have already experienced such a procedure: France (2003–07, 2008), Greece (2004–07), Portugal (2005–08) and the United Kingdom (2004, 2005–07).

In 2011, the European Semester was created in order to 'improve economic policy coordination and ensure the implementation of the EU's economic rules' (Darvas, Leandro (2015) 4). It aims at giving policy recommendations for the eurozone as an entity and for each EU Member State. We start from the European Semester to investigate the reality behind the SGP and the fiscal rules.

One of the latest analyses of the European Semester was carried out by Zsolt Darvas and Alvaro Leandro (2015) in their paper called: *The limitations of policy coordination in the euro area under the European Semester*. The authors created a European Semester reform implementation index that aims at measuring the percentage of reforms fully implemented – or that the government at least started to implement (indicators based on the European Commission's assessment).

Overall, the actual implementation of recommendations in the EU over 2012–14 is low and became worse. Regarding the SGP, it increased in 2013 but then it decreased sharply from more than 50 per cent to 29 per cent. Note that a score higher than 50 per cent means that at least some progress has been achieved on all recommendations, while a score of 29 per cent means that there was very little progress and limited implementation. Darvas and Leandro note that the downward trend is common to all Member States in the EU; however, it is stronger in non-EA countries.

The authors focus also specifically on the SGP and come to sobering conclusions: 'Given that the SGP has strong legal enforcement tools, one would expect a high implementation rate for recommendations related to the SGP' (p 6). Over the time period 2012–14, the rate of implementation for SGP tended to be higher than the rate for the MIP and for other recommendations but '[t]he average SGP implementation rate in 2012–14 was 44 per cent, which is not particularly high and suggests that the European Semester is not particularly effective in enforcing the EU's fiscal rules' (p 7).

The European Semester has also attempted to develop a vision on a euro-area wide fiscal stance but the recommendations are basically empty rhetoric according to Darvas and Leandro. In particular, the authors criticise that the optimal aggregate fiscal stance is not defined. They highlight that the recommendations talk about an aggregate fiscal stance that should be in line with sustainability risks and cyclical conditions, but that they do not clarify what the aggregate stance is in the first place. In conclusion, without a top-down approach to determine national fiscal stances that correspond with the optimal aggregate, it is accidental if the sum of country-specific fiscal stances corresponds with the optimal aggregate fiscal stance.

Overall, what the data and the analysis by Darvas and Leandro tell us is that the current European framework is clearly underperforming and that EU Member States are struggling to improve their budgetary and fiscal situation (table 4).

Table 4 Fiscal sustainability assessment by member state

Country	Overall short-term risk category	Debt sustainability analysis – overall risk assessment	SI indicator – overall risk assessment	Overall medium-term risk category	Overall long-term risk category
Austria					
Belgium					
Bulgaria					
Croatia					
Czech Republic					
Denmark					
Estonia					
Finland					
France					
Germany					
Hungary					
Ireland					
Italy					
Latvia					
Lithuania					
Luxembourg					
Malta					
Netherlands					
Poland					
Portugal					
Romania					
Slovakia					
Slovenia					
Spain					
Sweeden					
United Kingdom					

Legend: High risk (above 3% deficit and 60% debt)
Medium risk (above 3% deficit or 60% debt)
Low risk (below 3% deficit or 60% debt)

Source: European Commission, Fiscal sustainability report (January 2016).

Before moving to the third section and to the possible reforms of the current framework, we will try to list what reasons could actually lie behind the failure of the SGP.

B. The Structural Budget Balance Rule

The structural budget balance is a key indicator of the fiscal situation in a country and is used intensively in the European framework. However, the structural budget balance is an unobserved variable and is estimated with great imprecision. Its objective is to quantify the budget balance without taking into account the impact of temporary effects such as the cyclical effects (tax revenues and unemployment benefits) and the one-off expenditures (banks' bailouts, for instance). According to the OECD definition, the structural budget balance also represents what government revenues and expenditures would be if the output were at its potential level.

The main issue with the structural budget balance is its estimation. It is not clear how to properly estimate that unobserved variable. The EU has agreed on an approach based on an estimate of potential output. However, it is well documented that there have been huge revisions in these estimates after only one year.

In March 2016, finance Ministers of the EU Member States expressed their worries about the estimation of the potential output, like a group of economists before. In a blog post called *Mind the gap (and its revision)!*, Darvas argued that the major source of uncertainty in the estimation of the structural budget balance comes from the estimation of the output gap (namely, the difference between actual and potential GDP).

He also mentioned in a 2013 blog post (*Mind the gap! And the way structural budget balances are calculated*) that the EC's methodology to estimate potential output (D'Auria, Denis, Havik et al (2010)) is based on 'problematic' assumptions about capital, labour and total factor productivity (potential output is estimated using a production function).

The EU's recommendations on national fiscal policy are therefore based on an assessment of national fiscal policies relative to a variable measured with high margins of error. For example, a recommendation may be given to tighten public expenditure by 0.5 per cent of GDP to meet EU objectives. Only one year later, the revisions of the estimates could indicate that the recommendation was totally wrong and that instead a recommendation of a loosening of 0.5 per cent should have been given. These wrong estimates therefore have serious implications for fiscal policy and undermine the credibility of the EU fiscal governance framework.

To summarise, the three major impediments to the calculation of structural budget balances are: the estimation of the potential output, the quantification of its impact on the budget balance, and finally the measurement of the impact of one-off measures on the budget balance. As a result, the credibility of the EU's fiscal framework suffers and Member States often rightly question whether a certain recommendation is sensible.

C. The Lack of Clarity of the Current Framework

The EU's fiscal framework has become extraordinarily complex. The running joke in Brussels is that only one or two people in the European Commission actually understand the rules. Together, the Six-pack and the Two-pack encompass 70 pages of text.

Such complexity can result in a lack of transparency. In fact, for national parliamentarians who are supposed to approve budgets that are in line with EU rules, let alone citizens, it has become close to impossible to understand why a certain budgetary recommendation has been given. At the level of the European Commission, the complexity provides room for interpretation and flexibility. But the way this flexibility is exercised is not clear from the outside.

A priori, the complexity was a result of good intentions. It is generally accepted that mechanically sticking to the simple numerical thresholds of 3 per cent makes little economic sense. The intention was therefore to create 'intelligent' fiscal rules. In particular, policymakers tried to create a framework which would allow automatic stabilisers to operate freely and not be constrained by the 3 per cent threshold. The framework also permits discretionary fiscal spending should the business cycle situation allow for it.

However, at the same time, the new framework was trying to continue to be based on rules and not on economic, let alone political judgement. The result was a very complicated set of rules that aims to achieve this intelligent setup. However, as argued above, the complexity has become so great that the initial purpose is defeated and transparency and clarity of decision is missing.

III. Reform Proposals in the Current Framework

The call for a simplified version of the fiscal European system is becoming more and more vital according to a growing group of economists. According to what Jeffrey Franks stated during a seminar on predictability and transparency of the SGP in Brussels in March 2016, the reforms have already blurred the distinction between the preventive and corrective arms. He presented possible reforms in order to make the current system simpler: 'go back to the two-pillar model: fiscal anchor and operational targets; single fiscal anchor: public debt to GDP; single operational target: an expenditure growth rule, and possibly in combination with an explicit debt correction mechanism'. Overall, there is a 'need to improve economic governance, not just fiscal governance, as private and public imbalances are linked'.

One of the recent proposals for reform was written by Claeys, Darvas and Leandro (2016) in a paper called *A proposal to revive the European fiscal framework*. Their main idea is that fiscal surveillance should not rely on the structural budget balance rule due to the non-reliable estimates of potential output. It should instead rely on an expenditure rule (figure 3).

Since the structural balance rule has been the major and unique rule so far, the SGP and the Fiscal Compact would need to be revised to drop the 3 per cent deficit threshold and to avoid using the structural balance targets as operational targets. One would thereby scrap the complex web of flexibility options, but instead create an expenditure rule with a debt feedback mechanism.

The authors argue that the advantages of expenditure rule over structural budget balance rule are multiple: it is simpler, more transparent, easier to monitor and to explain to public and politicians, it is under the direct control of the government (therefore increases the ownership of the rule), it promotes debt sustainability and countercyclical fiscal policy in periods of growth and recession.

Figure 3 Actual expenditure growth (blue) and real-time expenditure limit estimate (green) based on the expenditure rule proposed by Claeys, Darvas and Leandro (2016)

Source: Claeys, Darvas and Leandro 2016.

The formal expression of the proposed expenditure rule is as follows: (growth rate of nominal public expenditures, excluding interest, labour market expenditures + smoothing public investment over years) < (medium-term potential GDP growth + ECB inflation target, 2% in the EA, −0,02 × debt-to-GDP ratio in the previous year −60%).

Claeys, Darvas and Leandro argue that the European Commission should not rely on the structural balance rule to calculate the adjustments that have to be implemented by Member States. The main reason behind this argument is that the calculation of the structural budget balance relies on the estimation of the output gap, which is wrong in real time due to measurement error. Therefore, it creates a series of estimation errors that have a significant impact on the decision-making process. Since the rule is written in the Treaty, it could be used as an index or an indicator but not as a basement to take political decisions.

Over the last decade, European Member States were often running procyclical fiscal policy. During periods of boom, governments increased public expenditures along with the increase of tax revenues, while they reduced dramatically public expenditures during periods of recession, increasing stress and risk of larger debt. There is a wide consensus among economists on the need of countercyclical fiscal policies (make efforts during periods of boom to reduce the debt by not increasing public spending that will give more fiscal space to increase unemployment benefits and extraordinary – one-off – measures during bad times).

The expenditure rule proposed by Claeys, Darvas and Leandro is based on a public expenditure growth ceiling that is equal to the potential GDP growth plus the inflation target set by the ECB. This would therefore make the fiscal policies almost acyclical, allowing for debt reduction during booms and fiscal space during recessions. As Alessandro Turrini concludes in his paper (2008), the procyclical bias tends to be really problematic especially during good times. Member States tend to increase too much their public expenditure, while they tend to do better during bad times (still reducing public spending more than they should but following a more reasonable path). The expenditure rule framework would significantly diminish the procyclical bias.

Figure 3 from Claeys, Darvas and Leandro (2016) plots the annual growth rate of public expenditures both realised (blue) and estimated under the expenditure rule (green) for a set of Member States. The estimated annual growth rate under the expenditure rule is overall more stable. The above figure shows that, overall, the plotted countries tended to implement procyclical fiscal paths making the actual expenditure growth unstable. For instance, Ireland's growth rate went from more than 8 per cent in 2009 to minus 8 per cent in 2010, which represents a full reversal in the fiscal path, moving from fiscal extension to strong fiscal narrowing. Spain shows a similar pattern, while Italy and Germany were overall following a more stable path.

An expenditure rule would therefore allow governments to follow more closely a countercyclical (almost acyclical) fiscal path, would give them more sovereignty and control over fiscal policies and debt reduction, and would be more easily understandable by politicians and citizens. Finally, by using the inflation target in the public expenditure growth ceiling, implementing such a rule would allow the European Commission and the Member States to help the ECB to fulfil its mandate and reach the inflation target in periods of growth and recession.

Claeys, Darvas and Leandro also propose a new framework for the surveillance of the rule. The idea is to have National Fiscal Councils that would monitor the implementation of the rule from drafting the budget to executing and validating the potential growth estimates used in the rule and a European Fiscal Council with a proper mandate and ECB-style governance. The Council would be granted with proper appointment procedure, proper bilateral accountability to the European Parliament, would exercise necessary discretion and could suspend rule for the whole union or particular countries and decide acceptable one-off measures to smooth investment.

The idea behind an expenditure rule and the implementation of national and European fiscal councils is to gradually move away from the use of sanctions to force Member States to reduce their debt and deficit. Fiscal recommendations need to be credible. Moreover, a country should not – and will not in the end – follow the rules because of sanctions, but because it agrees that the rule is the best guidance for fiscal policies to be sustainable.

Overall, it would obviously require an appropriate transition period to implement the whole procedure, but their proposal gives good prospects in practice.

In their paper called *Playing the rules: reforming fiscal governance in Europe* (2015), Luc Eyraud and Tao Wu discuss the issues raised by the steadily increasing public debt in the eurozone. In line with our observations in the second part of our chapter, they show that the EMU is having issues in implementing sound and countercyclical adjustments:

> An important lesson of this exercise is that countries should build sufficient fiscal buffers in good times to accommodate cyclical and exogenous shocks in bad times. […] most of the deterioration in public finances during the crisis was *not* due to discretionary fiscal stimulus. It was the effect of automatic stabilizers (as revenues fell and expenditures rose in the recession) and exogenous factors (like the bailout of the banking sector or the interest bill). In essence, countries did not enter the crisis with strong enough fiscal positions to withstand such large shocks (Eyraud, Wu (2015) 9).

Even if implemented reforms had an overall positive impact, they failed at reversing the deteriorating trend that public finances are currently following. Along with mentioning design-related issues already stated by Claeys, Darvas and Leandro, such as the growing complexity of the fiscal framework, the reliance on misleading estimates of structural budget balance and the inability to reconcile the two major purposes of the SGP, the authors note that the lack of coordination between the European Commission and the national councils, the poor compliance among Member States and the incomplete separation of powers also participate to the global inefficiency of the European fiscal framework.

Their reform proposal is based on the simplification of the current framework along with the creation of space for more flexibility to deal with shocks. Like monetary policies, a sound fiscal framework should rely on a final objective, which is referred to as 'fiscal anchor', and a medium-term operational target. However, Eyraud and Wu show that the current fiscal rules rely on too many operational targets that are not easy to monitor and too complex. However, defining the fiscal effort variable that will serve as the operational target is not an easy task. It could be a structural balance rule, an expenditure rule or a nominal balance rule. In the literature, a consensus seems to arise. For instance, Xavier Debrun, Natan Epstein and Steven Symansky (2008) proved that implementing an expenditure growth rule along with a debt feedback mechanism allows us to foster convergence to

the debt objective and to have more flexibility. It has also been showed that the expenditure growth rule works better when it is put in place with a corrective mechanism (Petrova (2012)). In his paper called *Evaluating fiscal policy: a rule of thumb* (2014), Nicolas Carnot argues that:

> a rule targeting the evolution of primary expenditure relative to trend output growth (adjusted for discretionary revenue measures) can strike a good balance between the objectives of long-term sustainability and short-term macroeconomic stabilization.

Moreover, Eyraud and Wu believe that a structural balance target in level should remain in the fiscal framework, but it should be used as an indicator rather than as an additional target.

Another part of Eyraud and Wu's proposal consists of improving the global governance of the framework. First, they show that formalising the cooperation between national fiscal councils and the European Commission through institutional structures that differ from their degree of integration would help to improve monitoring of the rules. For instance, Fatas, von Hagen, Hallett et al (2003) also argue for the creation of an EU-wide council. Secondly, they argue that reinforcing correction mechanisms by allowing the European Commission to impose sanctions more easily and by enlarging the set of sanctions and increasing Member States' compliance through a more credible no bail-out clause (greater market discipline) or central controls would make the enforcement process stronger.

To summarise, scholars have reached a consensus that the current framework is complex but there is no consensus on whether it should be abandoned altogether or reformed and if the latter, how. In the fourth part, we will introduce proposals that go beyond the reform of the current framework and offer a different approach to fiscal governance altogether.

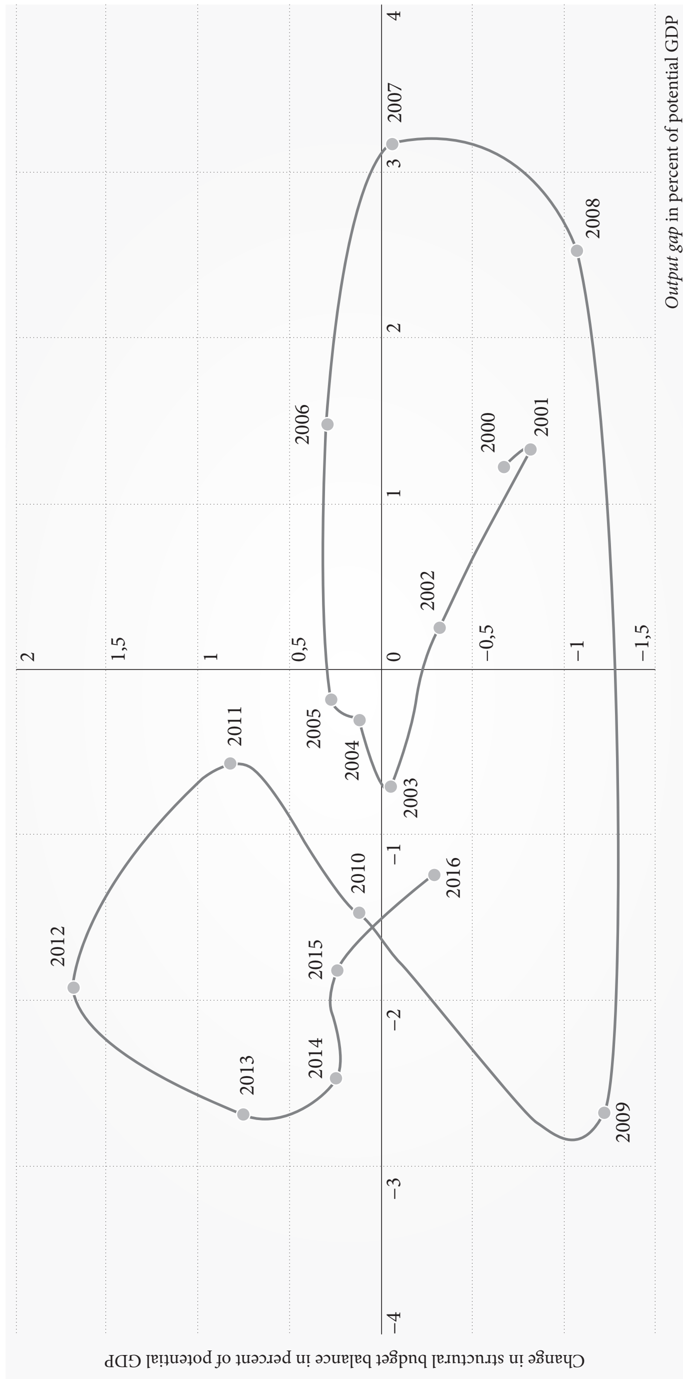
IV. Moving Beyond the SGP

There is a growing recognition that changes to the EU's fiscal rules can perhaps solve some problems of the fiscal framework but not the fundamental dilemma that fiscal policy in the current monetary union faces. This dilemma is that ultimate sovereign control of fiscal policy is national while the implications of fiscal policy extend well beyond borders and affect the monetary union as a whole. This interdependency is most pronounced when it concerns the possibility of unsustainable fiscal policies. But it is also relevant as it concerns the macroeconomic management of the monetary union.

The debate basically revolves around two polar options. On the one hand, there is the vision to create a European Treasury that would become the institution that would issue most debt of the euro area and be backed by a strong governance framework that would guarantee access to a future stream of tax resources. On the other hand, there is a vision to return to a framework in which national sovereignty and national responsibility are fully reinstated. To achieve this option, a credible no bail-out clause is the fundamental cornerstone that needs to be achieved.

Both options face significant problems. The first option essentially requires a step change in European integration with the creation of a true European sovereign that can raise taxes and limit excessively irresponsible behaviour of national sovereigns if it endangers the

Figure 4 Fiscal Stance in the Euro area over 2000–16



Source: IMF, *World Economic Outlook*, October 2016.

ability of the centre to collect taxes. The second option requires a framework that ensures that the no bail-out clause is actually credible. Moreover, the second option does not allow for any fiscal policy coordination to manage the eurozone macroeconomy. As EA Member States do not want to go either in one direction, or in the other, the status quo seems to prevail.

However, the status quo itself is unstable as it neither establishes national sovereignty nor true joint responsibility. The threat of applying the no bail-out clause is perceived as not being credible while at the same time the promise to mutualise debt is also not acceptable as it lacks a political, let alone legal, basis.

Moreover, the status quo itself leads to a fiscal stance for the EA as a whole that is not supportive of the EA economy. Figure 4 documents the fiscal stance in the EA and how it relates to the output gap. The fiscal stance measures how the change in the structural balance has almost always been procyclical in the eurozone. In other words, in times of recessions, discretionary room is used to tighten the budget while in times of booms it is used to loosen the budget. These discretionary actions offset, at least to some extent, the workings of automatic stabilisers.

The European Commission has recently launched an attempt to set an explicit numerical fiscal target for the euro area. In the document *Recommendation for a Council recommendation on the economic policy of the euro area*, it asked Member States to achieve a fiscal expansion of 0.5 per cent of GDP in 2017. The Commission also vaguely recommended that the stimulus should be distributed in a way that countries with stronger public finance would do a larger stimulus.

The initiative was severely criticised by Germany in particular. German criticism centred on three main issues. The first is that there is no legal basis for the Commission to ask a Member State like Germany to do a massive fiscal expansion. For Germany, it could amount to up to 2 per cent if all the other Member States would not do a fiscal expansion but rather stick to the current course of gradual fiscal adjustment. The second criticism was that if Germany was not doing the 2 per cent expansion, then implicitly the Commission was recommending that other countries break the rules and increase their fiscal deficits. Lastly, the German government expressed scepticism on whether it is actually feasible to 'fine tune' the business cycle with discretionary fiscal policy measures.

The European Commission's initiative did not lead to any concrete policy action. It is indeed questionable whether the current legal basis is strong enough for defining an EA fiscal stimulus. Instead, the author would advocate using the macroeconomic imbalance procedure as a legal basis to give binding policy recommendations to Germany to adjust its structural and macroeconomic policy in order to address its large current account surplus. That would contribute to the European fiscal stance, which however would not be the primary motivation for the expansion. Rather, it would be to address price divergences among States and to sustain inflation.

V. Developing the Fiscal Framework Further

Giamcarlo Corsetti, Lars Feld, Ralph Koijen et al (2016) support the creation of a debt restructuring mechanism that would help the implementation of a credible no bail-out

clause in the EA. As the European Union is facing new challenges and is going through its worst time until now, they claim for a need of institutional changes that can be implemented in the short-term, without more political integration, in order to restore growth. The current debt restructuring framework in the EA relies too heavily on rules to enforce discipline, while it should rely more on market mechanism. Since redistributing debt legacy over time is crucial for the wellbeing of the macroeconomy and the financial stability, they propose a steady-state fiscal framework that would deal with that issue without requiring any debt mutualisation or joint debt guarantee.

Their proposal is based on a debt restructuring regime that would complement the ESM. As mentioned in the first part, the ESM is the entity that provides lending to countries during crisis. As part of their framework, the ESM would (and should already) lend only to countries that are defined as solvent (able to pay back the amount of money borrowed on time), while the debt restructuring regime would help solve the issue of excessive debt in insolvent countries. This would require an amendment of the ESM's existing conditions in order to: first give the right incentives to the private lenders ex ante and secondly to prevent ex-post problems implied by minority creditors (procrastination and hold-out problem for instance). The amendment would consist of the implementation of two thresholds (public debt less than 90 per cent of GDP and gross financial needs less than 20 per cent of GDP) and the creation of a clause that would 'extend immunity from judicial process to sovereigns that negotiated a debt restructuring with a (super-)majority of creditors in the context of an ESM programme' (Corsetti, Feld, Koijen et al (2016)).

Along with the new fiscal framework, they propose a new financial and regulatory framework that would deal with the issue of the home bias in banks' sovereign portfolio. Note that both are crucial and needed, and cannot be implemented separately. The main purpose of such a framework is the current necessity to break the bank-sovereign loop. Eurozone banks hold huge amounts of debt securities and especially sovereign from their own origin country. This might have serious consequences in a monetary union since countries cannot use a national currency to adjust for the value of their debt and that countries are heavily dependent on other members' economic situation (shocks spread faster). In order to break the loop, they first propose to assign aggregated average risk weight for each country on sovereigns in order to reduce the home bias. Second, they propose to introduce 'a registration scheme for the private sector' within the ECB in order to create specific kind of collateralised debt obligations that are backed by sovereign debt.

Obviously, the implementation of this new fiscal, financial and regulatory framework would require a period of transition in order to decrease significantly the current level of debt-to-GDP ratios. It could be managed thanks to 'a coordinated one-off solution to remove the debt overhang problem' (Corsetti, Feld, Koijen et al (2016)) in return for stable institutions. This one-off solution would consist of both the creation of a stability fund that would act as a debt buyback and the use of a swap of sovereigns.

Maria Demertzis and Guntram B Wolff start from the observation that it is fundamental to achieve a credible no bail-out clause in order to reduce the reliance of the European policy system on a set of fiscal rules that are dysfunctional (Demertzis, Wolff (2016)). The central question is how the credibility of the no bail-out clause can be established. The central point they are making is that for the no bail-out clause to be credible, more fiscal integration is actually necessary. In fact, at a minimum, the EA would need to be able to decouple the financial system from the fates of national governments.

As long as a sovereign debt restructuring in one Member State can affect the financial stability of the core of the EA financial system, the no bail-out clause is not credible. The authors therefore argue that the next step the EA needs to make is to finish the banking union with full deposit insurance and a fiscal backstop to the resolution fund. To really delink banks from sovereigns, the EA should impose large exposure rules on sovereign debt. As the introduction of such a rule could create a funding squeeze on some sovereigns, it would be advisable to agree ex ante on a buyer of last resort to manage the effects of the introduction of such rules. The authors also underline the importance of the EA and the EU to demonstrate the value added that the union creates. That also means that sufficient resources should be available in the EA to fund EU-wide public goods. A further dimension to strengthen national responsibility and enhance the no bail-out clause would be a minimal joint resource for social needs.

In true federations like the United States, States are credibly subject to a no bail-out clause also because central government functions are exercised by the federal government. Moreover, the fiscal stance of the United States is taken care of by the central government. The eurozone could gradually move in this direction with some more centralised resources for area-wide investments. It could also consider the creation of an EA unemployment reinsurance to prevent excessively procyclical tightening in case of severe recessions that reduce access to borrowing for individual Member States. Together, these steps would allow not only to strengthen national liability but also to gradually discontinue a complicated system of fiscal rules.

One central question that such a nucleus monetary cum fiscal union would leave unanswered is the question of the fiscal stance for the EA as a whole.

Stable monetary unions go hand in hand with fiscal unions that ensure the central functioning of government even in case of default. Demertzis and Wolff therefore propose a long-term process in that direction for the euro area that is divided in the three steps described above. The question is what are the necessary economic and political conditions to:

(a) complete banking union;
(b) create European funds for investment;
(c) increasingly shift other government functions to the centre.

For the first step, they argue that it is imperative to tackle the still significant debt overhang and non-performing loan issue in a number of Member States. The authors argue that for the second step it is crucial to create a common and credible system of checks and balances at the European level, while for the third step, it is actually important that the Member States of the EA have seen a much greater convergence of their economic development levels. The more disparate economic levels of income and susceptibility to shocks are, the more difficult it is to enter into a fiscal union in which explicit risk sharing becomes more important.

Overall, the authors conclude that increasing fiscal capacity is desirable for the economic stability of the eurozone and would improve economic performance while at the same time decentralising fiscal governance and making sovereign debt restructuring possible. But advancing this agenda is politically difficult and raises serious questions about cohesiveness and how much economic convergence is needed.

VI. Conclusions

To summarise, the European Union has created one of the most elaborate fiscal frameworks. The framework developed from one based on simple rules to one that increasingly became more 'intelligent' in order to cater for different contingencies of the economy and prevent procyclical policies. However, compliances with the framework have become weaker and its complexity raises doubts about its legitimacy and transparency. Finally, fiscal outcomes, including concerns about the area-wide fiscal stance, are imperfect and not contributing to growth in the EA. Simultaneously, suspicions about other countries' fiscal policies have increased everywhere and many fear that they have to 'foot the bill' for others. We have proposed a direction of reforms addressing all these concerns by simultaneously increasing the credibility of the no bail-out clause while creating more European fiscal mechanism to achieve better results.

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