REBUILDING THE PUBLIC FINANCES AND FISCAL DISCIPLINE IN THE EURO AREA

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1 Introduction

The public finances in the euro area are in poor shape following the financial crisis. Debt-to-GDP ratios have reached very high levels by historical standards, while some countries are experiencing a sovereign debt crisis. While the main origins of the crisis were in the private sector and the credit cycle, fiscal positions in most countries were too lax during the run up to the crisis, failing to counter or even adding to expansionary pressures from the private sector in countries that built up large deficits. This limited the room for fiscal manoeuvre during the downturn. These poor fiscal outcomes partly have their origins in poor policy settings and the failure to achieve sufficiently sound fiscal positions in economic good times. Weak enforcement of the Stability and Growth Pact, particularly of the preventive arm, contributed to the failure to achieve prudent fiscal management.

This paper argues that the necessary reforms should be coherent with the economic and political design of the monetary union, particularly the absence of fiscal union, as well as with the lessons of past experience and the challenging fiscal circumstances of the coming years. This approach should span market discipline, stronger EU institutions and better national fiscal frameworks. The role of EU institutions should focus on avoiding fiscal positions that create excessive spillovers. The complementarity of different policy instruments should be exploited, while applying several instruments can be more robust if the effectiveness of each approach is not guaranteed. While adoption of reform proposals made in the late 2010 would do much to improve fiscal outcomes, crucial elements of a coherent approach have yet to be incorporated into the policy agenda.

The second section of the paper sets out the weaknesses in fiscal performance in the years running up to the crisis that contributed to ineffective economic stabilisation. The third section discusses how a combination of market discipline, EU institutions and national budgetary institutions could remedy these weaknesses.

2 Weak fiscal performance has left the public finances in poor shape following the crisis

The recent experience of the public finances in the euro area points to three main weaknesses. Firstly, large budget deficits are now widespread and there has been a sovereign debt crisis in some euro area countries. Secondly, the debt-to-GDP ratio has been trending up in most countries over recent decades to reach historically elevated levels. This is due to a pattern of narrowing deficits after downturns enough to bring debt dynamics under control but not to reduce indebtedness to their original levels. Thirdly, fiscal constraints limited the room for fiscal manoeuvre in the downturn, while policy settings failed sufficiently to lean against the upswing in some countries and actively contributed to economic in balances in some.

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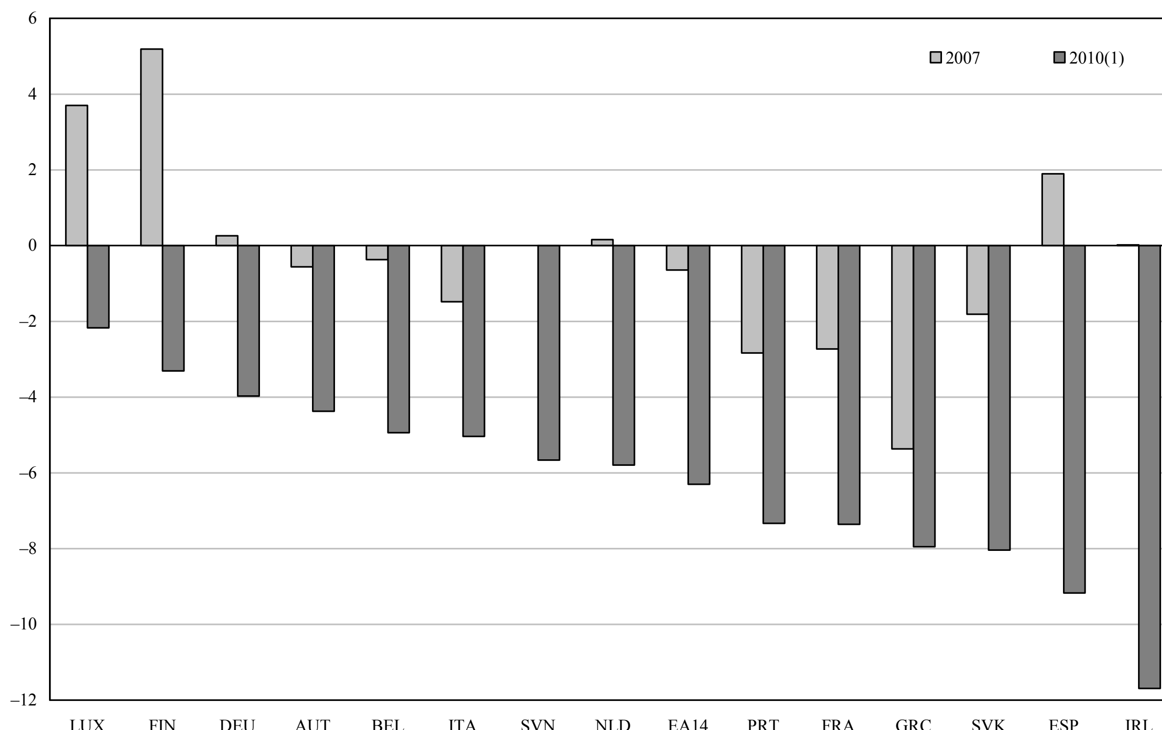
This paper is based on analysis undertaken for the 2010 OECD *Economic Survey* of the Euro Area. The paper has benefited from suggestions from Artur Radziwill, Paul van den Noord and Piritta Sorsa, as well as research assistance from Isabelle Duong. Special thanks to Didi Claassen and Olivier Besson for editorial assistance.

The views expressed and any errors and omissions are, however, the responsibility of the author.

Figure 1

Government Budget Balances Have Deteriorated
(percent of GDP)



(1) OECD estimates. For Ireland, the balance shown in the figure excludes the capital injections into the banking system.
Source: OECD, OECD Economic Outlook 88 Database.

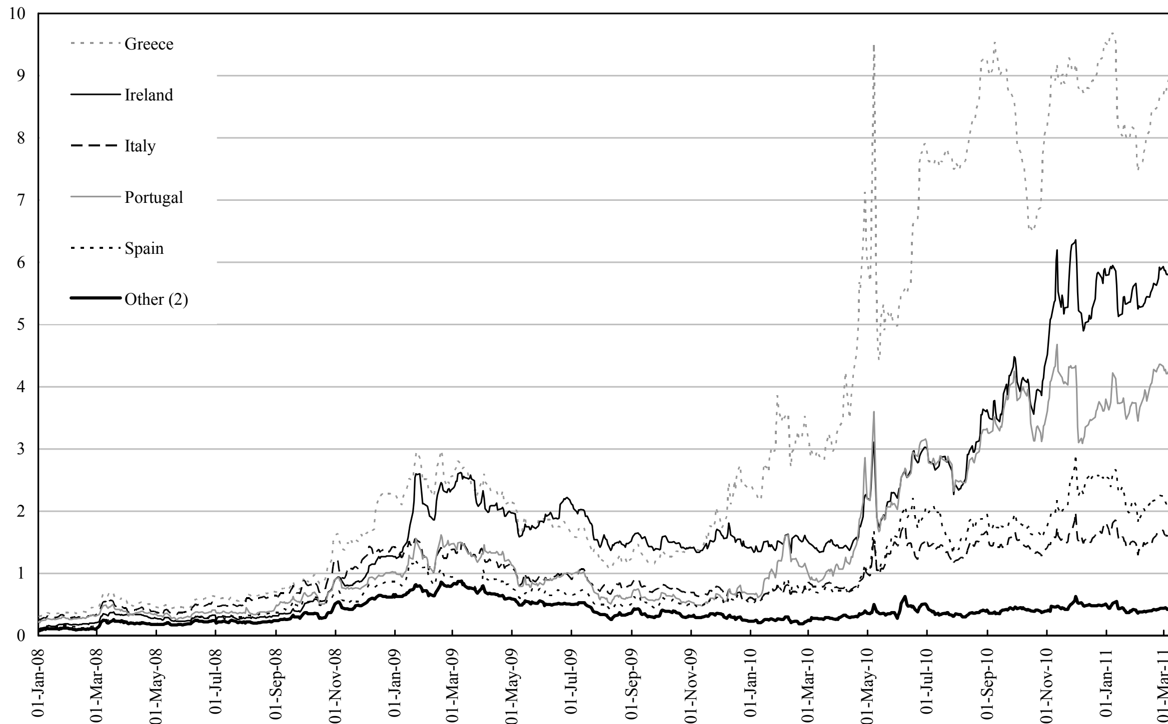
2.1 *The public finances have deteriorated sharply*

The budgetary position of euro area countries deteriorated rapidly following the crisis and current policy settings are unsustainable in many countries. The fiscal position in the euro area has deteriorated sharply since 2008: the budget deficit increased from 0.7 per cent of GDP in 2008 to 6.4 per cent in 2010, while the debt-to-GDP ratio measured on the Maastricht basis increased by over 10 percentage points to reach 81 per cent. This is broadly in line with the deterioration in the United States and for the OECD as a whole. The annual increase in the budget deficit as a share of GDP is very large by historical standards and substantially exceeds the increases in previous downturns in 1975, 1981, 1995 and 2001. This reflects the effects of the economic and financial crisis: revenues have dropped and spending has increased as the result of the normal automatic stabilisers. Tax receipts related to booming financial and property markets evaporated. Both the fiscal outcomes and the underlying drivers vary enormously across countries. In some countries, such as Germany, sizeable discretionary fiscal packages also explain a substantial part of the weakening of the public finances. Government borrowing further increased in some countries as the result of support to the financial system, some of which was in addition provided off-balance sheet. The scale of the weakening in public finances has been particularly marked in countries that are having to unwind excessive private or public sector borrowing: the general government balance between 2007 and 2010 weakened by around 12 per cent of GDP in Ireland, even allowing for major emergency fiscal tightening and excluding major costs related to bank recapitalisations, and

Figure 2

Credit Spreads[1] Have Widened

(percent)



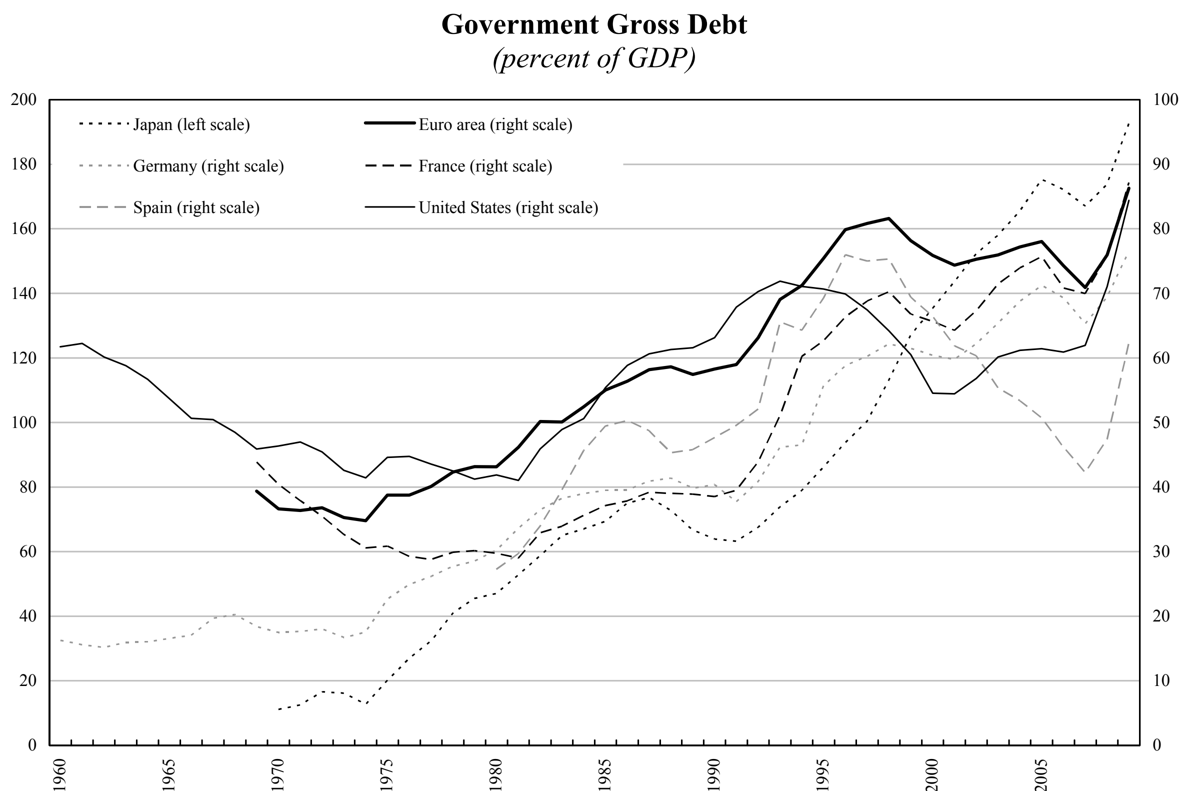
(1) Benchmark bond 10-year over German bond yields.
(2) Unweighted average of the spreads for Austria, Belgium, Finland, France and the Netherlands.
Source: Datastream.

more than 10 per cent of GDP in Spain (Figure 1). The sharp contraction of private demand, as private-sector economic imbalances adjusted, led to powerful effects from the automatic stabilisers and a marked drop in housing boom-related revenues. Excessive risk-taking by the financial sector in these countries with large imbalances added very substantially to fiscal costs.

Several euro area countries have experienced crises around sovereign debt as markets have sharply increased interest rates on their debt, leading Greece and Ireland to seek external official financing. Thecredit spread on government borrowing for many euro area countries began to widen in late 2008 and in the early part of 2009. From a situation where spreads against German debt were very narrow (Figure 2), the initial increase appeared to be largely explained by higher risk aversion with some greater differentiation according to national fiscal conditions (Haugh *et al.*, 2009). While flight-to-quality effects may have lowered yields on German debt somewhat, the main underlying driver was a reassessment of risk by markets. As financial conditions in general improved during the course of 2009, euro area sovereign spreads generally narrowed. However, spreads in a number of countries rose again during 2010 at the time of the fiscal crisis in Greece. Spreads remained high even after May 2010, when the support package for Greece was put in place, the European Financial Stability Facility (EFSF) was created and the European Central Bank (ECB) began to purchase government bonds in the secondary market through the Securities Market Programme. Despite some initial narrowing, spreads have remained at a high level and come under

Figure 3

Government Gross Debt
(percent of GDP)



Source: OECD, OECD Economic Outlook Database.

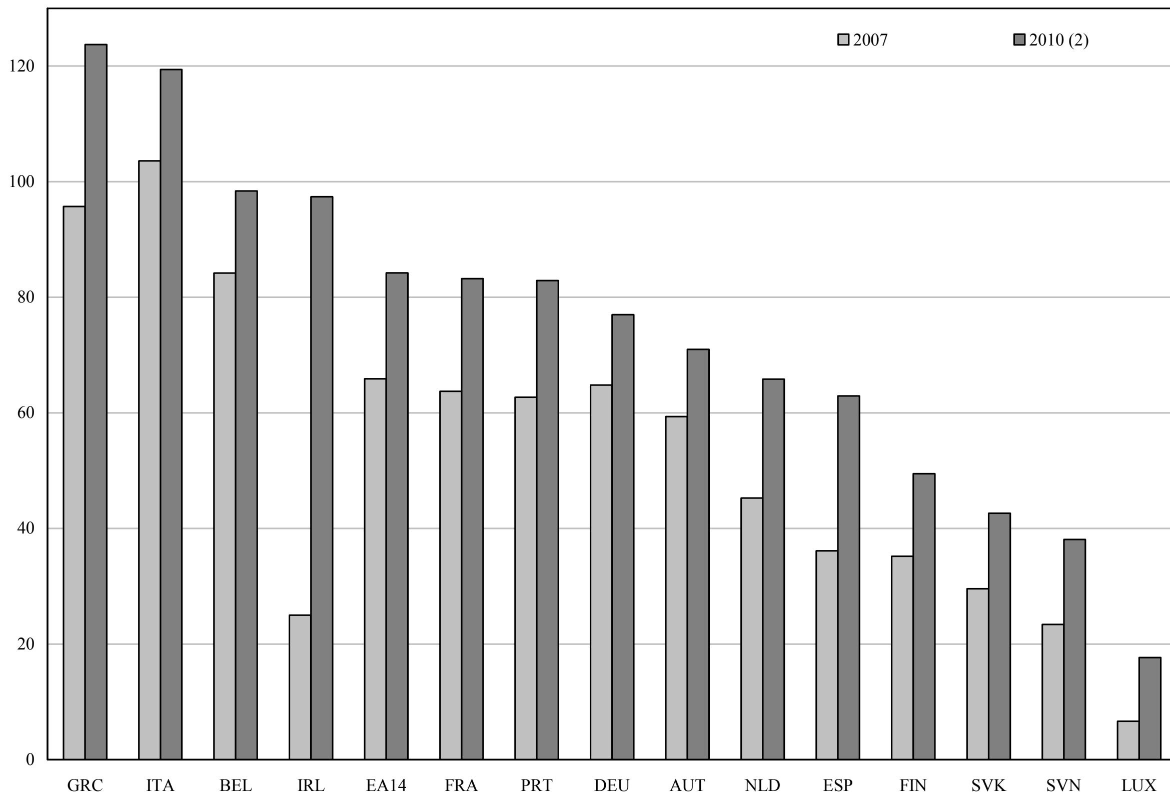
strong pressure at times. In November 2010, Ireland requested IMF and EFSF support and a package was put in place. Spreads on Portuguese and Spanish debt remain high. Although only in Greece, Ireland, Portugal and Spain are long-term borrowing costs similar to or higher than prior to the crisis, the current level of yields may give a misleading impression of future borrowing costs if there is a cyclical recovery in bond yields and credit spreads remain at their current levels.

2.2 Government debt has been trending up

Debt-to-GDP ratios have been trending upwards in many OECD countries, including many in the euro area, since the 1970s (Figure 3). The debt-to-GDP ratio for euro area countries in 2009 is just over double its level in 1979. While the ratio typically stabilises or even falls during an upswing, this has been insufficient to restore the initial position and so debt levels after each recession have been progressively higher. Current levels of debt are elevated by post-1945 standards. While current real interest rates are relatively low in this comparison, growth prospects are also notably weaker. Prospective indebtedness in the euro area, however, is much lower than in Japan and somewhat lower than in the United States in both gross and net terms. Per capita gross debt in the euro area in dollar terms is around half the level in the United States and a quarter of what it is in Japan, although per capita incomes are also lower in the euro area and the circumstances of each major economy are different. The debt-to-GDP ratios in Belgium, Greece and Italy stand at a particularly high level by international comparison, while debt will remain fairly low in Finland, Luxembourg, Slovakia and Slovenia (Figure 4).

Figure 4

The Debt-to-GDP Ratio Has Increased[1]
(percent of GDP)



(1) Maastricht definition.
(2) OECD estimates.
Source: OECD, OECD Economic Outlook 88 Database.

While many euro area countries have experienced a tendency to rising indebtedness over past decades, there have been some exceptions. Belgium, Finland and the Netherlands managed to reduce their debt-to-GDP ratios quite substantially since 1995 with only a relatively modest deterioration during the crisis. Ireland and Spain also reduced their debts over this period, although this was facilitated by high growth and ultimately much of the improvement was based on unsustainably strong revenues and excessive imbalances that have led to a sharp deterioration in their debt positions during the crisis. In general, such reduction in the debt-to-GDP ratio that occurred during the upswing was the result of nominal growth exceeding interest rates rather than through running primary surpluses.

Although it is difficult to assess what level of debt is optimal or prudent, there are reasons to think that the current level may be too high. Debt has been allowed to reach an undesirable level. Indeed, the increase in debt to these levels has not arisen out of a considered policy choice but largely through the process of minimal fiscal tightening in downturns and excessive budget deficits in goods times is the consequence of deficit bias in fiscal policy, which has its origins in political economy considerations related to deficit-augmenting decisions by incumbent policy-makers seeking to gain reelection and electoral uncertainty that encourages policy-makers to behave in a myopic way (Persson and Svensson, 1989; Alesina and Tabellini, 1990).

Higher debt levels increase the burden on future generations and fiscal risks in a number of ways. Firstly, they increase risks around access to market finance because the sustainability of debt becomes increasingly sensitive to sharp deteriorations in the budget balance, costs associated with calamities such as the financial crisis or large changes in interest rates or growth prospects. Also, sustainability is more difficult at higher levels of debt. Secondly, weak growth prospects in the euro area mean that debts today will continue to be a large burden relative to the size of the economy in the future. While using debt to finance productive investments should pay for itself in terms of higher growth, government investment as a share of GDP is lower in most euro area countries than the OECD average, although forms of other forms of social spending such as education and healthcare may also yield future as well as current gains. Thirdly, higher debt also requires higher interest payments that must be financed primarily through taxation. Although debt held within the country has a largely redistributive effect from tax payers to bond holders, although even for a debt-to-GDP ratio of 100 per cent of GDP, interest payments would probably only amount to 5 per cent of GDP so the distortion would not necessarily be large.[1] Fourthly, high debt may be incompatible with intergenerational equity as it shifts debts to future generations. This is a complex ethical and practical question, as future generations will inherit both some of the wealth and the liabilities accumulated by current generations. However, it is questionable how far future generations should be held responsible for decisions they did not take and the possibility of imposing costs on future generations creates poor incentives for current taxpayers, not least in the light of ageing costs and other contingent liabilities.

It is difficult to assess in quantitative terms what level of debt is appropriate, not least as this will depends on social preferences and the economic situation of a country, notably its growth prospects. Furthermore, by historical standards, current debt-to-GDP ratios are not especially high when compared with the pre-1945 period: ratios were often well above 100 per cent of GDP in this era, although it was a period characterised by a number of defaults (Reinhart and Rogoff, 2010a). Econometric research indicates that the wider effects of debt are non-linear and begin to have a significant effect above a threshold (Reinhart and Rogoff, 2010a). This would appear to be around 75 to 90 per cent of GDP, beyond which the effect of debt levels on GDP becomes substantially larger (Égert, 2010). Reinhart and Rogoff (2010b) find evidence that growth rates fall by around 1 per cent when the public debt-to-GDP ratio exceeds 90 per cent.[2] However, past relationships should be interpreted with caution and the limited experience of current levels of indebtedness in developed countries makes it difficult to draw inferences. Furthermore, in recent years, real interest rates have been lower than in the past, which may make it easier to support high levels of debt if these low financing costs were to be sustained.[3] Despite the difficulties of establishing the appropriate debt level, a number of OECD countries have set targets or ceilings: in New Zealand, the government fiscal target is net debt of 20 per cent of GDP, while the United Kingdom set a ceiling of net public debt at 40 per cent of GDP prior to the crisis. Poland has a constitutional limit of gross debt of 60 per cent of GDP with a target of 50 to 55 per cent. The euro area also has a ceiling set in the Stability and Growth Pact (SGP) for gross debt at 60 per cent of GDP with the expectation that debt will be reduced at a "satisfactory pace" to meet this objective.

One key problem in the euro area is that debt-to-GDP ratios have been allowed to rise at the same time as unfunded off-balance sheet pension liabilities. In almost all cases, these exceed explicit debt and explain a large share of the negative net worth of the general government sector

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1 For example, the semi-elasticity of the tax burden as a share of GDP implied by recent OECD research is only around –0.2 and this can be lowered if taxes are raised in the most efficient way (Arnold, 2008).

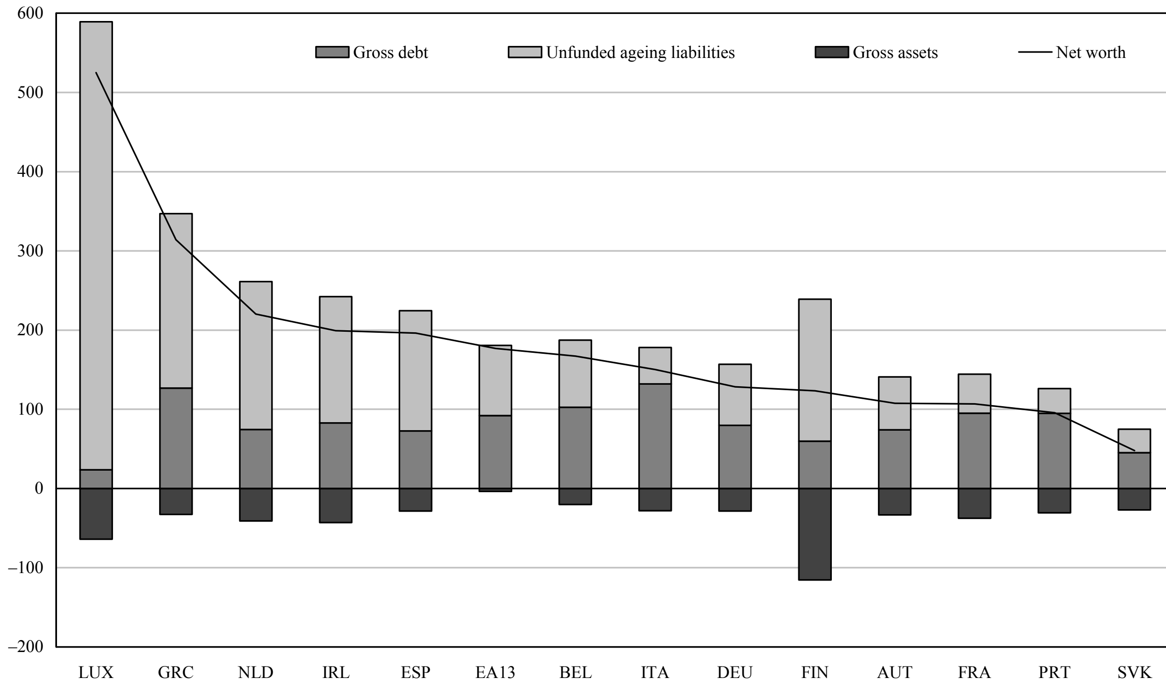
2 Caner *et al*. (2010) find a threshold around 80 per cent of GDP.

3 The impact of lower inflation expectations through nominal interest rates is more complex, depending on whether the inflation tax is more efficient than other taxes.

Figure 5

General Government Gross Debt and Unfunded Pension Liabilities[1]

(percent of GDP)



(1) Excludes the impact of some recent reforms, notably in Greece.
Source: OECD calculations, ECP Working Group on Ageing and Pensions and OECD Economic Outlook 88 Database.

(Figure 5).[4] In most cases, the present value of these costs exceeds 100 per cent of GDP and is very much larger for a few countries. Ageing-related costs are already rising in many countries and will pick up in many cases during the next decade. In the absence of reform, ageing-related expenditures in many euro area countries will rise substantially in the coming years and pension expenditures alone will generally be between 10 and 15 per cent of GDP for euro area countries in future decades (EC, 2010b). There has been considerable pension reform in euro area countries over the past decade (OECD, 2009b) and renewed efforts are underway in some countries. The scope to raise tax burdens to offset the costs of ageing is limited given the already high tax rates in most euro area countries. However, paying down government debt or pre-funding of pensions are strategies to help meet future pension liabilities and to avoid future generations subsidising current workers and pensioners. Some smoothing of pension costs may be particularly relevant in the context of the retirement "baby boom", which creates an inherent rise and fall in the pension costs even if there is no change in benefits across generations. The recent increase in the debt burden is therefore a huge setback in preparing for future demographic ageing, with the revenue-rich years of the boom having been largely wasted as an opportunity to prepare for the retirement of "baby boom" generations.

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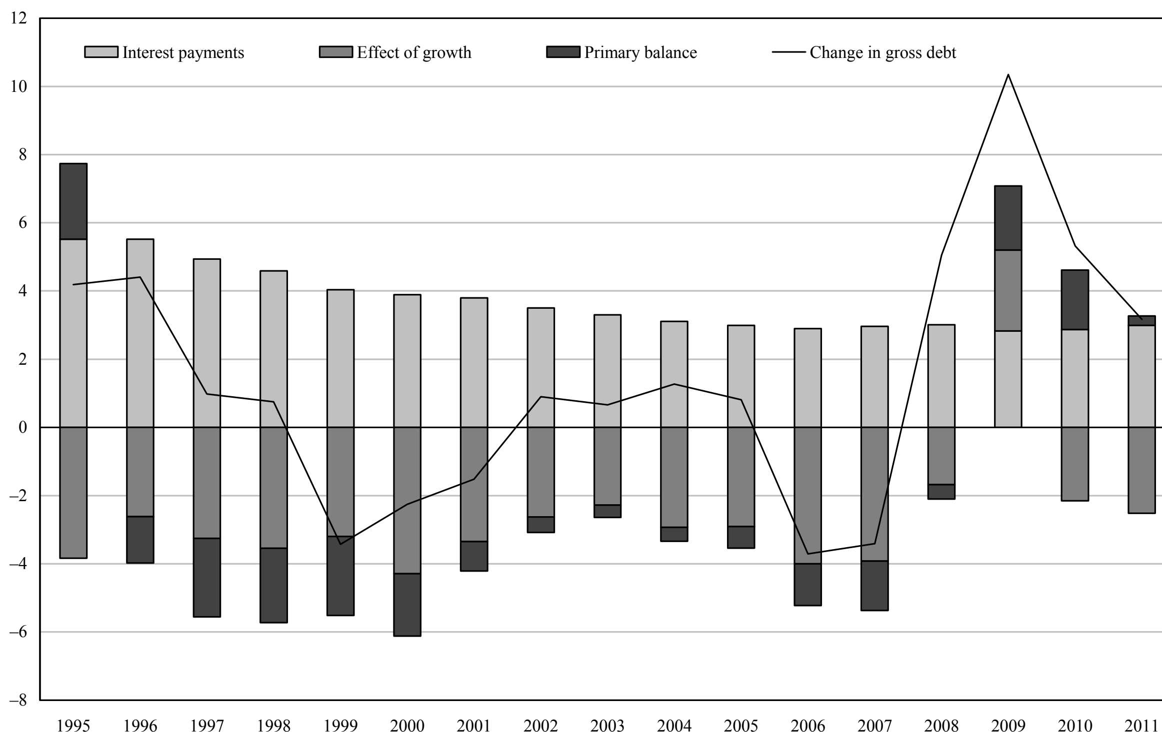
4 Calculations based on Abstracting from changes in tax revenues as a share of GDP related to ageing and assuming that non-ageing related expenditures remain constant as a proportion of national income, simple calculations suggest that the costs of increased ageing that would not be met out of current taxation are very large and generally of a similar order in present value terms to outstanding public debt. Results are similar to Velculescu (2010).

Figure 6

Contributions to Changes in the Euro Area Debt-to-GDP Ratio[1]
(percent of GDP)



(1) Excludes certain financial transactions.
Source: OECD, OECD Economic Outlook 88 Database.

2.3 *Fiscal stabilisation has been ineffective*

Weak fiscal policies have often led to ineffective economic stabilisation. During the upswing, there were only sizeable primary surpluses in the euro area as a whole during two years at the peak of the cycle and the relatively weak growth performance over the period did little to reduce the euro area debt-to-GDP ratio (Figure 6). The cyclically-adjusted euro area primary balance amounted to only about 3 per cent of annual GDP for the period of growth as a whole. In 2007, the last year entirely prior to the crisis, the majority of euro area countries were running fiscal deficits with the aggregate euro deficit at 0.65 per cent of GDP. Based on the OECD's current estimates of structural fiscal positions, only Finland, Luxembourg and Spain had underlying surpluses, with the euro area as a whole running an underlying deficit of 1.3 per cent of GDP. Furthermore, the strength of these underlying positions was overstated because of revenue buoyancy related to the credit and housing booms. This fits the long-run pattern of asymmetric fiscal policy with large deficits and accumulation of debt during recessions and little progress to reduce debt during boom years.

When the crisis came, high debt levels and weak fiscal policy settings meant that, discretionary fiscal stimulus was only around 1.5 per cent of GDP, despite the severity of the downturn, monetary transmission being impaired and the monetary policy rate being at a very low level (OECD, 2009c). Discretionary stimulus was unevenly distributed across countries because of

limited room for fiscal manoeuvre: half of the overall stimulus came from Germany with a further quarter from Spain. Stimulus measures in France and Italy were extremely modest. Greece, Ireland, Portugal and Spain actively tightened fiscal policy during intense periods of crisis due to market pressures despite particularly weak economies as the result of the unwinding of imbalances. This problem will only be greater at higher levels of debt as, based on past experience, there is evidence that fiscal policy has tended to become pro-cyclical at levels of debt higher than 90 per cent of GDP, while policy has been fairly neutral at above 30 per cent and counter-cyclical for lower debt levels (Égert, 2010). Furthermore, the high level of debt itself can reduce the effectiveness of fiscal policy by making households more worried about future fiscal adjustment and thereby reduce their current consumption in anticipation. Over a sample of OECD countries, the short-run private saving offset of fiscal stimulus is larger for countries with debt above 70 per cent (Roehn, 2010). Set against these effects, it could be argued that the scale of the endogenous deterioration in the public finances implies that automatic stabilisation was highly effective (Figure 6). For instance, in Ireland and Spain, the automatic stabilisers and fall in revenues imply that the government hugely contributed to offsetting the fall in private demand. However, it is doubtful that, for example, the reduction in housing transaction tax revenues had much of an effect on supporting private consumption in these cases.

Effective fiscal stabilisation through a stronger and more prudent underlying budgetary position is vitally important in a monetary union. Given the potentially destabilising role of real interest rates at the national level, sound fiscal policy to lean against the cycle could be a key instrument for avoiding excessive imbalances (OECD, 2010). In Greece and Portugal, high public debt has been a key component of a highly negative net foreign asset position. It is less clear that discretionary fiscal policy can be effective at national level, despite the area wide nominal exchange rate and monetary policy, because of the high degree of openness of many euro area economies and the normal difficulty in making discretionary fiscal policy timely, temporary and targeted. It was fortuitous that the slowdown in 2008 should have occurred in the autumn when many national budgets were being set. The effectiveness of systematic fiscal policy would be increased by more sustainable public finances overall, so that loosening would not be hindered by sustainability concerns, and by a clear fiscal framework against which discretionary and temporary decisions can be taken (Leeper, 2010).

Fiscal stabilisation inside a monetary union without fiscal transfers is likely to require capital markets to allocate funds to governments that need to borrow to support demand from countries that are over-heating or sectors that are saving. This is in contrast to the situation in other currency unions, such as the United States, where the federal government partly acts to ensure this distribution of resources. The sovereign debt crisis has underlined that such financing may not necessarily be available and that the ability to operate counter-cyclical fiscal policies may be compromised by a loss of confidence of liquidity shocks. Such problems may be particularly acute for small countries within a monetary union, whose bonds generally would be substitutable for the debt of other countries given the shared currency, and therefore can be very sensitive to news about the country.[5]

There are in principle a number of ways to avoid liquidity problems. In general, maintaining sound public finances and a strong institutional setting that leads to clear commitments about the sustainability of future finances should avoid losing market access. Furthermore, refinancing needs depend on both the overall level of debt and its maturity structure. Most euro area countries in 2008 had largely long-term debts, although debts that needed to be rolled over in the coming year

[5] In other respects, the relative illiquidity of the markets for some smaller euro area sovereigns can make it more difficult to raise finance and adds to uncertainty and risk.

amounted to around 20 per cent of GDP in Italy and Portugal (Eurostat, 2008).[6] When market conditions become unfavourable during a crisis, countries can draw down on reserves or liquidate assets. Indeed, they may build up "rainy day" funds in anticipation of such risks. In Ireland, heavy pre-funding of future financing needs in 2009 together with the National Pension Reserve Fund, with funds of around 15-20 per cent of GNP before the crisis (and even if not designed for this purpose), have provided some protection against the crisis and the need to borrow in the market. If liquidity shocks are not strongly positively correlated across countries, it is more efficient to have a system of insurance whereby countries with market access lend funds to those whose access is restricted. This should not in principle involve a fiscal transfer provided that the loans are provided at interest rates that reflect the riskiness of the fiscal position of the borrowing. The existence of such insurance may mean that it is never actually required. Prior to the fiscal crisis in Greece, there were limited mechanisms to provide support for a euro country facing liquidity crises other than the support available to members of the International Monetary Fund (IMF). A balance of payments support facility run by the European Union was too small to provide meaningful help for euro area countries, although it was expanded during the crisis to help Greece. The European Financial Stability Facility (EFSF) temporarily fills a gap in the institutional architecture by creating a liquidity facility for euro area countries, subject to the necessary strong conditionality. This basic architecture will be made permanent with the European Stability Mechanism (ESM).

3 Strengthening fiscal discipline

The setting of fiscal policy needs to be improved to avoid high levels of debt, manage long-term fiscal pressures and contribute more to the economic stability of national economies. These objectives are closely connected and avoiding high debt is central to meeting the other goals. The design of institutions needs to be coherent with the economic and political design of the European economic and monetary union. There is a common monetary policy but essentially no fiscal and political union (Issing, 2006). Countries in the monetary union therefore largely retain responsibility and the means to set their own national fiscal policy and stand behind their own debt. However, there is the possibility of spillovers between countries through the central bank, as well as through the high level of economic and financial integration that monetary union supports. Given the negligible role of fiscal transfers between countries and through the Union, the market plays the role of allocating capital across countries and providing finance to governments. In addition, the European Financial Stability Fund (EFSF) has been put in place on temporary basis to provide liquidity support to euro area governments facing difficult market conditions. This basic economic and political context defines the contours of a coherent set of fiscal institutions for the euro area based on market discipline, EU institutions and national budgetary frameworks. It implies a division of labour between then. These policies are complementary and, as none can be guaranteed to be effective, strengthening each pillar is the most robust strategy to improving fiscal performance. In addition, there are important interconnections: as long as this scope for contagion exists, it is difficult to develop time-consistent "no bail-out" policies. While "no bail out" issues are unresolved, market discipline cannot be effective.

3.1 Market discipline

Markets are relied up on to allocate finance to euro area governments and market discipline could help to achieve fiscal discipline by sanctioning risky policies through appropriate increases in

[6] By contrast, Greece was somewhat insulated by the very low share of short-term debt in the existing stock, although the combination of the large deficit and the refinancing need in 2010 became overwhelming.

borrowing costs. Admittedly, markets have a mixed record when it comes to assessing risks and under-estimated a wide range of risks during the credit boom. Euro area sovereign credit spreads prior to the financial crisis were negligible and broadly similar across countries: spreads over German government debt were at around 25 basis points for Greece, Italy and Portugal. Market prices proved a poor predictor of developments during the crisis, particularly for Ireland and Spain which had relatively low debt but fragile revenue bases. While the market reaction may subsequently have been excessive in some cases, market prices have differentiated between the riskiness of different countries. Greater transparency about fiscal positions, together with improved financial regulation, would help markets to assess risk more effectively.

The effectiveness of market discipline is undermined if there is a perception that debts will be repaid regardless of a country's fiscal situation through a bail-out. Article 125 of the Treaty, the so-called "no bail-out" clause, forbids countries from assuming each others' debts.[7] However, it does not prevent lending to a country to allow it to service or repay its existing debt. Prior to the crisis, there was room to doubt whether a euro area country could receive support from other countries given that no precise instrument existed to do so. However, the packages for Greece and Ireland in 2010 demonstrated that support could be made available for euro area countries and this type of support has been institutionalised on a temporary basis through the European Financial Stability Facility (EFSF) and in the future by the proposed European Stability Mechanism (ESM). While this could increase moral hazard by weakening the budget constraints, this risk can be mitigated or avoided by imposing strict conditionality. These conditions make it costly for countries to have recourse to this funding, while ensuring that measures to address the underlying problem are put in place. The tough conditionality imposed on Greece and Ireland, together with the participation of the IMF, is likely to discourage any country from seeing this as an easy option. However, it will be important for maintaining fiscal discipline in the future that countries in these programmes are actually held to their undertakings, even as the incentive to comply weakens as the underlying fiscal and financial sector problems ease.

Enforcing "no bail-out" conditions is difficult, as the experience of sub-federal governments in OECD countries shows (Box 1). In essence, this is because there is a time-consistency problem: *ex post* it may not be in the short-term interest of other countries not to help because of the possible spillovers through trade, the financial sector and contagion. In addition, if the underlying financing problem is related to liquidity, it is desirable for countries with liquidity to provide assistance to those whose access is impaired. For these reasons, a "no bail-out" clause is unlikely to be enforceable or even desirable in some case. However, in cases where these arguments do not apply (externalities are small, solvency risk is high), it is useful to have a mechanism that avoids bail-outs. One approach to committing credibly to not bailing out is to build a strong reputation. This has existed vis-à-vis the states of the United States for a long time. Depending on how the current crisis is resolved, the euro area may establish a similar precedent for applying strong conditionality.

Policies to limit spillovers would help to increase the credibility of the "no bail-out" commitment, where it is appropriate, by reducing the *ex post* incentives to bail out. This has two main aspects. *Firstly*, excessive risks exposures of euro area financial institutions and limited transparency about their holdings magnify the consequences of weaknesses in national fiscal positions (Blundell-Wignall and Slovík, 2010). In particular, it can be attractive to bail out a sovereign debt to avoid imposing losses on financial institutions unable to bear them and the wider

[7] The article states that "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project".

BOX 1
EXPERIENCE FROM SUB-FEDERAL FISCAL CRISES IN OECD COUNTRIES

The experience of sub-federal governments within OECD countries provides some insights into fiscal policy inside the monetary union as such governments do not issue their own currency. Over past decades, there have been a number of sub-national fiscal crises in OECD countries, including in the Italian regions in 1978, in Germany with Saarland and Bremen from the late 1980s, in Australia and Canada in the early 1990s and the bail-out of Mexican local governments in 1995. Episodes where there has been strong fiscal pressure at state-level are more widespread. The United States has a long history of sub-national default with a number of states declaring bankruptcy in the 1830s and 1870s, and a number of municipal defaults in the 1930s (Inman, 2001). A small number of municipalities have faced severe stress since the 1970s and other public entities have defaulted on occasion. Some US states are now experiencing difficult budgetary situations, however, explicit federal bail-out appears highly unlikely.

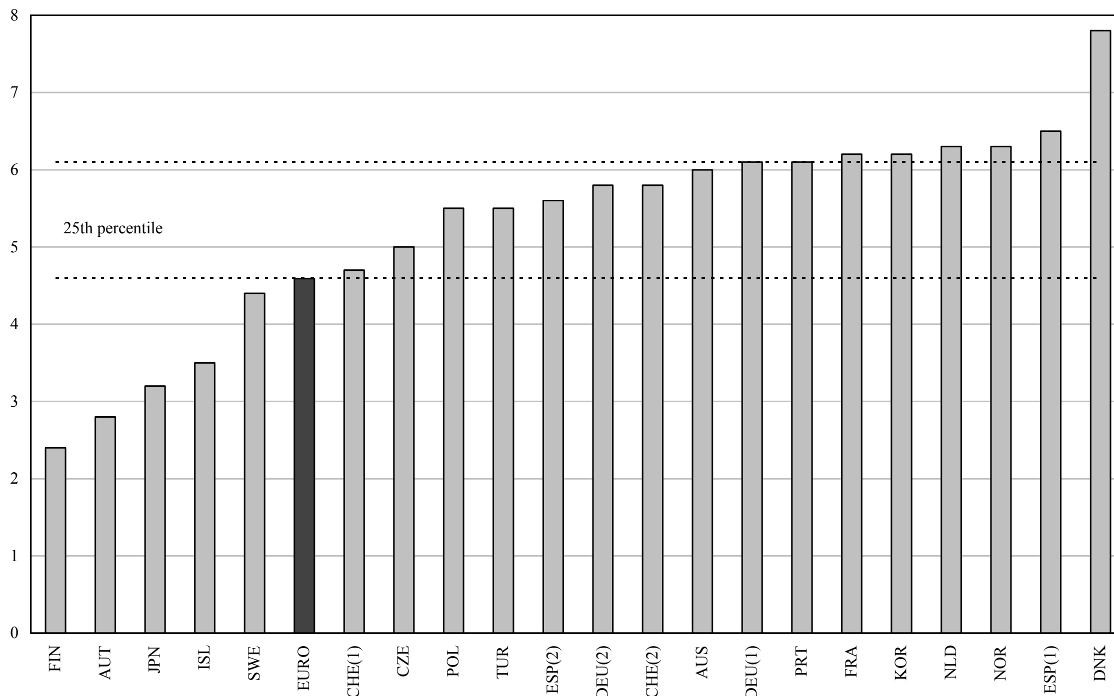
Two sets of factors contribute to state-level fiscal pressures. Firstly, unbalanced assignments of revenue and spending powers often create tensions with excessive demands for spending or too little scope to raise revenue. Secondly, soft budget constraints can encourage states to borrow excessively in the hope of a transfer from the central government. Given that tax and expenditure powers are almost entirely in the hands of nation states, assignments in the euro area are balanced but the tightness of the budget constraint has been more ambiguous. National responsibility for banking supervision adds an additional fiscal risk for euro area countries compared with many other OECD sub-national governments, although the Swiss cantonal banks have posed fiscal problems.

For sub-national level governments that have the power to borrow, there are two basic approaches to achieving fiscal discipline. Firstly, there are institutional measures. Most have balanced budget rules and face legal restrictions on their ability to borrow (Sutherland *et al.*, 2005). Thirty-two US states have balanced budget provisions in their constitutions and a further 11 have similar statutory requirements. Six out of eleven Canadian provinces have anti-deficit laws. Secondly, it is rare for sub-national borrowing to be explicitly guaranteed and this should, in principle, create market discipline. However, there is often a perception that such debt is implicitly backed by the national government and this weakens the disciplining force of the market. Applying the same methodology as Sutherland *et al.* (2005) to the euro area, the strictness of fiscal rules in the euro area appears weak compared with sub-national governments (Figure 7). While monitoring is much more comprehensive than for most sub-national bodies, the binding rules to enforce fiscal commitments appear weak.

A number of crises have resulted in the provision of bail-outs to sub-national governments. A very small number of constitutions make explicit provision for this type of support, usually in very narrowly defined circumstances, such as natural disasters. In Germany, states may apply for federal assistance. Bail-outs may also be channelled through implicit channels such as fiscal equalisation mechanisms. There are also numerous examples of *ad hoc* support being provided, realising implicit guarantees. In the euro area, the so-called "no bail-out" clause in the Treaty has prevented states from assuming each other's debts but not euro area states from providing finance to Greece and other EU countries.

Figure 7

Composite Indicator of Strictness of Fiscal Rules
(sub-index score)



(1) State government.
(2) Local government.
Source: Sutherland *et al.*, (2005), "Fiscal Rules for Sub-central Governments: Design and Impact", OECD Economics Department Working Papers, No. 465, OECD, Paris, and OECD calculations for the euro area.

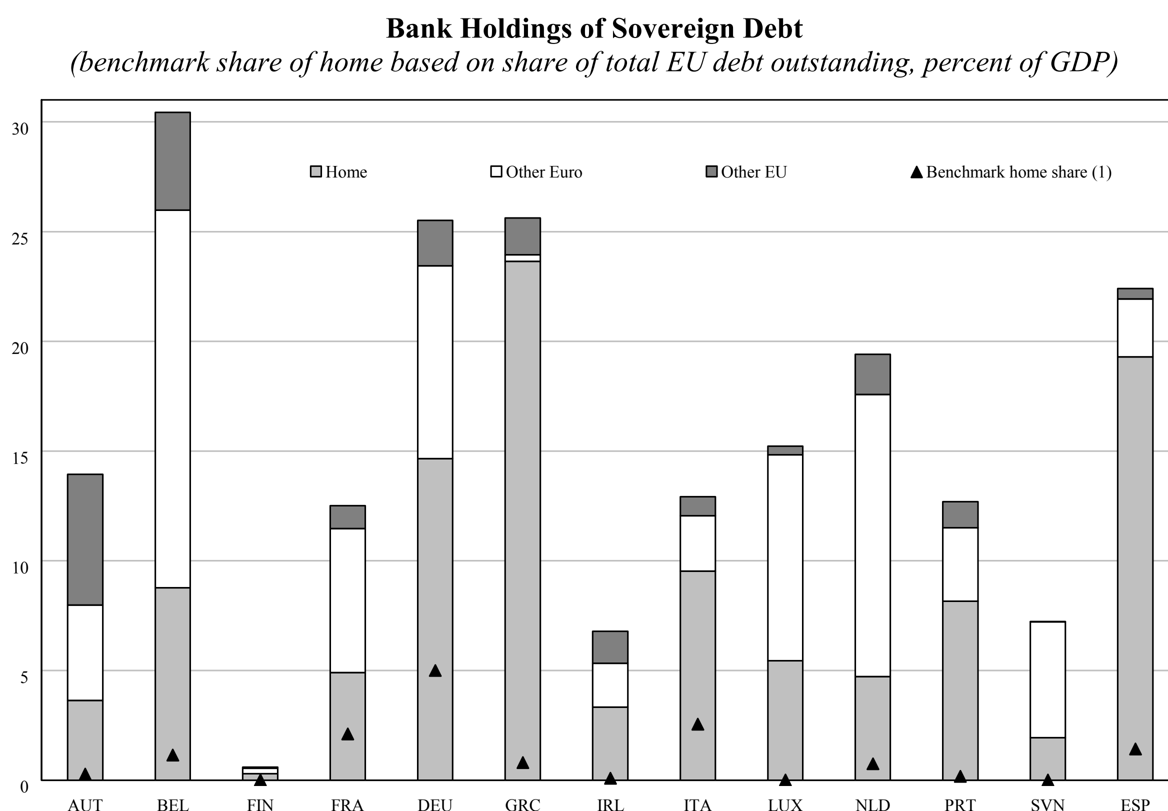
The experience of sub-national governments in OECD countries suggests that it is generally difficult to enforce "no bail-out" conditions because of the time-inconsistency problem. When a state is in trouble, the central government will have an incentive to act if failure would lead to: macroeconomic spillovers; losses on loans from the central government or other states; financial instability due to banks' exposure; pressure on the central bank to provide loans; a contagion effect to the cost of borrowing in other states or for the country as a whole. The United States has built up a strong reputation with no explicit state bail-out since the 1870s. Most recently, the federal government signalled little willingness to help California during the crisis. At municipal level, support was provided to New York in 1975 but this was "within the tradition of very limited local bail-outs" (Inman, 2001) and Philadelphia did not seek federal help during its crisis in 1990.

Fiscal crises often lead to reform of the finances of sub-national governments. These may be "top down" reforms, as in Australia in the 1990s, that strengthen the control of the federal government over the sub-federal governments in return for funds to resolve the immediate financial problems of states. By contrast, reform in the 1990s in Canada was essentially "bottom up" with the provinces applying stricter rules on themselves. It remains to be seen how far the fiscal crisis in the euro area will lead to reforms. Reform processes for sub-national governments have not always been successful. For example, after the bail-out of the Mexican states, many of the original problems quickly reemerged.

Figure 8

Bank Holdings of Sovereign Debt

(benchmark share of home based on share of total EU debt outstanding, percent of GDP)



(1) The benchmark home share is the share of the home country's sovereign debt in total euro area government debt outstanding.
Source: EU Stress Tests (2010), OECD calculations and OECD Economic Outlook 88 Database.

financial stability repercussions this can have. If banks holdings of sovereign debt were appropriate and well-diversified, there would be no problem. However, at institution level, a number of banks have had sovereign exposures that market prices imply are a serious risk to their capital base (Blundell-Wignall and Slovík, 2010). In addition, there is a marked home bias in many countries in sovereign debt holdings, which implies a close relationship between the national government and its banking system (Figure 8). This ties the stability of the national financial system to the credit of the government.[8] The reasons for the home bias are unclear, although it is also a feature of other asset markets. There are, however, a number of distortions in the treatment of government debt in financial regulations that need to be resolved:

- The overall treatment of government debt in financial regulations has been relatively favourable in a number of respects. The zero risk-weighting of government debt under Basel II capital requirements created an incentive towards holding debt and skewed this towards holding relatively risky bonds. For example, the 2010 Stress Tests revealed that French banks held more Greek and Spanish government debt than German. Furthermore, most government debt is held on the banking book, where it is not held on a mark-to-market basis. More generally, risk concentrations continue to be given a low priority in the international regulatory framework and are a "pillar 2" matter for supervisory authorities under the Basel framework.

[8] As the case of Ireland shows, this also presents large risks when the financial sector itself becomes a major driver of fiscal weaknesses and the ability of the government to stand behind its financial system is limited.

- The ECB's collateral policy has arguably been distorted in favour of government debt, particularly that which carried higher risks (Buiter and Siebert, 2005). While valuation margins are based on market prices, these in turn reflect the treatment of government debt, which is subject to its own, less stringent, schedule of haircuts (Category I) and where the penalisation of debt maturities according to these schedules favours the use of short-term collateral, a horizon over which some of the fiscal risks should be less apparent. More recently, the application of the minimum credit rating threshold for euro area sovereigns was suspended from 3 May 2010.[9]

A key aspect of improving market discipline, both in terms of encouraging financial institutions to assess sovereign risk properly and in making "no bail out" credible is to remove these distortions. Sovereign risk should be treated more symmetrically with other assets in financial oversight and excessive risk concentrations, particularly in the bonds of the home government, should be avoided (OECD, 2010). In addition, ECB collateral policy should be based on the notion that risks on euro area sovereign debt may differ and should be treated relatively similarly to other assets. This would imply increasing valuation margins for countries with weak fiscal positions, which could have the additional advantage of being based on objective criteria rather than then the judgements of the Council as is the case for penalties under the SGP. To ensure that banks diversify, one idea would be for the ECB to require the collateral banks submit to be diversified according to some minimal standard. These measures would not only improve market discipline and fiscal performance, but also contribute to financial stability. Conversely, strengthening financial crisis management, including by putting in place credible bank resolution legislation in all EU countries, could enhance the ability to apply a "no bail-out" approach (OECD, 2010). Furthermore, even if these mechanisms fail to prevent poor fiscal behaviour and countries get into difficulty, reducing the externalities between countries should avoid substantial costs to other euro area countries. While such a fiscal outcome would be regrettable, it would ultimately be the responsibility of that country and it would face the consequences.

Secondly, an effective system of crisis management is also required to make "no bail-out" conditions more credible. In particular, there must be a credible option to withdraw support if conditionality is not met. In the absence of such a mechanism, a high level of uncertainty is likely about what would happen if a country were no longer able to fulfil its financial obligations and the possible spillovers that could result may force countries to bail-out a country which has run a lax fiscal policy. The creation of a permanent liquidity-support mechanism subject to appropriate conditionality, along the lines of the proposed European Stability Mechanism (ESM) would be helpful in this regard as it provides a procedure to help countries with liquidity problems in a defined way. Furthermore, if conditionality is not met or a country is judged based on an objective analysis to be effectively insolvent, support would not be available under this mechanism and principles for a voluntary restructuring would be in place. The greater clarity provided by the ESM about its creditor status, which would be senior to other debt except for the IMF, helps to make the resolution mechanism credible. Additional legal certainty would be provided by a clarification of the ECB's status as a creditor if it were required to take losses in the event that a counterparty failed, leaving the ECB with collateral that was worth less than the valuation margin allowed for, as well as for losses on assets held under the Securities Market Programme. Given that there is a transfer of risk between sovereigns over the ECB's balance sheet and risks of adverse selection, there is a case for the ECB making public in a timely way the composition of its collateral in this respect. The proposed inclusion of collective action clauses (CACs) may facilitate this process, although arguably it would make little difference provided that debt continues to be issued under national law and CACs may be difficult to implement in practice or unnecessary (Buchheit and Mita Gulati, 2010). The wide range of different conditions attached to bonds in each country makes

[9] ECB, Press Release, "ECB announces change in eligibility of debt instruments issued or guaranteed by the Greek government", 3 May 2010.

it difficult for investors to assess the position in different countries, which is encouraged by the exemption of sovereign debt from EU securities legislation. There is a case for greater standardisation of new issuance around commonly agreed best practice.

The approach to reinforcing market discipline set out above would essentially align the de jure responsibility of each country for its government's debt with a set of more credible institutions that would de facto reduce the likelihood of external support in the case of solvency difficulties by reducing to other countries. This stands in contrast to proposals to issue a common "euro bond" (Delpa and Weizsäcker, 2010), which would tend to tie the liabilities of euro area countries closer together. While such proposals include ceilings on the amount of borrowing and institutional mechanisms that aim to impose conditions on accessing the "euro bond", with the gains of greater liquidity offering a quid pro quo for tighter policies, the success of such a system would nevertheless continue to rely on the ability of the institutional framework to overcome the inherent time consistency issues. These problems are avoided by the approach that seeks to limit this problem directly.

3.2 EU institutions

The EU fiscal framework, which is laid out in the Treaty, is necessary to reduce the risk of economic and financial spillovers arising from national fiscal policies. In normal times, the fiscal stance in each country has effects on aggregate demand and the cost of capital in the euro area as a whole, which may not be fully internalised by individual euro countries. Unsustainable fiscal policies can lead to financial spillovers through the banking system and financial markets to other countries, as has been seen in the euro area debt crisis. In addition, the risk of default creates costs for other euro area sovereigns in terms of their own funding costs, support for their financial system and exposure through the ECB. To the extent that the time consistency problem of "no bail-out" commitments cannot be fully resolved and that market discipline is not wholly effective, EU institutions should provide a safeguard against running lax fiscal policies to protect other euro countries and allow the European Central Bank to fulfil its mandate effectively. In addition, the creation of a European liquidity support mechanism creates the need to offset any increase in moral hazard that may arise as a result and to impose conditionality. EU institutions can in principle also serve as a mechanism to overcome weaknesses in national fiscal institutions, particularly in making binding commitments, but achieving this is fraught with difficulties.

The Stability and Growth Pact (SGP) provides the basic framework for fiscal policy in the European Union, including for the euro area. The SGP has a "corrective arm", set out by the Excessive Deficit Procedure (EDP), and a "preventive" arm that aims to support this objective more generally. Following the economic crisis, almost all euro area countries are subject to the EDP because their deficits are larger than the 3 per cent of GDP reference point set out in the Protocol on the Excessive Deficit Procedure. A major package of legislative proposals is now under discussion with the aim of strengthening the EU fiscal framework (EC, 2010c; EC, 2010d; EC, 2010e) and these issues have been examined by an EU Taskforce on economic governance (EU Taskforce, 2010). It is intended that this package of reforms will have been agreed by the summer of 2011, although the "European Semester" is being applied from 2011.

3.2.1 Institutional design

A difficulty with the implementation of the SGP has been that the "corrective arm" is most likely to bind during downturns because it is triggered by the actual budget balance. It is therefore unlikely to provide effective guidance about prudent fiscal policy during upswings. This may have contributed to the tendency to do too little to strengthen the public finances during good times. By

late 2008, no euro area member was subject to the EDP. Italy and Portugal had been subject to the EDP from 2005 to 2008, while France, Germany and Greece had been in EDPs for a number of years up to 2007. In 2007, France, Greece, Italy, Portugal and Slovakia had deficits at or greater than 1.5 per cent of GDP. While the severity of the crisis has been exceptional, many countries had too little room to cope with negative shocks and even a downturn of a normal business cycle magnitude would have resulted in many countries having excessive deficits. In principle, a binding constraint at 3 per cent of GDP could have encouraged countries to run sufficiently small deficits to make the probability of hitting the constraint low. However, it appears that the constraint has not been viewed as sufficiently binding for policy to set on such a prudent basis.

Following the revision of the Pact in 2005, the "preventive arm" of the SGP was developed to improve underlying budgetary positions. This was intended to make breaches of the 3 per cent deficit reference value less likely and to provide a better path for budgetary positions looking further ahead. A medium-term objective (MTO) for the structural fiscal balance was set for each country. MTOs targeted either a surplus, balance or a deficit no larger than 1 per cent of GDP. The methodology for determining the MTOs has been recently revised to incorporate a measure of implicit liabilities relating to ageing, while retaining a structural deficit cap of 1 per cent. The methodology has not been published, undermining its credibility and fiscal transparency. For those countries which have not reached their MTO, there is an expectation that the structural fiscal balance should be improved by at least 0.5 percentage points each year until the objective is reached, with some leeway in bad times and an expectation that faster progress would be made in good times. As this leeway has not been defined in quantitative terms, it has been difficult to apply.

The "preventive arm" has had a number of weaknesses. Firstly, half of euro area countries had not met their MTOs by 2007 and progress towards them was uneven. Many countries did not reach their MTOs and some of those that did were helped by exceptional and unsustainable growth and financial cycles (OECD, 2009a). The convergence process has been hampered primarily by the lack of political will, but also by the absence of an operational definition of "good times" in which progress towards MTOs should exceed 0.5 per cent of GDP. Secondly, the structural budget balance measure used to assess the MTO gave a highly misleading picture of the underlying fiscal position. The problems were twofold: the output gap was inaccurately assessed and highly buoyant government revenues tended to improve the estimated structural position of the economy without any real strengthening of fiscal policy settings. These effects were amplified by the credit cycle and economic imbalances, which led to strong demand in some countries but a low measured output gap. These generated large and unsustainable revenues from financial and housing transactions. Thirdly, until recently, countries were able to set their own MTOs within limits and there was no systematic link to their fiscal needs (OECD, 2009a). This practice has now been superseded, but the range of MTOs across countries remains relatively narrow compared with differences in long-run fiscal pressures. Fourthly, the MTOs do not appear to have achieved a high level of recognition or acceptance as a framework for budgetary decisions. Even within the EU budgetary framework, Stability Programmes have generally not included a clear path of measures towards meeting the MTOs and mention of them has been scant in some editions of Commission's main annual fiscal assessment, Public Finances in EMU. The medium-term objectives would be more effective if measures of underlying fiscal positions were improved, in particular to take into account economic and financial imbalances, and if countries were required to specify in greater detail how progress towards them will be achieved over the coming years.

Current legislative proposals set out a new additional principle of "prudent fiscal policy-making" (EC, 2010c). This is basically defined as ensuring that the annual expenditure growth does not exceed a "prudent" estimate of medium-term growth, unless explicitly covered by offsetting tax measures or the MTOs is already "significantly overachieved". Where it is a binding constraint, it implies that policy would be counter-cyclical through the automatic stabilisers with

expenditures growing at a steady pace and revenues following the cycle. As a result, the actual budget balance would be stronger in good times than in downturns. Given that the underlying basis of the new principle is a concept of structural growth, it provides some guidance about how MTOs should be achieved. It also shifts emphasis towards expenditure growth. However, the new principle still requires an assessment of structural growth, which is inherently difficult, although it does avoid relying on estimates of structural elasticities of government revenues to growth (which are especially problematic to estimate in an accurate way because of structural breaks and non-linearities).In terms of enforcement, expenditure growth is more directly under the control of the authorities than tax revenues so compliance with this principle will be more observable than for MTOs. But, there is a risk that the focus on expenditure creates an incentive to reduce taxes as a substitute for higher spending, particularly in the form of tax expenditures.

The impact of the Stability and Growth Pact on national budgetary decisions has been also been held back by the lack of integration of the EU level and national budgetary procedures. While this may largely reflect a lack of political will at national level to comply with EU requirement, it may also have reflected detailed aspects of the procedures. In particular, national budgets in most euro area countries are legislated at the end of the calendar year with the underlying forecast assumptions set in the autumn. This information was then submitted into Stability Programmes, prepared in the early part of the following year and assessed by the Commission and the ECOFIN Council in the spring. This *ex post* assessment was unlikely to have an *ex ante* effect on policy, not least because the main decisions about fiscal policy for the current year were already taken by the time the EU review was completed but also that circumstances could change significantly between then and the following budget. The creation of the European Semester from 2011, which modifies the timing and procedures for EU budgetary and economic surveillance, will help to address this problem with final recommendations on fiscal policy being made by the EU in July. This will more or less coincide with the beginning of the budget cycle in many countries and thus should increase national "ownership" of EU fiscal goals and analysis.[10] In addition, greater emphasis on multi-year planning, as described below, would also help to align the long-term objectives of the Stability Programmes with a national debate and commitment over the same horizon. However, the effectiveness of this approach will still continue to depend largely on political will both at the EU and national levels.

3.2.2 *Enforcement*

The effectiveness of the SGP framework has been impaired by the lack of effective enforcement. Under the "corrective arm" of the Pact, enforcement should in principle be relatively simple given that the reference value of a budget deficit of 3 per cent of GDP should be observable. A key problem, however, has been that the only penalties available have been *ex post* fines: these lack credibility because they would only apply to countries already facing budgetary problems and enforcing the sanctions would add to those difficulties. In addition, procedural delays and difficulties in identifying compliance with undertakings to take corrective action have impeded the swift return to SGP norms. Legislative proposals from the Commission imply a slight increase in some delays, from four to six months, but would clarify the criteria for assessing compliance with recommendations by putting greater emphasis on variables that are under the direct control of the national authorities, particularly in terms of government spending (EC, 2010c). More importantly, it is proposed that a sum equivalent to the fine under the EDP of 0.2 per cent of GDP should be deposited in a non-interest bearing account as soon as an EDP begins, which could be returned to countries if corrective action is undertaken. This combines a small sanction, the foregone interest, combined with an upfront fiscal cost, which may be more credible than threatening to levy a

[10] This was approved by ECOFIN on 7 September 2010.

similar fine when a country is deeper into budgetary problems. In addition, a range of sanctions and fines linked to the EU budget is envisaged when the new EU budget is negotiated.

The Treaty requires a Council decision at each step of the EDP from the finding that deficit is "excessive" to the imposition of penalties. These steps are not automatic and a fine has never been imposed. In 2003, the Council decided not to act despite a Commission recommendation to step up the EDP against France and Germany. This set a poor precedent. The European Court of Justice subsequently ruled that the Council can *de facto* put in abeyance the excessive deficit procedure, even against the recommendation of the Commission, although it cannot alone revise the EDP recommendations. Enforcement by the Council is therefore crucial, but it has not worked well either in ensuring compliance with the Pact or in terms of its deterrence effect.

There are limits within the existing Treaties to how far more binding rules can be applied, without a change in behaviour by the Council. However, legislative proposals from the European Commission and recommendations from the EU Taskforce set out a "reverse voting majority" mechanism within the existing Treaty that would consider a proposal on sanctions, either under the "corrective" or "preventive" arms of the SGP, to be adopted unless the Council rejects the proposal by an appropriate qualified majority within a given time delay (EC, 2010c; EU Taskforce, 2010). This could make it more likely that the Council backs the technical analysis of the Commission given that the required number of countries needed for the recommendation to pass would fall under this procedure. Nevertheless, this "quasi-automaticity" still relies on the willingness of members of the Council to enforce fiscal discipline on each other. There is a risk that the new procedures could change voting incentives in a perverse way: if countries are behaving strategically by not sanctioning others to set a precedent that reduces the risk of being sanctioned themselves, the reversed voting majorities may lead to a shift in behaviour whereby some countries act more leniently to offset the impact of the reform. Furthermore, while recent experience may underline to countries the risks created by the unsustainable budgetary positions of other euro area governments, the large number of countries that will be in EDPs in the coming years (especially if the debt criterion is operationalised) may build a constituency against stricter application of the fiscal rules.

The enforcement of the reference value of public debt in excess of 60 per cent of GDP has been even more limited than for the deficit rule. This partly reflects the overall focus of the Excessive Deficit Procedure, which as the name suggests is mostly concerned with the budget balance. Furthermore, few countries exceeded the reference value for debt in the years leading up to the crisis. The debt criterion can lead to enforcement action "unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace". This phrase leaves considerable room for interpretation. While it would be unreasonable to expect countries far above the reference level to reach it over a short period of time, progress in the past has been mixed during the past cycle. While Belgium managed to reduce its debt-to-GDP ratio by around 20 percentage points over a six-year period, indebtedness was roughly unchanged in Italy. The enforceability of the debt criterion would be greatly improved by setting a numerical standard for the required pace of reduction, although determining the exact appropriate minimum pace is difficult as it should take into account country-specific factors as well as the point of the cycle. Current legislative proposals suggest that debt reduction should be at an annual pace of closing one-twentieth of a three-year weighted average of the gap in the debt-to-GDP ratio over a three-year period (EC, 2010c). A standard argument based on tax smoothing is that the debt should largely be taken as given and gradually paid back over time at a smooth rate or simply rolled over (Lucas and Stokey, 1983). However, the deficit bias means that this approach would lead to ever higher debt. One-off taxes to repay debt, as opposed to reducing the deficit, could be less distorting particularly in their effects on capital accumulation, provided that their one-off nature is credible. In addition, asset sales could be an important solution to the current debt levels, although "one off" in its nature and requiring careful management. In political economy terms, larger adjustments can

also be more costly and so it is optimal to begin consolidation early rather than pushing larger efforts into the future even for relatively high discount rates (Cournède, 2007). High levels of debt can have a non-linear effect on financing costs, which supports front-loading debt reduction in this situation (Koutsogeorgopoulou and Turner, 2008). Much may depend on the past record of countries in reducing debt (Ostry *et al.*, 2010). Current legislative proposals set out an operational definition of the required reduction in the debt-to-GDP ratio under the SGP as a reduction of the distance with respect to 60 per cent over the previous three years at a rate of the order of one-twentieth per year (EC, 2010c). This implies a strong degree of front-loading in the early years for countries with high debt, while the averaging over three years allows some flexibility with respect to asset sales and limited room for manoeuvre during each time window.[11] By contrast, the implied pace of convergence for countries with indebtedness closer to 60 per cent of GDP is very slow.[12] It is important to note, however, that convergence to and adherence with the MTOs (which are specified in terms of the overall fiscal balance) are likely to impose a tighter fiscal position for most countries with debt in excess of 60 per cent of GDP than this formula for debt reduction, so that the debt criterion would only be the binding constraint for countries that are sufficiently far from their MTOs.

Enforcement of the "preventive arm" of the Pact has proved more difficult than for the "corrective" part and has been the main weakness of this mechanism. The key problem has been lack of sanctions to ensure that fiscal policy is set in the good times to avoid problems in economic downturns and remove the bias towards higher debt. Application of the framework relied solely on peer review to achieve the MTOs and appropriate convergence towards them. National authorities are required to submit annual Stability Programmes. The Commission and the Council have the power to monitor, examine and assess proposed national adjustment paths. This includes making recommendations on the necessary adjustment measures and, where divergence from the objective persists, to make public recommendations on prompt corrective measures. While weak fiscal policy settings were identified through this approach, too little was done to ensure that all countries achieved sustainable medium-term budgetary positions. Sanctions are inherently more difficult to apply in this case as they involve a greater element of judgment. Nevertheless, the introduction of *ex ante* sanctions into this arm of the Pact would be an important step forward. This would be reinforced by "quasi-automatic" decision-making, as well as clearer criteria for judging compliance with corrective action. Proposed legislation from the European Commission (EC, 2010c) sets out new sanctions to include:

- new procedural sanctions consisting of a warning from the Commission and ultimately from the Council. More frequent and intrusive surveillance by the Commission and the Council would be undertaken for countries with weak fiscal policy settings;
- a financial penalty of posting 0.2 per cent of GDP to an interest-bearing account for as long as the country is deemed to be in breach of its obligations (EC, 2010c). The suspended funds could be forfeited if the fiscal weaknesses are not addressed with an unanimous decision of the Council required to lift the sanction.

3.2.3 Monitoring

Enhanced enforcement of the SGP requires better monitoring of the fiscal positions of euro area countries and greater transparency. This would facilitate fiscal dialogue at the EU and

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[11] A country with a debt-to-GDP ratio of 100 per cent, nominal growth of 3.5 per cent and facing interest costs of 4.5 per cent would be required to run a primary surplus in the early years of close to 3 per cent of GDP. By contrast, a country with a 70 per cent debt-to-GDP ratio would only be required to run a primary balance of around 1.5 per cent of GDP.

[12] Under the assumptions in the previous footnote, it would take well over a decade for country with a debt-to-GDP ratio of 80 per cent to get its debt ratio down to 70 per cent.

national level, as well as making it easier for investors to assess risk. The Directorate-General for Economic and Financial Affairs (DG ECFIN) has increased its resources and is undergoing an internal restructuring to strengthen its capacity to monitor economic and fiscal developments in EU countries. The presentation of Stability Programmes should be enhanced. Projections should be presented in a more similar way across countries. The presentation should clearly distinguish between a scenario based on a "no change" assumption (incorporating only specific legislated changes) and plans that assume hypothetical future decisions. Forecasts should be made for at least the next three years, or for as long as it is expected to take to reach MTOs. Projections should identify expected current spending, capital spending and tax revenues, based on an outline of specific measures to achieve the stated objectives.

Stability Programmes are currently set out using national fiscal forecasts. These are in most cases largely provided by national finance ministries and so are not politically independent. There is bias towards overly optimistic forecasts, which imply an easier trade-off between spending decisions and raising revenue (Jonung and Larch, 2006). In the 2010 round, the Commission judged many forecasts to be "optimistic" (EC, 2010b). The Commission and the Council base their assessments of the Programmes on the Commission's own projections. However, the dialogue about policy is partly obscured by differences in underlying economic and budgetary assumptions, aggravated by national forecasts being based on data from the autumn rather than the early spring. Appropriately-mandated national forecasters could in principle have some advantages over the Commission in making forecasts, in particular through privileged access to highly detailed confidential expenditure and revenue data. Stability Programmes would benefit from national forecasts being formulated by independent fiscal councils as set out below. This is likely to facilitate the assessment of policies by removing any political bias in national forecasts, providing a more similar set of assumptions between national and EU authorities.

The analysis of monitoring of structural budget positions should be improved, as these underpin the "preventive arm" of the SGP, and should systematically reflect uncertainties in fiscal forecasting. The assessment of structural positions should not solely be grounded in estimates of the output gap, which is an unobserved variable and difficult to estimate in real time. Estimates of the structural fiscal position should follow a disaggregated approach, allow for time-varying tax elasticities and structural breaks. As discussed in the OECD Economic Survey of the euro area (OECD, 2010), economic and financial imbalances are much wider in scope than the balance between internal demand and supply. Furthermore, capital flows and immigration may lead to shifts in short-run supply that make the output gap particularly difficult to identify. The creation of the European Semester and co-ordination with broader economic policy orientations should bring broader developments systematically into the setting of EU fiscal policy recommendations. The effect of credit and asset prices on revenues should be systematically taken into account. The presentation of forecasts of the budget balance and estimates of the underlying budgetary position should reflect economic, data and model uncertainty and the representation of fiscal forecasts should be less reliant on point estimates.[13] While this would add to the complexity of the discussion, it would provide a better reflection of the state of knowledge about the future of fiscal positions. In addition, it would help to highlight risks to the fiscal position when the economy is performing strongly.

Large revisions to GDP and the fiscal position in Greece threw the weaknesses in the collection of accurate and timely statistical data into sharp relief. Based on current data, Greece would have exceeded the reference value in 2008 and the EDP would not have ended. These weaknesses further undermine the credibility of the system. The auditing of fiscal positions should

[13] Part IV.3 of *Macro-financial and (Contingent) Fiscal Risks – An Analysis with Composite Indicators* by the EC (2010b) constructs indicators of macroeconomic and fiscal risks.

be strengthened and make greater use of independent auditing. Eurostat's powers to validate data were increased in July 2010, including a system of methodological visits where weaknesses are identified and increased powers to oversee the preparation of fiscal statistics at national level.[14] Eurostat should allocate sufficient resources to fiscal monitoring and weaknesses in national audit processes should be addressed as the credibility of fiscal data is essential to the effective operation of EU fiscal institutions and market discipline.

Fiscal monitoring should be broadened along two dimensions. Firstly, surveillance and transparency around off-balance sheet liabilities should be strengthened. In a narrow sense, this should cover off-balance sheet operations that can distort the headline statistics on the public finances, as well as important off-balance sheet positions such as government guarantees, special purpose vehicles that may ultimately create a liability for the state, and obligations under Public Private Partnerships (PPPs). It is important that gaps in monitoring do not bias policy decisions towards less transparent forms of support. This will be particularly important as tighter budgets in the coming years will create strong incentives to avoid fiscal discipline. More broadly, liabilities under public-private partnerships should clearly be accounted for in budget annexes. Secondly, the monitoring and availability of data about debt management should be stepped up. This is extremely important given the role that short-term financing needs can have on market pressures, which have been a key conduit for contagion during the crisis. Given these liquidity risks, these issues should be given prominent scrutiny and all countries should move into line with best practice in terms of institutional arrangements and management of liquidity and market risks. Fiscal stress tests should be undertaken to explore and communicate these risks.

3.2.4 Limits of EU institutions and fiscal rules in the current fiscal situation

While the SGP may have played a positive role in fiscal outcomes, it has ultimately fallen short of its objectives. The financial crisis may have been an unusually tough test of the public finances, but the euro area sovereign debt crisis has underlined real weaknesses in the ability of the SGP to protect the central bank and other EU countries from fiscal spillovers. In addition, the revision of the Pact, which was intended to address perceived shortcomings in its credibility, suggests that these problems may have inherently difficult to solve. In particular, the more sophisticated approach of the "preventive arm" that was intended to create national ownership of the objectives appears to have failed. The implementation of current legislative proposals would mark an important step forwards by addressing some of the key weaknesses in the existing system, notably the weak credibility of *ex ante* sanctions, the failure of peer pressure to enforce the preventive arm and the making of decisions by the Council "quasi-automatic". However, the key issue remains the willingness of national authorities to abide by the rules and, if not, of the Council to enforce sanctions effectively and for the Commission might not use its powers, even if expanded, fully.[15] Under the existing architecture of the monetary union, there are good reasons for which enforcement at the EU level will remain limited. Setting fiscal policy depends on a very large element of judgement, more so for than for monetary example (Leeper, 2010). It is therefore appropriate that it is set by a political process with a high degree of legitimacy, most obviously national and some sub-national levels in this case. Furthermore, in the absence of transfers, the consequences of the exercise of this judgment at European level could not be compensated in any way by fiscal transfers.

[14] Council Regulation (EU) No. 679/2010 of 26 July.

[15] For a parallel, the enforcement of warnings and the Broad Policy Guidelines in relation to Ireland proved difficult and ultimately this approach was never again attempted (Deroose *et al.*, 2008).

Appropriate fiscal rules that are optimal in all circumstances are likely to be difficult to derive. This imposes a limit on how much EU institutions can be expected to achieve, given that the circumstances of European countries are so different both with respect to their membership of the monetary union but also future growth prospects and other key variables in terms of fiscal consolidation. This argues for an EU approach based on ensuring basic sustainability and avoiding spillovers rather than trying to approximate optimal policies for all countries. Furthermore, the coming years are likely to provide a highly unusual background against which fiscal institutions must operate: reaching the objectives set by the Stability Programmes and then the Medium-term Objectives will be difficult given the scale of the consolidation required to achieve it and high debt levels. Based on the experience of 84 fiscal consolidation episodes in 24 OECD countries since the late 1970s, the overall size and duration of consolidation required just to fulfil 2010 "Stability Programmes" is not out of line with past experience (Guichard *et al.,* 2007; Figure 9) with the notable exceptions of Greece and Ireland.[16] However, if countries then continued to converge with the more demanding standard of achieving Medium-term Objectives, this would imply that consolidation would have to be longer and in a number of cases larger than has been normal in the past (see OECD, 2010 for more detailed discussion of the underlying assumptions). Such a scenario would be needed for most countries so that debt falls towards the 60 per cent of GDP ceiling in the Treaty. With a large number of countries likely persistently to exceed the Treaty benchmarks for many years, past experience suggests that consolidation is more likely to be durable if accompanied by strong fiscal institutions (Guichard *et al.*, 2007). At the same time, the political economy pressures arising from such an intense consolidation will need to be carefully managed and may lead to greater resistance from national governments to EU fiscal constraints.

3.3 Reform of fiscal frameworks at national level

The poor fiscal outcomes of many euro area countries, however, suggest that national authorities have faced two kinds of problems. Firstly, political incentives often lead to short-term decision-making and excessive risk-taking. In addition, the conditions of monetary union together with low risk aversion in financial markets may have weakened some elements of market discipline. Countries, which did little to reduce their high debt-to-GDP ratios since 2000, were clearly taking large fiscal risks. Secondly, it is technically very difficult in real time to distinguish structural from cyclical revenues and to build up sufficient reserves. Despite apparently good fiscal outcomes at the time, it is clear *ex post* that some countries should have made a greater effort to improve their fiscal positions. By 2007, Ireland and Spain had reduced their debt-to-GDP ratios to among the lowest in the euro area and were among the few countries to run budget surpluses. While there were some indications at the time that the fiscal position in these countries may not have been sufficiently solid given the overheating of domestic demand, the scale of the subsequent weakening has been a surprise relative to forecasts both by the authorities and external commentators. Furthermore, it may be politically very difficult to justify sufficiently large surpluses to address such domestic imbalances. To address these weaknesses, budgetary frameworks at national level should generally be upgraded through a combination of well-designed fiscal rules (consistent with the SGP framework) and the introduction in many countries of independent national fiscal councils.

Wider user of medium-term fiscal framework in euro area countries would help to strengthen fiscal performance. These rules can embody sound budgetary principles in decision-making and help governments to pre-commit to setting policies in a particular way. There are several basic types of fiscal rules, including deficit and debt rules, as well as revenue and expenditure rules.

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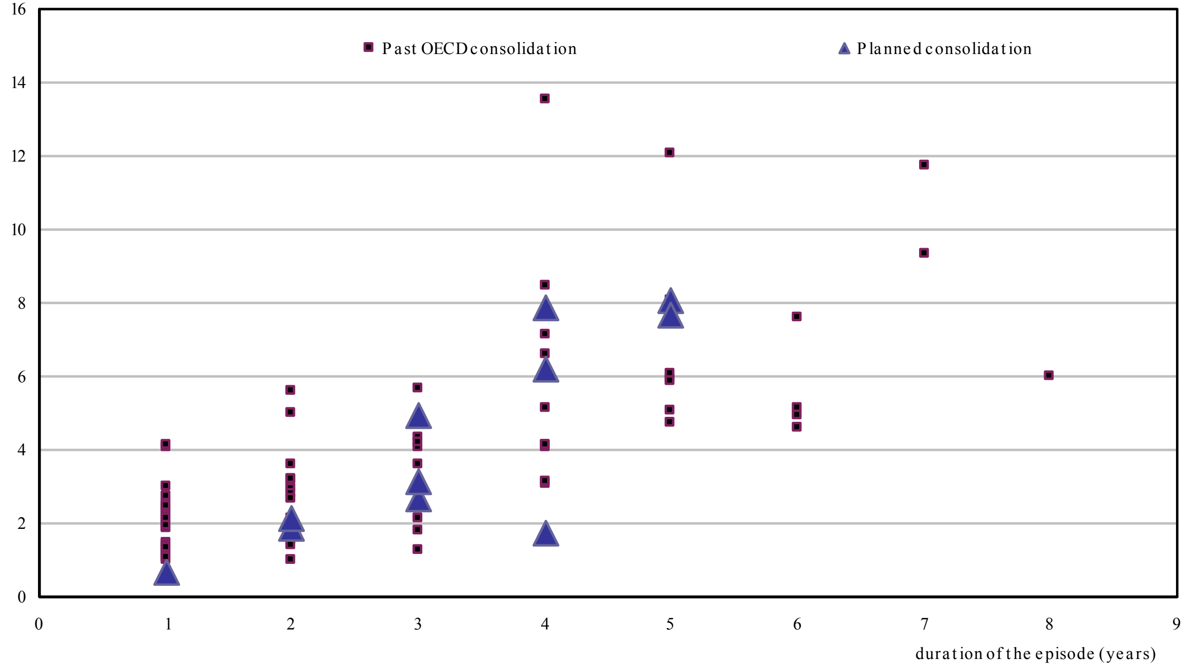
[16] Consolidation for Ireland is understated under this methodology as some of the current episode occurred prior to 2010.

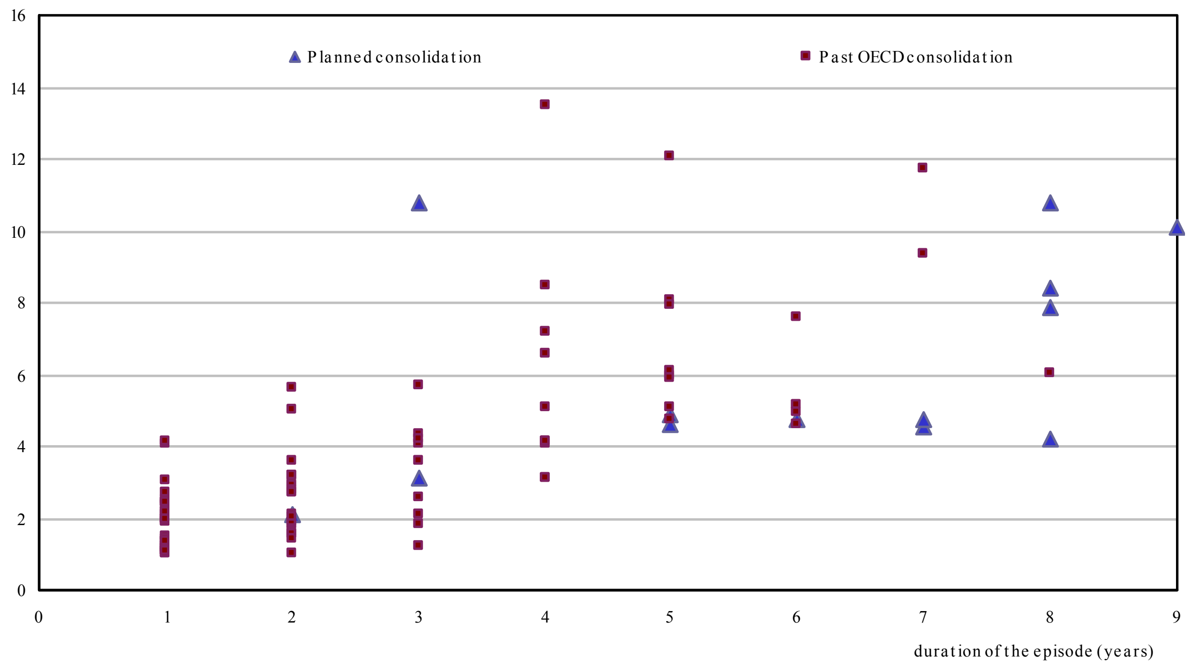
Figure 9

Planned Consolidation Compared with Past Experience[1]
(improvement in budget position, percent of potential GDP)

Stability Programme Scenario



Convergence to Medium-term Objectives Scenario



(1) See assumptions given in OECD (2010).
Source: Guichard *et al.* (2007), "What Promotes Fiscal Consolidation: OECD Country Experiences", OECD, Economics Department, Working Paper, No. 553, and OECD, OECD Medium-term Database and OECD calculations.

Rules may either specify a target or a ceiling. Deficit and debt rules are highly appropriate at the EU level, given that the main externalities in fiscal policy between countries arise from unsustainable public finances. However, other types of rules may be useful at national level, not least because deficit and debt rules are less likely to bind during periods of economic expansion when governments find it difficult to save. While this problem can in principle be overcome by basing the rules on estimates of the structural fiscal balance, this measure is unobservable and difficult to estimate accurately. Deficit rules (including the SGP) are the most commonly used fiscal rules among OECD countries and are in place in some form in almost all countries (Guichard *et al.*, 2007).

3.3.1 Medium-term fiscal frameworks

Medium-term expenditure rules have significant advantages compared with deficit rules. They involve setting a multi-year plan or ceiling for government expenditures. These build on the sensible practice of viewing the public finances from a multi-year perspective, both to see through the cycle and avoid boom and bust in government spending. The implication is that these plans will be met irrespective of actual government revenues, so that stronger than expected revenues are saved rather than spent (Anderson and Minarík, 2006). Unlike deficit rules, expenditure-based rules are likely to be binding through the cycle. Indeed, the disadvantage of deficit rules is that they will typically require consolidation when the economy is already in a weak state. Expenditure rules have the additional advantage that expenditure is generally more directly under the control of the authorities than revenues, which are more cyclical and autonomous (Atkinson and van den Noord, 2001). This implies that violations of the rules are easier to observe and enforce. To be effective, expenditure rules must cover all categories of expenditure to avoid gaming of the system by reclassifying expenditures to categories outside the cap.[17] This argues against the use of "Golden Rules", which exclude government investment, because there is ambiguity about which category some types of spending belong (Fatás, 2005). The main argument against expenditure rules is that they may reduce the quality of public finances by distorting expenditure decisions, for example leading to cuts in pro-growth investment to meet the cap. However, a broad definition of expenditure should not in itself lead to these problems. A large number of OECD countries now have some system of expenditure targets while some others have rules about the use of windfall tax revenues, which can be seen as potentially having a similar effect (Guichard *et al.*, 2007). The importance of expenditure-based rules is recognised in the new concept of "prudent fiscal policy-making" in current EU legislative proposals, which imply a basic rule (EC, 2010c).

Overall, there is some evidence that the existence of fiscal rules is associated with better fiscal outcomes, although much depends on their design and the circumstances (EC, 2006b; Guichard *et al.*, 2007). In the euro area, Austria, Greece, Ireland, Luxembourg, Portugal, the Slovak Republic and Spain have not had rules for central government or the general government public finances beyond the excessive procedure and SGP rules.[18] While several of these countries appeared to perform well during the upswing, the most severe fiscal problems in the downturn have all been among countries in this group. The experience of countries with strongly overheating economies raises two important issues for expenditure rules. Firstly, the implied surpluses would have been extremely large during the upswing and would most likely have led to strong pressure on governments to renege on their commitments. Secondly, the scale of the reversal of fortunes in these countries was very large and so even prudent expenditure plans made after several years of boom would most likely have been totally unrealistic for the coming years. Taken together, these considerations imply a need for some well-defined clauses setting out exceptional circumstances

[17] An exception may be justified for social security expenditure related to unemployment.

[18] In Spain, there are expenditure ceilings and several debt limits for regional and local authorities.

when the rules may be relaxed, while maintaining discipline in the face of strong revenue booms. The exact design of fiscal rules may be difficult and can imply trade-offs between various objectives, such as stabilisation of the cycle and maintaining the pace of investment. The design of fiscal rules to achieve consolidation in the coming years may involve some special considerations beyond those that are eventually required to keep the public finances on a prudent path. It would be appropriate to design fiscal rules at a national level, within the minimum deficit and debt criteria set out by the SGP, fully to reflect national circumstances, preferences and approaches. There is some scope for EU monitoring to help ensure that these rules are well-designed, but it is important that political will at national level supports the rules and that there is national ownership of the fiscal frameworks.

3.3.2 Independent national fiscal councils

Enforcement of the fiscal rules and budgetary outcomes would be improved if all euro area countries had independent national fiscal councils. These could reduce political biases, increase the commitment to rules and raise the level of analysis and debate around fiscal policy. In principle, independent fiscal institutions could assume a variety of tasks, ranging from setting the ultimate objectives of fiscal policy to providing technical input to the policy-setting process such as a forecast or to making a normative assessment of the fiscal position. However, there are good reasons for limiting the scope of independent fiscal bodies more than for central banks given the lower level of agreement about objectives and stronger distributional impact of fiscal policy. No OECD country has an independent fiscal authority in the sense given below, but an increasing number have adopted some form of fiscal council (Debrun *et al.*, 2009).

Independent fiscal councils in euro area countries should be allocated two tasks:

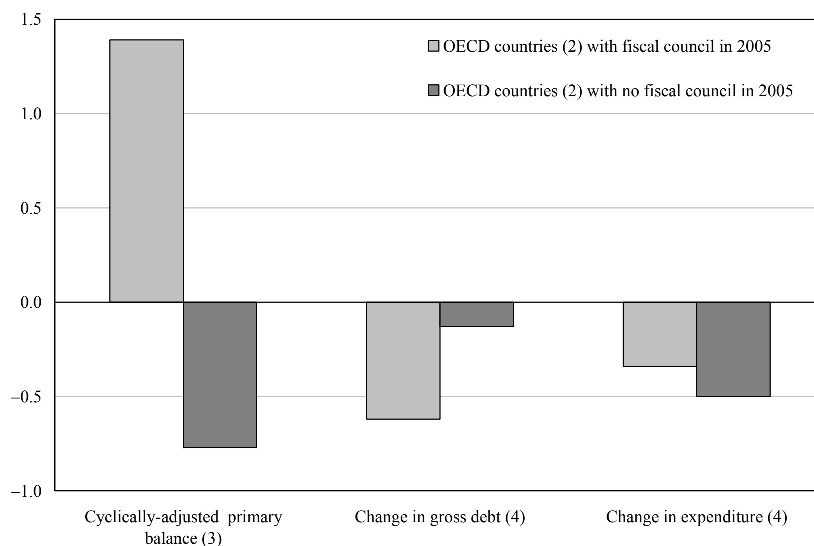
- preparing independent forecasts of the public finances to remove bias;
- independent fiscal policy assessment. At a minimum, this should include assessing whether fiscal rules have been met. This is particularly important where judgment is required. More broadly, a fiscal council can provide normative commentary on the state of the public finances and also the fiscal stance. This analysis can also be applied to political parties' election manifestos.

This mandate would improve transparency and the quality of public debate about fiscal issues. In most countries, there is already a wide range of commentators on fiscal policy, such as research institutes, academics and banks. However, these commentators do not have formal mandate to provide such scrutiny and lack accountability. This can undermine their impact on the public debate. Furthermore, these *ad hoc* commentators do not have the privileged access to confidential government data that is required to undertake detailed and robust analysis of the public finances. The resources available to commentators for fiscal policy tasks are also typically very small relative to those required to undertake thorough analysis. Many euro area and OECD countries already have an institution that performs some of the functions of a fiscal council (EC, 2006a; Hagemann, 2010). Many have a forecasting role but this is usually limited to setting underlying macroeconomic assumptions. Only a few euro area countries have a fiscal council that produces forecasts for the government balance and debt. There is typically some analysis of the fiscal policy position, although monitoring of budgetary implementation or analysis of outcomes with respect to fiscal rules is less common. The normative role is generally limited to a commentary on whether rules or budgetary plans are respected and how to deal with slippages. Implementing fiscal councils in all euro area countries with the dual mandate of preparing independent forecasts and assessing the fiscal position would therefore be a major change.

The design of fiscal institutions can help to ensure their effectiveness. The optimal configuration will depend on the circumstances of each country. However, the mandates of national fiscal councils must be clear and achievable. Agencies need to be assured of full discretion in carrying out their mandates. Independence from political influence and the executive is crucial and adequate firewalls are required to ensure the independence of staff and everyday operations. Conversely, they must be democratically accountable, for example to national parliaments, for meeting these objectives. In addition, the funding of independent agencies should be protected as far as possible from political influence and be sufficient to carry out the important tasks that have been delegated to them. The development of independent central banks over recent decades provides a model in some respects in terms of independence, analytical capabilities, the collection of data necessary to carrying out this analysis, and an increasing emphasis on communication and transparency. The integration of national fiscal councils with the other political and budgetary processes is a key determinant of their effectiveness. This explains why such national institutions might be able to achieve results where EU surveillance cannot. In the United States, the Congressional Budget Office (CBO) prepares a baseline against which budget proposals are prepared, although this role is somewhat impaired by a legal obligation to follow current law rather than a more realistic policy scenario. The CPB stands out as an institution that has over the decades become fully integrated into the policy-making process while retaining a solid reputation for professionalism and impartiality in its analysis.

Figure 10

Budgetary Developments and Fiscal Councils, 1995-2005[1]



[(1)] Fiscal councils as defined in EC (2009), *Public Finances in EMU – 2009* and OECD calculations.
[(2)] OECD countries excluding Chile, Mexico, Slovenia and Turkey.
[(3)] Average balance over the period.
[(4)] Average yearly percentage point change in the ratio to GDP over the period.
Source: OECD, OECD Economic Outlook Database.

The experience with independent fiscal councils is encouraging, even if there are few examples of the type of institution with the full mandate proposed here for euro area countries. Over the period from 1995 to 2005, the unweighted average fiscal performance of OECD countries with fiscal councils in terms of the cyclically-adjusted primary balance and the reduction in debt was stronger than for those without fiscal councils (Figure 10). This parallels similar findings based on the same methodology for the European Union (EC, 2006a). This *prima facie* evidence is difficult to evaluate because of the endogeneity of the decision to create a fiscal council: these are more likely to be created in countries that are serious about budgetary discipline, although the need for such institutions may be less where budgetary processes are already sound and have political support.

While the experience of institutions with the full range of the necessary powers is limited, there is some evidence that these bodies can be effective if well-designed and truly independent. Much of their success will also depend on how serious policy-makers are about fiscal prudence and allowing these institutions to flourish. However, it is precisely this link to local circumstances that provides legitimacy in the national policy process and strong integration to the budget. At the EU level, the European Commission already plays a somewhat analogous role by monitoring national fiscal positions and compliance with the SGP rules. The Commission is not politically independent in the same way as a national fiscal institution would need to be. Nevertheless, it has a mandate to protect the EU interest and so should not be subject to influence from national governments.

4 Conclusion

While the immediate priority is to stabilise the public finances and then reduce the debt-to-GDP ratio to more prudent levels over the coming years, strengthening the fiscal framework would enhance the credibility of the consolidation process. Stronger market discipline and fiscal frameworks are required to avoid pro-cyclical policy settings and to ensure long-run sustainability. The institutional design should reflect that national governments retain the main responsibility for the state of their public finances, while EU institutions are needed to avoid fiscal spillovers and to mitigate moral hazard.

This coherent approach should be based on three pillars: market discipline, EU institutions and national budgetary frameworks. At EU level, the experience of the Stability and Growth Pact has been that it has been difficult even to enforce the basic rules and the sovereign debt crisis has led to important financial spillovers between countries. Reforms in this area should focus on achieving these core objectives and not overloading the EU level with other objectives, outside this core role, that it is unlikely to be able to achieve. One reform strategy would be to focus on enforcing the pre-revision Pact aimed at providing a maximum allowable fiscal deficit and debt ratio, augmented by stronger and more credible sanctions, improved monitoring and including a numerical standard for the required reduction in the debt-to-GDP ratio towards 60 per cent. The currently discussed reform proposals aim to implement the post-revision Pact more effectively and also include extensions, for example to co-ordinate with policies to avoid unsustainable imbalances. While current reform proposals would be a major step forward, there is a risk of continuing to place more weight at the EU level than it can reasonably be expected to bear, while neglecting the role of market discipline and national fiscal institutions.

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