Session 2

FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

SGP 3.0: CONTINUITY AND INNOVATION IN THE EVOLUTION OF THE EU FISCAL FRAMEWORK

Martin Larch,[*] *Lucio R. Pench*[*] *and Christine Frayne*[*]

1 Introduction

The global economic and financial crises has exposed the need for greater coordination and enhanced surveillance of economic policies in Economic and Monetary Union (EMU). Existing instruments and methods of coordination and surveillance enabled the EU to avert a full-scale depression in the midst of a storm that no Member State could have managed on its own. However, recent experiences also showed remaining gaps and weaknesses in the current system of coordination and in the existing surveillance procedures.

Against this background, a broad-based reform process is under way in the EU that seeks to address the lessons of the crisis. While no one would argue that the post-2007 economic and fiscal crisis was caused by flaws in EU economic governance, its is also clear that (i) existing arrangements did not necessarily facilitate an effective policy response during the crisis and (ii) the unprecedented impact caused by the crisis calls for changes in the governance structure to put public finances back to a sustainable path after.

Our paper provides a detailed presentation of the reform project deliberated at EU level to strengthen economic governance in the Union. Reflecting the sweeping impact of the crisis, which seriously affected the entirety of our economic system – the real economy, financial systems and public finances – the actual reform debate and reform effort goes well beyond fiscal policy. It embraces all areas of economic policy making in the EU including for instance financial market supervision and regulation.

Keeping this in mind, our main objective is to take a closer look at how the broader reform process will change the EU fiscal framework, which together with centralised monetary policy making was and still is at the core of the EU economic governance framework. Our attention will be centred on two sets of specific initiatives: (i) the legislative proposals for a stronger EU economic policy coordination adopted by the European Commission on 29 September 2010; and (ii) initiatives launched by the Member States within the Council creating mechanisms for crisis resolution, that is arrangements that come into play when sovereign borrows are facing problems of illiquidity or insolvency or both.

Although dealing with interlinked issues, the two sets of initiatives are separated by important legal and institutional differences. The legislative package of the Commission emerges from what is generally called the community method and takes the Treaty provisions as given. The Member States' initiatives largely follow the intergovernmental path including possible changes to EU primary law.

Taking a macroscopic view, the Commission's reform package of 29 September 2010 consists of two major blocks. The first comprises a set of measures aimed at strengthening the provisions of the Stability and Growth Pact, the existing EU fiscal surveillance framework. The second block proposes an entirely new surveillance procedure dealing with macro financial developments. Its aim is to prevent and correct macro financial imbalances which, if they unwind,

[*] European Commission – Directorate-General for Economic and Financial Affairs.

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can have a bearing on the sustainability of public finances and the stability of the economy as a whole.[1]

Both blocks offer concrete responses to important lessons from the crisis. On the fiscal side, the crisis has drastically reversed the favourable economic and financial conditions that prevailed until 2007 and made clear yet again that windfalls accumulated during good times have not been sufficiently used to create room for manoeuvre. As a result, many Member States entered the crisis with little or no fiscal space.

Also on the fiscal side, the slow decline of public debt before the crisis and the very sharp increase during the crisis underscored the need to pay more attention to debt developments. On the back of slowing potential economic growth and an increasing number of below the line operations, keeping the deficit below the 3 per cent of GDP threshold of the Treaty is not longer sufficient to ensure a declining debt ratio.

Finally, fiscal surveillance before and during the crises clearly showed that EU rules can only work if they are backed by national frameworks. In many Member States arrangements of fiscal governance are not necessarily consistent with the obligations under the Treaty. In particular, few countries have effective fiscal rules, institutions or procedures conducive to achieving the objectives of the SGP. Existing frameworks are largely dominated by national institutional history.

Moving beyond the fiscal area, the emergence of large macroeconomic imbalances, including large and persistent divergences in competitiveness trends, proved highly damaging to the EU and in particular to the euro when the crisis struck. In the years preceding the crisis, low financing costs fuelled the misallocation of resources to often low productive uses, feeding unsustainable levels of consumption, housing bubbles and the accumulation of external and internal private debt.

These accumulated debt positions created significant vulnerabilities which were not captured on the radar screen of existing economic surveillance frameworks. Mirroring the prevailing macroeconomic paradigms, low and stable inflation in combination with sustainable public finances were deemed to be sufficient to guarantee overall macroeconomic stability. When they eventually unwound, macroeconomic imbalances turned into massive liabilities of the government sector as fiscal authorities endeavoured to safeguard overall macro financial stability by expanding its own balance sheet.

In particularly severe cases, the financial and economic crisis developed into a sovereign debt crisis where the solvency or liquidity of government was at stake. Such a situation was alien to the logic of the SGP. A forceful implementation of the fiscal framework in combination with the no-bail out clause of the Treaty was meant to prevent any sovereign debt crisis.

Once the unthinkable eventually happened, the no-bail out clause lost its credibility and the lack of provisions to deal with an outright crisis turned into a clear handicap. When faced with the choice of accepting a sovereign default or providing financial help to ailing countries the Council eventually went for the latter. The risk of a financial meltdown of a highly integrated financial market such as the euro area was deemed to be more serious than deviating from the spirit of EU primary law.

While the issues and problems outlined above did not come as a complete surprise their extent and relevance was clearly underestimated. This holds particularly true for macro-economic imbalances. In its Communication and Report on "EMU@10: successes and challenges after

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1 A schematic view of the reform package is provided in the Annex.

10 years of Economic and Monetary Union",[2] the Commission had stressed the need to broaden economic surveillance in order to detect and address macroeconomic imbalances at an early stage. Enhanced surveillance efforts were seen as warranted in the area of external competitiveness and current account balances where noticeable divergences between Member States had emerged since the launch of the euro. However, at the time no one anticipated that macro imbalances could shake the foundations of EMU.

With the benefit of hindsight we know better. The crisis has triggered a veritable paradigm shift. An eloquent and succinct account of why and how the crisis forces us to rethink macroeconomic policy is provided by Blanchard *et al.* (2010). Similar and more extensive (re)appraisals are likely to follow. As part of this learning process, the official narrative of EU economic governance, whereby monetary and fiscal discipline would be sufficient to ensure macroeconomic stability and that existing rules would effectively stave off the risk of sovereign default, have been put into question.

Europe is currently trying to adapt its economic policy framework to the "new paradigm". Although incisive and comprehensive, the reform approach is not a radical one. It represents a reasoned balance between continuity and innovation. Existing arrangements, notably the rules-based framework of EU fiscal surveillance, are not thrown over board. Their rational is still valid. The reform seeks to strengthen them. In addition, the reform extends the scope of fiscal policy coordination to include national fiscal arrangements, the interplay between macroeconomic imbalances and public finances and explicit crisis resolution mechanisms.

The remainder of our paper takes a closer look at the main elements of the proposed reform of the EU's fiscal framework. Section 2 details the proposals to strengthen the existing provisions of fiscal surveillance, that is the SGP proper. Section 3 describes the planned extension of the surveillance framework to prevent and correct macro-economic imbalances which, if out of hand, can weigh on public finances and jeopardise overall macro financial stability. Section 3 focuses on crisis resolution reviewing both the ad hoc instruments decided in the face of the Greek sovereign debt crisis in May 2010 and the plans for a permanent mechanism outlined by the Council on 16 December 2010 and confirmed in March 2011.

2 Fiscal surveillance and coordination

2.1 The EU rules: a stronger Stability and Growth Pact

The SGP consists of two arms: one on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies – the so-called preventive arm, based on Article 121 of the Treaty – and one on the implementation of the excessive deficit procedure – the so-called corrective arm, based on Article 126 of the Treaty.

The SGP underwent a first reform in 2005 as a direct consequence of the institutional stand-off in November 2003 when the Council decided not to step up the excessive deficit procedure for Germany and France as required by the SGP. The declared goal of the first reform was to make the Pact "smarter". Existing rules were felt to be excessively rigid and to lack economic rational. As a result, while professing the rules-based nature of the SGP, the 2005 reform introduced additional elements of flexibility that were expected to improve the working of the Pact not least by modulating fiscal adjustment as a function of economic conditions. Concretely, the Council report underpinning the 2005 reform considered that, in order to avoid pro-cyclical fiscal

2 See European Commission (2008).

policy, Member States should "[…] use more effectively periods when economies are growing above trend for budgetary consolidation […]".

Backed by remarkably favourable public finances in the vast majority of Member States, the assessment of the 2005 reform prior to the crisis was fairly positive. In 2007, the headline deficit of the EU as a whole was 0.7 per cent of GDP, the lowest level in more than two decades and the debt ratio had embarked on a downward trend. Moreover, available estimates of the structural deficit seemed to suggest the improvement in the headline deficit was accompanied by an improvement in the structural budget balance; most countries were considered to be close or at their respective medium-term objective (MTOs)

Admittedly, doubts were raised about the truly structural nature of the observed improvements. In the 2007 edition of its annual report on Public Finances in EMU the European Commission, when commenting budgetary outturns in 2006 noted that "*the improvement of government budget balances took place against the background of a broad-based economic recovery over the course of which the inflow of tax revenues went clearly beyond normal rates*". However, these concerns did not impact on actual fiscal policy making as official recommendations and opinions issues under the SGP were strictly based on the indications of the commonly agreed assessment tools in particular the cyclically-adjusted budget balance net of one-offs and other temporary measures.

The post-2007 crisis eventually exposed the "Emperor's new clothes". Progress towards MTO turned out to be insufficient and the structural balance, while conceptually a valid indicators, proved an inadequate measure of the underlying fiscal position of a country for two reasons: (i) the difficulty of assessing the cyclical position of the economy in real time and (ii) insufficient account being taken of revenue windfalls and shortfalls not directly related to the economic cycle (in particular housing and financial market developments). As a result, apparently sound budgetary positions before the crisis masked in a number of countries strong reliance on windfall revenues to finance expenditure, the reversal of which contributed to soaring budget deficits.

The crisis also underscored the need to keep a closer eye on debt developments. Within two years, the combined effect of falling revenues, discretionary fiscal expansions and below the line operation aimed at stabilising the financial system, led to an increase of the debt-to-GDP ratio in the EU by around 20 per cent of GDP. In addition, in the face of a general slowdown of potential output growth, visible before the crisis and accelerating as a consequence of the crisis, respecting given thresholds for the budget deficit would no longer be sufficient to ensure a decline in the debt ratio.[3]

2.1.1 Strengthening the preventive arm

The preventive arm of the SGP is meant to ensure that Member States follow prudent fiscal policies, and thereby avoid more stringent forms of coordination, so as to not put fiscal sustainability at risk with potentially negative consequences for EMU as a whole. Accordingly, Member States are required to present stability and convergence programmes outlining their plans to achieve medium-term budgetary objectives (MTO), which are defined in percentage of GDP in structural terms (*i.e.*, adjusting for the effect of the cycle and excluding one-off and temporary measures) and are differentiated across countries around a close-to-balance position to reflect the level of public debt and liabilities related to ageing. Member States not having reached the MTO

[3] When the SGP was designed in the 1990s the 3 per cent of GDP reference value of the Treaty was rationalised as the level of deficit which, with an average growth rate of at the time 3 per cent per year and an inflation target of 2 per cent per year, would ensure a declining debt ratio.

are expected to converge towards it at annual pace of 0.5 per cent of GDP in structural terms. However, as indicated above progress towards MTOs has been generally insufficient, leaving public finances badly exposed to the economic downturn.

To respond to these shortcomings the reform of the preventive arm put forward by the Commission on 29 September 2010 as part of the overall reform package defines principles of prudent fiscal policy-making (PFM), which, while retaining the current MTOs, and the 0.5 per cent of the GDP annual convergence requirement, provide operational guidance on how to effectively achieve the required annual adjustment in structural terms. In point of fact, the structural budget balance and the PFM have a common basis. In both cases fiscal policy is assessed with respect to a benchmark of medium-term economic growth. The analytics of the relationships is detailed in the Annex.

PFM implies that annual expenditure growth should not exceed – and, if the MTO has not been achieved, should be clearly *below* – a prudent medium-term rate of growth of GDP, unless the MTO has been more than attained or the excess of expenditure growth over the prudent medium-term rate is matched by discretionary measures on the revenue side. The essential aim is that of preventing that revenue windfalls are spent and are instead allocated to debt reduction.[4]

PFM will provide the benchmark against which countries' fiscal plans in the stability and convergence programme will be examined. Additionally, failure to respect the agreed rate of growth of expenditure, in conjunction with the stipulated revenue measures, will make the concerned Member State liable to a warning from the Commission and, in case of a persistent and/or particularly serious infraction, to a Council recommendation to take corrective action, on the basis of Article 121 of the Treaty.

It is important to note that principles of PFM do not impose constraints on the size of government or changes thereof. Irrespective of the size of government, principles of PFM simply ensure that, taking into account budgetary objectives, expenditure plans are adequately resourced, specifically, by discretionary measures on the revenue side and not through reliance on revenue windfalls. Consequently, the prime objective of principles of PFM is to have a transparent and effective benchmark for assessing whether fiscal-policy making is geared towards achieving and maintaining the MTO across the cycle.

2.1.2 Taking stock of the Excessive Deficit Procedure

The corrective arm of the SGP is meant to avoid gross errors in budgetary policies, which may put at risk the sustainability of public finances and potentially endanger EMU. This translates into the obligation for Member States to avoid excessive government deficits, which are defined against numerical threshold for deficit (3 per cent of GDP) and debt (60 per cent of GDP or sufficiently declining toward it). The excessive deficit procedure (EDP) that implements the ban on

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4 Conceptually, the principle of prudent fiscal policy making draws on the main intuition underlying the notion of fiscal sustainability, namely that over the long term government expenditures should not grow faster than available government revenues. The intuition can be formalised by looking at the derivative with respect to time of the budget-balance-to-GDP ratio:

$$\dot{bb} = \left(\frac{\dot{R}}{R} - \frac{\dot{Y}}{Y}\right)\frac{R}{Y} - \left(\frac{\dot{G}}{G} - \frac{\dot{Y}}{Y}\right)\frac{G}{Y}$$

where a dot indicates a change over time, bb stands for the government balance-to-GDP ratio, R for government revenues, G for government expenditures and Y for the growth rate of GDP. Assuming that the growth rate of revenues equals the growth rate of GDP, the dynamics of the budget-balance-to-GDP ratio depends on the growth rate of expenditure *vis-à-vis* the growth rate of GDP. To achieve an annual reduction of the budget balance of 0.5 per cent of GDP over the cycle with a government size of say 0.5, the growth rate of government expenditure needs to be 1 percentage point lower than the rate of economic growth.

excessive deficits foresees a sequence of steps, which, for euro-area countries, include the eventual imposition of financial sanctions.

The 2005 reform of the SGP did not alter the core of the corrective arm. In line with the overall objective of the project, it only introduced elements of flexibility into the sequence of steps which were made contingent on relevant economic factors and economic conditions. Government actions to correct an excessive deficit were to be considered in a conditional manner, that is, in connection with the prevailing economic outlook. As a consequence, a failure to bring the headline deficit below the 3 per cent of GDP reference value would not necessarily imply a tightening of the EDP, provided the Member State had taken the agreed action and an unexpected deterioration of economic conditions had hampered the achievement of nominal deficit targets. Apart from these procedural innovations, the government deficit remained the focal point of the corrective arm.

The EDP has been regularly applied in line with the relevant provisions, even against the background of the exceptional circumstances of the financial crisis, thereby contributing to anchoring expectations of its orderly resolution. However, a number of shortcomings have emerged. While the deficit and the debt criterion are in principle on an equal footing, and persistently high levels of debt arguably represent a more serious threat to public finance sustainability than occasionally high deficits, in practice the 3 per cent of GDP threshold has been the nearly exclusive focus of the EDP, with the debt playing so far a marginal role. This owes to the less straightforward nature of the debt threshold compared to the deficit, including the ambiguity of the notion of sufficiently diminishing pace of reduction and the greater impact on the debt ratio of variables outside the control of the government, notably inflation.

The existing EDP is backed in principle by a strong enforcement mechanism, as financial sanctions can, and should be, imposed in case of persistent failure to correct an excessive deficit. However, such sanctions arguably come into play too late in the process to represent an effective deterrent against gross fiscal policy errors, not least because the financial situation of the concerned country may be so deteriorated to make the threat of a fine less credible at the moment when it should become actual.

The credibility of sanction is further dented by the discretion effectively enjoyed by the Council in the decisions to proceed with the successive steps of the EDP. Finally, the recent crisis has highlighted that if the obligation to correct excessive deficits contributes to anchoring the expectation that government solvency will be maintained, the timeline of the correction and the profile of the adjustment may have to reflect EMU-wide considerations, in a situation where the assignment of the respective roles of fiscal and monetary policy may be less clear than in normal circumstances.

2.1.3 Ensuring a more effective corrective arm

To respond to these shortcomings the following key proposals for the reform of the corrective arm are being put forward.

The debt criterion of the EDP is to be made operational, notably through the adoption of a numerical benchmark to gauge whether the debt ratio is sufficiently diminishing toward the 60 per cent of GDP threshold. Specifically, a debt-to-GDP ratio above 60 per cent is to be considered sufficiently diminishing if its distance with respect to the 60 per cent of GDP reference value has reduced over the previous three years at a rate of the order of one-twentieth per year. Non-respect of this numerical benchmark however is not necessarily expected to result in the concerned country being placed in excessive deficit, as this decision would need to take into account all the factors that are relevant, in particular for the assessment of debt developments, such as whether very low inflation is hampering debt reduction as well as risk factors linked to the

structure debt, private sector indebtedness and implicit liabilities related to ageing. In line with the greater emphasis on debt, more leeway in taking into account relevant factors is also foreseen in case of non-respect of the deficit criterion, if a country has a debt below the 60 per cent of GDP threshold.

A particularly important element among the other relevant factors is the impact of the economic cycle. If the numerical benchmark of on average one-twentieth per year over the previous three years was applied mechanically, there would be a clear risk of pro-cyclicality: The assessment would signal non-compliance, and possibly warrant procedural steps during temporary downturns, while it would conceal unfavourable debt dynamics and delay procedural steps during temporary economic upturns. In order to avoid this type of situation, the assessment of debt developments needs to take into account the effect of the cycle. Such an exercise is not going to be easy as any adjustment for cyclical factors is subject to a considerable degree of uncertainty. Moreover, while there are established methods for purging headline deficits there is no equivalent for the debt. A good portion of judgement will be necessary.

More flexibility in taking into account relevant factors when determining the existence of an excessive deficit could also benefit countries undertaking systemic pension reforms, beyond the currently foreseen five-year transitory period. The special provisions of the SGP for systemic pension reforms with regards to the deficit criterion are also extended to the debt criterion, through establishing the same 5-year transitory period for considering the net costs of such reforms when assessing the compliance with the debt criterion. Finally, equal consideration shall be given to the partial or total reversal of previously implemented systemic pension reforms, during both the launch and the abrogation of an EDP.

2.1.4 Backing up the new framework with meaningful sanctions

Enforcement is strengthened by introducing a new set of financial sanctions for euro-area Member States, which would apply much earlier in the process according to a graduated approach. Specifically, in addition to the "atomic option" at the very end of the Excessive Deficit Procedure under current provisions the new set of instruments will involve an increasing cost for each successive deviation from the provision of the Stability and Growth Pact. These costs would be mainly reputational at the beginning and translate in real financial costs as the obligations under the Pact are successively violated.

To start with, euro-area Member States could be asked to lodge an interest-bearing deposit amounting to 0.2 per cent of GDP already under the preventive arm of the Pact. The triggering event would be the Council recommendation under Art. 121(4) mentioned in Section 0 issued in the event of a persistent and/or severe deviation from the path of fiscal adjustment towards the MTO. The deposit would become due semi-automatically that is on the issuance of the recommendation by the Council, unless the Council within ten days decides the contrary by qualified majority.

If the euro-area Member State concerned corrects the situation giving rise to the deposit, meaning if it corrects the significant deviation from the adjustment path, the deposit will be returned with accrued interest and the actual financial cost will, depending on the difference between the interest paid on the deposit and the interest rate paid on government debt, be fairly negligible for most countries. The main price to pay is more of moral kind; a country is singled out and has to provide a sort of bail.

The second stage in the proposed set of new sanctions is a non-interest bearing deposit amounting again to 0.2 per cent of GDP. It would apply upon the decision of placing a country in excessive deficit. Like for the interest-bearing deposit, the non-interest-bearing variant would

effectively be imposed with reversed qualified majority: Following the decision to place a country in EDP according to Art. 126(6) of the Treaty, the decision to impose the non-interest bearing deposit would be deemed adopted by the Council unless it decided to reject within ten days of the respective Commission proposal.

In case a country that was previously asked to lodge an interest-bearing deposit does not correct the deviation from the adjustment path and ends up with an excessive deficit, the existing deposit is converted into a non-interest bearing one taking into account the accrued interest. Finally, the non-interest bearing deposit would be converted into a fine in case of non-compliance with the initial recommendation to correct the deficit.

The amount of the fine is equal to the fixed component of the sanctions already foreseen in the final step of the EDP, *i.e.*, 0.2 per cent of GDP. It also bears a link with the minimum amount that Member States currently receive in annual commitments from a relevant subset of EU expenditure categories whose effectiveness depends on sound fiscal policies and that have an impact on the quality of public spending and structural adjustment (Cohesion Fund, European Regional Development Fund, European Social Fund, European Agricultural Fund for Rural Development, European Fisheries Fund). Specifically, half of the amount (0.1 per cent of GDP) corresponds to the minimum GDP share perceived by any Member States under the above-defined subset of EU expenditure categories.

This should facilitate the eventual move to a system of enforcement linked to the EU budget as outlined in the above-mentioned Commission communication of 30 June 2010. Further non-compliance would result in an intensification of the sanction, in line with the already existing provisions in the SGP. To reduce discretion in the enforcement, the procedure of "reverse voting" mechanism is foreseen for the imposition of the new sanctions in connection with the successive steps of the EDP. Specifically, upon each step of the EDP, the Commission will make a proposal for the relevant sanction, and this will be considered adopted unless the Council within ten days decides against it by qualified majority. The size of the non-interest bearing deposit or the fine can only be reduced by the Council based on a specific proposal the Commission following a reasoned request by the Member State concerned.

Moreover, the criteria for assessing compliance with the recommendations at each step, including the possibility allowing an extension of the deadlines for the correction of the excessive deficit, are clarified by placing explicit emphasis on the fiscal variables that can be assumed to be under the direct control of the government, notably expenditure, in analogy with the approach proposed for the preventive arm. Beyond these country-specific circumstances, the possibility of extending the deadlines is introduced also in case of a crisis threatening the smooth functioning of EMU.

Compared to current arrangements, the proposed set of graduated disincentives and sanctions in combination with the reversed qualified majority voting constitutes an important step forward. Sanctions will kick in earlier and be imposed in a semi-automatic fashion. Critical observer, however, doubt whether the reversed qualified majority voting will lead to a more effective enforcement of the rules. In their view the term semi-automatic is misleading because sanctions would only be imposed after the Council has determined, via traditional voting, that provisions of the SGP have been breached. They argue that one can speak of semi-automatic sanctions only if there is no discretionary filter between the breaching of an SGP rule and the reversed qualified majority voting on the sanction. At the same time they acknowledge that it would be difficult to attain such an unfiltered mechanism because it would require a Treaty change. According current EU primary law pertaining to fiscal surveillance, any type of procedure, with the exception of the warning under Article 121(4) which, however, does not lead to sanctions, can be stepped up only after the Council has found the required majority to do so.

2.2 National arrangements: domestic fiscal frameworks

Effective enforcement of the EMU budgetary coordination framework cannot be expected to derive only from provisions established at EU level. The particular decentralised nature of fiscal policy-making in the EU and the general need for national ownership of EU rules make it essential that the objectives of the EMU budgetary coordination framework are reflected in the national budgetary frameworks.

A *national budgetary framework* can be understood as the set of elements that form the basis of national fiscal governance, *i.e.*, the country-specific institutional policy setting that shapes fiscal policy-making at national level. This includes public accounting systems, statistics, forecasting practices, numerical fiscal rules, independent national budget offices or institutions acting in the field of budgetary policy, budgetary procedures governing all stages of the budget process and medium term budgetary frameworks in particular, and fiscal relations across government layers. While Member States' specific needs and preferences must be respected, a number of features stand out as being needed in terms of ensuring minimum quality and consistency with the EMU budgetary framework.

These are the subject of the Directive on national budgetary that is being proposed to complement the reform of the SGP. Such features firstly require that the most fundamental elements of national budgetary frameworks, namely accounting and statistical issues as well as forecasting practices, accord to minimum European standards to facilitate transparency and the monitoring of fiscal developments. Domestic budgetary frameworks need also to adopt a multi-annual fiscal planning perspective so as to ensure the achievement of the medium-term objectives set at EU level. Additionally, Member States must have in place numerical fiscal rules conducive to the respect of the deficit and debt thresholds. Member States must ensure that these features apply to all general government layers. National authorities must also guarantee the transparency of the budget process by providing detailed information on the existing extra-budgetary funds, tax expenditures and contingent liabilities.

3 Tackling macroeconomic imbalances

The foreseen mechanism strives to provide the framework for identifying and addressing macroeconomic imbalances, including deteriorating competitiveness trends. As such it complements the macro-structural country surveillance process foreseen under Europe 2020. It would comprise a regular assessment of risks of imbalances, including an alert mechanism, coupled with a system of rules designed to enable corrective action in case of adverse macroeconomic imbalances beyond fiscal policy. Its scope would cover all Member States.

3.1 The Alert Mechanism

Surveillance would start with an alert mechanism that aims at identifying Member States with potentially problematic levels of macroeconomic imbalances. The alert mechanism would consist of a scoreboard complemented by judgemental analysis. The scoreboard is designed to be transparent, reasonably simple and underpinned by economic rationale. For that purpose, a set of indicators aims at timely identification of imbalances emerging in different parts of the economy. The set of indicators should be sufficiently large to cover any possible case of major imbalance and making sure that it is sufficiently sensitive to detect imbalances early on.

Alert thresholds would be defined and announced for each indicator to increase transparency and accountability. For some indicators, thresholds would be symmetric in the sense of detecting imbalances for both excessively high levels and excessively low levels of the variable. The thresholds should therefore be seen as indicative values which would guide the assessment but should not be interpreted in a mechanical way; they should be complemented by economic judgment and country-specific expertise.

The scoreboard would be composed of several indicators for each Member State. Its composition may evolve over time due to changing threats to macroeconomic stability or advances in data availability. Although the same indicators would be used for all Member States, their availability and underlying methodology may differ from one Member State to another. The structure of the scoreboard would be updated informally, depending on any new threats to macroeconomic stability or progress in statistics availability.

3.2 Preventive surveillance

The Commission would release the results of the scoreboard on a regular basis and attach a Commission report putting it into perspective. On the basis of all available information, the Commission will draw a list of Member States deemed at risk of imbalances. The early discussion of such a list at the Council and the Euro Group will enable the Commission to get appropriate feedback from Member States and ensure transparency of the Commission deliberations. Following such discussions and for Member States where the Commission has detected possible imbalances or the risk thereof, the Commission will provide country-specific in-depth reviews. The in-depth reviews will consist of a detailed investigation of the underlying problems in the identified Member States. When assessing imbalances, account should be taken of their severity, of the degree to which they may be considered unsustainable and of the potential negative economic and financial spillovers to other Member States. The economic adjustment capacity and the track record of the Member State concerned as regards compliance with earlier recommendations under this Regulation and recommendations issued as part of multilateral surveillance should also be considered.

The analysis may be undertaken, where needed, in conjunction with surveillance missions to the country concerned. Any early warnings or recommendations from the European Systemic Risk Board will be taken into account, as well as the policy intentions of the Member State under review as reflected in its Stability and Convergence Programme and National Reform Programme.

If macroeconomic imbalances are considered unproblematic, the Commission will propose that no further steps are undertaken. If the Commission considers that macroeconomic imbalances (or the risk thereof) do exist, it will come forward with preventive recommendations for the Member State(s) concerned. Consistent with the macro-structural surveillance process and depending on the nature of the imbalance, the preventive recommendations may address policy challenges across a range of policy areas.

3.3 The excessive imbalance procedure (EIP)

When the alert mechanism points to severe imbalances or imbalances that jeopardise the proper functioning of Economic and Monetary Union in a specific Member State, the Council, on a recommendation from the Commission, may adopt recommendations in accordance with Article 121(4) of the Treaty declaring the existence of an excessive imbalance and recommending the Member State concerned to take corrective action within a specified deadline. Member States in excessive imbalances in the meaning of the EIP would be subjected to a regime of stepped-up peer pressure. Depending on the nature of the imbalance, the policy prescriptions could potentially address fiscal, wage and macro-structural as well as macro-prudential policy aspects under the control of government authorities. Following the opening of an EIP, the Member State concerned will be obliged to adopt a corrective action plan to set up a roadmap of implementing policy measures.

The flexibility embedded in the procedure should enable the Council to set appropriate deadlines when issuing corrective recommendations, taking into account the nature, scale and urgency of imbalances and the capabilities of policies to remedy the situation. Unlike fiscal policy, not all policy levers are under the direct control of national governments when it comes to the resolution of imbalances. Furthermore, corrective policies may only have a lagged impact on the correction of imbalances, depending on their nature. The Commission will monitor the implementation of corrective action by the Member States concerned.

The Council, on the basis of a Commission recommendation, will conclude by the expiration of the initial deadline whether or not the Member State concerned has taken the recommended corrective action. If the Council decides that the Member State concerned has taken appropriate action, the procedure will be placed in abeyance. Abeyance means that the Member State is making satisfactory progress with corrective action. However, due to the possibly long lags between adoption of corrective action and its effect on the ground, effective resolution of macroeconomic imbalances might take some time. The Member State concerned will be subject to periodic reporting and surveillance until the EIP is effectively closed.

Eventually, sustained and successful corrective action will facilitate the resolution of imbalances. The Excessive Imbalances Procedure shall be closed once the Council, on the basis of a recommendation by the Commission, concludes that the Member State is no longer experiencing excessive imbalances.

3.4 Enforcement measures

If the Member State concerned has not taken appropriate action, the Council would have to adopt stepped up recommendations associated with a new deadline – likely to be shorter – for corrective action. For euro area Member States the enforcement mechanism may ultimately lead to sanctions. If a Member State fails repeatedly to act in compliance with the Council recommendations to address excessive macroeconomic imbalances, it will have to pay a yearly fine, until the Council establishes that corrective action has been taken.

To ensure equal treatment between Member States, the fine should, as a rule, be identical for all euro area Member States and be equal to 0.1 per cent of the GDP in the preceding year of the concerned Member State. As a rule, the Commission will propose the maximum amount of the fine foreseen by this regulation. The Council, on the basis of a Commission proposal, may decide to cancel or to reduce the size of fine.

The Council decisions concerning the fine will be made by only those members of the Council that represent Member States whose currency is the euro. The vote of the member of the Council representing the Member State concerned by the decisions shall not be taken into account.

ANNEX

Schematic overview of the Commission reform proposals

Fiscal governance	Macroeconomic governance
Surveillance - Preventive arm of the SGP: principles of prudent fiscal policy making (amendment to Regulation (EC) 1466/97) - Corrective arm of SGP: benchmark for sufficiently diminishing debt ratio (amendment to Regulation (EC) 1467/97) - Minimum requirements of national fiscal frameworks (new draft directive)	**Surveillance** New procedures for monitoring, preventing and correcting macro-economic imbalances (new draft regulation)
Enforcement New disincentives/sanctions in case of non-compliance in preventive and corrective arm of SGP (new draft regulation)	**Enforcement** New disincentives/sanctions in case of non-compliance with new macro surveillance procedure (new draft regulation)

Changes in the CAB versus principles of PFM

This box examines the analytical basis the CAB and its link with the PFM approach. Starting with the CAB, the budget can be described as the sum of two components a structural and cyclical. Expressing all budgetary variables in percent of GDP we have:

$$b_t = r_t - g_t = r^s - g^s + (\varepsilon_r - \varepsilon_g)\,(\frac{y_t}{y_t^P} - 1) \qquad (1)$$

where r, g, y and y^P are total revenues, total expenditures, actual GDP and potential GDP respectively. The cyclical component of the budget balance is typically modelled as a function of the output gap $(\frac{y_t}{y_t^P} - 1)$ scaled by the difference between cyclical sensitivity of revenues and expenditures ε_r and ε_g. The structural components of the budget balance are indicated by the superscript *s*.

The total differential of equation (1) gives the change of the budget balance:

$$db_t = \left(\frac{\partial r_t^s}{\partial y_t^P} y_t^P - \frac{\partial g_t^s}{\partial y_t^P} y_t^P\right)\frac{dy_t^P}{y_t^P} + \left(\varepsilon_r - \varepsilon_g\right)\left[\frac{dy_t}{y_t} - \frac{dy_t^P}{y_t^P}\right]\frac{y_t}{y_t^P} \qquad (2)$$

Subtracting the cyclical component from the change in the headline balance yields the change in the CAB:

$$dcab_t = db_t - (\varepsilon_r - \varepsilon_g)\left[\frac{dy_t}{y_t} - \frac{dy_t^P}{y_t^P}\right]\frac{y_t}{y_t^P} = \left(\frac{\partial r_t^s}{\partial y_t^P} y_t^P - \frac{\partial g_t^s}{\partial y_t^P} y_t^P\right)\frac{dy_t^P}{y_t^P} \tag{3}$$

Turning to the PFM-based approach we know that:

$$dcab_t = dr_t^s - dg_t^s = \left(\frac{\dot{R}^s}{R^s} - \frac{\dot{Y}^p}{Y^p}\right)\frac{R^s}{Y^p} - \left(\frac{\dot{G}^s}{G^s} - \frac{\dot{Y}^p}{Y^p}\right)\frac{G^s}{Y^p} \tag{4}$$

where capital letters indicate levels of the respective variable and a dot a change with respect to time. This expression tells us how the underlying budget, *i.e.*, the CAB, evolves depending on how fast revenues and expenditures grow relative to potential GDP.

If government revenues *R* have a unit elasticity with respect to potential GDP the first term on the right hand side of equation (4) is equal to zero. In that case, the change of the CAB can only be zero if expenditure *G* grows in line with potential GDP. In terms of equation (3) it means that the increase in expenditure equals the increase in revenues implied by an increase in potential GDP.

Similarly, assuming a government size (G/Y) of around 0.5 an improvement of the CAB in the order of 0.5 per cent of GDP requires that expenditure growth is one percentage point lower than potential GDP growth, unless higher expenditure growth is compensated by discretionary revenue measures, which would go on top of the “natural” increase of *R*.

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REBUILDING THE PUBLIC FINANCES AND FISCAL DISCIPLINE IN THE EURO AREA

Sebastian Barnes[*]

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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[*] Senior Economist, Head of Euro/EU Desk, in the Economics Department at the OECD.

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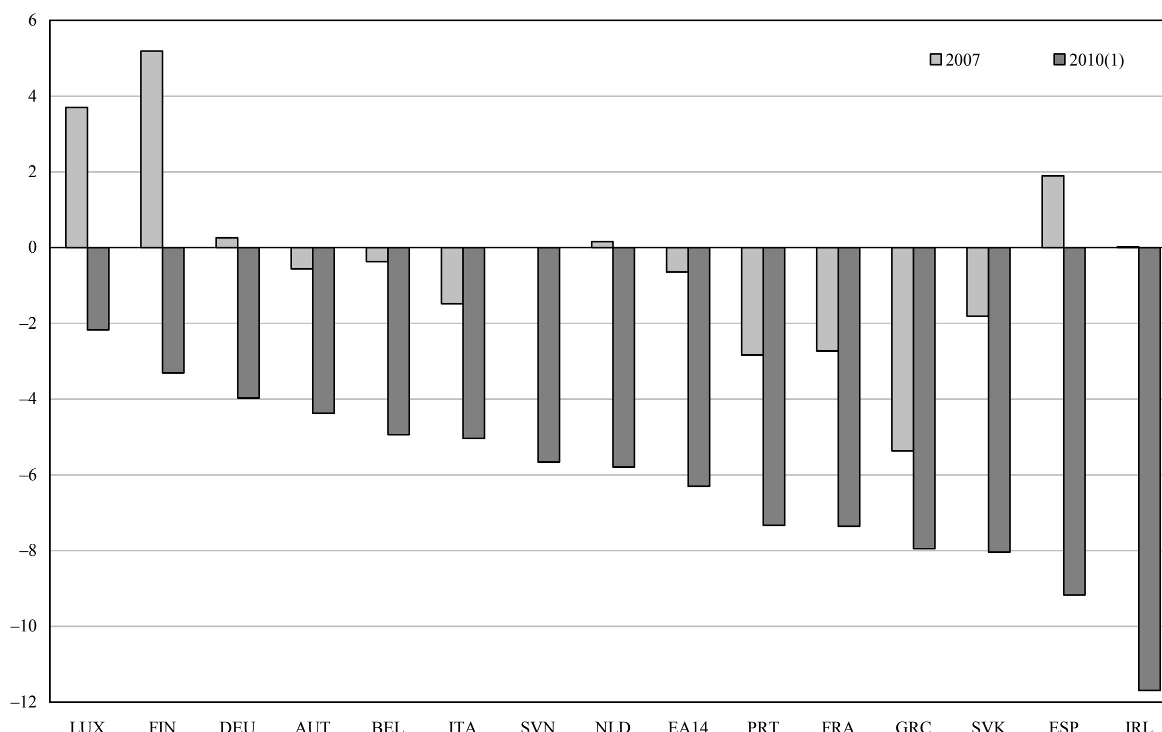
The views expressed and any errors and omissions are, however, the responsibility of the author.

Figure 1

Government Budget Balances Have Deteriorated
(percent of GDP)



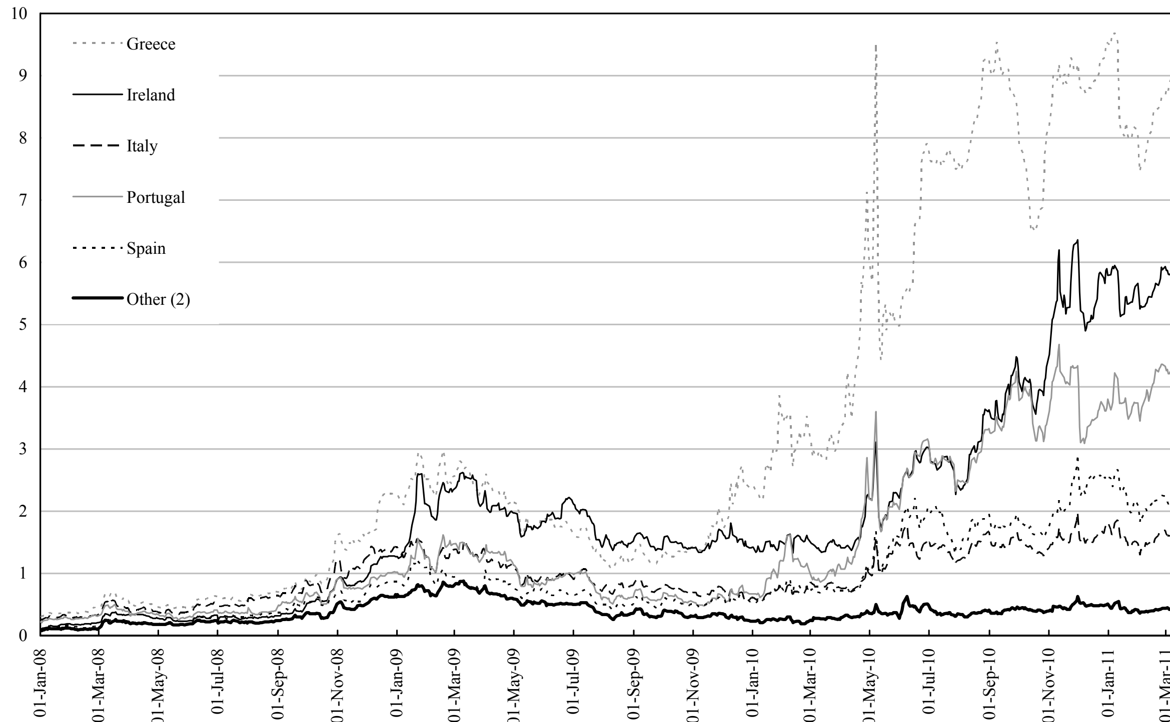
(1) OECD estimates. For Ireland, the balance shown in the figure excludes the capital injections into the banking system.
Source: OECD, OECD Economic Outlook 88 Database.

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)



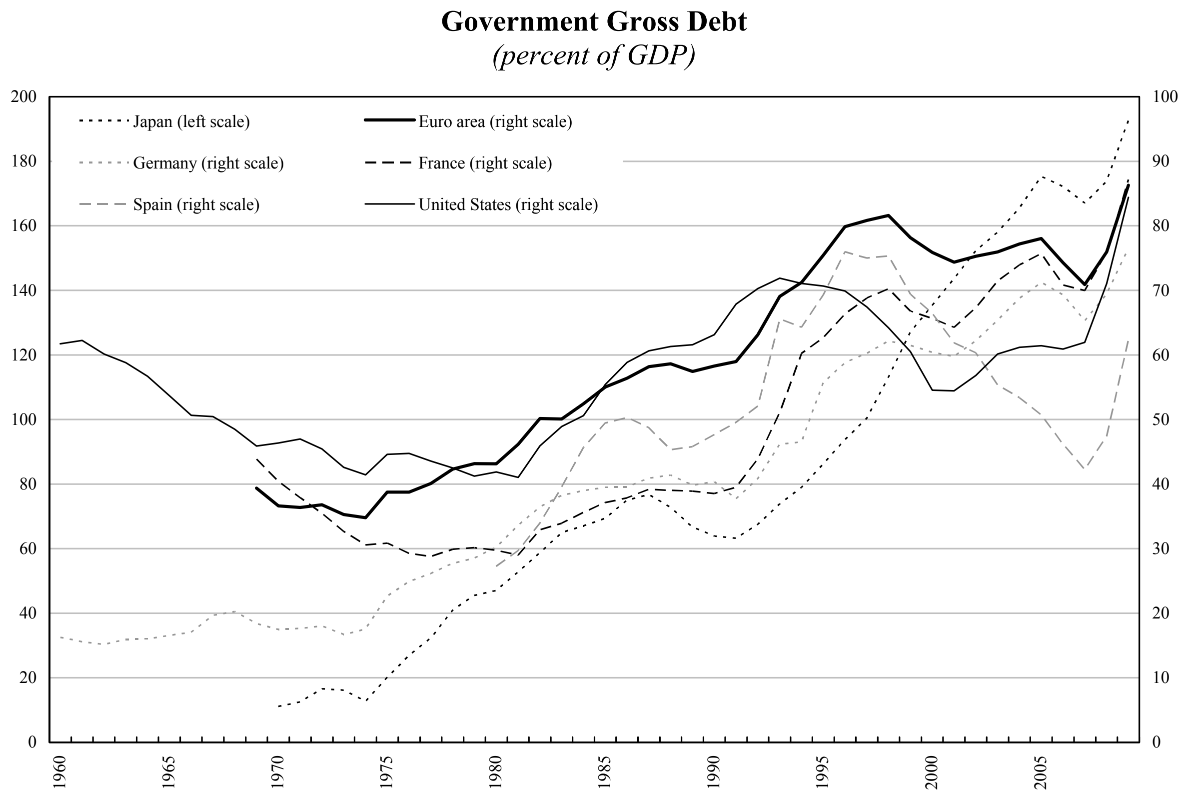
(1) Benchmark bond 10-year over German bond yields.
(2) Unweighted average of the spreads for Austria, Belgium, Finland, France and the Netherlands.
Source: Datastream.

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.

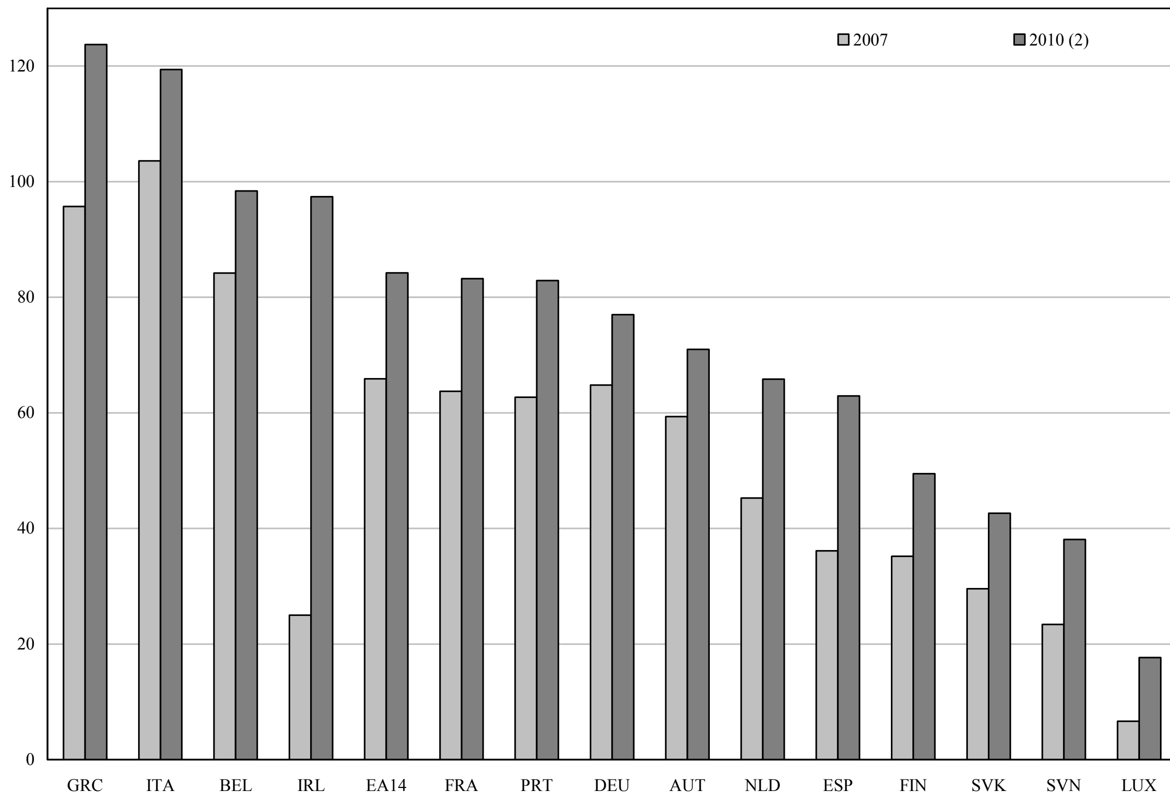
strong pressure at times. In November 2010, Ireland requested IMF and EFSF support and a package was put in place. Spreads on Portuguese and Spanish debt remain high. Although only in Greece, Ireland, Portugal and Spain are long-term borrowing costs similar to or higher than prior to the crisis, the 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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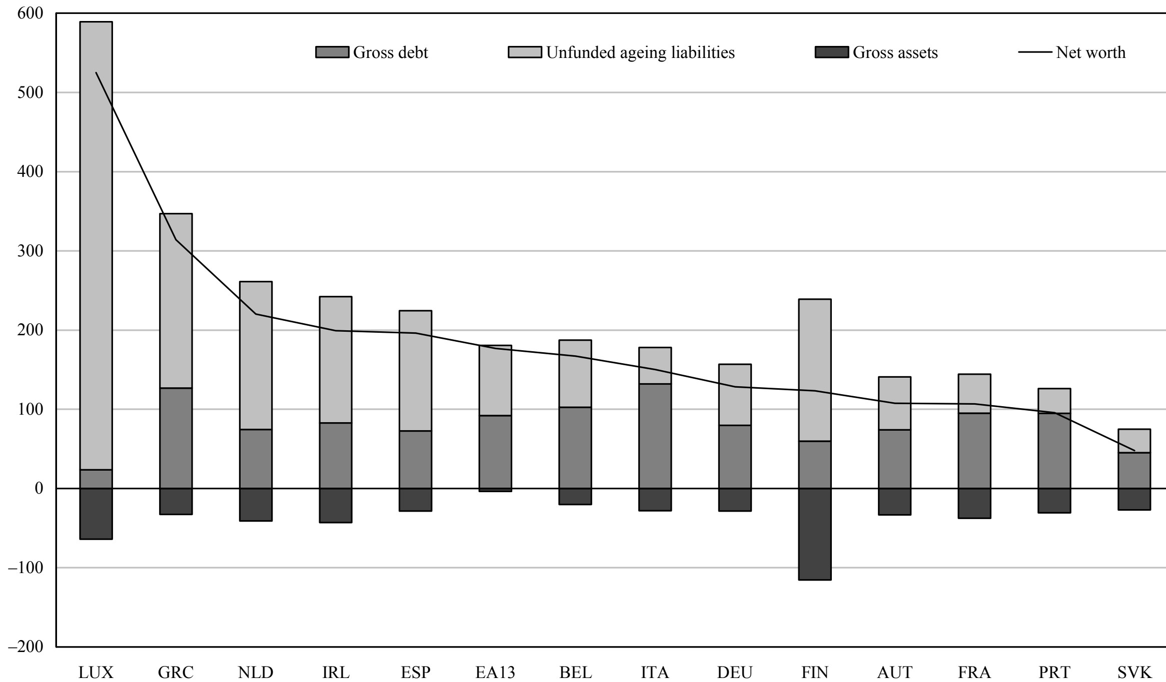
1 For example, the semi-elasticity of the tax burden as a share of GDP implied by recent OECD research is only around –0.2 and this can be lowered if taxes are raised in the most efficient way (Arnold, 2008).

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)



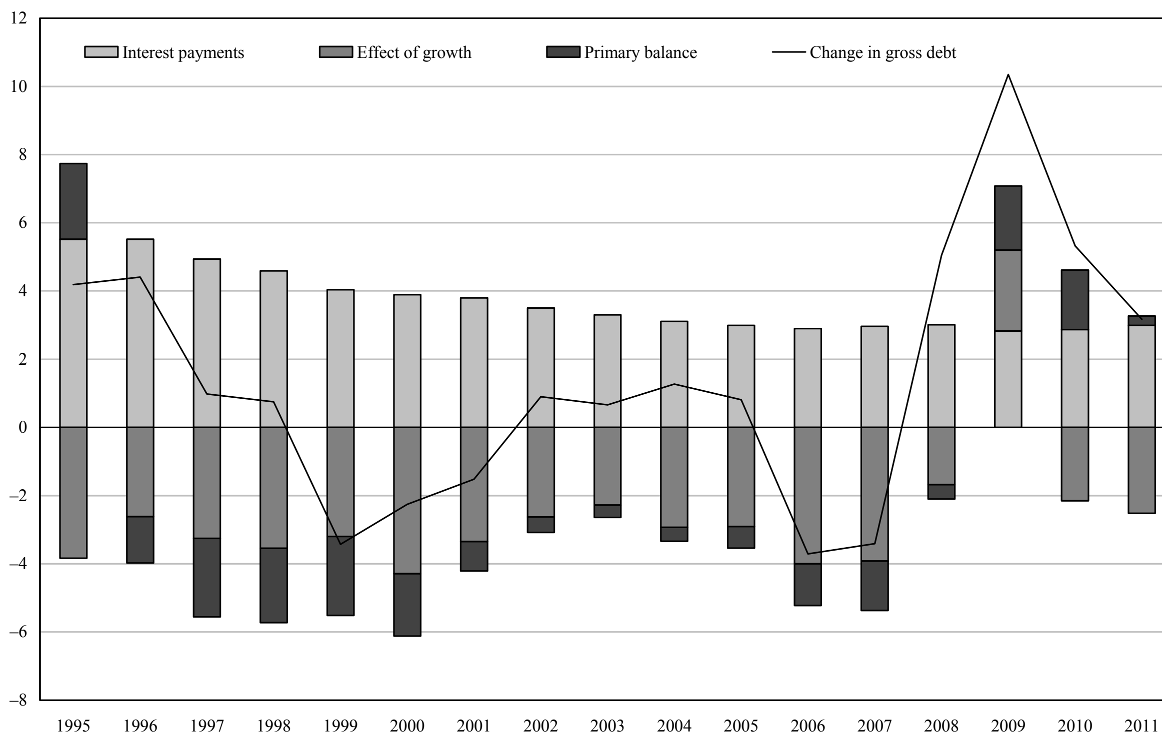
(1) Excludes the impact of some recent reforms, notably in Greece.
Source: OECD calculations, ECP Working Group on Ageing and Pensions and OECD Economic Outlook 88 Database.

(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.

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.

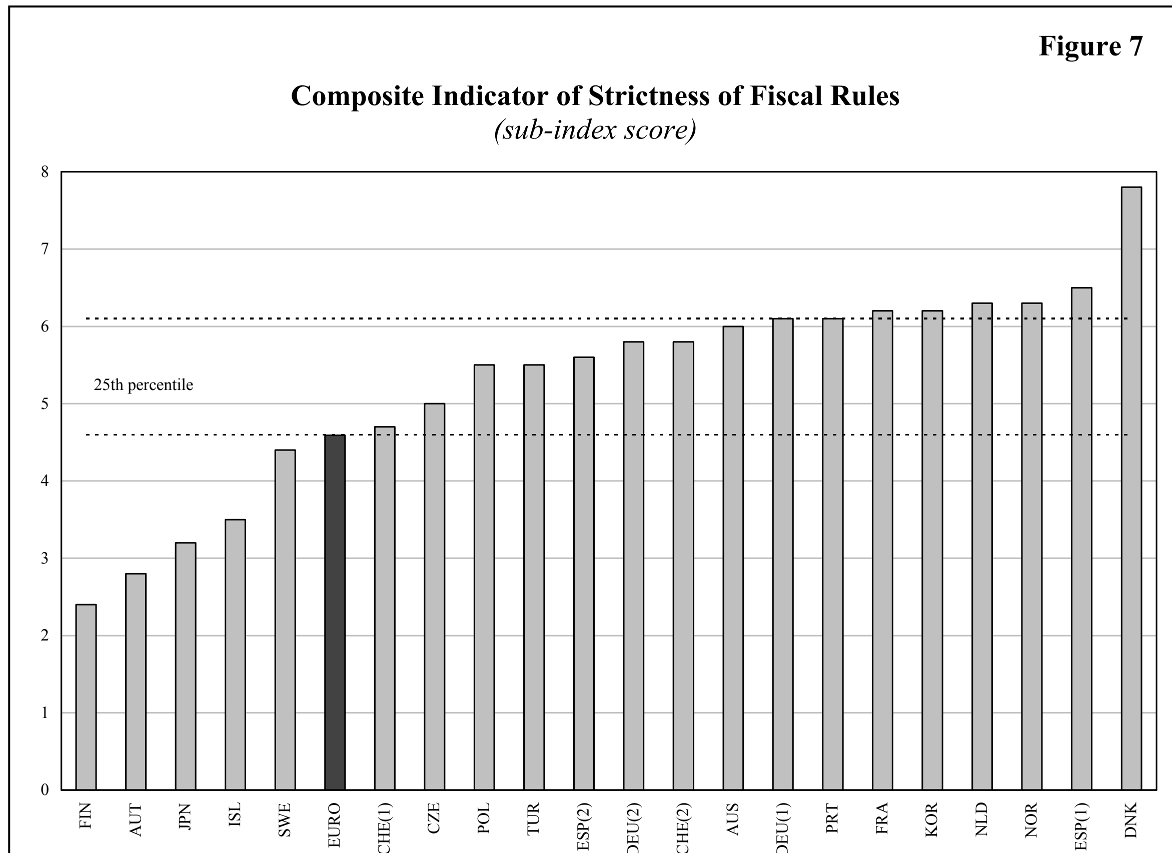


Figure 7

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.

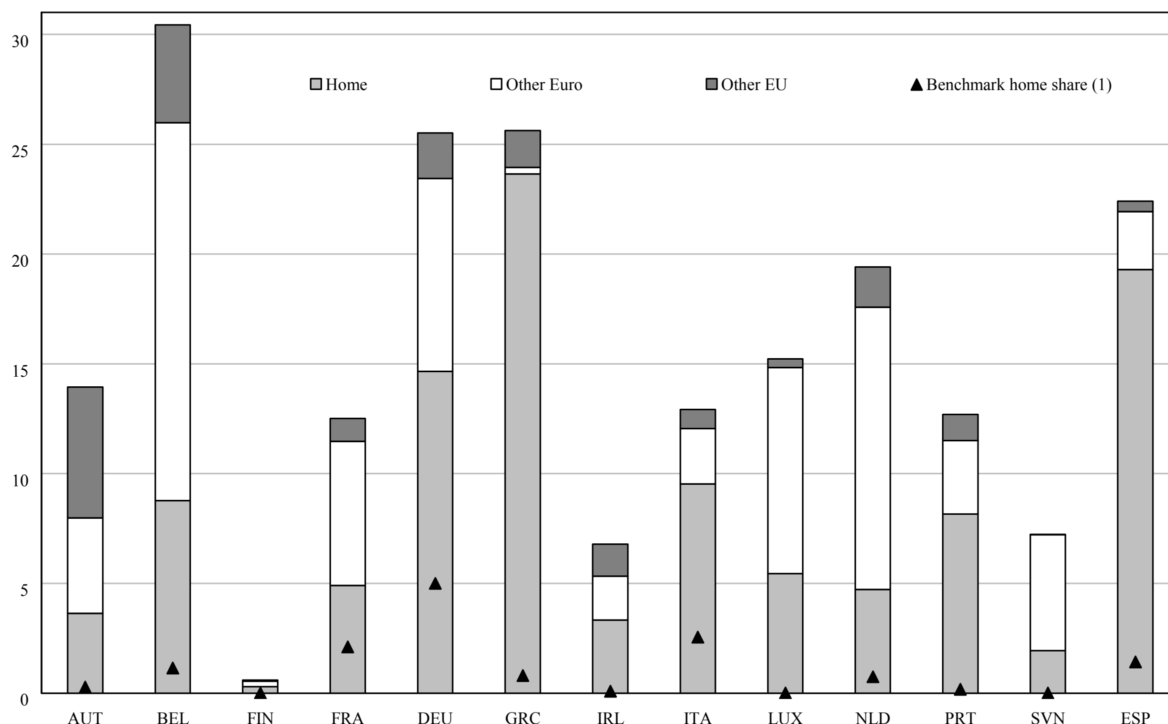
The experience of sub-national governments in OECD countries suggests that it is generally difficult to enforce "no bail-out" conditions because of the time-inconsistency problem. When a state is in trouble, the central government will have an incentive to act if failure would lead to: macroeconomic 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

[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.

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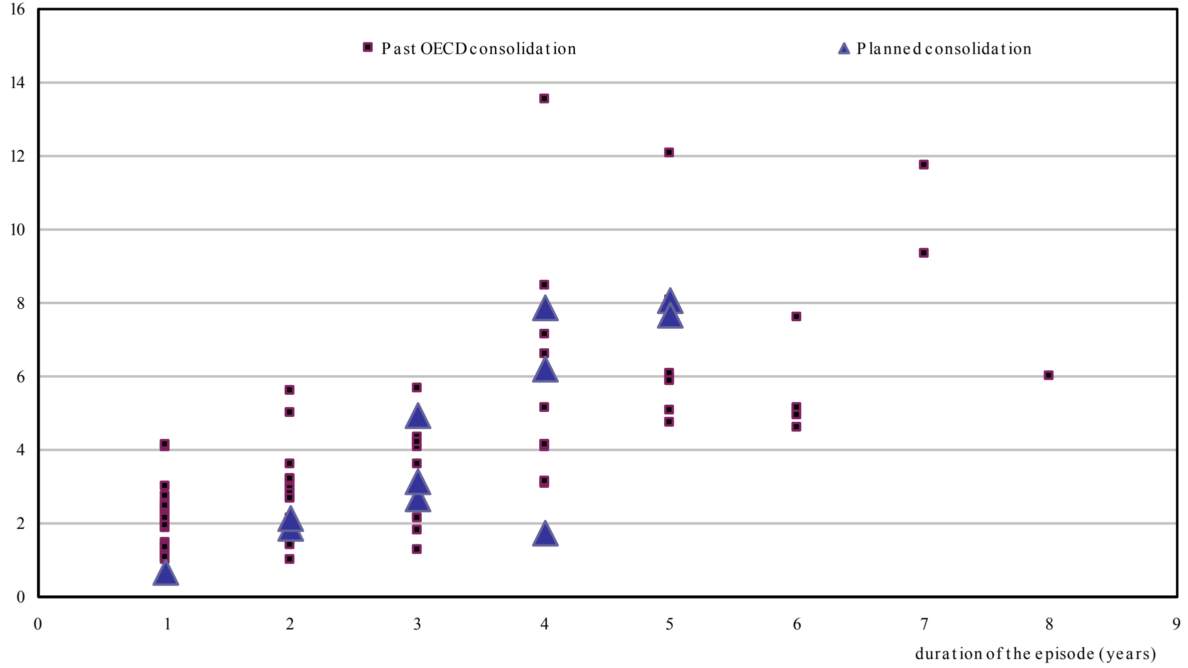
[16] Consolidation for Ireland is understated under this methodology as some of the current episode occurred prior to 2010.

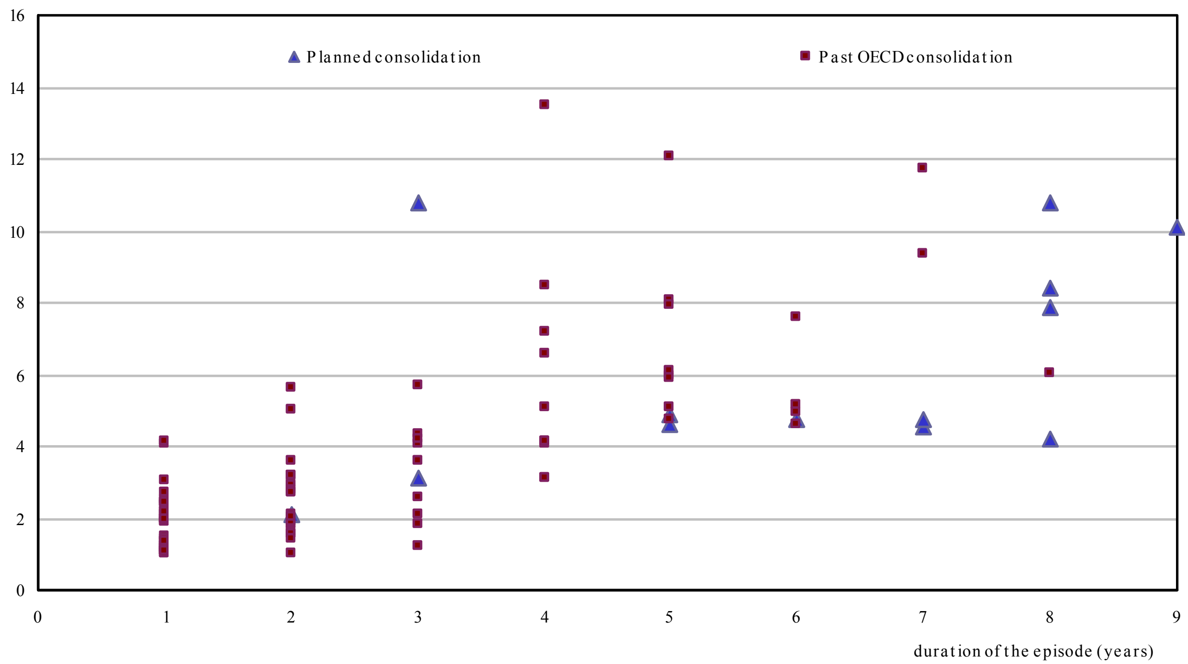
Figure 9

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:

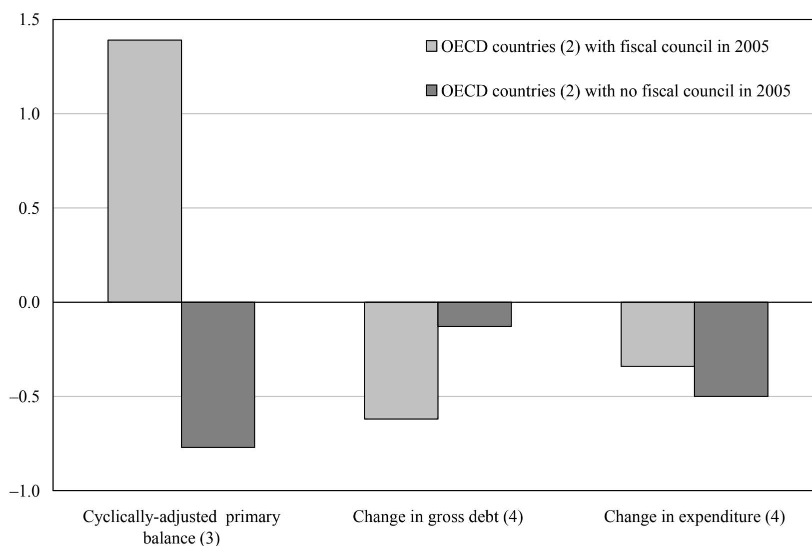
- preparing independent forecasts of the public finances to remove bias;
- independent fiscal policy assessment. At a minimum, this should include assessing whether fiscal rules have been met. This is particularly important where judgment is required. More broadly, a fiscal council can provide normative 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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CLOSING THE GAPS OF THE SGP. WHY A SOVEREIGN DEBT RESTRUCTURING MECHANISM? REFLECTIONS FROM A POLITICAL ECONOMY PERSPECTIVE

Christian Kastrop[*] *and Werner Ebert*[*]

1 Motivation

The agreements reached by the European Heads of State or Government at their recent summits and the succeeding implementation steps have caused intense public discussions. The crucial question is if the tools developed under the new EU coordination framework, including the fiscal compact, provide a comprehensive answer in resolving the major economic and fiscal crisis in the euro area or if major conceptual issues remain which could lead to a prolongation of the current turbulences. One major flaw is still evident and will be of great influence. The summits did not answer the crucial question whether there is a bail out or not; markets will further speculate on the answer.

At the same time the current debate reflects fundamental misperceptions of the political economy of the EU economic and fiscal governance. This raises the question of how to address the possible conceptual shortcomings.

In this essay we explore what we see as major structural gaps or black holes of the SGP architecture and of the macro/microeconomic governance and we propose as a vital complement to the current (reformed) framework a comprehensive sovereign debt restructuring mechanism. We clearly offer the following view: there will be no solution without a clear perspective concerning bail-outs and an insolvency scheme or full joint commitment for all sovereign debt. And we also clearly expect that the latter alternative brings us into a state of the union of a quite different kind with very dangerous economic, political and legal pitfalls.

We derive our conclusions from a political economy perspective as we focus mainly on the institutional side of the EU governance. In a way, we contrast the ongoing real time politics with an ideal-type view or blueprint idea, as the German sociologist Max Weber once put it. Furthermore, if we want to break new ground and get a full picture of the European Scenery, we have to know where we come from – historically and institutionally. Having been involved in all the stages of SGP development and reform starting from the late nineties and during the last decade, we start with a reflection of the history of the SGP from the very beginning until the current crisis.

When assessing the current reform package labelled SGP 3.0 based on quite reasonable proposals by the European Commission, we turn the screw of these ideas slightly further and focus on structural gaps which have not been closed by the current reform, not even by the fiscal compact from December 2011. We refer to important fiscal governance elements that were under discussion in the European arena in recent years. We also assess the fiscal and economic governance elements which have been laid down in the current 6-pack (plus fiscal compact) with a plea for an integrated approach.

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[*] Contacts: Werner.Ebert@bmf.bund.de and Christian.Kastrop@bmf.bund.de

The authors work at the German Ministry of Finance, Berlin.

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Derived from the severe shortcomings of the whole governance architecture, the debt restructuring issue brings an additional dimension into play: a comprehensive approach with an orderly use of market forces and the systematic involvement of private actors beyond the political process. The basic ingredients for such a complementary framework will be compared with the current ESM consensus from a political economy or public choice perspective.

2 From SGP 1.0 to the sovereign debt crisis

In order to reach a full understanding of the underlying problem structure of the current economic and fiscal developments in the present institutional setting, it is sometimes wise to reflect historically where one comes from, the fundamental ideas and different stages of the evolution of the SGP framework and the specific reasons for the respective institutional set-up.[1]

2.1 The invention of SGP

The well known basic premise of the original Stability- and Growth-Pact for the nineties relied on the conviction that the independent monetary policy of the ECB has to be and can be complemented by a political process of controlling public finances and of indirectly fostering convergence in the euro area – without leading to a "gouvernment economique". That philosophy implied that the prevention and correction of unsound fiscal (and economic) developments depends exclusively on the effectiveness of cooperative political institutions, processes and actors.

In substance, the Pact in its "premature" state of the art at that time focussed on the current deficit, the 3 per cent ceiling in the famous dictum of the former German finance minister Theo Waigel: "3.0 is 3.0". What was meant by that saying is the presumption that a clear and undisputable focus on the deficit is necessary and sufficient to ensure sound public finances in the euro area. Although the 60 per cent public debt criteria was already mentioned in the Maastricht Treaty, there was a general consensus that – under certain then realistic assumptions for GDP growth and interest rates – respecting the deficit criteria would automatically lead to a convergence of the public debt level below 60 per cent. Although scientific literature already had developed the concept of fiscal sustainability,[2] there was no sense for or focus on fiscal sustainability in the fiscal policy debate.

Nevertheless, what was rooted in the expectations of political stakeholders at that time – particularly on the German side – was the conviction that beyond the institutionalized political pressure of the Pact, market forces expressed by interest rate spreads would continue to do their job and create sufficient complementary incentives to discipline the fiscal policy of politicians. It turned out that this ambition was not met by reality, on the contrary, a strong convergence of interest rates in the currency union occurred in the run-up to EMU. In addition to "false" exchange rate relations specified for entry to the EMU, that under-pricing of risks[3] weakened the stabilizing effect of an exclusively politically steered SGP process.

The lesson to be learned from that history is that the narrow focus on the public deficit and the dependency of a full functioning political process with a "blackout" of disciplining market forces were key issues in the early phase of the SGP which must be addressed in the subsequent reform periods. And, it should not be forgotten that the issue of sustainable economic development

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1 See, e.g., EU COM (2011), Van den Noord *et al.* (2008), and Heipertz/Verdun (2011).

2 See the seminal paper by Blanchard *et al.* (1990).

3 See, recently, OECD (2010). That unsound development was countered later by an overshooting on the upside.

Table 1

Public Finance in EMU
(public deficit, percent of GDP)

Country	97-01	2002-06	2007	2008	2009	2010	2011	2012	2013
Belgium	–0.7	–0.6	–0.3	–1.3	–5.8	–4.1	–3.6	–4.6	–4.5
Germany	–1.7	–3.3	0.2	–0.1	–3.2	–4.3	–1.3	–1.0	–0.7
Ireland	2.4	1.2	0.1	–7.3	–14.2	–11.7	–10.3	–8.6	–7.8
Greece	–4.2	–5.9	–6.5	–9.8	–15.8	–10.6	–8.9	–7.0	–6.8
Spain	–1.9	0.6	1.9	–4.5	–11.2	–9.3	–6.6	–5.9	–5.3
France	–2.2	–3.2	–2.7	–3.3	–7.5	–7.1	–5.8	–5.3	–5.1
Italy	–2.3	–3.6	–1.6	–2.7	–5.4	–4.6	–4.0	–2.3	–1.2
Portugal	–3.3	–3.9	–3.1	–3.6	–10.1	–9.8	–5.8	–4.5	–3.2
Hungary	–5.3	–8.0	–5.1	–3.7	–4.6	–4.2	3.6	–2.8	–3.7
Sweden	1.0	0.6	3.6	2.2	–0.7	0.2	0.9	0.7	0.9

Source: EU Commission, Autumn Forecast 2011.

leading to a convergence of the euro are economies was more or less taken for granted, there did not exist a serious coordination framework to ensure this.

2.2 The SGP reform 2003/05

Triggered by Excessive Deficit Procedures against Germany and France from 2001 onwards, the launch of the SGP reform brought indeed some progress on the conceptual side. The so-called SGP 2.0 was clearly less simple and mechanistic compared to the original start-up: the whole surveillance process was refreshed and departed to a certain degree from the simplistic 3.0 per cent dogma. Specifically and in addition to the Maastricht reference value, the dimension of sustainability was systematically incorporated in the preventive arm of the Pact leading to a safety margin by shifting the medium term objective close to or above surplus. On the other hand, the fiscal impact of structural reforms was to a certain extent included in the corrective arm, and more transparent consolidation paths (0.5 per cent-points per year) were defined. Not covered in the sustainability and public debt assessment were implicit liabilities or implicit debt.

The other side of the coin, however, was that the institutional backing and the incentive structure of the SGP were improved only partially or even weakened by the "original sin" of the Franco-German case. The enforcement of the Pact based on hard political sanctions remained as an overarching principle. In that sense the power and credibility of the Pact relied totally on the strength and effectiveness of the political process, an idea that was simply proven wrong after 2001. As the former chief economist of the ECB, Otmar Issing, criticized sharply, the reform caused severe political losses which outweigh the conceptual improvements. From a political

economy view, it is indeed this dependence of the functionality of the Pact on a political process which represents the Achilles heel of the whole fiscal coordination architecture.

2.3 *Remaining gaps and missing links to economic governance*

Beyond the institutional shortcomings severe conceptual gaps and undiscovered areas remained: the concept of the Pact at that time oaid no attention to (sovereign) debt risk, the debt criterion remained more or less untouched. Obvious malfunctions of the markets were not addressed. Driven by the hope that different interest rates paid by the currency's members are a sufficient incentive for prudent fiscal policies, *i.e.*, SGP plus markets work, the possibility of market distortions and non-linearities was not recognized. The reality was that, until recently, there were no spreads emerging at all, rooted in a public bail-out belief which could not be encountered by the political stakeholders.

A further conceptual issue was that, although fiscal institutions matter a lot, they were not prominently highlighted in the Pact. The academic debate and the international institutions, EU Commission, OECD and IMF, focussed in recent years on the exchange of best practices regarding the supporting role of institutions for an effective enforcement of fiscal rules. The Pact itself, however, was blind with respect to the national institutional setup.

Moving beyond the mere public finance dimension, a missing link from the SGP to economic governance has to be recognized. Although complementary coordination mechanisms were developed, they had never been devoted to the issue of euro area coherence or systematically linked to each other. Economic governance as the second major arm of coordination in Europe started from scratch and it took some years for the so-called Broad Economic Policy Guidelines, the major coordination tool, to develop – and it evolved in the wrong direction, economically and institutionally. Economically, the focus on growth and competitiveness of Europe as a whole against rest of the world neglected economic disparities or unsustainable developments with the common currency area. Institutionally, squeezed by the heterogeneous interests of the political and bureaucratic actors, a "Christmas Tree" evolved, meaning that a focus on growth and employment, which could function as links to the Pact, could not be produced. And departing from the political platform of the Lisbon Strategy of the year 2000, the Mid-Term Review in 2005 with a final relaunch via the EU 2020-Strategy delivered only insufficient improvement. At least it can be said that the tools of Integrated Guidelines and National Reform Programmes were able to streamline the processes.

Regarding enforcement, the Treaty based BEPGs were even weaker and, as history showed, never focussed on problematic developments. In addition, there was no systematic macro/micro „check" incorporated in the system, for example in form of a competitiveness review or in form of an assessment of the fiscal impact of structural reforms. And we have to keep in mind that we still lived in a pre-crisis world, Greece was not on the institutional radar at all, although it had already materialized in substance.

3 Sovereign debt crisis changes the picture

After the financial markets crisis and the real economy crisis, the Sovereign Debt Crisis (Crisis 3.0) changed the picture dramatically and revealed additional major gaps in the whole governance architecture. As documented in the historical analysis by Reinhart/Rogoff,[4] the

[4] Reinhart/Rogoff (2009).

Sovereign Debt Crisis typically emerges from a crisis of financial markets and real markets and it spreads quickly.

Despite that empirical wisdom, the political stakeholders and also the political economists never imagined that a sovereign debt crisis in a relatively small country could affect the entire Eurozone and weaken confidence in the common currency. Indeed, it was a fact that after the limits of rational markets became visible during the financial and banking crisis in 2008, market beliefs shifted 180 degrees and led to an overshooting of spreads on the upside (today Spain faces a spread more or less equal to North Korea). And it is for the accumulation of systemic risks, the risk that one country's debt crisis will prove contagious for the collective area as a whole, that the SGP without complementary support fails to function as an adequate provision and that we end up with a total bail-out.

That does not mean that governments do not need the markets. On the contrary: we will not find a permanent solution to the Euro zone problems if we cancel out the function served by interest rates signals. This market instrument forces countries, parliaments and governments to take the necessary decisions and reduce incentives for pursuing poor policies indefinitely. Nevertheless, we face a new conceptual problem dimension in the sense that at the end of a political process – represented by the preventive and corrective arm of the SGP - the process does not stop and that the (economic/fiscal) process is not under control.

The strategic question is then: in our attempt to remedy the system, should we still rely totally on the strength of the political coordination framework or should we complement an improved political process (SGP+) with a systematic and institutionalized use of market forces as a disciplinary instrument, *i.e.*, to force governments to do the right things early and comprehensively. One should be reminded that regarding the private sector, there was no monitoring of private bank debt, no clear mechanism for bank failure and inadequate financial market supervision and regulation.

The question of what a systemic response could look like was answered by the real political process. In 2010 time for crisis management was running out quickly, and what followed was mere ad-hoc or piecemeal engineering. Partly, the rescue packages and day-to-day solutions were a natural reflection of the pressing short term-problems which were occurring. Therefore, the creation of the EFSM and the further evolvement of the EFSF were thoroughly necessary steps towards stabilising the situation.

Nevertheless, history demonstrated quite vigorously that such structural weaknesses of a coordination framework cannot be fixed by ordinary measures. In a sense, one could argue that short-term solutions may even turn out to be dangerous precedents as they obstruct the view to the underlying systemic problems and politically they block the requested comprehensive response. We face a clear political lock-in situation.

4 SGP 3.0 – Promising start for problem resolution but more to be done

As the political negotiations on the SGP approached the final stretch we nevertheless enjoyed clear improvements which partly resolve some open issues mentioned above.

4.1 New elements of the Pact and remaining issues

In substance, the public debt criterion now is much more in the focus. It has become a transparent and politically sanctionable reference value. In future, it will not only be obligatory to

Figure 1

New Fiscal and Economic Surveillance System

O V E R V I E W	**More effective Stability and Growth Pact**	• In future, it will not only be obligatory to comply with the deficit criterion (ratio of new debt to gross domestic product (GDP) below 3 per cent) under the Stability and Growth Pact, but also the debt criterion (ratio of total debt to GDP below 60 per cent). • Obligatory reduction of debt: reduction in difference between debt and reference value of 60 per cent of GDP by 1/20 each year.
	Earlier sanctions	Introduction of a sanction mechanism for the euro countries in the "preventive arm" of the Stability and Growth Pact (if public deficit is less than 3 per cent of GDP): obligation to ensure that budget is close to balance/in surplus.
	More rapid sanctions	Reform of the sanction mechanism in the "corrective arm" or the Stability and Growth Pact (if deficit is greater than 3 per cent of GDP and/or insufficient action has been taken to reduce debt): sanctions are triggered more rapidly for the euro countries.
	More comprehensive sanctions	Not only can financial penalties and fines be imposed, in future a Member's EU funding could be cut far more than previously. This would mean a stronger linkage of payments from certain EU funds to sustainable fiscal policies than in the past.
	European Semester	National planning and reporting cycles will be synchronised in the "European Year": the Member States' budgetary and structural policies will be reviewed over a period of 6 months to identify inconsistencies and emerging imbalances.
	New Surveillance Procedure	New procedure for the surveillance and correction of macroeconomic imbalances with concentration on Member States that are running large current account deficits and have lost competitiveness.

comply with the deficit criterion but also with the debt criterion (ratio of total debt to GDP below 60 per cent). The balanced budget will become compulsory and be backed up with sanctions over the medium term. A violation of the deficit criterion and/or insufficient action to reduce debt leads to an EDP and can in the end lead to sanctions under the new regime. The agreed correction path leads to the obligation to reduce excessive debt, defined as the difference between actual debt level and the 60 per cent-reference value, by 1/20 each year.

On the institutional side we can expect – at least on paper – a better and quicker enforcement via quasi-automatic sanctions. In the "corrective arm" of the Pact sanctions are triggered more rapidly for the euro countries. Not only can financial penalties and fines be imposed, in the future a Member's EU comprehensive funding can be cut far more than previously. This would mean a stronger linkage of payments from certain EU funds to sustainable fiscal policies than in the past.

Most important, the overruling power of the Council is to a certain extent blocked. But that necessitates that the EU Commission now takes its responsibility as guardian of the Treaty

seriously, which was in the past not always the case and which can be doubted for the future. Also fiscal institutions are now more prominent, although the conceptual role and the legal status are still to be developed further. These developments are all fine, but it should be seen that there are quite substantive agenda points not settled yet.

One important element is an even more ambitious shift of the SGP anchor (MTO) to surplus as the fiscal impact of the ageing societies calls for a much more prudent safety margin against these developments and in order to increase the resilience of public budgets against future shocks.

As recent analysis by Deutsche Bank Research reveals, the major economies in the world will face a dramatic pressure on public debt, even under a scenario where significant budget consolidation following the current SGP rules is implemented. The quite substantive risk factors and the fiscal sustainability problems will add up to an upward pressure on public debt that can hardly been controlled by merely reaching a balanced budget. Rather, what is necessary are significant primary surpluses. Furthermore, the upward pressure is triggered by the fact that there is no containing effect in the economic upswing. What was conceptually healed in Germany by the introduction of a cyclically adjusted MTO,[5] is unfortunately not implemented in Europe in a real credible manner. These empirical finding should therefore translate into the set-up of the MTOs and the enforcement of the MTOs over the cycle.

There are experts who argue that this kind of tough fiscal consolidation, a smaller public sector and austerity as a paradigm (together with a competitiveness fetish) will lead to a decrease in consumption in these countries in the immediate future and therefore to negative macroeconomic spillovers for the euro area as a whole. We would rather argue that an increase in consumer and investor and financial markets confidence and a shortening of unemployment lines will in the medium term cancel out by far any possible short-term dip of consumption. It will take time before these efforts will bear fruit and the situation normalise. But not consolidating, not sticking to such tough MTOs and reforming now would be much worse and would undermine confidence in the crisis countries and the Euro area even more.

The second remaining major reform element is the revival of the “quality of public finances” agenda, meaning that the link between public budgets and economic growth being systematically highlighted in the surveillance process, mirroring the issue of the (macro-)fiscal impact of structural reforms.

Starting from the year 2000, there was an ongoing debate on complementing the Pact with a process that tries to capture the growth effects of public expenditure and revenues resulting in a widely acknowledged EU initiative by Germany, Denmark and Austria, backed by the EU Commission and the Economic Policy Committee of the EU.[6]

The task in this concept is threefold: first, there is a need to assess the effects of the composition of public expenditures on sustainable growth and employment. At issue here is mainly the prioritization of expenditures as well as efficiency and effectiveness analysis, for example in the policy areas of social spending, R&D, health care and education.

Second, we have to analyze how the tax structure can contribute to sustainable growth paths. OECD[7] has done a great deal of work in that field and recent analysis shows that national tax policies were among others responsible for asset price bubbles particularly in the housing sector.[8]

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[5] There are still open issues, see Ebert (2012).

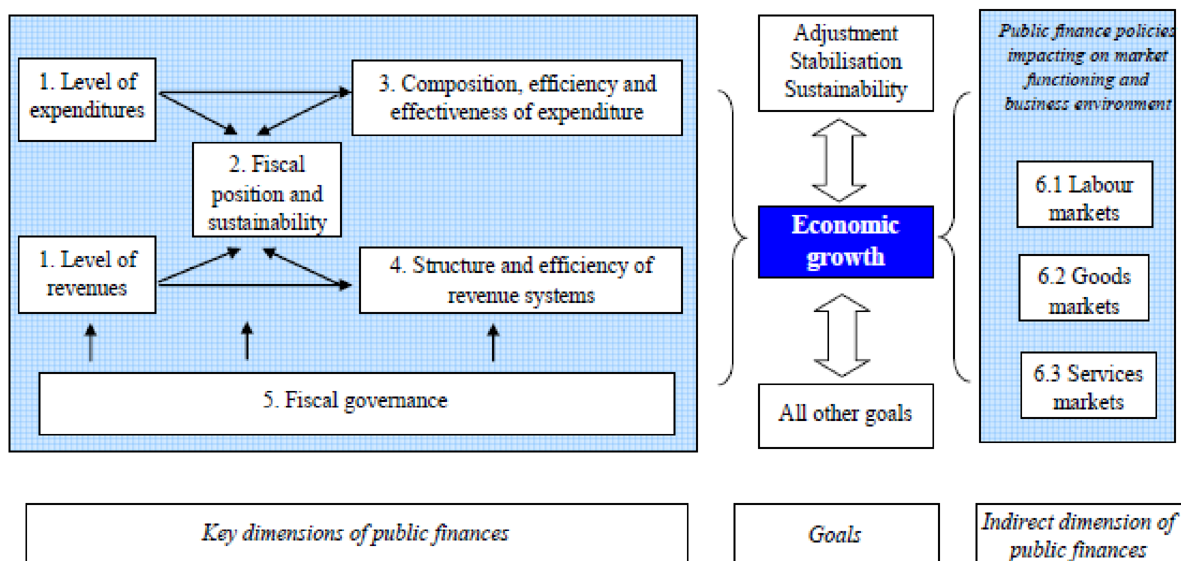
[6] For a comprehensive overview see Kastrop/Deroose (2008) and Ebert (2009).

[7] Heady (2007).

[8] OECD (2010).

Figure 2

The Quality of Public Finances: A Multi-dimensional Framework



Source: Barrios/Schächter (2008) with further references.

Third, we have to deepen our understanding of fiscal institutions and the role of national implementation of EU type fiscal rules. We would like to point here to the experience made in Hungary, where the then independent Fiscal Council was chaired by George Kopits,[9] but also to other independent bodies, such as in the Netherlands or Sweden, which help to control public expenditure and which procedures like Top-down-Budgeting (for strength of fiscal rules and institutions, see Figure 3).

A further gap of the SGP which is only closed partly relates to the full integration and strengthening of national fiscal rules and frameworks in the Pact. As we learned, the political process under the Pact will not be sufficient to realize the necessary prudent fiscal policy path without backing by the national fiscal authorities. Therefore, to add clear procedures regarding the transfer of the European logic into national rules and institutions, as done in the case of Germany, or even amend the SGP logic with complementary framework tools is key. And the fiscal compact from December 2011 points exactly in that direction, although it is not clear yet if that transfer of institutions into national law will materialize as it was envisaged.

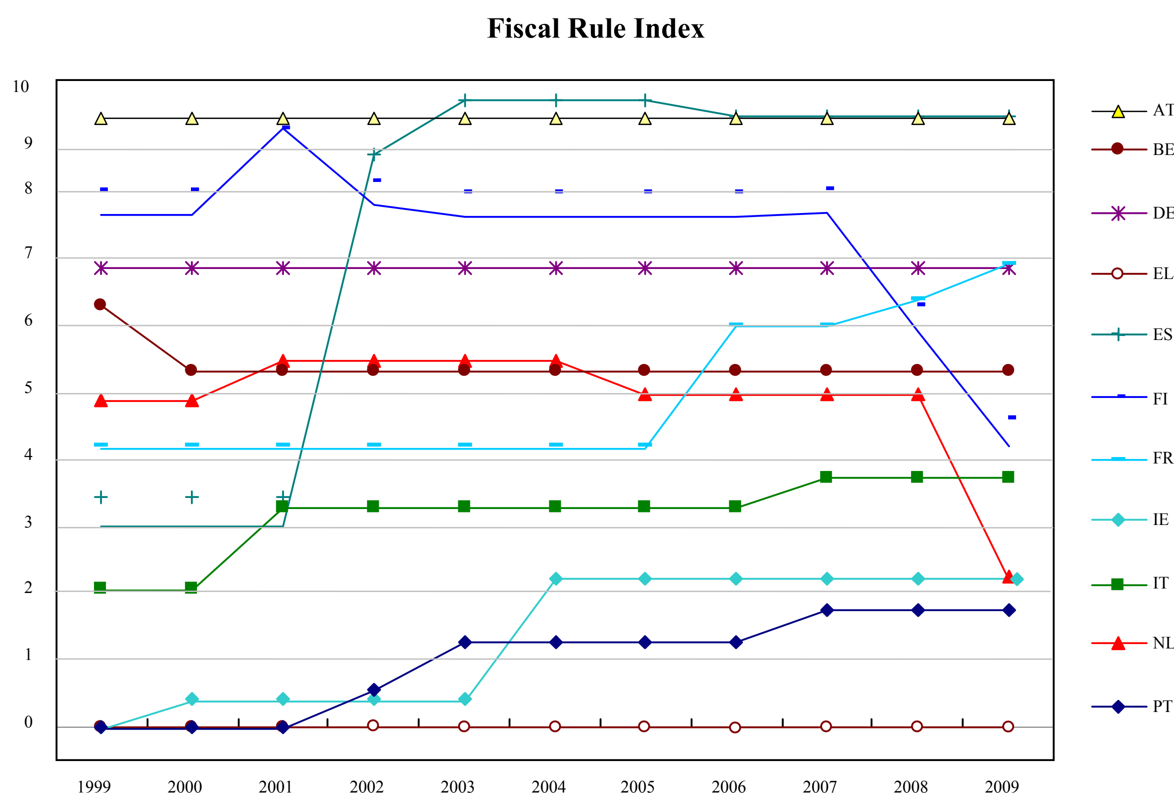
4.2 The fiscal compact

The decisions taken by the European heads of state and government on 9 December 2011 regarding a new fiscal compact represent an important step forward towards the formation of a fiscal union in the spirit of a stability union. Based on the model of Germany's constitutional debt rule which itself is based on the EU fiscal stability model, the Euro countries commit to introduce national arrangements for balanced budgets. In future, the annual cyclically adjusted deficit is not

[9] See Kopits (2012), in this volume, and the supporting Debrun/Takahashi (2011), as well as Nyikos (2012)

Figure 3

Fiscal Rule Index



Source: Iara and Wolff (2010).

allowed to exceed 0.5 per cent of GDP. This should on a long-term basis ensure that budgets are kept close to balance over the economic cycle, while fiscal policy can be counter-cyclical.

This national budget rules are supposed to strengthen the preventive arm of the SGP. The rule will be introduced into national legal systems at constitutional or equivalent level. It is planned that the European Court of Justice will control whether the new budget rules have been correctly transformed into national law. This is an entirely fresh aspect which emphasises the credibility of the fiscal compact.

Furthermore, the preventive monitoring of national budget policies will be enhanced noticeably. This goes so far as to enable the European Commission to ask a Member State to resubmit a budget. The corrective arm of the Stability and Growth Pact will be further strengthened on the basis of inter-governmental agreement. Member States under EDP are to commit to detailed consolidation and adjustment measures as part of a partnership programme, with compliance monitored by the European Commission and Council. Furthermore, sanctions imposed on Member States for exceeding the 3 per cent deficit threshold will be triggered in a more automatic way. All recommendations and decisions leading to sanctions can only be rejected by qualified majority. This introduces an automatic response that substantially limits the leeway for generous interpretation of the provisions.

The rules and obligations of the new fiscal compact should be implemented by way of primary legislation in order to strengthen their binding force; this was a particular concern of the German Government. However, as long as this step towards integration is not taken by all

27 Member States, any amendment to the treaties is impossible. Therefore, implementation is to be achieved initially via an inter-governmental treaty, with the objective of bringing it under EU law subsequently.

4.3 Integration of fiscal and economic surveillance

The experience with the unsustainable developments in some countries of the euro area, combined with unsustainable fiscal positions revealed that the economic governance in Europe cannot solely rely on a tough fiscal monitoring. What is needed instead is a systemic integration of fiscal and (macro-/micro-)economic governance in the corrective and in the preventive arm. The "New Normal" after the crisis is to put economic imbalances and unsustainable position, competitiveness questions as well as the coherence issue in the euro area and the micro-macro/fiscal link to the forefront of the surveillance process and on the political agenda.

In that philosophy, a new procedure for preventing and correcting macroeconomic imbalances has been developed, partly complementing the EU2020-Strategy and taking up a few institutional elements of the Pact (e.g., the form of an Excessive Imbalances Procedure EIP).

Not all new elements of that process can be reviewed in this paper,[10] therefore we want to focus on two issues: economically, there has been an ongoing discussion about the focus of the assessment of external imbalances, if the procedure should be applied symmetrically (current account surplus countries should also be subject to an EIP) or asymmetrically (only deficit countries are under closer surveillance). Much has been said about the economic reasoning for both sides – the pure micro pro-competitiveness view against the pure macro-view. Using some economic common sense and taking a look at the historical figures, it seems quite reasonable that a moderate (a)symmetry, for example –4/+6 per cent (plus a catching-up mark-up if appropriate) could serve as thresholds. That would give the country specificities, such as the export orientation of countries as in Germany, enough room without releasing them from co-responsibility for the coherence of the euro area as a whole. A link to the SGP in this procedure can be created if the implications of public and private debt to the stability of the euro area are addressed in the analysis. Other important issues in this context are the role of external debt, the identification of asset price bubbles and a clear focus on competitiveness in general. Widely undeveloped in this surveillance process and also in the work of the ESRB is a systematic macro-prudential supervision of financial markets in a general (macro- and micro)economic context. A lot of follow-up work on that issues will be necessary to make the picture complete.[11]

A word on the Lisbon Strategy and its follow-up, the strategy Europe 2020: Although it is economically reasonable to focus economic surveillance on competitiveness combined with macro-structural aspects, the case of Greece brings one additional dimension in the focus which has not been addressed conceptually by the European institutions. The central aim to take care of a coherent and sustainable economic development in the common currency area in principle should call for a renewed Lisbon Strategy focussed on growth and jobs – and convergence of developments. To focus this task on competitiveness, as done by the EIP, seems much too narrow in view of the immense challenges a dispersed euro area faces. Insofar the Lisbon Strategy after the Mid-term review in 2005 was right in focus; again, it lacked a constructive institutional back-up and it lacked a second stage in form of an economic union which is able to steer growth in the respective regions. The Strategy Europe 2020 with its Christmas tree approach and unclear competences is not capable to fulfil such an ambitious task.

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10 See the respective COM proposals and Ebert (2011).

11 See Pisani-Ferry, J., A. Sapir and G. Wolff (2011); and keep in mind the bad (surveillance) examples of Ireland and Iceland.

The second crucial issue, however, concerns again the institutional side. The experience of developing an economic governance under the former Art. 99, now Art. 121, of the Treaty, made clear over the last decade that, despite having reached some mutual understanding of national economic policies within the EU, it is a long way to go reaching a surveillance process which is sharp and focussed and shows the necessary bite. Until today, the processes have been diluted in a bureaucratic monster with too many stakeholders in charge, from the side of the EU Commission (where DG ECFIN lost leadership) and from the side of the Council (where ECOFIN lost its dominating role) – and it is highly improbable that the treaty based processes will in the future deliver reasonable recommendations for national economic policies or even sanctions, and that might be true even for the economic surveillance under the new macroeconomic procedure: anyway, its main task will be to focus on the problematic, unsustainable developments and to draw substantive structural recommendations which are backed by a credible enforcement technology.

The introduction of the European Semester as a formal requirement is by far not sufficient for that ambitious institutional task. Although synchronizing the national planning and reporting cycles and structural policies in the "European Year" may help to identify inconsistencies and emerging imbalances, what is really needed is the political will of the Council of the Commission to fill the new EIP with life. The first round of assessment in June 2011 was far from promising and shows a clear danger of once again diluting the process.

5 Why a sovereign debt restructuring mechanism?

The historical reflection showed that the governance architecture re is incomplete both in substance and in its institutional set-up. Now, after the reform of the SGP by the 6-Pack plus fiscal compact and the installation of the European Stability Mechanism (ESM) replacing the EFSF and EFSM from mid 2012 onwards, the crucial question comes up if these new tool are sufficient to prevent and to manage the crisis. Greece, which is now predominantly an emergency management case, is not the issue here, we focus more on the "unknown future", the possible next crisis. The task is twofold: improve the resilience of the system against a new sovereign debt crisis and minimize economic costs if an emergency case does arise.

5.1 SGP 3.0 Plus fiscal compact and new ESM – Sufficient tools to prevent and manage the crisis?

The new ESM builds upon and complements the SGP framework and the existing short-term solutions EFSF and EFSM.[12] The ESM is equipped to assist countries whose financing problems threaten the stability of the Euro area as a whole. Its toolbox consists of loans provided on condition of strict economic reform and adjustment programmes, the right to intervene in primary and secondary markets, the ability to recapitalise financial institutions of systemic importance and precautionary programmes.

The ESM is characterized by a focus on liquidity help as it is derived from the EFSF and from IMF type liquidity facilities. Even if the main purpose of the ESM is to avoid a situation in which an illiquidity develops into a state insolvency, through Collective Action Clauses (CACs) as ultima ratio-measure it provides at least basic elements for an orderly debt restructuring, should such restructuring become unavoidable.

[12] This new governance structure cannot be described in detail, for details see Schuknecht *et al.* (2011) and German Federal Ministry of Finance (2011).

One month after the ESM treaty will come into effect, CACs will be introduced in all new sovereign bond contracts of Euro area countries with maturities of more than one year. This makes allowances for the fact that the decentralized approach of CACs is becoming the predominant instrument to enable easier coordination between bondholders for a debt restructuring. They will assist in fostering an early dialogue between the debtor and the bondholders. And they hopefully will prevent individual creditors from blocking negotiations on specific debt restructuring models. Although these EURO CACs are principally based on existing CACs under UK and New York law, they have been re-modelled in order to find a distinct balance between an effective restructuring and creditor interests.

In this context, it is noteworthy that Euro zone finance ministers in March 2011 explicitly decided that an aggregation clause is to be introduced which allows an aggregation of claims across different instruments. For this to happen, a two-stage decision-making procedure with different majorities is envisaged, the result of which is binding for the outvoted minority. This restructuring-friendly approach will be counter-balanced by creditor-friendly majority rules. In particular, it is guaranteed that any decision is taken at least by a simple majority. It is also envisaged, that creditors may appoint a representative who prepares for negotiations with the debtor country.

If we look on the negative side one has to acknowledge that, analogous to the IMF toolbox, although a thorough debt sustainability analysis is the core of the decision basis, the concepts and definitions of debt sustainability are far from clear or transparent.

Its governance is politically driven and it is based on unanimous decisions, as was the rule in the SGP before the recent reform. Here the political economy mistakes of the setup of the SGP are repeated for worse. And similar to the SGP process one can question if the conditionality of the mechanism and sanctions in the case of deviation are strict enough.

Against that background the danger of moral hazard and bail out through the back door is quite realistic. The ESM set-up has a malevolent incentive structure for markets and for both, indebted and „supporting“ countries. This has fostered the public view of a looming transfer union which could indeed be a realistic alternative if one has a clear euro federal vision. But again, even in such an equalization regime, the right incentive structure would be needed, as the German system of fiscal equalization and its treatment of emergency cases demonstrate. Even in such a system we are not out of the game and maybe that bridge to such a vision is still a bit too far to cross.[13]

5.2 *Elements of a comprehensive crisis mechanism*

Under current circumstances it is in any case unavoidable that we reach a comprehensive and complementary crisis mechanism which is more than just ESM. And, as Barry Eichengreen pointed out recently, the systemic question will arise soon.

What we have to clarify is the starting position of the countries with SD-Problems, and we should always keep in mind that we do not primarily face a financial market problem rather than a structural economic and fiscal problem. A negative track record within SGP 3.0 procedures immediately leads to the question whether we are dealing with an “illiquidity or insolvency case”. Independent of the decision who conducts such an assessment, we propose that if a clear solvency case exists, managed default should be possible. This no-bail out message, which at the same time safeguards against contageon, is a favorable way of healing the disease instead of fiddling around with the symptoms.

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[13] See the assessment of the economic advisors at the German Ministry of Finance, WBR (2012).

In a suitable setup, we first need a tool: an independent debt sustainability analysis which clearly indicates whether we have an L or S case. Several concepts are available and could be checked for significance, for example a mix spreads, debt stock, market environment, implicit debt and other indicators. Such an evaluation could be undertaken by the ECB, the ESRB or – better – an independent Fiscal Council. We have to distinguish clearly between liquidity and solvency: we surmise that, except in special cases such as Ireland, the real problem remains the solvency issue and not transitory liquidity difficulties which can indeed be solved by EFSF/ESM.

One issue of utmost necessity should not be overlooked: it is absolutely crucial not just to think in terms of crisis resolution, but in terms of crisis prevention. Crisis tools might help resolution but can be very detrimental from a prevention point of view. Even if a mechanism would be more costly in the short term, this should be judged against the tremendous prevention effect.

So, in the end the core mechanism of the restructuring part[14] of the crisis tool box is all about incentives avoiding moral hazard and blackmail potential from markets and countries with adequate governance: decisions in principle will then be case by case. As an example, a necessary debt restructuring could include the following elements:

1) significant debt haircut (50 per cent);
2) guaranteed debt part with premium (30 per cent);[15]
3) free-floating part to test markets (20 per cent).

Case by case means a toolbox for a comprehensive ESM; while ESM is not given here there is some sense to use the existing ESM also as a "broker" for a managed default "deal" with the ingredients: CAC's, guarantees, liquidity, collateral of the country concerned where available. Default should by no means be "attractive". Therefore tough conditionalities are needed such as fees, mandatory programs, tight fiscal control and even the (partial) loss of deficit sovereignty. The other necessary side of the coin is the systematic integration of financial market regulation into the governance structure. From a public finance point of view issues like FTT are relevant here not only for getting returns but also in terms of political economy.

Important will be the governance structure of the crises mechanism – additionally to the right "set" of economic incentives. In principal there are three "governing" principles: market driven, politically driven or independent. A clever combination of all three would probably deliver best results, not only in economic terms but – what is at least of the same importance – with respect to political economy. However, it can be left open here, which specific institutional setup will serve best: options range from a loosely institutionalized but very efficient and fast setup like the London Club via an substantial extension of the ESM structure plus independent fiscal council to a formalized procedure like an Re-solvency mechanism.[16] In any case, under the current state of the European Union, a pure politically-driven mechanism/institution seems to be less favorable. The whole SGP 3.0 corrective/preventive arm and complementary measures of the fiscal compact are so far to a large extent politically driven, in decision, in commitment and even in enforcement.

If a country seeks support within a crises mechanism neither the pure market, nor the pure political solution might be feasible. Market driven would imply no political influence at all. Just political driven/enforced crises mechanism, with strong conditionality and a potential loss of certain budgetary sovereignty, would probably fuel political stress, not only in receiving but also in

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14 See also Darvas (2011).

15 See for an alternative option of a European Redemption Pact the German Council of Economic Advisors SVR (2011).

16 See, for example, Paulus (2012).

"giving" countries, when a guarantee or equivalent or at the very end tax payers money is necessary. If we stick to the ESM, the crisis management institution needs to be converged to an independent and expert driven mediator between markets, countries in trouble and the community which has to cushion the unavoidable pain and bridge the gaps. It is that reason why a political ESM should be supported strongly by a European fiscal council, which should be installed in any case as supervisor. Insofar, we go slightly beyond the scope, George Kopits has outlined for such a Council.

6 Summary and outlook

We are in the process of creating the structures for a fiscal union which in principle allows us to overcome the mismatch between monetary and fiscal policy coordination and restore public and financial market confidence. If we have a fiscal union that makes the Stability Pact more binding and enforceable, and which does the same for provisions to improve competitiveness, we could convince the public and financial markets that European Monetary Union will remain stable. Nevertheless, taking a broader and more long-term view and following the political economy reflections of the last 20 years of economic governance in Europe, there is significant room for improvement and the following ingredients of a comprehensive and systemic response are crucial to improve the resilience of the euro area system and to manage crisis in an orderly manner.

- First of all: let markets work, but of course with a clear-cut regulation and a ban on all financial activities which have clearly no positive impact on the real economy. Whether this is done by pure regulation or equity provisions of 100 per cent on certain activities or a financial transactions tax should be judged against other arguments (fiscal, locational factors, etc).
- Second: profit oriented rating agencies have to be cut off and only NGO's should deal with ratings as "consumer agencies".
- Third: full implementation of the six-pack and complementary measures such as the fiscal compact treaty (solve the legal ambiguity as soon as possible)
- Fourth: implementation of a full-fledged and partly independent crises mechanism with liquidity and solvency "arm". The ESM institution as mediator between markets, state and community, supported by an independent Fiscal Council. There is no bail-out but a rescue line which will be calibrated between all actors. Funds shall not be limited beforehand, they are created when they are needed.
- Fifth: the ECB will not be in the game, but as with any other central bank should still be the final lender of last resort in their fully given independence.
- Sixth: the fiscal strategy needs to be accompanied by an intelligent growth strategy, and that is the reason why we strongly call for a revival of the Quality of Public Finances Agenda which unfortunately had been block on the EU level by political interests. Such an agenda is conceptually clearly linked to a renewed Lisbon agenda, the new EIP and to the Pact 3.0.

Debt crisis have always been hard and costly to solve as they require significant behavioural, financial and institutional changes. A stage has been reached where countries within the Euro area have to make overdue and painful structural adjustments. We have come to a point where more solidity is the only thing that will increase confidence. To this end, we need stronger European institutions. We do not claim a European super-state rather than a new form of governance that does not just transfer certain competencies to a more central level by international treaty. The approach that the Euro zone has to take is taking limited but stringent additional steps towards a

deepening of institutions, otherwise we will not succeed in equipping Europe to act in the long term. This process is underway in the Euro area and we have presented further proposals for a comprehensive solution. But what should be avoided at all cost is a disorderly default and instability and default spreading from one country to others and by that leading to a breakdown of the euro area.[17]

[17] See also the reflections in Thiel (2010) and the recent, quite bold proposals by Marzinotto, Sapir and Wolff (2011).

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RULES AND RISK IN THE EURO AREA: DOES RULES-BASED NATIONAL FISCAL GOVERNANCE CONTAIN SOVEREIGN BOND SPREADS?

Anna Iara[*] *and Guntram B. Wolff*[*]

The strengthening of national fiscal frameworks, including numerical fiscal rules, has recently been proposed as an important part of the economic governance reform of the EU. The strength of numerical fiscal rules can be described along the dimensions of their statutory base, the room to revise budgetary objectives, provisions for their monitoring and enforcement, and their media visibility. With a unique data set summarizing the quality of national fiscal rules along these dimensions, we show that stronger fiscal rules in euro area member states reduce sovereign risk. According to our estimates, yield spreads against Germany of countries with relatively weak fiscal rules could be up to 100 basis points lower if they upgraded their numerical fiscal rules. The legal base turns out to be the most important dimension for the perceived effectiveness of the rules. The effectiveness of the correction and enforcement mechanisms turns out to be very important as well, while the role of the bodies in charge of monitoring and enforcing compliance is somewhat smaller. Overall, national fiscal rules are found to be beneficial for market assessments of governments' ability and willingness to timely service debt: they could thus provide an effective way to implement fiscal discipline.

1 Introduction

The ongoing economic and financial crisis has put public budgets world-wide under extraordinary strain. Large public spending packages designed to support domestic consumption and the financial sector coincided with sizeable drops of public revenue and resulted in soaring public debt in many countries. The members of the euro area experienced an increase of public debt from 66 per cent of GDP in 2007 to 79 per cent in 2009 on average. At the same time, differences of government bond yields relative to German bonds have increased markedly in euro area members. A part of the increase in these spreads can be attributed to different developments in explicit debt (Schuknecht, von Hagen and Wolswijk, 2010) and government liabilities due to potential banking liabilities (Gerlach, Schulz and Wolff, 2010; Ejsing and Lemke, 2010).

Going beyond these factors, investors' expectations regarding the credibility of the commitment of governments to ultimately correct unsustainable fiscal policies could be a further central determinant of increased sovereign spreads. In the wake of rising bond spreads and increasing fiscal difficulties, several governments in the euro area are currently contemplating the introduction of stronger fiscal rules to increase confidence in the sustainability of public finances. Germany recently introduced a constitutional rule, the "debt brake", to limit government debt. France, one of the largest euro area countries, is currently concerned about preserving the AAA rating of its debt and about the yield of its sovereign bonds relative to Germany.[1] The introduction of a debt brake is therefore deliberated in France as well.[2] Moreover, the strengthening of fiscal

[*] European Commission, DG ECFIN. E-mail: Anna.IARA@ec.europa.eu and Guntram.WOLFF@ec.europa.eu

[1] See, for example, the interview with Christine Lagarde, the then French minister of finance, in the *Financial Times*, 23 August 2010, http://www.ft.com/cms/s/0/d1b79676-ae16-11df-bb55-00144feabdc0.html The French prime minister Francois Fillon voiced concerns in this regard as well (see *Le Monde*, 10 June 2010).

[2] Going further, stronger fiscal rules might even reduce short-term consolidation needs as they might increase investors' trust, thereby allowing for a more gradual fiscal exit (Fatás, 2010).

frameworks at a national level has received particular attention in the euro area in view of the difficulties to effectively enforce European fiscal rules. A legislative proposal to strengthen numerical fiscal rules at EU member states' level has been made by the European Commission (ibid., 2010a) on September 29, 2010.[3]

The present paper investigates whether national numerical fiscal rules can contribute to containing the interest required on government bonds. Based on a unique dataset on fiscal governance in EU member states, we show that stronger numerical fiscal rules contribute to lower government bond spreads, in particular in periods of higher risk aversion of market participants. In particular the legal base turns out to be the most important dimension for the perceived effectiveness of the rule. The stronger the statutory base establishing national fiscal rules (that may vary between mere party coalition agreements and constitutional law), the lower risk premia will be. But also the enforcement mechanisms of the rules turn out to be important while the body in charge of the supervision of compliance with the fiscal rule appears to be somewhat less important. Our results thus show that rules become the more credible to market participants the stronger their binding character is, and the more effectively they can be enforced.

Numerical fiscal rules are a central part of the institutional setting of countries that shapes countries' budgetary policies. They are defined as permanent constraints on summary indicators of fiscal performance, such as the budget deficit, debt, or a major component thereof (Kopits and Symansky, 1998). Such constraints are aimed at reducing the policy failures due to which budget process outcomes tend to be biased towards deficits. This includes in particular the common pool problem of governments without centralised spending powers and the short-term orientation of governments due to short electoral cycles and possibly the short-term orientation of voters as well. In the EU, fiscal rules further aim at mitigating the incentives for deficits resulting from a common currency. In an important recent contribution, Krogstrup and Wyplosz (2010) study theoretically the implications of supra-national and national fiscal rules. They find that a supra-national fiscal rule is welfare improving relative to a national rule, while a supra-national rule alone does not fully eliminate the deficit bias. Their results thus lend support to strengthening national alongside supra-national fiscal rules.

Empirical research of the past two decades has shed light into the role of numerical fiscal rules for sound public finance. While earlier research concentrated on the experience of the US states, sometimes in view of deducting insights for the nascent EMU (e.g., von Hagen, 1991; Bayoumi and Eichengreen, 1994; Alesina and Bayoumi, 1996; Bohn and Inman, 1996), the undertaking of the EMU fostered the adoption of fiscal rules in EU member states and the EU and shifted the focus of empirical research to Europe. The effectiveness of national fiscal rules to shape fiscal performance has been shown to crucially depend on the mechanisms established to enforce compliance with the rule (Inman, 1996; Ayuso-i-Casals, Gonzalez Hernandez, Moulin and Turrini, 2009), as well as on the type of the rule, where budget balance and debt rules appear to outperform expenditure rules (Debrun, Moulin, Turrini, Ayuso-i-Casals and Kumar, 2008). Taking the institutional characteristics of the rules into account, fiscal rules are also found instrumental for the initiation of lasting fiscal consolidations (Larch and Turrini, 2008). Recent research has also scrutinized the role of fiscal rules in the budgetary process: they can serve as commitment devices to tie governments' hands that are tempted to pursue short-sighted and pro-cyclical budgetary policies (Debrun and Kumar, 2007a, Debrun *et al.*, 2008). Alternatively, they can fulfil the role of

[3] The ideas have been developed in earlier communications of the European Commission (ibid., 2010b, 2010c) and have been supported by the European Central Bank (ibid., 2010).

signalling tools meant to remove information asymmetries between governments and the electorate (Debrun and Kumar, 2007b; Debrun, 2007). European fiscal rules have further been shown to be effective, but to lead to significant creative accounting to circumvent them at the same time (von Hagen and Wolff, 2006; Buti, Nogueira Martins and Turrini, 2006). Finally, the fulfilment of fiscal plans by EU governments – a central plank of EU budgetary surveillance – is found to hinge on the stringency of fiscal rules among others (von Hagen, 2010).

The past several years witnessed a surge of research interest in the impact of fiscal variables on government bond spreads. In an international context, Alexander and Anker (1997), Lemmen and Goodhart (1999), Lonning (2000), Copeland and Jones (2001) and Codogno, Favero and Missale (2003) consistently confirm a positive relationship between public debt and interest rates. Bernoth, von Hagen and Schuknecht (2004) study the bond market of euro area member states during 1991-2002 and find that debt, deficits and debt-service ratios all have a positive impact on sovereign bond spreads. Schuknecht, von Hagen and Wolswijk (2009) analyse regional government debt and show that regions also pay higher risk premia when fiscal fundamentals are weak. Investigating the German sub-national bond market in detail, Heppke-Falk and Wolff (2008) and Schulz and Wolff (2009) find weak evidence of market reaction to fiscal fundamentals. Bernoth and Wolff (2008) document that sovereign bond markets in the EU also react to hidden fiscal policy activity and creative accounting practices. Moreover, they uncover that governments of countries with better transparency performance pay lower premia on government debt. Focusing on the period during the global financial crisis of 2007, Barrios, Iversen, Lewandowska and Setzer (2009) underline the impact of general risk perception on government bond spreads and document an increased relevance of domestic fiscal variables. Bernoth and Erdogan (2010) highlight the time-varying nature of sovereign risk.

Empirical research has also studied the impact of fiscal restraints on the borrowing cost of US states in particular. Bayoumi, Goldstein and Woglom (1995) show that the impact of constitutional controls on US state borrowing depends on the level of public debt; at average debt levels, the presence of such controls is found to be associated with a reduction of the interest cost by 50 basis points. Eichengreen and Bayoumi (1994) confirm the negative impact of fiscal rules on the cost of government borrowing. Poterba and Rueben (1999) uncover that expenditure, deficit, and debt rules (negatively) as well as tax limitations (positively) impact on state bond yield differentials, while debt rules appear to be the least effective in this respect. Differentiating this result, Johnson and Kriz (2005) show that revenue limits have a direct impact on state government borrowing, while the effect of expenditure, budget balance, and debt rules is indirect via improved credit ratings. In the euro area context, Hallerberg and Wolff (2008) show that fiscal institutions play an important role for government bond yields. The quality of fiscal governance and in particular the budget process is found to be a significant determinant of sovereign spreads. Moreover, they highlight that controlling for this institutional quality is important when assessing the impact of EMU on sovereign bond pricing in the euro area. Our study uses a unique dataset compiled by the European Commission on numerical fiscal rules and assesses the much-debated importance of national numerical fiscal rules for sovereign risk in the euro area.

The remainder of the paper is structured as follows. Section 2 outlines the theory foundations of our inquiry and the empirical strategy adopted. Section 3 describes our dataset and the construction of the fiscal rule index in particular. Section 4 discusses the results of our panel data estimations and a set of robustness checks. Section 5 concludes.

2 Theory and empirical approach

To investigate the effects of fiscal rules and fiscal policy on risk premia in euro area government bond markets, we depart from a simple no-arbitrage condition, in which an investor has the choice between a risk-free and a risky asset, both issued in the ongoing budget year $t = 0$, and maturing in $t = 1$. The risk-free asset bears an interest of r^*. The creditor of the risky asset of country i with interest r_i faces a default probability $\theta \in\ ]0; 1[$. Under risk-neutrality, the no-arbitrage assumption requires that expected returns on both assets be equal:

$$1 + r^*_t = (1 - \theta_{t+1})(1 + r_{i,t}) \quad (1)$$

which approximately implies:

$$r_{i,t} - r_t^* = \theta_{t+1}$$

The empirical literature on sovereign bond spreads has elaborated that the price of sovereign risk systematically varies with international credit risk (Favero, Giavazzi and Spaventa, 1997 and Codogno, Favero and Missale, 2003), which implies variations in the level of risk aversion. To cater for such variation and allow for risk-averse investors, we introduce a time-varying scaling factor $\alpha_t \geq 1$ to the above approximation, where $\alpha_t = 1$ describes the case of risk-neutrality:

$$r_{i,t} - r^*_t = \alpha_t \theta_t$$

The difference between the yields is thus proportional to the risk θ_t of the debtor's default; it is the larger the higher the level of risk aversion.

The risk of default of country i in $t = 1$, in turn, is a function of expectations on standard determinants of the sovereign debtor's solvency, such as the level of debt B, and the budget balance s, as well as institutional characteristics of the country that can be considered time-invariant, c_i, such as the transparency of public accounting and the extent to which budgetary procedures are conducive to fiscal stability and sustainability:

$$\theta_{i,t} = \xi\,(E_t(B_{i,t+1}), E_t(s_{i,t+1}), c_i) \quad (2)$$

The expected value of debt in the next period equals its actual realization as it can be obtained from current debt and deficit observed in time t, *i.e.*, $E(B_{t+1}) = B_{t+1} = B_t + s_t$.[4] Sovereign spreads are thus a function of the scaling factor reflecting the level of risk aversion, present debt and deficit, and expectations of future deficits:

$$r_{i,t} - r^*_t = f\,(\alpha_t, E_t\,(X_{i,t+1}), B_{i,t}, s_{i,t}, E_t(s_{i,t+1}), c_i\,) \quad (3)$$

Among the arguments of f, α can be proxied by standard measures of international risk such as the spread between US low grade corporate and government bonds, or the Chicago Board Options Exchange Market volatility index known as VIX conventionally employed to measure the fear of market participants of volatility. Information on $B_{i,t}$ and $s_{i,t}$ is readily available. Deficit forecasts $E(s_{i,t+1})$ however are endogenous with respect to the bond spreads. A straightforward instrument would be the variable on contemporary deficits $s_{i,t}$. Indeed, $s_{i,t}$ will pick up the effect of expected deficits on the risk of default as well, but this effect can not be identified in separation from its direct effect on debt. As concerns the functional form of our regression equation, we adopt a flexible approach based on linearity, allowing for interactions between the variables proxying the arguments of ξ and a.

What is the contribution of rules-based fiscal governance to the evaluation of sovereign default risk? The very role of numerical fiscal rules is to constrain realisations of fiscal outcomes:

[4] This equation ignores stock-flow adjustments.

they hence reduce the range of values that fiscal deficits may assume. Accordingly, fiscal rules play a crucial role in the formation of expectations on fiscal outcomes and of future deficits $E(s_{i,t+1})$ in particular: they reduce the range of values that deficits can be expected to assume. While the mean forecast error in budget balance forecasts should be zero, the variance of forecast errors in countries with numerical fiscal rules should be lower as compared with countries without such rules or with only weak rules. In other words, rules-based domestic budgetary frameworks render the estimator of budget deficits on which the forecast is based more efficient. This will not be relevant for risk-neutral investors. The reduction of the deficit forecast error variance will become important in times of elevated risk aversion, when the willingness to accept uncertainty is reduced. Moreover, the constraints imposed by numerical fiscal rules will be more likely to become binding in times of higher uncertainty or negative shocks that are characterised by higher risk aversion. Hence, our prediction is that effective domestic fiscal rules constraining deviation from balanced budgets[5] are the more important in reducing sovereign bond spreads the more risk-averse investors are.

We test this hypothesis by the inclusion of a fiscal rule index *fri* measuring the stringency of rules-based fiscal governance in the regression. The index is included both separately and in interaction with the risk aversion indicator among the regressors. We further control in our regressions for liquidity risk, *i.e.*, that the assets cannot be sold quickly in the markets, employing bid-ask spreads of the respective government bonds *bas* to this end. With an indicator of risk aversion *risk,* the stock of public debt and the general government balance as percentage of GDP *debt* and *bal* respectively, the fiscal rule index *fri* and country fixed effects *c*, our baseline estimating equation thus becomes:

$$r_{i,t} = \beta_1 risk_t + \beta_2 bas_{i,t} + \beta_3 risk_t\, bas_{i,t} + \beta_4\, debt_{i,t} + \beta_5\, risk_t\, debt_{i,t} + \\ + \beta_6\, bal_{i,t} + \beta_7\, risk_t\, bal_{i,t} + \beta_8\, fri_{i,t} + \beta_9\, risk_t fri_{i,t} + c_i + u_{i,t} \qquad (4)$$

where all terms except *risk* are measured in deviation to the benchmark country, Germany; $u_{i,t}$ is an error term with the usual properties.

The endogeneity of fiscal rules with respect to fiscal policy outcomes has been explored in empirical research (e.g., Debrun and Kumar, 2007a; ibid., 2007b). Our research benefits from the advantage that the fiscal rules can be considered exogenous or predetermined to government bond yields. While certainly at present, national fiscal framework reform debates are driven by the consolidation pressures and high sovereign bond spreads, changes in fiscal governance have not been connected with bond markets in the time period of our sample as government bond spreads across euro area countries had been too low to fuel institutional debates. Fiscal framework reforms were enacted because of domestic and EU level pressure instead and endogeneity should thus not be an issue. Still, to be sure that our results are not impaired by endogeneity concerns, we check for the robustness of our results to the exclusion of the 2009 data where the strength of numerical fiscal rules might have been pre-determined by the fanning out of the government bonds yields in the previous year. In turn, measures of common risk, including the US corporate bond spread, are driven by global shocks and are thus also exogenous to euro area bond spreads.

Our baseline regressions are amended by further analysis. We do not only consider the global impact of rules-based fiscal governance on sovereign risk premia but study the impact of its different dimensions in separation as well. Besides we provide robustness analyses with regard to the time period covered and the sovereign debt crisis in particular, the role of liabilities stemming from bank rescue operations, the frequency of our data, and the choice of some indicators. The data employed in our analysis are described in the next section in more detail.

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[5] Fiscal rules may constrain different budgetary aggregates; but most serve the ultimate goal of stability and/or sustainability.

3 The dataset

Our empirical analysis is based on a dataset covering 11 euro area countries in the time period of 1999 to 2009 respectively 2010. Luxembourg – with very little public debt until recently – as well as the latest euro area entrants Cyprus, Malta, Slovenia, and the Slovak Republic are not included. The country specific variables are expressed in differences to German data, which leaves us with a panel dataset of 10 countries.

Our dependent variable is the government bond spread against the German Bund of the above euro area members based on the yield of their 10-year on-the-run fixed coupon bonds obtained from Bloomberg. Bid-ask spreads obtained from the EuroMTS indices platform are used to control for liquidity risk in sovereign bond markets. We also provide robustness checks using the data set of Gerlach *et al.* (2010), where yields and bid-ask spreads are derived from information on the individual on-the-run bonds provided by Bloomberg. As an indicator of the debtors' repayment capacity, data on government debt and deficits from the Ameco dataset are employed. As a general measure of investors' willingness to take on risk, we employ the seven-to-ten year US corporate bond spread for the rating category BBB from Merrill Lynch against US treasuries. Financial data are available at a very high frequency. However, as the fiscal and institutional data are only available at quarterly respectively annual frequency, we average the financial data to annual frequency. We further provide robustness checks with financial data averaged at quarterly frequency and quarterly fiscal data stemming from the Trimeco dataset of the European Commission.

The innovative element of our research is the inclusion of the index of the strength of numerical fiscal rules at country level in our analysis. This fiscal rule index has been constructed by the fiscal policy unit of the European Commission's Directorate-General for Economic and Financial Affairs from information on fiscal governance obtained from the EU member states via the Economic Policy Committee of the Ecofin Council of the EU.[6]

The fiscal rule index is based on information on five dimensions describing each fiscal rule in force at the local, sub-national or national level in an EU member state: (1) the statutory base of the rule, (2) room for revising objectives, (3) mechanisms of monitoring compliance with and enforcement of the rule, (4) the existence of pre-defined enforcement mechanisms, and (5) media visibility of the rule. According to a pre-defined scale distinguishing different degrees by which the design of the rule supports its strength along these dimensions, scores are attributed to each of the dimensions for each fiscal rule. Box 1 shows how the index is computed based on different characteristics of fiscal rules.

To construct the fiscal rule index, these scores are aggregated using weights obtained as averages of 10,000 randomly drawn numbers from a uniform distribution, following the method used by Sutherland, Price and Joumard (2005). The random weights technique is applied because of the absence of theoretical guidance on the importance of each criterion in the composite index of the strength of fiscal rules. Finally, the indices of the strength of a fiscal rule obtained for each single rule are aggregated to a single comprehensive score per country per year by adding up the indices of single fiscal rules adjusted by the coverage of general government finances by that rule.

[6] This rich dataset is updated annually; it is accessible to the public at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm.

BOX 1
SCORES ASSIGNED TO CHARACTERISTICS OF FISCAL RULES BY 5 DIMENSIONS

Dimension 1 (FRI_1): Legal base of the rule

4 The rule is established by the constitution;
3 The rule is based on a legal act (e.g., public finance act, fiscal responsibility law);
2 The rule is based on a coalition agreement or an agreement reached by different general government tiers, but not enshrined in a legal act;
1 Political commitment by a given authority (central/local government, Minister of Finance).

Dimension 2 (FRI_2): Room for setting or revising objectives

3 There is no margin for adjusting objectives: they are encapsulated in the document underpinning the rule;
2 There is some but constrained margin in setting or adjusting objectives;
1 There is complete freedom in setting objectives: the statutory base of the rule merely contains broad principles or the obligation for the government or the relevant authority to set targets.

Dimension 3 (FRI_3): Nature of the body in charge of monitoring respect and enforcement of the rule

The score of this criterion is constructed as a simple average of the two elements below:

<u>Nature of the body in charge of monitoring respect of the rule</u>

3 Monitoring by an independent authority (fiscal council, court of auditors or any other court) or the parliament;
2 Monitoring by the ministry of finance or any other government body;
1 No regular public monitoring of the rule (no report systematically assessing compliance).

The score of this sub-criterion is augmented by 1 if there is real time monitoring of compliance with the rule, *i.e.*, if alert mechanisms of risk of non-respect exist.

<u>Nature of the body in charge of enforcement of the rule</u>

3 Enforcement by an independent authority (fiscal council or court) or the parliament;
2 Enforcement by the ministry of finance or other government body;
1 No specific body in charge of enforcement.

Dimension 4 (FRI_4): Enforcement mechanisms of the rule

4 There are automatic correction and sanction mechanisms in case of non-compliance;
3 There is an automatic correction mechanism in case of non-compliance and the possibility of imposing sanctions;
2 The authority responsible is obliged to take corrective measures in case of non-compliance or is obliged to present corrective proposals to Parliament or the relevant authority;
1 There is no ex-ante defined actions in case of non-compliance.

The score of this dimension is augmented by 1 if escape clauses are foreseen and clearly specified.

Dimension 5 (FRI_5): Media visibility of the rule

3 Observance of the rule is closely monitored by the media; non-compliance is likely to trigger public debate;
2 High media interest in compliance, but non-compliance is unlikely to invoke public debate;
1 No or modest interest of the media.

Table 1

Correlation Across the Components of the Fiscal Rule Index

	FRI	FRI_1	FRI_2	FRI_3	FRI_4
FRI_1	0.95	1.00			
FRI_2	0.97	0.91	1.00		
FRI_3	0.97	0.90	0.95	1.00	
FRI_4	0.93	0.90	0.90	0.84	1.00
FRI_5	0.93	0.84	0.86	0.93	0.80

In the presence of more than one rule covering the same government sub-sector, the second, third and forth weaker rules obtain weights ½, 1/3, and ¼, to reflect decreasing marginal benefit of multiple rules applying to the same sub-sector of general government. The design of the index is inspired by Deroose, Moulin and Wierts (2006). The index is re-scaled to assume values between 0 (minimum) and 10 (maximum). An improvement of the index is achieved by strengthening one or several existing numerical fiscal rules along either of the above dimensions, by introducing new numerical fiscal rules, or by extending the coverage of general government by existing or new rules. Note that the fiscal rule index only considers if there is a numerical constraint to a budgetary aggregate: it does not take into account however if this constraint is realistically binding in reality (e.g., debt rules allowing for a comparatively high debt level are not binding in low-debt countries).

We also analyse the impact of numerical fiscal rules on sovereign bond spreads considering the five above components separately. To this end we apply the same technique of aggregation as for the composite index. Obviously, no weighting is involved in obtaining this set of sub-indices. Table 1 shows the correlation between the components of the global fiscal rule index: correlations between pairs of components are typically high. Country sets of rules that are strong by one dimension tend to be strong along other dimensions as well. The correlation between components 1 and 3 of the overall index (referring to the legal base and the body in charge of monitoring and enforcing compliance with the rule respectively) appear to be particular strong. Components 4 and 5 of the overall index (referring to its enforcement mechanisms and media visibility) appear to be less connected to the overall index than components 1 and 2.

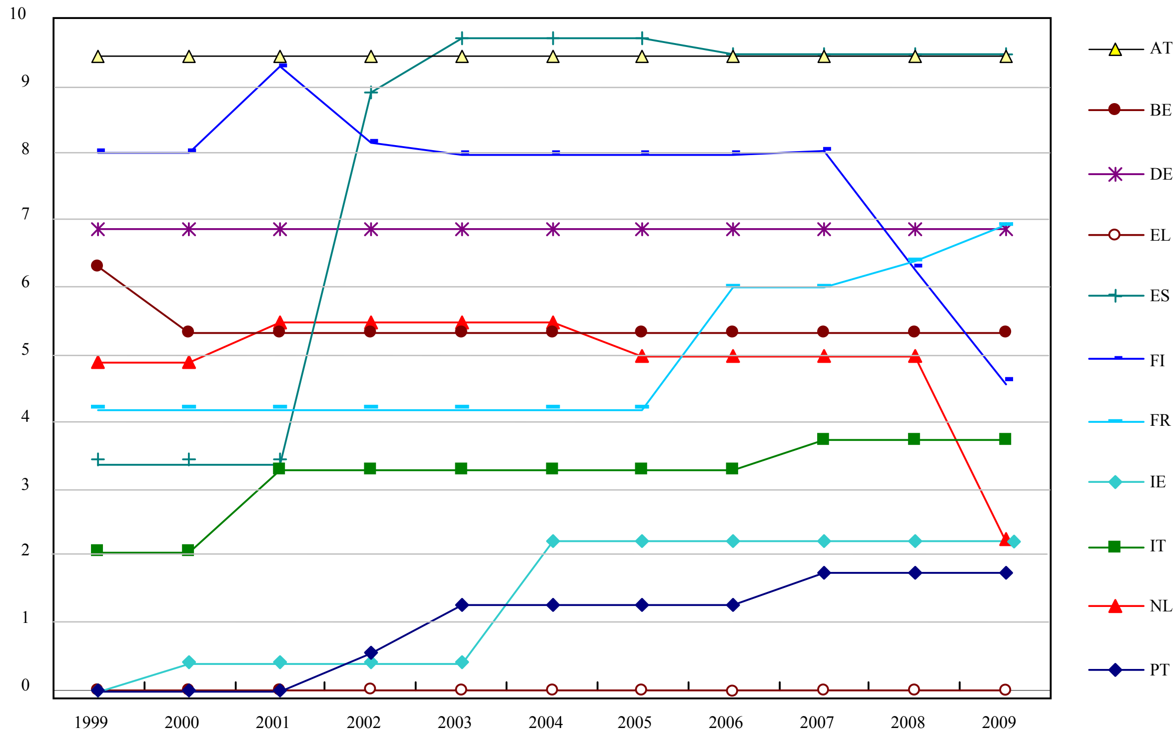
Figure 1 shows the development of rules based fiscal governance in the eleven euro area members of our sample, as measured by the fiscal rules index, 1999 to 2010 (data in 2010 are preliminary). The strength of the fiscal rules in force in our country of reference, Germany, has been above average and constant at around 7 throughout the period considered.[7] The strength of the numerical fiscal rules in force in the other euro area countries ranged between zero (for Greece, that has had no such rule in force) and 9.5 (the Netherlands,[8] unchanged, and Spain as

[7] In the period covered by our sample, Germany has operated "golden" budget balance rules and rules limiting nominal expenditure growth for both the federal government; local governments�' budgets have been constrained by debt ceilings and a balance budget rule. In the period considered, the target of the nominal expenditure rule was reformulated, that had no impact on the score of the fiscal rule index, though. Note that the much-debated "debt brake" for the federal government and the Länder will be phased in only from 2011, so the score of the index is unaffected in our sample.

[8] The Netherlands have been operating a real expenditure ceiling and a rule to allocate windfall revenues applying to all general government.

Figure 1

The Fiscal Rule Index in 11 Euro Area Members, 1999-2009



from 2006) and 9.7 (Spain,[9] 2003-05) respectively. Countries with below-average fiscal rule index scores were Ireland, Portugal, and Italy, while the scores of France, Austria, Belgium, and Finland qualified these countries as having stronger fiscal rules than on average. Remarkable changes to the better occurred in the case of France 2006 and 2008 to 2009,[10] as well as Ireland 2004, while the strength of the fiscal rules deteriorated in Finland after 2007 and in Austria in 2009,[11] in particular due to the suspension of rules in force in the course of the economic and financial crisis.

Turning now to the development of the government bond spreads as compared to German Bund yields in the period under review, these spreads were below 30 basis points for most euro area members, with a slight increase until 2001 and decreasing in the period between 2001 and 2006. Sovereign bond spreads mounted and fanned out in the wake of the economic and financial crisis, with particularly high values of 190 basis points reached on average by Greece and Ireland

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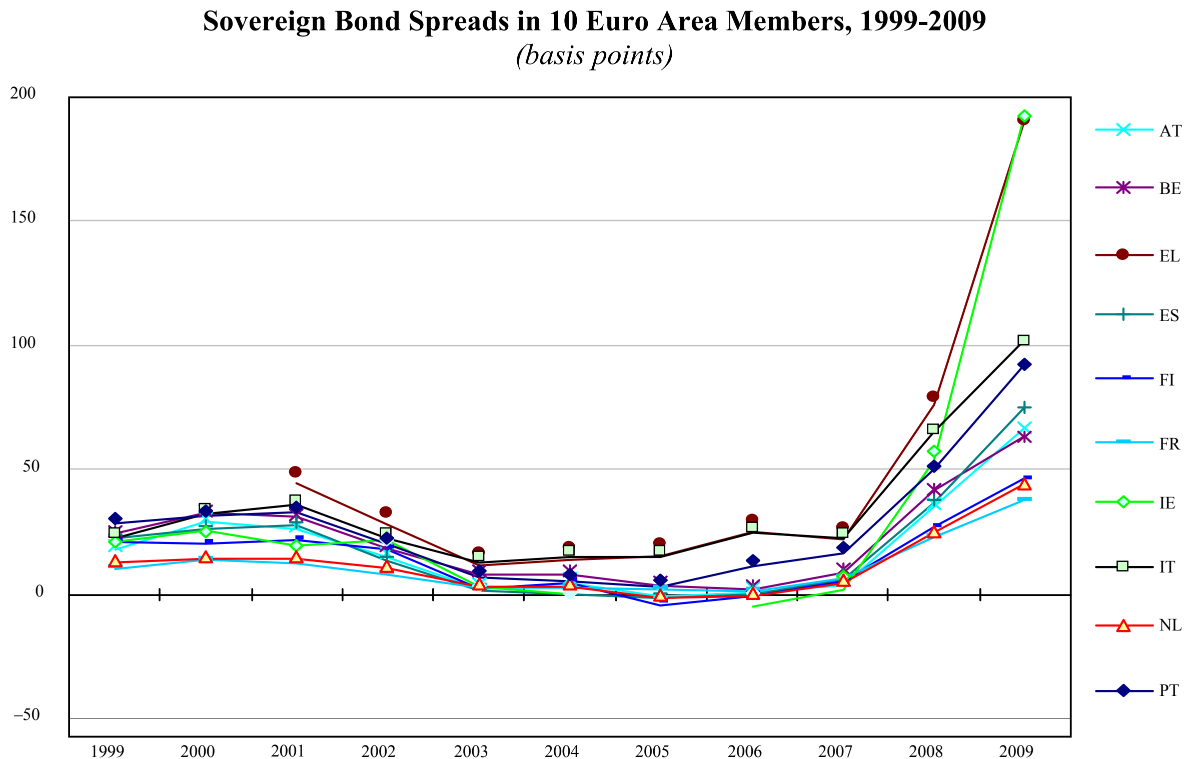
[9] Until 2002, Spain has operated debt ceilings to local and regional governments. In 2002, a budget-balance rule covering all general government was introduced, which was slightly modified in 2006. In 2003, the rules-based framework was extended by further restrictions on debt applied to regional governments.

[10] In 2006, France introduced a rule to the central government to pre-commit unexpected revenues, and a ceiling to the growth of health expenditure to be established by the parliament. In 2008 the increase of social security debt was made conditional upon an increase in revenues. Finally, since 2009, unexpected revenues were automatically assigned to deficit reduction.

[11] In Finland, a debt rule and budget balance rule applied to the central government were no longer in force after 2007 and 2008, respectively. In Austria, the budget balance rule laid down in the National Stability Pact was replaced in 2009 by a nominal expenditure ceiling for five headings of the general government budget. The main difference between the two approaches is that the more recent nominal expenditure ceiling only covers a fraction of parts of the budget previously covered by the National Stability Pact.

Figure 2

Sovereign Bond Spreads in 10 Euro Area Members, 1999-2009
(basis points)



and values between 40 and 100 basis points for the other euro area members during 2009 (see Figure 2). The ranking of the euro area members by the size of the spread of their bond yields against Germany was broadly constant in the period considered, with France, the Netherlands, and Finland being closer to the benchmark and Greece, Italy, Portugal and Spain being at the higher end of the distribution.

In Figure 3 we look at the development of international risk aversion as measured by the spread between low-grade US corporate and government bonds, *uscorp*. As can be seen by comparison with Figure 2, euro area government bond spreads have moved in parallel with international risk aversion. In fact, international risk aversion was particularly low in the mid-2000s, when euro area sovereign bond spreads were historically low as well. With the rise of international risk aversion during the economic and financial crisis, sovereign bond spreads increased markedly, too.

Table 2 provides the simple correlations of the variables applied in our analysis. High correlations of around 0.75 can be observed between the indicator of international risk aversion, *uscorp,* and the bid-ask-spread, and between the fiscal rule index and its interaction with *uscorp*.

4 Estimation results

4.1 Main results

Table 3 shows the baseline results of our regression analysis of the determinants of government bond spreads in the euro area. The results document an important role of fiscal rules in

explaining sovereign risk in the euro area. Fiscal rules do not have a significant explanatory role regarding sovereign bond yields as such (regression C). However, they are highly relevant when investors become risk averse as implied by our analytical framework. As regression D documents, when global risk aversion increases, countries with better fiscal rules witness lower increases of sovereign bond yields relative to Germany.

Figure 4 illustrates how the effect of fiscal rules depends on the level of international risk aversion. When international risk aversion rises, stronger fiscal rules are increasingly important to reduce sovereign risk: their marginal benefit increases with uscorp. This effect is statistically significantly at a 5 per cent level when *uscorp* exceeds 155 basis points.

These effects are also economically meaningful. Suppose that Greece, a country with no fiscal rule in place to date, had fiscal rules of similar quality as Germany. When risk aversion peaked at a spread of 750 basis points in 2009, risk premia required on its bonds would have been 55 basis points lower.

Figure 3

Spread Between Low-grade US Corporate and Government Bonds (*uscorp*), 1999-2010
(basis points)

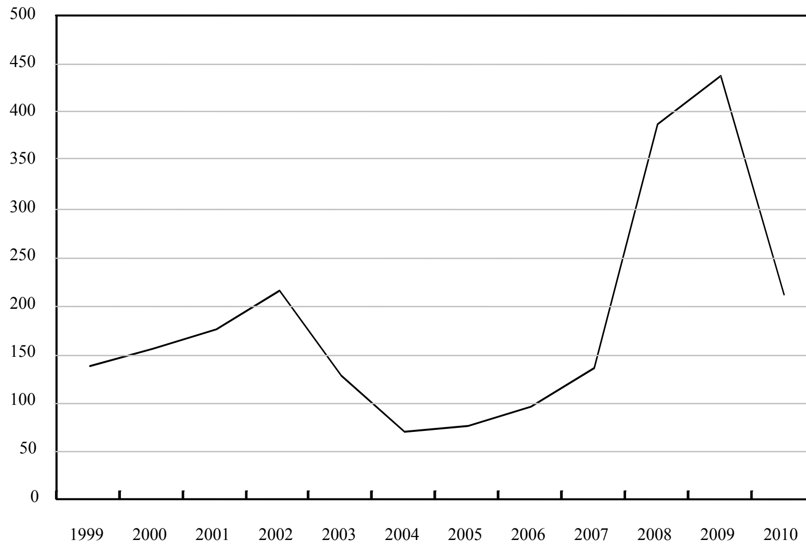


Table 2

Correlation Across Variables Employed in the Analysis, 1999-2009

	r	ris	fri	risk*fr	ba	deb
risk	0.75***	1.00				
	(0.00)					
fri	–0.31***	–0.03	1.00			
	(0.01)	*(0.79)*				
*risk*fri*	–0.66***	–0.39***	0.74***	1.00		
	(0.00)	*(0.00)*	*(0.00)*			
bal	0.74***	0.57***	–0.44***	–0.52***	1.00	
	(0.00)	*(0.00)*	*(0.00)*	*(0.00)*		
debt	0.29**	0.06	–0.47***	–0.36***	0.43***	1.00
	(0.01)	*(0.63)*	*(0.00)*	*(0.00)*	*(0.00)*	
bas	0.71***	0.79***	–0.08	–0.45***	0.57***	–0.07
	(0.00)	*(0.00)*	*(0.52)*	*(0.00)*	*(0.00)*	*(0.55)*

Note: *p*-values in parentheses.

Table 3

Main Estimation Results

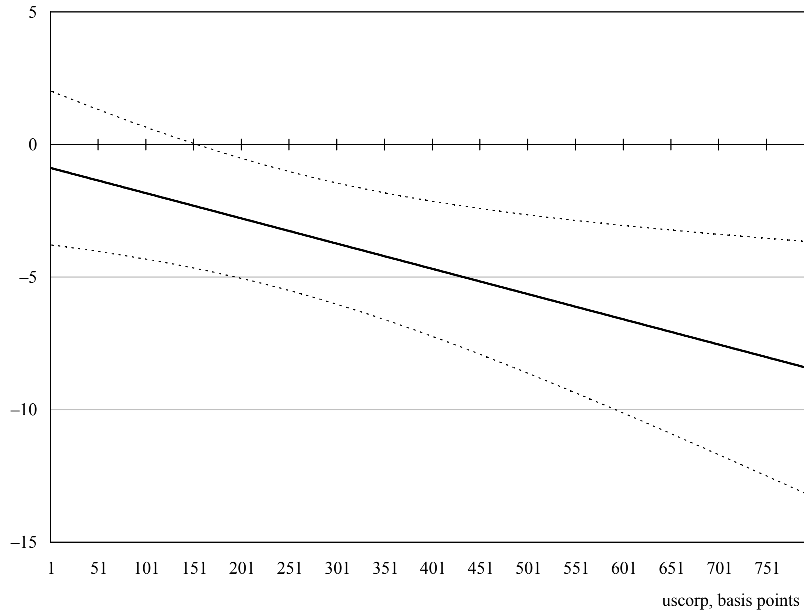
Variable	A	B	C	D	E	F	G	H	I	J	K	L	M
uscorp	0.19*** *(0.02)*	0.18*** *(0.01)*	0.14*** *(0.02)*	0.08*** *(0.02)*	0.08*** *(0.02)*	0.08*** *(0.01)*	0.07 *(0.04)*	0.08*** *(0.02)*	0.08*** *(0.02)*	0.06** *(0.02)*	0.07*** *(0.02)*	0.05** *(0.02)*	–0.44*** *(0.12)*
FRI		0.75 *(1.57)*	4.37*** *(1.59)*	3.90*** *(1.32)*	2.66* *(1.41)*	–0.88 *(1.48)*	5.58 *(3.54)*	4.00*** *(1.34)*	–1.14 *(3.05)*	–10.22*** *(3.19)*	–0.48 *(2.93)*	–9.32*** *(3.19)*	1.91 *(2.47)*
*uscorp**FRI			–0.02*** *(0.00)*	–0.02*** *(0.00)*	–0.02*** *(0.00)*	–0.01** *(0.00)*	–0.02** *(0.01)*	–0.02*** *(0.00)*	–0.02*** *(0.00)*	–0.004 *(0.005)*	–0.02*** *(0.00)*	–0.01 *(0.01)*	–0.023* *(0.012)*
balance				–4.04*** *(0.61)*	–4.39*** *(0.62)*	0.69 *(1.22)*	–5.27*** *(1.61)*	–3.99*** *(0.62)*	–4.29*** *(1.03)*	–0.93 *(1.62)*	–3.64*** *(1.02)*	–1.35 *(1.62)*	0.82 *(1.13)*
debt		0.93*** *(0.24)*	0.81*** *(0.22)*	0.75*** *(0.18)*	0.56*** *(0.20)*	0.57*** *(0.18)*	1.57*** *(0.47)*	0.76*** *(0.18)*	1.63*** *(0.45)*	1.03** *(0.40)*	1.40*** *(0.44)*	0.97** *(0.39)*	–1.24*** *(0.41)*
*uscorp**balance						–0.02*** *(0.00)*				–0.02*** *(0.01)*		–0.01** *(0.01)*	–0.02*** *(0.00)*
*uscorp**debt					0.001** *(0.001)*	0.001 *(0.001)*				0.002** *(0.001)*		0.002** *(0.001)*	0.012*** *(0.002)*
debt²								–0.002 *(0.003)*					
bid-ask spread									–13.50 *(42.29)*	14.15 *(38.20)*	–357.18** *(148.26)*	–193.61 *(134.16)*	
*uscorp**bid-ask spread											0.882** *(0.366)*	0.542 *(0.336)*	
N	107	107	107	107	107	107	117	107	69	69	69	69	107
R^2	0.60	0.66	0.73	0.82	0.82	0.86	0.42	0.82	0.86	0.91	0.87	0.91	0.93

Estimation with panel fixed effects. Standard errors in parentheses. Time period: 1999-2009 (107 observations), 1999-2010 (117 observations), 2003-09 (69 observations).
Regression M is with panel fixed effects in interaction with *uscorp*.

Figure 4

Marginal Effect of Fiscal Rules on Sovereign Bond Spreads

(marginal effects, basis points)



Note: The figure shows the marginal effect of fiscal rules on sovereign bond spreads as a function of international risk aversion measured by *uscorp*, based on regression F shown in Table 3. Dotted lines indicate the 95 per cent confidence interval. Source: authors' calculation.

Better fiscal rules can thus effectively reduce sovereign bond spreads in times of marked turbulences in international markets. Similarly, the quality of Irish fiscal rules could be significantly improved relative to Germany: this would imply a lowering of the sovereign bond yields by up to 40 basis points. For Portugal, at the culmination of the international crisis during 2009, yields could have been by up to 50 basis points lower according to our estimates, had it enhanced the quality of its rules to the level of Germany's. In contrast, the quality of fiscal rules in Spain contributed to the comparatively low level of sovereign bond yields in Spain in 2009.

In line with previous research, we also find that international risk aversion – as measured by *uscorp* – is an important driver of sovereign bond spreads in the euro area in itself. We also find that the ratio of general government debt to GDP significantly enhances sovereign bond yields throughout (regressions B to M). In regression E, we add an interaction effect between *uscorp* and the debt-to-GDP ratio and find that with increasing international risk aversion, countries with high debt levels are increasingly punished by financial markets as well.

General government budget deficits are also found to strongly shape differences in sovereign bond yields in normal times. When we further add an interaction effect between *uscorp* and the budget balance (regression F), the budgetary position has a sizeable effect depending on the level of risk aversion while the interaction between risk aversion and debt levels becomes insignificant. When risk aversion is high, markets thus punish countries with large deficits more, while the pricing of differences in levels of debt does not change with risk aversion.

In regression G, we extend the sample to include also observations of 2010.These results should be considered with caution as the fiscal rules data are preliminary and the other data are based on forecasts respectively in case of the financial variables the first 5 months of available data. Given this caveat, a number of results stand out. First, the estimated effect of fiscal rules remains robustly in place despite the huge uncertainty in the euro area sovereign bond market. Second, the variance explained by the model drops significantly, highlighting non-linear developments in the bond market in the eurozone in 2010 in particular. Third, public debt and deficits are punished much more significantly when 2010 data are taken into account as well.

We have further included a quadratic term of the debt-to-GDP ratio (regression H), in order to allow for nonlinearities in the increase of the risk of default with higher levels of debt resulting from interest payments. We do not find, however, any evidence of such non-linearity. We also control for differences in liquidity across bond markets by employing bid-ask spreads to this end. Unfortunately, this measure of liquidity is only available as of 2003. We continue to find a significant role for fiscal rules (regressions I to L). While the interaction effect in this shorter sample becomes insignificant in some specifications, fiscal rules become significant determinants of sovereign risk in levels, with the marginal effect only slightly differing from the marginal effects obtained above when risk aversion is high. We also allow for an interaction term between liquidity risk and risk aversion, thereby permitting markets to value liquidity differently in different states of the economy (Regression K and L). This does not, however, change the results. Our results are therefore robust to controlling for this measure of liquidity.

We further address the fact that in many countries the quality of fiscal rules moves only rarely: the fiscal rule index and its interaction might pick up other non-observable time-constant factors in these cases. To control for non-observable time-constant factors that vary with the level of overall risk, we employ country fixed effects in interaction with *uscorp* along with the country effects in levels (regression M). This implies that sovereign risk premia may increase more strongly with risk aversion when countries have bad unobserved characteristics. Our findings on the relation between fiscal rules and sovereign spreads are preserved in this highly flexible specification as well.

4.2 What characteristics of fiscal rules matter most?

To assess the relative importance of the different characteristics of national fiscal rules for reducing sovereign risk, we compare the effects of the components making part of the fiscal rule index, namely the legal base of the rule, the room for setting or revising objectives, the nature of the body in charge of monitoring respect and enforcement of the rule, its enforcement mechanisms, and its media visibility. Table 4 first shows estimation results using the above components of the fiscal rule index one by one (estimations D1 to D5). All components are found significant in reducing sovereign risk in times of higher uncertainty. However, the size of the effect differs across the characteristics of the rule. The legal base of the fiscal rules turns out to be particularly relevant: the marginal effect of an improvement is largest. Besides, the stringency of the enforcement mechanisms attached to the rules is also found to be quantitatively important. The separate dimensions of national fiscal rules are highly correlated, though (see Table 1): countries with fiscal rules well anchored in law, for example, also tend to have strong enforcement provisions for their rules. To account for such correlation, the last regression includes all components of the fiscal rules index simultaneously. Now, the legal base of the rules in force is found to be the only characteristic to significantly – and sizeably – contribute to the reduction of sovereign bond spreads. A stronger legal base of the rules in force is found to be associated with lower risk also in times of relatively low international risk aversion.

The economic effects are sizeable. Our analysis implies that a strengthening of the legal base of the rules in force in a country where this characteristic of the rules is weak to the level of the German rules (before the introduction of the constitutional debt brake) could reduce sovereign risk premia by almost 100 basis points in times of severe market turbulence.[12]

[12] At *uscorp* = 750, the marginal effect of the legal base of the numerical fiscal rules is –12.4. In terms of the legal base of the rules, Greece scores –7.4, signaling its weakness in comparison to Germany (note that our regressors are defined as differences to German values). This implies that Greece could experience an improvement in its sovereign bond spreads by –12.4*7.4 = –91.8 upon the introduction of numerical fiscal rules with similarly strong legal base as the German ones.

Table 4

Estimation Results with Components of the Fiscal Rule Index

Variable	D	D	D	D	D	D	D
uscorp	0.08*** (0.02)	0.06*** (0.02)	0.11*** (0.01)	0.11*** (0.01)	0.13*** (0.01)	0.00 (0.03)	–0.04 (0.08)
FR	3.90*** (1.32)						
*uscorp**FRI	–0.02*** (0.00)						
FRI		3.46** (1.40)					–10.08** (4.85)
*uscorp**FRI		–0.02*** (0.00)					–0.03* (0.02)
FRI			4.06*** (1.23)				5.17 (3.88)
*uscorp**FRI			–0.02*** (0.00)				–0.02 (0.02)
FRI				3.24*** (1.09)			3.39 (4.45)
*uscorp**FRI				–0.02*** (0.00)			0.03 (0.02)
FRI					3.41*** (1.24)		0.65 (2.67)
*uscorp**FRI					–0.02*** (0.00)		0.01 (0.01)
FRI						3.96*** (1.32)	4.78 (4.70)
*uscorp**FRI						–0.02*** (0.00)	–0.01 (0.01)
balance	–4.04*** (0.61)	–4.18*** (0.61)	–4.02*** (0.61)	–4.09*** (0.61)	–3.90*** (0.65)	–4.08*** (0.61)	–4.29*** (0.62)
debt	0.75*** (0.18)	0.72*** (0.18)	0.73*** (0.18)	0.73*** (0.19)	0.79*** (0.19)	0.84*** (0.18)	0.88*** (0.21)
N	10	10	10	10	10	10	10
R^2	0.8	0.8	0.8	0.8	0.8	0.81	0.8
marginal effect of FRI_i at *uscorp* = 500	–6.15	–7.12	–4.79	–4.73	–5.72	–5.45	–24.71

Table 5

Dimensions of the Fiscal Rule Index: Marginal Effects, Equality of Coefficients

	Coefficient of Interaction Effect	Marginal Effect at *uscorp* = 500	Hausman test – H_0: $\beta_1 = \beta_2$ *p*-values				
			FRI	FRI1	FRI2	FRI3	FRI4
FRI	–0.020	–6.15					
FRI1	–0.021	–7.12	0.61				
FRI2	–0.018	–4.79	0.02	0.21			
FRI3	–0.016	–4.73	0.00	0.05	0.06		
FRI4	–0.018	–5.72	0.44	0.43	0.81	0.40	
FRI5	–0.019	–5.45	0.43	0.50	0.46	0.09	0.81

Table 4 compares the size of the effect of the components for the regressions in which the components are introduced one by one. For convenience, the first column replicates the coefficient of the interaction term between the respective component and *uscorp*. The coefficient related to the legal base is the strongest. The second column presents the point estimate of the marginal effect of an improvement of the fiscal rule index components when international risk aversion reaches relatively high levels (uscorp = 500). Again, the largest marginal effect is found for the aggregate strength of the statutory base of the set of numerical fiscal rules in force. We investigate the equality of the coefficients of the interaction effects between uscorp and the components of the fiscal rule index respectively by means of a Hausman test: columns 3 to 7 of Table 4 show the *p*-values attached to the test statistics. These tests confirm the statistical difference between some of the estimated coefficients, underlining that different characteristics of numerical fiscal rules in force do matter for the containment of sovereign bond yields to different degrees. The strictness of the rule (as captured by the legal base, the room to revise objectives and the enforcement possibilities) are found to be similarly important while they are statistically significantly different from the effects of the differences in the body in charge of the supervision of the rule. Independent fiscal councils with monitoring functions – while effective – appear to impress the markets significantly less than strong constitutional limits or tough enforcement mechanisms.

4.3 Robustness checks

We supplement the basic analysis presented above by a number of robustness checks. First, we assess the robustness of our results against the consideration of a set of specific factors: the effects of the crisis materialising in 2009 specifically, the burdens of support to the banking sector on public authorities and the critical features of Ireland in particular, and the role of expectations on the fiscal policy stance as measured by deficit forecasts (Table 6). Excluding the data of 2009 renders the regression robust to the special crisis effects and has the additional advantage that we can safely consider the quality of rules-based fiscal governance to be exogenous with respect to government bond yields and their spreads. Before 2009, debates on the reform of fiscal governance were not influenced by sovereign bond spreads, that were comparatively small. Second, we provide a set of regressions with variables at quarterly frequency where available, to establish the invariance of our results to the level of aggregation in time (Table 7). Third, we use a different

Table 6

Robustness Checks: Time Period, Banking Sector, Deficit Forecasts

Variable	D’	N	F’’	O	F’’’	P
uscorp	0.08 ***	0.10***	0.09 ***	0.08 ***	0.09 ***	0.10***
	(0.01)	*(0.01)*	*(0.01)*	*(0.02)*	*(0.01)*	*(0.01)*
FR	0.41	–0.74	–0.15	4.07 ***	–0.93 *	0.04
	(0.66)	*(0.63)*	*(0.79)*	*(1.40)*	*(1.40)*	*(0.78)*
*uscorp*FRI*	–0.01 ***		–0.01 **	–0.02 ***	–0.01 **	–0.01 ***
	(0.00)		*(0.00)*	*(0.00)*	*(0.00)*	*(0.00)*
balance	–1.54 ***	–1.61 ***	–1.21 *	–4.20 ***	0.27 *	
	(0.31)	*(0.34)*	*(0.66)*	*(0.74)*	*(1.12)*	
debt	0.50 ***	0.52 ***	0.45 ***	0.73 ***	0.37 **	0.46 ***
	(0.09)	*(0.09)*	*(0.10)*	*(0.19)*	*(0.18)*	*(0.11)*
uscorp *balance			0.00		–0.01 ***	
			(0.00)		*(0.00)*	
uscorp *debt			0.00		0.00 *	0.00
			(0.00)		*(0.00)*	*(0.00)*
E(F3.balance)						–0.99 *
						(0.59)
bankassets				–0.01		
				(0.03)		
N	97	97	97	107	97	97
R^2	0.85	0.82	0.85	0.82	0.86	0.81

Estimation with panel-fixed effects. Standard errors in parentheses. Time period: 1999-2008 (estimations D’, N, F’’, P), 1999-2009 (estimations O and F’’’). Data on Ireland excluded from estimation F’’’.

data set of sovereign bond yields available from Gerlach *et al.* (2010), which provides us with a longer data set on liquidity as measured by bid-ask spreads in particular (Table 8). Finally, we repeat our regressions using a measure of international risk aversion other than the US corporate bond spreads (Table 9).

Table 6 first shows the robustness of our results with respect to potential effects of the crisis impacting on public budgets and crisis-related market risk aversion in 2009 (regressions D’, N, F’’): our central result regarding the beneficial effects of better fiscal rules remains in place when we exclude the 2009 data from the sample. Next, to cater for governments’ support of the banking sector and the potential liabilities resulting from it, we include the size of the aggregate bank assets as a proportion of GDP (relative to Germany) among our regressors (regression O). We further run a regression without the observations on Ireland to avoid that our results are spuriously driven by the high degree of bank vulnerability that coincides with a comparatively low quality of fiscal rules in force (regression F”). These robustness checks all leave our central results regarding the importance of national fiscal rules for containing sovereign bond yields unaltered.

Table 7

Robustness Checks with Quarterly Data

	A'	B'	C	D'	I	I'
uscorp	0.18***	0.17***	0.13***	0.11***	0.09***	0.06***
	(0.01)	*(0.01)*	*(0.01)*	*(0.01)*	*(0.01)*	*(0.01)*
FR		1.98	5.35***	2.15***	0.18	–0.70
		(1.37)	*(1.48)*	*(0.69)*	*(1.87)*	*(1.39)*
*uscorp*FRI*			–0.02***	–0.02***	–0.02***	–0.02***
			(0.00)	*(0.00)*	*(0.00)*	*(0.00)*
balance (quarterly)				–2.16	–2.17	
				*(0.58)****	*(0.82)****	
balance (annual)						–4.35***
						(0.39)
debt		1.51***	1.41***	0.57***	1.15***	1.70***
		(0.21)	*(0.20)*	*(0.09)*	*(0.22)*	*(0.20)*
bid-ask					60.91***	43.53***
					(17.26)	*(14.66)*
N	448	448	448	394	229	259
R^2	0.32	0.40	0.43	0.77	0.85	0.89

Note: Estimation with panel-fixed effects. Standard errors in parentheses. Time period: 1999-2009 (regressions A' to D''), 2003-09 (regressions I' and I'').

Finally, to better capture the developments of fiscal fundamentals in the near future, we add the three-year-ahead deficit forecasts obtained from the stability and convergence programmes of the EU members (regression P). Deficit forecasts are found to be a significant and quantitatively important determinant of government bond spreads, while our main results are again confirmed. Rules-based fiscal governance thus plays an important role for the formation of expectations by financial markets in the longer run specifically. Even when we control for the effects of expectations on fiscal policy for a period of 3 years ahead, sound domestic rules-based fiscal governance has a significant and quantitatively important risk-reducing effect by reducing uncertainty affecting expectations on the fiscal deficit, as well as better anchoring longer term expectations.

Financial market data come at a very high frequency and are typically available on a daily or even hourly basis. At the same time, the institutional measures are rather stable and move annually at most. To assess whether the results presented above with annual data are not just a statistical artefact of aggregating financial market data to an annual frequency, we carry out the regression analysis using the financial data aggregated at higher frequency such as to better reflect their variation. Hourly (financial) and annual (institutional) data do not match well, because much of the information reflected in the annual data is de facto available to the decision-makers in financial markets long before the release of data updates. As a compromise between loosing variation from aggregating financial data and accepting measurement error from institutional data, we aggregate the financial market data to a quarterly frequency and choose the quarterly Trimeco release of the government statistics data instead of the annual Ameco series respectively, while the annual data on fiscal rules remains unchanged.

Table 7 presents the first set of our robustness results. Our previous findings are essentially confirmed. Again, the interaction between risk aversion and the fiscal rules index is an important determinant of sovereign spreads. The effect is also quantitatively comparable to our baseline results.

Table 8

Robustness Checks with Gerlach *et al.* (2010) Data

	Q	R	S	I'''
uscorp	0.19 **	0.18 **	0.18 **	0.11 **
	(0.02)	*(0.01)*	*(0.01)*	*(0.01)*
FR			0.37	3.76 **
			(1.77)	*(1.40)*
*uscorp*FRI*				–0.02 **
				(0.00)
balance				–3.19 **
				(0.70)
debt		0.94 **	0.95 **	0.66 **
		(0.26)	*(0.27)*	*(0.20)*
bid-ask spread	3.26	4.44	4.62	0.23
	(4.19)	*(3.95)*	*(4.06)*	*(3.11)*
N	105	105	105	105
R^2	0.74	0.77	0.77	0.88

Note: Estimation with panel-fixed effects. Standard errors in parentheses. Time period: 1999-2009.

As a next set of estimates to investigate the robustness of our findings, Table 8 shows the regression results using the data set on sovereign bond yields computed by Gerlach *et al.* (2010). This data set extends over a longer time horizon, covering the years 1999 to 2009. Moreover, information on bid-ask spreads has been gathered specifically from the very same bonds from which the yield information is obtained. The original data set is available at weekly frequency which we have aggregated to annual data to render results comparable with our main regressions.

The results again confirm our previous findings. We find a highly significant interaction effect between *uscorp* and the fiscal rule index, underscoring that in times of elevated market risk aversion, countries clearly benefit from more stringent and effective fiscal rules. The magnitude of the effects obtained with the Gerlach *et al.* (2010) data is also very similar to our first set of results.

Finally, we re-estimate our regression model employing a different measure of international risk aversion than the US corporate bond spread, namely the Chicago Board Options Exchange Market volatility index, *VIX*. Table 9 presents these estimation results. Our main findings are again corroborated: the choice of the measure of international risk aversion does not drive our results.

5 Conclusion

The present paper documents the importance of rules-based national fiscal governance for the assessment of sovereign risk by financial markets in the euro area. Stronger fiscal rules turn out to be of great importance to contain sovereign bond spreads in times of elevated market uncertainty in particular. Under extreme circumstances, better fiscal rules can reduce sovereign bond spreads between euro area member states and Germany by as much as 80 to 100 basis points according to our estimates. Of particular importance is the strength of the legal base of the fiscal rules in force. Countries operating rules with stronger legal foundations obtain lower risk premia,

with beneficial effects potentially reaching up to 100 basis points. The stringency of the enforcement mechanisms of national fiscal rules further turns out to be comparatively important for the effectiveness of the rules in view of reducing sovereign risk premia as well. Our results are robust to the level of aggregation of the data in time, the length of the time period, and the measurement of international risk aversion, and they are not flawed by the impact of the financial crisis 2009 and by burdens to public finance resulting from liabilities of the banking sector either.

Table 9

Robustness Checks with Measuring Risk Aversion by *VIX*

	A'	B''	C'	D''	I'''
uscorp	2.51***	2.43***	1.86***	1.08***	0.90***
	(0.20)	*(0.21)*	*(0.22)*	*(0.18)*	*(0.26)*
FR		2.02	8.97***	8.17***	4.68
		(1.62)	*(2.02)*	*(1.48)*	*(3.03)*
*vix** FR			–0.29***	–0.28***	–0.29***
			(0.06)	*(0.04)*	*(0.05)*
balanc				–4.65***	–4.79***
				(0.51)	*(0.93)*
debt		0.40	0.35	0.43**	1.06**
		(0.26)	*(0.23)*	*(0.17)*	*(0.41)*
bid-ask					–0.04
					(34.67)
N	107	107	107	107	69
R^2	0.62	0.64	0.71	0.85	0.88

Note: Estimation with panel-fixed effects. Standard errors in parentheses. Time period: 1999-2009 (regressions A"-D'"), 2003-09 (I'"").

We argue that national fiscal rules have their beneficial effect by reducing the uncertainty of market expectations of fiscal variables. This is specifically important in times of higher risk aversion, which often coincide with higher uncertainty or negative shocks. Overall, our results lend strong empirical support to the recently debated policy proposals that the strengthening of national fiscal rules should be an integral part of the European economic governance reform. National fiscal rules can thereby contain sovereign risk by increasing trust in the sustainability of public finances in addition to their direct contribution on better fiscal outcomes.

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IMPLEMENTING GERMANY'S NEW CONSTITUTIONAL FISCAL RULES

Jürgen Hamker[*]

1 Historical background

In June 2009, a new constitutional debt rule was passed by the Bundesrat following approval by the Bundestag. 2/3 majorities of the members – as required by article 79 II of the German Basic Law – voted in favour of a debt brake for Federal and state government budgets to become fully binding as of 2016 and 2020, respectively. To understand the reasons for this step, it seems necessary to take into account prior developments concerning government deficit and debt in Germany.

Government borrowing has been subject to constitutional limits since the foundation of the Federal Republic of Germany in 1949. By the end of the 1960s, a constitutional reform had been made to commit fiscal policy to safeguarding macroeconomic equilibrium. According to Section 1 of the Act to Promote Economic Stability and Growth, fiscal policy measures must contribute to the stability of the price level, high employment levels, external equilibrium and continuous as well as adequate GDP growth. In order to avert a disruption of the macroeconomic equilibrium, the former article 115 of the Basic Law allowed central government borrowing to be extended above the ordinary limit defined by the total of estimated investment expenditure in the budget. The extent of such exceptional borrowing was not limited effectively and there was no obligation to repay these debts. General exceptions from borrowing limits could also be claimed for special funds outside of the core budget.

Given that strong political incentives to spend now and to shift financing burdens into the future exist in Germany, too, it was no surprise that debt levels grew significantly in the decades after the aforementioned constitutional reform for Federal and state government budgets.[1] During the first few years, attempts were made to stabilise GDP growth and employment levels. While providing additional stimuli was easy and also successful at first, cutting deficits in relatively good times was not nearly as successful. As trend GDP growth declined significantly throughout the last decades, the misinterpretation that the cyclical environment was unfavourable prevailed and eliminating deficits was not considered to be the main task of fiscal policy. Instead of implementing consolidation measures, the exception clause for averting a disruption of the macroeconomic equilibrium was used quite often, especially during the first decade of the 21st century. Consequently, debt levels climbed considerably.

In addition, during the process of German reunification, off-budget funds and entities were used to finance political tasks, such as compensating east German banks for converting customer deposits at more favourable exchange rates than those applicable to their own assets, providing state governments with money for creating infrastructure and preparing state enterprises for a competitive environment while providing their staff with earnings above productivity levels. By 1995, a respective debt total of about 10 per cent of GDP had been accumulated. The largest part was attributed to a new special fund for the redemption of inherited liabilities. While it was possible to repay a minor part, e.g., by means of part of the Bundesbank profit distributions, the

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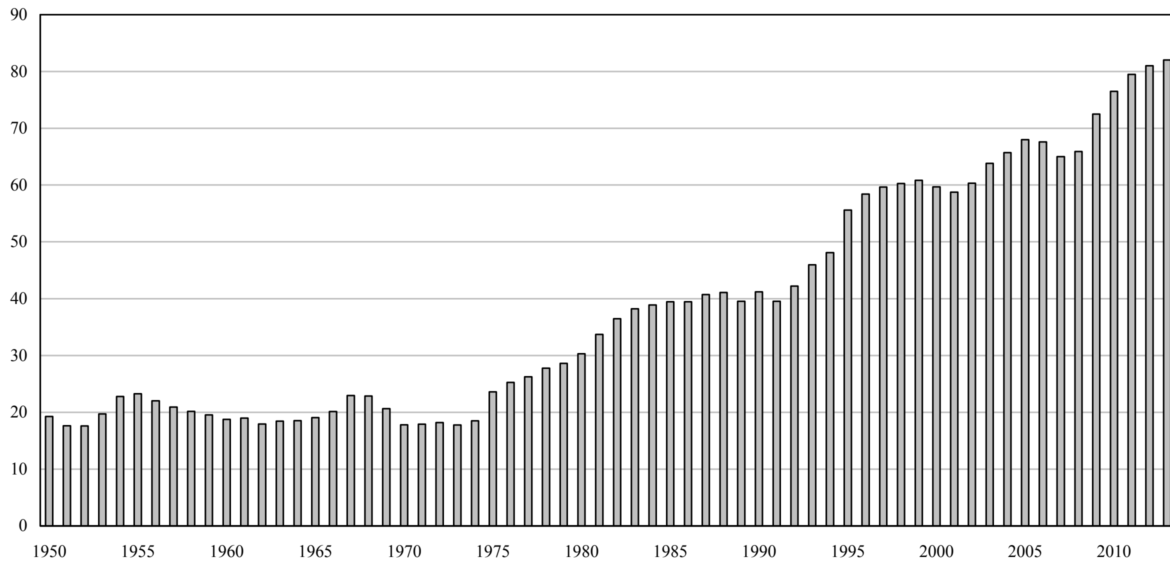
The opinions expressed in this document are those of the author and do not necessarily reflect the views of the Deutsche Bundesbank.

[1] For the development of debt levels and the underlying reasons, see Deutsche Bundesbank (2010), "Government Debt and Interest Payment Burden in Germany", monthly report, April, pp. 15-33.

Figure 1

Government Debt*

(percent of GDP)

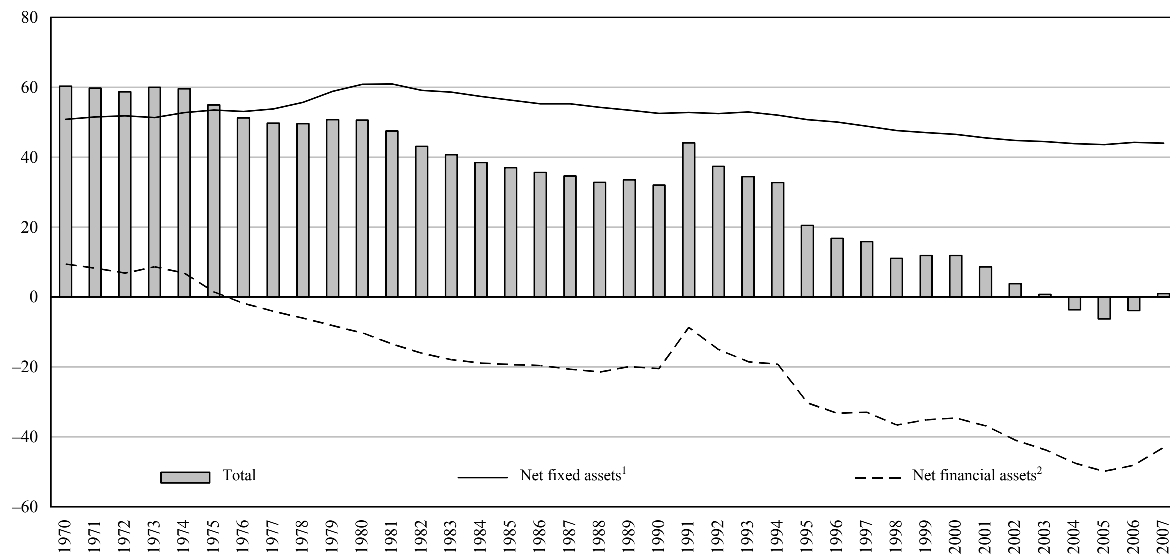


* Up to and including 1990, data from debt statistics, Western Germany. From 1991, pursuant to the Maastricht criteria. From 2009, data from the updated stability programme of January 2010.
Deutsche Bundesbank.

Figure 2

Government Net Assets*

(percent of GDP)



Source: Federal Statistical Office and Bundesbank calculations.
* As defined in the national accounts; central, state and local government and social security funds. Up to and including 1990, western Germany.
[1] At replacement cost: tangible and intangible fixed assets less depreciation, as at the beginning of the year.
[2] Financial assets less liabilities, as at the end of the year. Results of the Deutsche Bundesbank's financial accounts.
Deutsche Bundesbank.

majority was refinanced via Federal debt instruments and is no longer separated from other debt instruments.

Even before the financial crisis and its effects on economic activity began to have an impact on government finances, the German Maastricht general government debt-to-GDP ratio had climbed to above 65 per cent. Bringing this ratio back below the reference value of 60 per cent sufficiently quickly seemed barely feasible after the outbreak of the crisis. If the development of the general government debt rate had been accompanied by a comparable increase in the asset position, it probably would have given less cause for concern. But, in reality, the net asset position had decreased significantly during the previous decades. Furthermore, in 2007, the German constitutional court judged that the central government's 2004 budget – for which the exemption clause for averting a disturbance of the macroeconomic equilibrium was used for the third time in a row, despite rising GDP growth rates – could not be declared unconstitutional. It noted that the constitutional borrowing limits were not sufficient to safeguard sound public finances. As the judges are not entitled to change the constitution, they called for politicians to create an effective framework to safeguard sustainable public finances.[2]

While in many European countries deficits and debt occur almost exclusively at the level of central government, state governments in Germany are usually responsible for about 1/3 of general government deficit and debt levels. Despite a revenue sharing system that largely aligns per capita-tax revenue, significant differences prevail between the budgetary positions of the sixteen German states. In 1992, the German constitutional court decided that the two (least populated) states of Bremen and Saarland were suffering from extreme budgetary hardship and were consequently entitled to claim assistance from the other members of the German federation. From 1994 to the end of 2004, the two states received aid totalling €15 billion and were obliged to limit their annual expenditure increases (e.g., to just 1 per cent on average for 2003 and 2004).[3] Nonetheless, they did not manage to return to sound budgetary positions and filed lawsuits for further financial assistance. In addition, the state government of Berlin also called for help to overcome a situation it considered to be a case of extreme budgetary hardship (following a judgment by the Berlin state constitutional court offering additional borrowing possibilities in such a case).[4] However, in 2006, the German constitutional court decided that help for Berlin was not necessary because such assistance can only be claimed if all possibilities to improve revenue have been used and expenditure levels have been restricted to the level considered strictly obligatory under Federal law and other binding commitments.[5] As most other state governments also faced severe budgetary pressure in the first years of the 21st century,[6] they acknowledged that a comprehensive change of their fiscal policies was necessary to avoid unsustainable debt growth and further cases of states claiming help due to extreme budgetary hardship. All in all, strict borrowing rules were considered to bring about the exterior pressure needed to enable politicians to eliminate deficits from the budgets.

2 The main elements of the German debt brake

The main elements of the new fiscal rules were agreed by a commission of 16 Bundestag members and one member of each state government – in most cases the prime minister. Discussions were held for about two years starting in 2007. The time was considered suitable for

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[2] See German Constitutional Court, 2BvF 1/04 from 9 July 2007, Sections 133-135, available in German only.

[3] See Bericht des Saarlands zur Sanierung des Landeshaushalts – Sanierungsbericht 2004, p. 9-10.

[4] See Berlin state constitutional court, VerfGH 125/02, Section D.III, available in German only.

[5] See German constitutional court, 2BvF 3/03 from 19 October 2006, available in German only.

[6] See Deutsche Bundesbank (2006), "State Government Finances in Germany", monthly report, July, pp. 29-50.

changing budgetary rules as a coalition of the two largest German parties formed the central government in the legislative period from autumn 2005 to autumn 2009. They had a 2/3 majority of Bundestag members and were also in a position to organise the majorities in the Bundesrat that were needed to change the Basic Law. Furthermore, following the impressive deficit reduction from 2006 onwards, many politicians believed that avoiding borrowing in the future should not be too challenging.

While the Council of Economic Experts had favoured a net investment-based borrowing limit,[7] politicians decided to follow an “at least close-to-balance approach” as already prescribed over the medium term by the European Stability and Growth Pact. Keeping in mind that a structural general government deficit ratio of about 0.5 per cent was considered to be in line with European rules, central government – in line with its share in general government debt and its financial responsibility share in the event of European sanctions due to persisting excessive deficits – claimed a structural borrowing limit of about 2/3 of this amount. However, dividing up the remaining amount among the sixteen states would have created significant problems. A zero borrowing limit was ultimately agreed. Some relatively strictly defined exceptions are foreseen under the condition of a redemption plan for incurred additional debt. As it was obvious that the deficits expected in early 2009, partly due to measures aimed at overcoming the effects of the financial crisis, would not be eliminated in the near future, transitional periods were agreed. While the years up to 2016 were considered sufficient for central government, prior to the final outbreak of the crisis state governments had already claimed the period up to 2020 to give those states with high structural deficits enough time to balance their budgets. Transitional auxiliary payments for five states with high deficits or debt levels were agreed under the condition of a gradual reduction of structural deficits in the transitional period. In order to closely monitor the agreed deficit reduction and also to prevent new cases of extreme budgetary hardship, a stability council was founded.

For central government, the commission also developed the main rules for the use of the debt brake, which were passed as the new article 115 of the Basic Law and the Law to Execute Article 115 of the Basic Law. For state governments, a balanced budget rule is prescribed in article 109 of the Basic Law. It will become effective in 2020 without further state parliament action. However, the relevant details (and the limited set of exceptions) have to be defined by state (constitutional) legislation.

3 The details of the debt brake for the Federal government budget

3.1 Constitutional and legal framework

The new borrowing limit for central government budgets clearly refers to the European Stability and Growth Pact.[8] The draft law to introduce the constitutional debt brake stresses the intentions of the reform. By setting an at least close-to-balance budget in structural terms as an upper limit, the reform aims to stop the upward trend of the Maastricht debt ratio in particular. As a consequence, several changes to the traditional concept were introduced.

To begin with, the borrowing limit had to be defined precisely. In order to come close to the deficit relevant for the preventive part of the Stability and Growth Pact, a cyclical adjustment procedure was introduced. The Basic Law stresses the importance of symmetry of the procedure during upturns and downturns to prevent an increase in the debt level. An accumulation of

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7 See Council of Economic Experts (2007), “Effectively Limiting Government Indebtedness”, March, available in German only.

8 See Bundestag Document No. 16/12410, e.g., pp. 1 and 5.

"cyclical" debt would have to be expected if the procedure were to detect more severe or longer recession periods than years with output levels above potential. Section 5 (4) of the Law to Execute Article 115 of the Basic Law also contains an indication that the methods used by the European Commission should be followed. Furthermore, the cyclical adjustment procedure is also to be adjusted to reflect scientific progress. The legal definition of the cyclical effect is the output gap multiplied by the budget sensitivity of the central government budget. More detailed prescriptions on how to calculate this effect were laid down in a regulation by the German Ministry of Finance in consultation with the Ministry of Economics and was published in summer 2010. According to the regulation, output gaps have to be calculated in line with the EU Commission procedure when the budget is drafted and finalised. In later steps, a simplified approach is envisaged. Differences between expected and actual GDP growth are considered to be entirely cyclical. According to Section 7 of the Law to Execute Article 115 of the Basic Law, revisions of the cyclical component will be stopped by 1 September of the year after the budget is implemented.

In addition, financial transactions are not included in the borrowing limits. While central government budgets have, in the past, often contained significant amounts of sales of financial assets[9] – in order to limit borrowing and not to exceed the former borrowing limit – such transactions can no longer be used for this purpose. On the other hand, the acquisition of such assets is not limited by the debt brake. As granting loans and acquiring shares are also excluded from the Maastricht deficit, this procedure could be considered to be straightforward.

Furthermore, the borrowing rules no longer apply only for the drafting period but also for the implementation stage, too. This was deemed necessary, since problems might occur if cyclical conditions prove to be better than expected or net borrowing requirements for financial transactions are lower than budgeted. If a government nevertheless uses the full amount of borrowing entitlements given in the budget and possibly also inherited borrowing entitlements from the previous year, constitutional structural limits could be exceeded. Consequently, a control account was identified as being needed. On this account, the difference between the constitutional borrowing limit – adjusted for actual net financial transactions as well as the actual cyclical effect – and the actual net borrowing in a budget has to be booked every year. If a debt threshold of 1 per cent of GDP is surpassed on this account and the government expects cyclical burdens to decrease, borrowing has to be restricted below the constitutional limit by an amount of up to 0.35 per cent of GDP (Section 7 (4) of the Law to Execute Article 115 of the Basic Law) to prevent a permanent increase of burdens on that account. Under this restrictive framework concerning results, borrowing limits for supplementary budgets were made less challenging to avoid urgent needs for sizeable short-term consolidation measures. Section 8 of the Law to Execute Article 115 of the Basic Law consequently allows additional borrowing for such budgets of up to 3 per cent of estimated tax revenue above the constitutional limit provided that no additional deficit-increasing measures are implemented.

Moreover, reflecting that the Maastricht deficit also includes government entities beyond the core budgets, the general exception from borrowing limits granted for special funds was abandoned. According to article 143d of the Basic Law, which stipulates rules for the introduction of the debt brake, from 2011 onwards – also defined as the first year of application of the debt brake for the central government budget – no additional special funds may be founded or given entitlements to borrow. Only those special funds that had been given borrowing entitlements before the end of 2010 may still use them up to the expiration date.

Furthermore, article 143d of the Basic Law contains the clause that the reduction of structural deficits – expected to rise up to 2010 – should begin in 2011. A postponement of consolidation measures was not definitively ruled out due to concerns about a possible need for

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[9] From 1995 to 2010 receipts of €140 billion were recorded – in addition to total borrowing of about €470 billion.

further government stimuli in order to return to macroeconomic growth after the crisis.[10] However, the Law to Execute Article 115 of the Basic Law (which could be amended by a Bundestag majority if needed in the event of a longer severe crisis phase) goes further and stipulates that the structural borrowing limits of the central government budget are to be reduced in equal steps, starting in 2011, from the level reached in the budgetary year 2010 (Section 9 (2)).

Finally, according to article 109 of the Basic Law, exceptions from the debt brake are only envisaged in the event of natural disasters or outstanding emergencies beyond government control (meaning that the government and the legislation are not in charge of the situation) and if budgetary effects are sizeable. According to the draft law to change the constitutional borrowing rules, the traditional justification for exceptional borrowing to avert a disruption of the macroeconomic equilibrium does not qualify for the new clause. Even more importantly, exceeding the constitutional borrowing limit will only be allowed if a concept is approved on how to repay the additional debt incurred. The incentive to use the exception clause should consequently be much lower than under the preceding borrowing rules.

In summary, the clearly announced intention to limit the growth of central government debt levels was underpinned by a series of relatively detailed constitutional and legal rules which intended to close the main loopholes of the old constitutional borrowing limits. Only time will tell whether these efforts are really sufficient. The first months of the implementation stage, however, show that continuous vigilance is necessary to avoid recourse to – almost unavoidable – loopholes.

3.2 Implementation of the framework: possible loopholes and actual problems

As the first application of the debt brake was for the 2011 budget, the actual implementation for central government budgets was due after the general elections in autumn 2009. Voters changed the majorities by adding much weight to the Free Democratic Party (FDP), which had stressed its firm intention to cut levies, especially income taxes. Hence a coalition agreement between the Christian Democrats and this party was signed promising further tax cuts of €24 billion (about 1 per cent of GDP). After additional smaller steps in 2010, major tax relief was envisaged – if possible – for 2011 or later in the legislative period (up to 2013). However, all additional measures were only promised on the condition that they could be refinanced within the budget already burdened by a high structural deficit. It was also declared that the rules of the new debt brake would be respected.[11] It therefore seemed at least useful for the new government to find loopholes in order to finance the promised tax relief measures.

The first attempt was already mentioned in the coalition agreement. The parties proposed the creation of a *special fund* to finance transfers to compensate crisis-related deficits of the Federal Employment Agency and possibly also revenue shortfalls of the statutory health insurance scheme (page 24 of the agreement). By creating the fund before the old exception for borrowing by such bodies had expired, sizeable transfers could have been financed for a number of years without being subject to the new borrowing rules. However, the public response was strictly negative. Such very obvious recourse to loopholes in the highly appreciated debt brake could not be explained credibly. Hence, the idea of creating a big special fund to provide – interim – relief for the core budget was dropped at an early stage.

However, one year later, a new special fund responsible for stability within the financial sector has been created. In October 2008, at the peak of the banking crisis, SoFFin was established

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[10] See Bundestag Document No. 16/12410, pp. 13-14.

[11] See “Growth. Education. Unity. The coalition agreement between the CDU, CSU and FDP for the 17th legislative period”, available at: http://www.cdu.de

as a special fund to stabilise monetary financial institutions for a limited period. New measures could only be taken up to the end of 2010. While borrowing entitlements, mainly for recapitalisations, amounted to up to €80 billion, actual borrowing requirements only reached about 1/3 of this amount by the end of 2010. The successor fund is primarily to be financed via a bank levy. As regular annual revenue was expected to reach about €1.3 billion only, the idea of "inheriting" borrowing entitlements from SoFFin was proposed. In order to fulfil the requirements of the debt brake, the new special fund had to be created before the start of 2011 and the inheritance of borrowing entitlements had to take place just before the actual end of the SoFFin assistance measures. Unlike the above mentioned intentions to create additional borrowing facilities in late 2009, the actual transfer of borrowing entitlements of €20 billion did not cause any political problems. While this transfer was obviously designed to circumvent the veto on borrowing by new special funds, the transaction ultimately does not give any additional room for budgetary manoeuvre. A possible extension of the SoFFin assistance period could have led to even higher borrowing. Furthermore, as the borrowing entitlements of the new fund are to be used for capital injections to stabilise the financial sector, acquiring equity through the central government budget instead would not be limited under the debt brake if the measures can be considered to be financial transactions.

A further issue for concern is the *borrowing limit during the transitional period* from 2011 to the end of 2015. The Law to Execute Article 115 of the Basic Law states that the limit is formed by the structural deficit of the 2010 budgetary year being reduced in six even steps in each of the following years, leading to the permanent limit of 0.35 per cent of GDP in 2016. Two main questions arose concerning the starting level for the structural borrowing ceiling in 2011.

The first issue not explicitly addressed in the legal rules was *how to proceed with one-offs* in the reference year 2010. The new coalition partners agreed that no adjustment was to be made. Consequently, by budgeting high one-off burdens in 2010, structural borrowing limits in the following years up to 2015 could be increased. Consequently, instead of providing a loan to finance the expected very high deficit of the unemployment insurance scheme (Federal Employment Agency) – as legally prescribed since 2007 and considered to be exempt from the structural deficit under the debt brake rule as a financial transaction – the government decided to make a transfer for this purpose just for 2010. Furthermore, a one-off transfer to the statutory health insurance scheme to provide compensation for crisis-related revenue shortfalls was budgeted. As labour market developments turned out to be not as bad as expected, the estimated transfer to the Federal Employment Agency was revised downwards from €16 billion in December 2009 to €12½ billion when finalising the 2010 budget in the Bundestag in March 2010. Together with the additional transfer to the health insurance scheme, estimates of about €16½ billion were budgeted for one-off burdens. Adjusted for the cyclical component in the transfer to the Federal Employment Agency, the one-off structural deficit increase in the reference year would have been about €10 billion (0.4 per cent of GDP), leaving short-term scope for parts of the tax cuts promised in the coalition agreement or the postponement of ultimately necessary, but unpleasant consolidation measures.

The second issue was *when to define the reference value* prescribed by law as the "structural deficit in the 2010 budget year". The necessity to draft budgets and medium-term financial plans on the basis of reliable assumptions was stressed by the Federal Ministry of Finance. Hence, it was announced that the budget estimates for 2010 would be used to calculate the reference value.[12] However, there seemed to be an even more important factor. As budgetary developments were much better than to be expected under the improved macroeconomic conditions – mainly owing to positive tax revenue surprises, labour market-related expenditure shortfalls, €4.3 billion in one-off relief from an auction of mobile phone licences and declining interest expenditure – using the

[12] See the statement by parliamentary state secretary Steffen Kampeter, Bundestag Document No. 17/494, pp. 14-15.

budget estimates instead of the final result or a best interim guess leads to a much higher reference value for the structural deficit and higher borrowing limits in the transitional period.

All in all, the 2010 budget law granted borrowing entitlements of €80.2 billion. After deducting cyclical components and net effects of financial transactions, an amount of €66.7 billion was classified as the structural component. Taking into account the structural part of the upward revision of the official tax forecast from May 2010 and the revenue from the mobile phone licence auction also concluded in that month combined with the positive surprises from German labour market developments and from the interest conditions for German bonds, it could be expected in June that the actual deficit would probably be about €60 billion and the structural component still about €10 billion lower. Neglecting the positive developments would have enabled the Federal government to draft a budget for 2011 showing an increase in the structural deficit and total borrowing entitlements compared with the results for 2010 that were expected in June.

In order to avoid a scenario with a deficit increase, which was too obviously not in line with the intentions of the debt brake, the Federal Ministry of Finance decided to adjust the starting point for the structural deficit limits notably by assuming a 2010 result for the total borrowing requirement of €65 billion and a structural component of €53 billion.[13] Based on these figures, central government agreed a consolidation package on 7 June 2010. On 7 July, the draft budget for 2011 was approved by the cabinet. The borrowing entitlement amounted to €57.5 billion, the structural component – excluding, in particular, a loan of €6.6 billion to balance the deficit of the Federal Employment Agency – was calculated to be about €46 billion and hence just fulfilled the limit for 2011 derived from the Ministry's own (cautious) 2010 estimate.

However, positive surprises continued to occur up to the end of 2010. When making final parliamentary adjustments to the 2011 draft budget after the new official November tax revenue forecast, the government conceded that the actual borrowing requirement in 2010 would be only about €50 billion. However, no figures for the structural component were mentioned. According to rough estimates, a size of about €40 billion seemed plausible. To avoid an increase in the 2011 borrowing entitlements compared with the expectations for 2010, the figures for 2011 were adjusted mainly for the increase in tax revenue estimates. However, further adjustments, mainly regarding lower interest or labour market-related expenditure, remained strictly limited. Hence sizeable buffers remained in the budget estimates. Total borrowing entitlements were reduced to slightly above €48 billion, while the structural component was declared to be €41 billion. The borrowing limit, however, had not been adjusted to the new 2010 forecasts. Hence, a safety margin of almost €5 billion between the borrowing entitlement and its constitutional limit was claimed to exist – created mainly by the base effect of a more favourable outcome for 2010.

By mid-January, official figures for the 2010 budget had been published. Total net borrowing amounted to just €44 billion. However, figures for the cyclical impact as well as for the net effects of financial transactions were not published by that time. According to preliminary approximate calculations by the Bundesbank, the structural component should be about €38 billion instead of the amount of €53.2 billion estimated in June 2010. Not adjusting the starting point for the constitutional borrowing limits for the transitional period is hence a clear and quantitatively highly significant contravention of the intentions of the debt brake. Assuming that most factors contributing to this improvement cannot be considered to be "one-offs", there would be no need to reduce the structural deficit until 2013 by additional measures in order to keep borrowing in line with the adjusted limit for the transition period. While analyses from the most important economic research institutes and from the German Council of Economic Experts reached the conclusion that 2011 offers very good conditions for consolidation measures,[14] central government's interpretation

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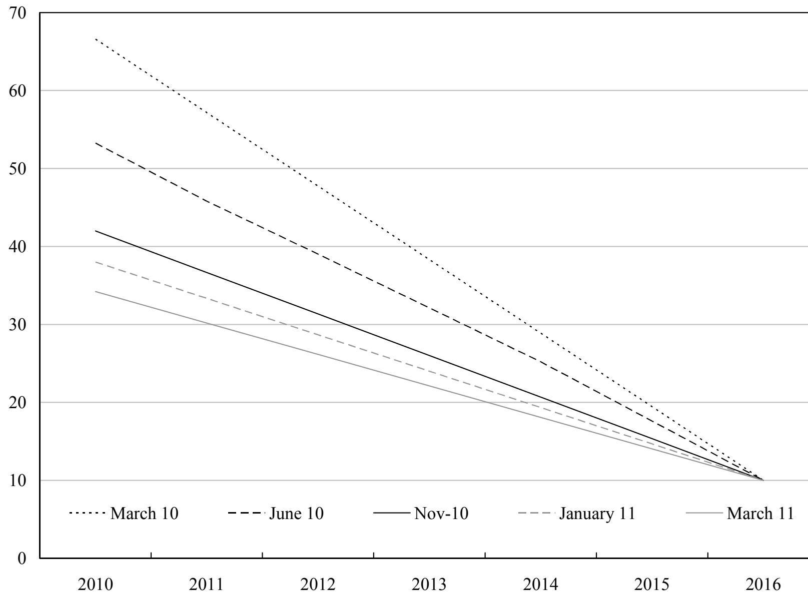
13 See Federal Ministry of Finance press release: "Debt Rule Compels Us to Consolidate", 6 July 2010.

14 See Gemeinschaftsdiagnose Autumn 2010, p. 47, and Council of Economic Experts (2010), p. 11.

Figure 3

Minimum Adjustment Path
for the Structural Federal Government Budget Deficit
(billion euros)



March and June 2010 data from Budget Law rsp. Federal Ministry of Finance, later data partly based on own estimates for cyclical effects and financial transactions.

of the debt brake signals no necessity to do so. Adjusting the starting point for the borrowing limits in the transitional period is essential to preserve the credibility of the debt brake. Otherwise, the deficit in the 2011 budget – the first year under the debt brake – would be allowed to rise again substantially, even in structural terms.[15] If the consolidation of the 2011 budget is nevertheless continued as announced, the room for possible deficit increases in the next few years will remain significant and pressures, e.g., to lower tax rates despite still high structural deficits may become hard to resist. In general, it is very important to make use of the current opportunity of good cyclical conditions to bring down structural deficits by more than the prescribed minimum amounts – not least in order to be in a better position in case macroeconomic growth perspectives take an unexpected turn for the worse in the future. If the minimum target is not set at a sufficiently ambitious level now, there is a danger of repeating a major mistake from past years when necessary consolidation measures were postponed during good times.[16]

The fact that the government has used a misinterpretation of the wording of the debt brake rules becomes even more evident under the assumption that the 2010 budgetary development would have brought about sizeable negative surprises from June onwards. If the starting point for the structural deficit had been fixed in June and the expected outcome after the official tax forecast in November had been, e.g., €10 billion higher owing to lower tax revenue, there would have been an urgent need to fully compensate this amount in 2011 on top of the graduated consolidation measures agreed upon in June 2010, as the budget for 2011 would have had to respect the borrowing limit derived from the June estimates. Such pressure would have been against the spirit of the transitional rule for the debt brake and could have led to its failure during the first year.

The importance of the 2010 reference value can be seen in the chart below. Sticking to the structural deficit figure estimated in June 2010 leads to a difference of €15 billion for the structural

[15] The biggest opposition party in the Bundestag proposed passing a law prescribing corrections for the structural borrowing limits in the transitional period by using the 2010 results as the starting point. See Bundestag Document No. 17/4666 dated 8 February 2011. However, a majority of Bundestag votes rejected the proposal. See Bundestag Protocol No. 17/117 (30 June 2011), p. 13486.

[16] See also Deutsche Bundesbank (2010), "Overview", monthly report, November, p. 10.

borrowing limit in 2011, if March 2011 figures (derived by using the new cyclical adjustment procedure agreed upon for the European Union budgetary surveillance procedure currently used for the German debt brake) are taken as a benchmark. Up to 2016, the difference would accumulate to almost €50 billion for the stock of Federal government debt.[17]

Besides the issues surrounding special funds and the starting point, the treatment of *financial transactions* might prove to endanger the success of the debt brake. While excluding sales of financial assets from the deficit rule closes an important gap in the old constitutional borrowing limit, the general exemption for the acquisition of such assets could open another loophole. After paying a transfer to finance the deficit of the Federal Employment Agency in 2010, central government budgeted a €5.4 billion loan for 2011. However, the good performance of the German labour market in 2010 may mean that only a much smaller amount will be needed. The medium-term financial plan from 2010 to 2014 had already envisaged repayments from 2013 onwards. Given the better-than-expected performance, continuously accumulating loans no longer seemed to pose a threat. As a consequence, politicians soon came up with the idea of diverting funds. The German constitutional court had judged that a reform of the benefits for the long-term unemployed was necessary. As approval from the Bundesrat was required (and the central government parties had lost the majority of votes in the second chamber), a package was bundled to obtain approval. As local governments had run up high deficits during the crisis and improvements were hard to achieve, the central government offered to take on their burdens of about €4 billion for social benefits for the basic needs of the elderly and persons with disabilities affecting their capability to work. State governments co-responsible for the finances of their local authorities hence were under pressure to approve the reform package. Ultimately, with only small adjustments to the benefits for the long-term unemployed, the reform passed the two legislative chambers. As the central government budget still suffers from high structural deficits and the borrowing limits of the debt brake have to be respected, recourse was made to the regular transfers to the Federal Employment Agency. Since 2007, revenue from 1 percentage point of the increase in the general VAT rate has been forwarded to the Federal Employment Agency, which, in turn, has lowered contribution rates by 1 additional percentage point. From 2012 onwards, this transfer will be lowered in three steps. From 2015 onwards, an annual amount of €4 billion will be diverted to the aforementioned local authority relief measure. Hence, a trend towards growing stocks of central government loans to finance deficits of the Federal Employment Agency can no longer be ruled out.[18] By practically shifting burdens to the agency (while still offering central government loans to balance deficits), a possible loophole of the debt brake was already used in the first months of the new rule being applied.

A crucial question will then be how to proceed if the loans given to finance deficits reach a level that makes repayment obviously implausible. If a *debt release* takes place for the benefit of the Federal Employment Agency, Federal government debt will remain without the corresponding financial assets. From a budgetary perspective, this might be no cause for concern, because no entitlements for payments are needed. But under the debt brake framework, this is obviously inappropriate. Article 109 (2) of the Basic Law postulates that the main goal is to balance the general government budget according to the European budgetary accounting rules laid down in the European System of National Accounts 1995. Under this framework, debt releases have to be booked as capital transfers. As these potentially very sizeable transactions increase the deficit, the use of such instruments has to be restricted under the debt brake rules. Hence, a debt release would

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17 See the Statement given by the Bundesbank at an expert hearing by the budget committee of the Bundestag on 21 March 2011 at www.bundestag.de, available in German only.

18 See Deutsche Bundesbank (2011), Public Finances, monthly report, May.

need to be recorded as a transaction that increases borrowing analogously for the debt brake.[19] Otherwise it would be possible to pay, e.g., individual social benefits as principally repayable loans and borrow as much as needed for such purposes. After a defined period without (sufficient) repayments, unlimited debt releases could take place, leaving high government debt without corresponding financial assets. This would be a clear breach of the intentions of the debt brake. If this is not stopped, there will be only very limited hope for the lasting success of the new rules.

Generally, strict rules to *clarify which payments may be classified as financial transactions* seem necessary. Given the principal goal pursuant to article 109 II of the Basic Law, the rules for the European budget supervision should be applicable. The above-mentioned loans to the Federal Employment Agency are given without interest claims and redemption dates. Hence, they would usually hardly qualify as a financial transaction. The same conclusion would have to be reached in the case of capital injections to enterprises that do not seem to be sufficiently profitable to pay an adequate return via profit distributions. For central government, capital injections have so far only played a minor role of less than €1 billion per year. The largest part is obviously paid as capital injections into multilateral development banks that mainly give concessional loans and hence can hardly be profitable. The government classified these payments as financial transactions until 2011, but obviously treats them as transfers in the 2012 draft budget. This new treatment seems appropriate and should be used in all similar cases in the future. Otherwise even regular transfers to prevent or compensate losses might qualify as financial transactions under the debt brake framework. The incentive for misclassification would then strongly endanger the effectiveness of the new borrowing limits. A more difficult question is how to treat calls on guarantees. Backed by the experience that calls on guarantees given for claims from exports typically lead to notable repayments in later years, central government considers such calls to be financial transactions as well as received corresponding repayments. When expecting a continuation of high repayments, this treatment seems adequate. By contrast, calls on guarantees given for transactions within Germany increase structural deficits.[20] However, within the regular reporting framework for 2010,[21] no budgetary figures were published showing a breakdown of calls on guarantees within Germany and those abroad. Hence, there was at least a lack of transparency regarding the actual structural deficit 2010.

In principle, the *cyclical adjustment* of deficits within the framework of fiscal rules is an accepted procedure. However, it is necessary to respect some basic principles. The debt brake for the central government budget encompassed the concept of symmetry as a constitutionally fixed condition. Following the wording of article 109 of the Basic Law, symmetry could be understood as using the same procedures in upturns and downturns. The explanations in the draft law to establish the constitutional reform, however, make it clear that the intention is to prevent a structural increase in nominal debt levels due to effects labelled as cyclical. The Law to Execute Article 115 of the Basic Law also rules that the details of the adjustment procedure have to be fixed by a regulation from the Ministry of Finance (with the agreement of the Ministry of Economics) in accordance with the rules used for the European budgetary surveillance procedure. This reference to an institution considered competent and neutral seemed at that time helpful to prevent politicians from fine-tuning procedural details in order to achieve cyclical components that are compatible with the intended fiscal policy. Furthermore, the principles of transparency and simplicity should be taken into account. Although there was no legal prescription to publish the code of the cyclical

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[19] See the Statement given by the Bundesbank at an expert hearing by the budget committee of the Bundestag on 21 March 2011 at www.bundestag.de, available in German only.

[20] See Kompendium zur Verschuldungsregel des Bundes gemäß Artikel 115 Grundgesetz, pp. 11-12.

[21] Adjusted figures for financial transactions were only given after an inquiry by a member of the Bundestag. See Bundestag Document 17/4987, p. 12, available in German only.

adjustment programme or the data used, central government provided experts with detailed explanations.

Meanwhile, the *cyclical adjustment procedure* used for European budgetary surveillance was *changed considerably*.[22] While the new concept is said to produce less sizeable data revisions for individual years, the pattern of calculated cyclical effects has changed markedly. Compared with the preceding adjustment procedure, cyclical effects in the past tended to be more positive or less negative, while the results for the most recent years show less positive or more negative cyclical impacts. While long-term symmetry still seems to be given, higher cyclical burdens during the crisis and the following recovery period justify higher borrowing even in coming years. When deciding headline figures for the 2012 draft budget in March 2011, central government assumed a cyclical component of –2.9 billion, whereas a comparable estimate with a standard filter (HP-ilter, lambda 100) delivered a slightly positive cyclical component.[23] If the change in the adjustment procedure is fully based on scientific progress, this may be no reason for concern.

However, given the special rules for the central government borrowing limit in the transitional period before 2016, the cyclical component for deriving the structural deficit for 2010 as the starting point would have to be recalculated with the new cyclical adjustment procedure. The consequence would be a notably lower structural borrowing limit, especially in the first years of the transitional period. By changing to the revised cyclical adjustment procedure and not redefining the borrowing limits, central government is using another loophole, securing some margins that might be used to fill up the control account (with the option of strategically distorting budget estimates in the future if needed to circumvent consolidation measures) or in order to limit short-term consolidation efforts or to fulfil tax relief promises made for the current legislative period. Each of these options would be in clear contrast to the intentions of the debt brake. However, it seems questionable whether this can still be stopped.

Another possible problem concerning cyclical adjustment is the question of *when and how to calculate the cyclical effects ex post*. While safeguarding symmetry would, in principle, also require an adjustment of the effects recognised for former years, probably numerous sizeable revisions of the total stock recorded on the control account could lead to some general distrust concerning any results. Hence, stopping adjustments for every single year after a limited time span would seem to be useful if systematic breaches of the symmetry principle can be avoided. Section 7 of the Law to Execute Article 115 of the Basic Law stipulates that the final entry for a budgetary year has to be made on 1 September of the following year. Furthermore, the regulation on execution details of article 115 of the Basic Law rules that after passing the main budget law no adjustments are to be made with regard to estimates of trend growth: differences between predicted and actual GDP growth have to be considered entirely cyclical. While the rules did not define whether real or nominal growth has to be considered, the Ministry of Finance obviously decided to base its calculations on nominal rates,[24] which are in fact more important for tax revenue developments. Having a final deadline for entry adjustments on the control account and simplifying *ex post* calculations of cyclical impacts on the budget really simplify the application of the new borrowing rules. However, problems regarding the constitutional symmetry condition for cyclical effects will occur if trend GDP growth continues to decline as it did over the past few decades or is just overestimated when drafting the budgets. If this occurs, misestimates of trend growth will be labelled as cyclical once a budget has passed the legislative process. To limit corresponding debt

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[22] For information on the interconnection with the German debt brake, see Deutsche Bundesbank (2011), "Requirements Regarding the Cyclical Adjustment Procedure Under the New Debt Rule", monthly report, January, pp. 55-60.

[23] The Bundesbank Spring 2011 forecast also envisages a positive output gap for 2012. See Deutsche Bundesbank (2011), "Outlook for the German Economy – Macroeconomic Projections for 2011 and 2012", monthly report, June, pp. 13-26.

[24] See Baumann, E. and J. Schneider (2010): "Die neue Regel des Bundes", in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, pp. 109-110.

increases, it would also be useful to introduce a control account for cyclical effects. While no limit on its stock is needed, it seems useful to prescribe that after a full cycle the stock may not increase on its level at the start of the cycle. If this condition is not fulfilled, the respective debt growth should have to be compensated by lowering the structural borrowing limit over the next few years.

A further loophole might be found in the use of *public private partnerships* (PPPs). By giving orders to build and operate infrastructure projects, budgetary burdens can be postponed under the framework of cash-based accounting systems run by central government and also by most state governments. Instead of budgeting investment expenditure and borrowing to finance it right from the start of a project, when choosing a PPP only smaller payments in later years have to be budgeted. Hence, borrowing limits could be formally respected without reducing long-term budgetary burdens in a comparable way. Paying for a PPP might be considered to be indirectly paying interest and redemption for incurred debt. From a purely legal point of view, this does not seem to be a problem, as constitutional borrowing limits are usually understood as rules governing immediate borrowing only.[25] However, the objective of article 109 II of the Basic Law to achieve an at least close-to-balance general government budget seems to necessitate a different approach. According to the European accounting rules, PPPs have to be recorded as government investment if certain main risks are not transferred to the private partner. In Germany, the necessary degree of risk transfer to avoid investment expenditure entries in the government accounts does not seem to be achieved in most cases. Hence, PPPs will have an immediate impact on the Maastricht deficit. Not including PPPs in the borrowing rule would then make it impossible to ensure that the above-mentioned overriding objective of the debt brake laid down in article 109 II of the Basic Law is achieved. However, it cannot be ruled out that the legalist view may be followed. As a consequence, it would seem useful to explicitly include transactions similar to taking up a loan in the structural borrowing limit.

Although the above-mentioned possible loopholes could already endanger the debt limitation intended by the reform of the borrowing rule, there is a further problem that might prove to be very severe. While additional borrowing entitlements are available for supplementary budgets, and higher-than-expected deficits during the execution of the budget may be financed via recourse to borrowing entitlements inherited from the previous budget, the budget for the next year has to fulfil the structural borrowing limit set by the debt brake. As deficit problems in the German central government budget were often caused by tax shortfalls which went beyond the amounts that could be classified cyclical, they could not be reverted easily. During the protracted phase of low GDP growth from 2001 to 2004, even additional substantial structural tax shortfalls were noticed in every year. If the debt brake had been implemented before that time and no *safety margin* had been established between the structural borrowing limit and the actual structural deficit, a series of very sizeable consolidation measures would have become necessary despite real and nominal GDP growth rates that were (almost) close to zero (instead of the former common recourse to sales of financial assets or the exemption clause "averting a disturbance of the macroeconomic equilibrium"). Sizeable consolidation measures might have even aggravated the poor performance of the German economy during that phase. This could have strongly endangered the acceptance of the strict borrowing rule. As a consequence, sufficient safety margins between constitutional limits and budgetary plans or smooth adjustment path rules should be implemented.[26] However, no such elements are explicitly included in the central government debt brake. A useful instrument would be an obligation in the budget regulations law for central government to strive for a slight structural

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[25] See Tappe (2010), "Haushaltsrechtliche Umsetzung der Artikel 109 und Artikel 115 GG n.F. in Bund und Ländern", in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, p. 435.

[26] For information on the necessity of safety margins, see also Deutsche Bundesbank (2009), "The Reform of the Borrowing Limits for Central and State Government", monthly report, May, pp. 78-79, and Kremer, J. and D. Stegarescu (2009), "Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik", *Wirtschaftsdienst*, Vol. 89/9, pp. 630 and the followings.

surplus. If this target is missed, gradual adjustments during the medium-term financial planning period could be a useful setting to prevent fiscal policy from being obliged to almost immediately take sizeable consolidation measures. The safety margin might also be used for active countercyclical policy in very bad times. Given that no redemptions are necessary in that case, stabilisation success might be easier to achieve than by using the exception clause. In order to prevent abuse of the growing bonus amounts booked on the control account due to the safety margins, it might be helpful to also introduce an upper limit of 1½ per cent of GDP. Higher amounts would not be recorded then. Notwithstanding, reaching this level should not be considered a signal to change fiscal policy to, e.g., tax relief measures, at least as long as debt levels are still above the European reference value.

4 Implementation of the debt brake at state level

Whereas the legal details of the central government debt brake had been laid down together with the reform of article 109 of the Basic Law in summer 2009, overall progress at state government level is far more moderate. Without amendments in the state constitutions, a balanced budget rule without any exceptions at all will be applicable for state government budgets from 2020 onwards. As also mentioned above, the long transitional period was agreed to give sufficient adjustment time for the states that had high structural deficits even before the outbreak of the major crisis in the course of 2008 (mainly Bremen, Saarland and, to a far lesser extent, Schleswig-Holstein). From 2011 to 2019, these states plus two heavily indebted ones (Berlin and Saxony-Anhalt) will be granted annual transitional aid of €0.8 billion in total, financed by the Federal and each of the state budgets. As a gradual reduction of structural deficits was prescribed as a precondition for actual aid payments, these states should feel compelled to make early adjustments, whereas the other ones are just vaguely obliged by article 143d of the Basic Law to avoid a fiscal situation that might make a balanced budget in 2020 impossible. However, there seems to be a lot of scope for different interpretations about what was actually agreed in 2009.

A first and very important question refers to the definition of the ban on (structural) borrowing for state budgets. Legal experts tend to follow the traditional definition of borrowing. According to this approach, only the issuance of all types of bonds or financing by taking up loans is prohibited. Consequently, transactions as sale-and-lease-backs or PPPs would not be limited directly.[27] As at central government level, this does not seem to reflect the wording of 09 2) of the Basic Law or the intentions of the debt brake. Besides limiting the increase in future budgetary burdens, caused in particular by growing outstanding debt, a clear commitment to the rules of the European Stability and Growth Pact was given. This means that at least close-to-balance budgets have to be ensured. As European rules treat typical German PPPs in a different way than national budgetary practice, the overriding goal of avoiding breaches of European obligations should be given priority over the traditional view of legal experts. Hence, the budgetary data should be corrected if European rules lead to a different classification. As a by-product, future budgetary burdens as a result of present decisions would be limited much more effectively.

In addition, the traditional view might lead to the conclusion that the ban on structural borrowing would only apply for the core budgets. From this point of view, borrowing limits would only bind the legal person immediately addressed. *Entities beyond the core budgets* would then have constitutionally unlimited recourse to financing by loans. However, article 143d (1) of the Basic Law governing the introduction of the debt brake already casts doubts on such reasoning. It is stipulated that from 2011 onwards, special funds may only use those credit entitlements granted

[27] See Tappe (2010), "Haushaltsrechtliche Umsetzung der Artikel 109 und Artikel 115 GG n.F. in Bund und Ländern", in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, p. 435.

up to the end of 2010.[28] While no explicit reference is made in this section, the background documentation as well as the difference concerning the date of entry into force seem to indicate that the focus was only on central government special funds.[29] Once again, a look at the rules for European budgetary surveillance proves helpful. As their focus is on general government, all entities to be classified within the government sector would have to be included. Consequently, not only the core budgets of the states would have to be (structurally) balanced, but also their special funds and those among their institutions that do not have sufficient autonomy in their main business or cannot be considered market producers. Furthermore, the Basic Law only distinguishes two levels of government (see article 106 of the Basic Law). Hence, deficits at local government level would have to be interpreted as state government deficits,[30] although background parts of the draft law to introduce the constitutional debt brake state that such an inclusion of local government would be impossible due to insufficient timely information. However, local governments usually already have to adhere to very strict budget rules forcing them, ultimately, to avoid structural deficits over a longer period. Hence, the question of including local government deficits in state borrowing does not need as much attention as the issue of outsourcing deficits to special funds and state enterprises.

There seems to be uncertainty over whether state governments also have to establish *control accounts* recording differences between the constitutional borrowing limit and the actual level *ex post* and whether to make adjustments for financial transactions. Article 109 (3) of the Basic Law does not give any indications on this matter. For central government, these elements were introduced on the basis of article 115 of the Basic Law, which is announced as just specifying details regarding the principle rules in article 109 of the Basic Law. As the prescription of an at least balanced budget in structural terms must include the results, *ex post* control via control accounts seems to be necessary for state government budgets, too. Given the reference to European budgetary obligations, adjustments for purely financial transactions also seem to be intended for state government budgets. At least for those states receiving transitional aid, reporting obligations were introduced that explicitly prescribe adjustment of budgetary figures for financial transactions and also encompass *ex post* controls (Section 2 of the law on granting consolidation assistance).

While state parliaments are explicitly allowed to include *cyclical adjustment* mechanisms in their debt brakes provided the symmetry condition is fulfilled (see article 109 (3) of the Basic Law), there seemed to be widespread objections to using the central government method. Concerns especially referred to the significant revisions of structural deficits that tend to occur when using established cyclical adjustment procedures. In addition, it is still questionable whether the state governments will agree on a single procedure for all of them. While comparability of data is desirable for analysts as well as taxpayers, state politicians might fear augmented control of their fiscal policy. Moreover, being able to fine tune the adjustment procedure may help to obtain politically desirable results. Meanwhile, agreements have been reached between the Federal Ministry of Finance and the five states nominated for transitional aid to use a procedure very similar to the one chosen by central government.[31] However, the procedure may be revised later and it cannot be concluded that the other states will follow suit.

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[28] This might be considered as also referring to state governments' special funds. See, for example, the statement by Reimer (p. 91) at an expert hearing concerning the introduction of a debt drake in the state constitution of Hesse (draft law: 18/2732) on 3 November 2010, in Stenografischer Bericht – öffentliche Anhörung –, available at: www.hessischer-landtag.de

[29] For arguments referring to the timing issue, see Tappe (2010), "Haushaltsrechtliche Umsetzung der Artikel 109 und Artikel 115 GG n.F. in Bund und Ländern", in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, p. 456.

[30] See Reimer (p. 90) at the expert hearing mentioned in footnote 29.

[31] See the respective administrative agreements, available at: www.stabilitaetsrat.de

Nonetheless, some states have already *introduced constitutional debt brakes* according to the new concept of the Basic Law. In May 2010, *Schleswig-Holstein* (just under 3 million inhabitants)[32] was the first state to pass a new constitutional borrowing limit after attempts in North Rhine-Westphalia and Thuringia failed due to the lack of the necessary high degree of parliamentary approval. Being forced to gradually reduce its structural deficit by 2020 in order to receive its annual transitional aid of €80 million (almost 1 per cent of the state budget), the minimum deficit adjustment path was also defined: each year the constitutional borrowing limit declines by 1/10 of the structural deficit level achieved in 2010. Compared with the old regular constitutional borrowing limit, this provides significant additional scope for deficits over the coming years. While the borrowing limit derived from estimated investment expenditure would be about €0.5 billion, the budget for 2011 and 2012 includes entitlements of €1.3 billion and €0.9 billion, respectively. Despite the constitutional reform, the state budget regulations law has so far not been adjusted. However, the administrative agreement with the Federal Ministry of Finance closes the gap by including the details of the consolidation process up to 2020 regarding cyclical adjustment, financial transactions, inclusion of entities beyond the core budget and borrowing limits to qualify for transitional aid payments. While the state constitution does not explicitly address the treatment of off-budget entities such as the unit founded in 2009 to supply the HSH Nordbank with necessary additional own funds (contribution of Schleswig-Holstein: €1.5 billion), the agreement excludes it. Other entities belonging to the government sector and being allowed to borrow are included in the borrowing limit under the agreement and hence cannot be used as a loophole. Furthermore, the constitutional reform prescribes a 2/3 majority approval by state parliament for using the exemption clause according to article 109 of the Basic Law to prevent abuse by the government parties.

The second state to change its constitutional borrowing limit was *Rhineland-Palatinate* (4 million inhabitants). As this state does not receive transitional aid, politicians felt no need to define a constitutional path for minimum consolidation up to 2020. Instead, the old borrowing limit will be applicable until the end of 2019.[33] Furthermore, in comparison with article 109 of the Basic Law, an additional exemption was introduced. Stressing the need for stable revenue development but being afraid of having a minority position in the Bundesrat, the state considers consequences of Federal laws on structural revenue (and expenditure) to have a similar status to natural disasters or major emergencies as they may have severe budgetary consequences and cannot be influenced by the government of Rhineland-Palatinate. During the transitional period up to the end of 2019, the state is free to define its constitutional borrowing limits. From 2020 onwards, the rules of the Basic Law will have to be complied with. It has to be considered at least questionable whether Bundesrat decisions will obtain the same classification as natural disasters in the case of complaints being submitted to the Federal constitutional court. However, with regard to the delineation of the debt brake, it is stressed that no structural deficits shall be outsourced to circumvent the constitutional borrowing limit. Rhineland-Palatinate had founded public enterprises to take over responsibilities from the core budget in the fields of road construction and real estate management in the first years of the 21st century. For European budget surveillance, these enterprises are to be included in the government sector. Hence, the inclusion of their borrowing[34] would follow the intentions of the national debt brake laid down in article 109 (2) of the Basic Law.

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[32] The number of inhabitants compared with the German total population of about 82 million is a good indicator for the specific state's share of total state government expenditure.

[33] The draft budget for 2011 referred to the need to avert a disturbance of the macroeconomic equilibrium and it cannot be ruled out that this clause might have to be used again for the next budget despite strong GDP growth and broadly normal capacity utilisation in 2011. Using a moderate negative output gap as a main indicator for such a disturbance appears to be problematic as such figures do not show severe imbalances.

[34] Article 117 III of the state constitution contains some conditions for borrowing by enterprises to be included in the debt brake framework. The respective enterprises have to perform governmental tasks and the debt service has to be financed from the core

(continues)

In *Hesse* (6 million inhabitants), the state parliament passed a law to adjust the constitutional borrowing limit which was approved by a very large majority of votes afterwards. The rule strictly follows article 109 (3) of the Basic Law. To give voters a better foundation for their decision, the main features of the future law to execute the state debt brake were also agreed by a very broad parliamentary majority and published. As the Federal government debt brake is used as a guideline, adjustments for financial transactions, a control account (limited to 15 per cent of average tax receipts) and additional borrowing options for supplementary budgets are envisaged. With regard to special funds and enterprises, however, the debt brake tends to remain rather vague. Borrowing will not be allowed for them unless a specific law entitles them to do so.[35] Upon request, it will be up to the Federal constitutional court to decide whether such laws can be considered to be in line with article 109 (2) of the Basic Law (primarily referring to European obligations concerning deficits). However, attempts to make laws that are not in line with European budgetary surveillance principles cannot be excluded.

In *Mecklenburg-Western Pomerania* (less than 2 million inhabitants) the state parliament also passed a debt brake for the state government budget with the necessary 2/3-majority of votes. The rule strictly follows the wording of Article 109 (3) of the Basic Law. While the draft law also included an explicit redemption duty for borrowing related to cyclical burdens, the final version sets this restriction only for exceptional borrowing in case of severe catastrophes and similar cases.

Some other states introduced *balanced budget rules in their state budget regulations law*. The first state to do so was *Bavaria* (12 million inhabitants) in 2000 starting with the budget for 2006. While principally prohibiting borrowing, exemptions can be made to respect the needs of macroeconomic equilibrium. If they are used, redemption duties do not exist. As Bavaria's politicians were very proud of the low level of their state government indebtedness, strong efforts were taken to meet the balanced budget provision. During the recent crisis, substantial reserves could be used. However, when the Bavarian Landesbank got into trouble in late 2008, a supplementary budget was passed with a borrowing entitlement of €10 billion (to be compared with regular total expenditure of about €40 billion). Possible conflicts with the Bavarian debt brake were resolved by a paragraph ruling that the legal borrowing rules need not be respected for this specific transaction. The protective power limit of state budget regulations law became apparent as even a budget law might adjust the rules of the budget regulations as an equivalent *lex posterior*.

Similar problems could be observed in *Baden-Württemberg* (almost 11 million inhabitants). This state introduced a debt brake in its state budget regulations law in 2008. Balanced budgets are prescribed in principle. Exemptions can be made to compensate cyclical effects or to avert a disruption of the macroeconomic equilibrium. Only in severe emergencies, natural disasters or decreases of tax revenue by at least 1 per cent is borrowing allowed and the level of state government indebtedness reached at the end of 2007 may be exceeded. However, a full redemption has to be accomplished within seven years. The exemption clause had to be used for the budgets of 2010 and 2011 that were passed together by the end of 2009. Meanwhile, tax revenue perspectives for 2011 look much better and the conditions for the exception clause seem to be met no longer. But without a supplementary budget updating these estimates, the use of the exception clause will still be in line with the debt brake rule as a tax revenue decline was budgeted and a redemption plan had been agreed upon. Furthermore, in 2009 and 2010, additional recourse to a loophole was taken by creating state enterprises that borrow to finance capital injections into the Landesbank (€2 billion) and the acquisition of the regional energy supplier (up to €6 billion). While these

budget. According to parliamentary documentation (see Rhineland-Palatinate parliamentary documents 15/4966 and 15/4967 as well as the protocol of the 97th session in the 15th legislative period, p. 5768 ff), it was intended to include those enterprises that are not in the position to finance interest and redemptions by performing profitable activities. Consequently, special funds are covered by the debt brake, too.

[35] See Hesse Parliamentary Document No. 18/3492.

enterprises are not included in the state debt brake and hence no borrowing limits apply, for European budgetary surveillance purposes their indebtedness has to be treated as part of the Maastricht debt. However, as borrowing by these enterprises is just for financial transactions, the exclusion from the debt brake might be considered acceptable. The election of a new state parliament in 2011 changed political majorities, and the limited protective power of state budget regulations law seems to have become an issue as the new majority parties appear to have postponed the aim of a structural balanced budget to 2020.[36]

While in the east German state *Thuringia* (more than 2 million inhabitants) an early attempt to introduce a constitutional debt brake failed, especially Section 18 of the state budget regulations law was adjusted in 2009 to become effective in 2011. Borrowing is allowed only in the case of major emergency or natural disasters. A further exception applies to the extent that expected tax-related revenue (excluding gradually diminishing special central government transfers to east German states) is lower than the average value in the three years preceding the year of the drafting process (2007-09 for the 2011 budget). This exception clause was used for 2011 and net borrowing estimates of almost €0.5 billion could be budgeted. According to the state budget regulations law, the redemption has to be accomplished within five years after the first year without additional borrowing requirements. In the medium-term fiscal plan, the start of repayments was announced for 2013. However, given the better-than-expected macroeconomic and fiscal development, far less borrowing than budgeted might be needed in 2011 and more timely redemptions seem to turn out to be only a moderate challenge. Adjustments for cyclical effects (and also for financial transactions) are not made within the state debt brake. While special funds, in principle, have to respect the balanced budget rule, exceptions may be granted by special laws (Section 113 of the state budget regulations law).[37]

All in all, much progress still has to be achieved during the coming years. While the 2020 deadline is still relatively far away, a significant acceleration of the implementation process might be brought about by *rulings by state constitutional courts* that partly even try to make the old borrowing limits effective. The most prominent example is the constitutional court of *North Rhine-Westphalia* (state population: 18 million inhabitants). After the state elections in May 2010, the new government soon drafted a supplementary budget raising borrowing entitlements by another €2 billion (almost 4 per cent of total expenditure) to almost €9 billion. Immediately after the law became effective, the biggest opposition parties started a lawsuit similar to a previous case where the ruling went against the government and the parliament majority in 2003 and – for the first time in German history – asked for an immediate intervention to stop the execution of the budget. In the latest case, the judges actually ordered the execution to be stopped and announced a final decision by mid-March 2011. The court was in doubt as to whether the exception clause to avert a disruption of the macroeconomic equilibrium could still be used by the end of 2010, given the relatively favourable economic conditions in Germany by that time. Ultimately, the judges decided that there was insufficient explanation as to how the measures chosen would solve the macroeconomic problems claimed by the state government.[38] As the macroeconomic situation has since improved, justifying further recourse to the exemption clause might turn out to be almost impossible.[39] As individual state governments have only very limited tax-setting powers, expenditure cuts seem to be inevitable. However, short-term adjustments are possible only to a very limited degree as compensation of employees (mainly civil servants), grants for local government

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36 See Der Wechsel beginnt (coalition agreement for Baden-Wuerttemberg up to 2016), available at: www.gruene-bw.de

37 Further legal debt brakes were introduced in Saxony, Saxony-Anhalt and Hamburg, partly still to become effective by 2013.

38 See press release by the state constitutional court of North Rhine-Westphalia: Supplementary budget law 2010 unconstitutional, 15 March 2011.

39 See Deutsche Bundesbank, Implications of the ruling on the supplementary budget of North Rhine-Westphalia for 2010, Monthly Report, April 2011, pp. 10-11.

and interest expenditure are responsible for about 2/3 of total expenditure. There is a risk, that a *changeover to the debt brake* is used as a less painful exit for politicians if a gradual adjustment path is defined, starting with the deficit level achieved in 2010. An extension of borrowing compared with the old constitutional limits was obviously not intended by the introduction of the debt brake. However, taking the opportunity to define a moderate adjustment path in the state constitution might prove to be a politically attractive loophole.

5 Summary and conclusions

The 2009 constitutional reform to introduce a national debt brake in the German Basic Law was a huge success. The preceding "golden rule" had failed to stop the increase in the government debt ratio. In addition, the net government asset ratio had also decreased rapidly. The reform directly addressed the main weaknesses of the old borrowing limits:

- the definition of investment expenditure did not contain sufficient restrictions. To avoid definition problems, the balanced budget concept was chosen;
- the exception clause regarding macroeconomic imbalances contained vague definitions and no redemption duties while inheriting respective unused borrowing entitlements was allowed. To avoid further abuse, definitions of exceptions are much stricter and redemptions are mandatory;
- a general exception clause was included for special funds. To stop outsourcing deficits, the old article 115 (2) of the Basic Law was abrogated. Furthermore, there is a reference to the Stability and Growth Pact (setting limits for the whole government sector);
- borrowing limits were applicable only for the drafting process. To safeguard adherence *ex post*, a control account was introduced explicitly for the Federal government.

However, whether the debt brake for central and state government budgets will be able to safeguard sustainable public finances in Germany ultimately depends on the implementation of the new rules. Some recent developments give cause for concern:

- The exception for financial transactions might induce abuse (e.g., classification of transactions as loans despite very favourable conditions for the debtor). However, from the author's point of view, the clear reference to the objectives of the European Stability and Growth Pact should make it necessary to follow its classification rules. As a consequence, (strict) ESA definitions and Eurostat decisions should be applicable. In the case of significant transfer elements (e.g., sizeable interest concessions or debt release agreements), classification as a financial transaction would be impossible.
- State government implementation plans so far do not fully exclude outsourcing government borrowing to special funds or – which also seems to be under debate for central government – public enterprises. As this would not be in line with the structurally almost balanced budget objective of the Stability and Growth Pact and the clearly stated intentions of the reform of the Basic Law, limits might ultimately have to be drawn by constitutional courts.
- As German budgetary rules traditionally defined borrowing as limited to transactions acquiring cash funds, PPPs might be used as a loophole. However, taking the Stability and Growth Pact as a benchmark again, exclusion of investment via PPPs from the borrowing limit is only acceptable if there is sufficient transfer of risks to the private sector. As this does not seem to be a typical element of most German PPP treaties, respective attempts to circumvent the debt brake might also be stopped.
- The cyclical adjustment procedure seems to offer room for creating fiscal scope mainly by redefining methods as needed in a given circumstance. Such adjustments can be stopped by strictly referring to the clearly announced necessary condition for cyclical adjustment – the symmetry condition intending to avoid systematic growth of the debt level due to effects

(mis)labelled as being cyclical. Hence, a change in the method should make it necessary to also adjust data for past years and to correct the amounts booked on the control account accordingly. In general, cyclical deficits should also be monitored closely. Misclassifications can be detected by subtracting allowed amounts of structural borrowing and by means of financial transactions from the total debt level increase after a full cycle. Corresponding amounts should be corrected by lowering the limit for the structural deficit over the next few years.

- Politicians are obviously trying to manipulate the borrowing limits during the transitional period. From the author's point of view, constitutional reference to the 2010 structural deficit or an even later one as a starting point does not give much room for interpretation. As it was clearly stated that the adjustment path could not be defined by mid-2009 due to crisis-related high uncertainty concerning macroeconomic and budgetary developments, only actual results can be an acceptable benchmark. Refusing to adjust the starting level would bring about additional borrowing options of about €15 billion for central government in 2011. However, the fiscal leeway added would decline every year and come to an end in 2016. If this leeway were not (fully) used, it would lead to a significant buffer stock on the control account which might induce central government to make strategic favourable budget estimates in future years. While deficit-increasing effects could only be of a temporary nature, it is important to stop the abuse of the debt brake in order to avoid additional interest burdens and – much more importantly – to strengthen the trust in and the effectiveness of the new borrowing rules.
- A very big fundamental problem of binding constitutional borrowing limits seems to be the need for sufficient safety margins to prevent the need for sizeable almost immediate consolidation measures mainly occurring in bad times. In Germany, budget execution during the past years often suffered from major surprises due to lower-than-expected "structural" tax revenue. Major parts of deviations could not be classified by common methods as cyclical effects or just one-offs. Such surprises cannot be ruled out for the future. Consequently, a need to compensate such effects almost without delay will come up under the new debt brake, if there is no sufficient safety margin between the constitutional borrowing limit and the budgetary entitlement. It seems impossible that politicians will agree to strive for such reserves – possibly up to €20 billion – without binding rules. Hence, a respective supplement to the German debt brake seems useful. However, the use of this safety margin will have to be governed by rules strictly limiting flexibility concerning timing and the size of consolidation measures needed to regain the buffer between the budget estimate and the constitutional limit for borrowing. A delayed gradual correction of a structural balance not in line with the safety margin may be an adequate approach. Generally using significantly more cautious (nominal) GDP growth assumptions when preparing a budget and especially the medium-term financial plan would also help to prevent negative surprises such as those often experienced in the past.

A restrictive implementation of the debt brake taking into account the problems listed will be a challenging task. Effectively limiting circumvention activities requires transparent and – as far as possible – simple rules. This is a precondition for the necessary public support. Furthermore, only clear rules can be given effective judicial protection against abuse. Hence, definitions of details should be made with care. If this seems hard to achieve, explicit reference to well-defined and carefully supervised statistical figures – as the Maastricht deficit – may enable a clear interpretation and avoid the creation of dangerous loopholes.

THE IMPORTANCE OF FISCAL POLICY FRAMEWORKS – SWEDISH EXPERIENCE OF THE CRISIS

Robert Boije[*] and Albin Kainelainen[*]

The unfavourable development of public finances in many European Union countries during the current crisis has intensified the discussion on the importance of national fiscal policy frameworks. The Swedish fiscal policy framework is interesting in this context. As one of few EU countries, during the present economic crisis Sweden has been able to combine significant fiscal stimuli with limited deficits. Deficit and debt levels have also stayed below the levels set by the SGP. We argue that the relatively favourable development of the Swedish public finances both before and under the crisis, to a large extent, can be attributed to the national Medium Term Budgetary Framework combined with a strong political support for the framework. To strengthen the framework the government recently introduced a Code of Conduct for fiscal policy.

1 Introduction

The economic crisis that started in 2007 has led to a rapid deterioration of public finances in most advanced economies. In many of the countries where fiscal deficits were large before the crisis began, deficits have reached or approached double-digit levels, raising concerns about the sustainability of public finances. In some countries (Greece, Ireland and Portugal being the most prominent examples), this development has not only contributed to significantly increased risk premia, but also accentuated the sustainability problem and made stabilisation policy measures less effective.

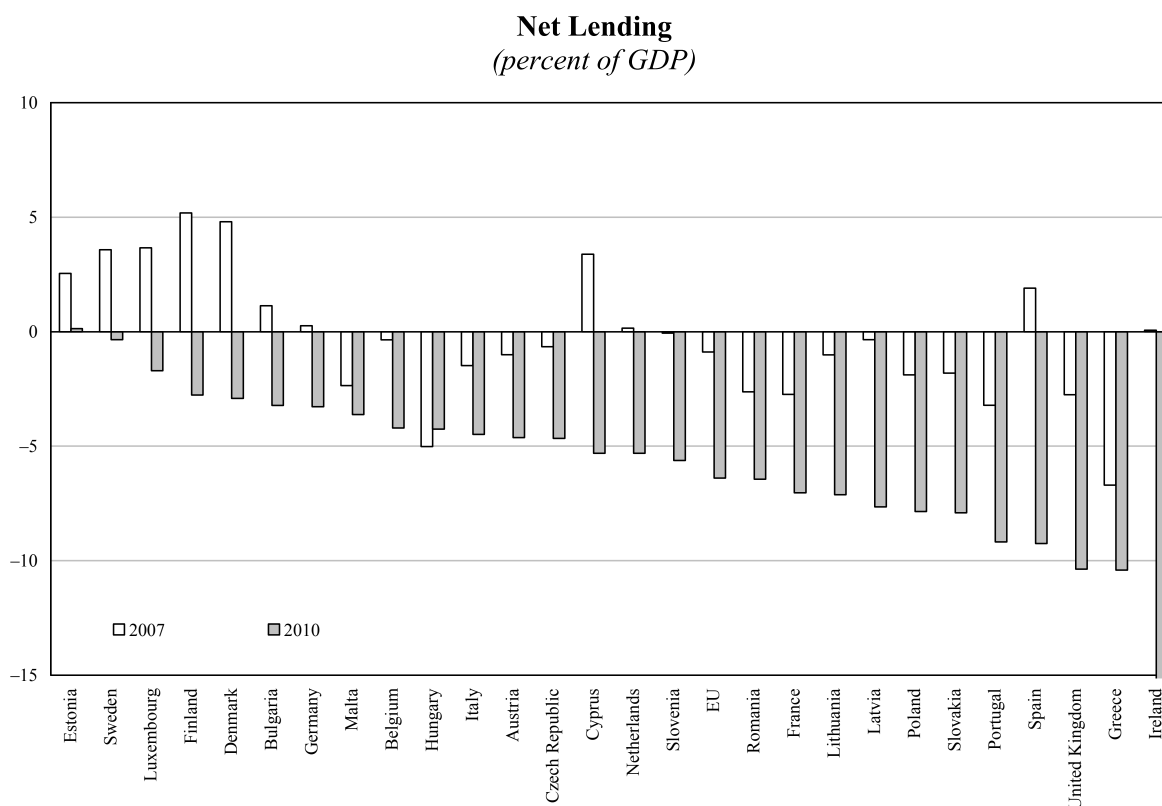
The unfavourable development of public finances in many EU countries has renewed the discussion on the need to strengthen the Stability and Growth Pact (SGP). Besides suggestions on how the Pact itself can be strengthened, the importance of national Medium Term Budgetary Frameworks (MTBFs), as a complement to the Pact, has been emphasized. The European Commission (2010b) has proposed a directive that would set minimum standards for national budgetary (or fiscal) policy frameworks. This proposal is currently being negotiated between the commission, the council and the parliament with the intention to reach an agreement before the end of spring 2011.

As one of few EU countries, during the present crisis, Sweden has been able to combine significant fiscal stimuli with limited public deficits. In addition, deficit and debt levels have stayed below the levels set by the SGP. We argue that the relatively favourable development of Swedish public finances both before and during the crisis, to a large extent, can be attributed to the national MTBF combined with a strong political support for the framework. The framework, introduced 1997-2000, consists of a surplus target for *general* government, an expenditure ceiling for *central* government (combined with a stringent top-down budget process), and a budget-balance requirement on *local* governments. Both the former social democratic governments and the current center-right government have, largely, respected the framework. During its first term of office 2006-2010, the current government strengthened the framework by making central parts of it mandatory by law. Recently the government has strengthened the framework further by introducing a Code of Conduct for fiscal policy.

[*] Ministry of Finance, Sweden.
Corresponding author: robert.boije@finance.ministry.se
The views expressed herein are those of the authors and should not be attributed to the Swedish Ministry of Finance.

Figure 1

Net Lending
(percent of GDP)



Source: AMECO-database.

The purpose of this paper is to contribute to the debate on the significance of MTBFs by describing the Swedish framework, how it has functioned and recent improvements of it.[1] The paper is organized as follows: Section 2 compares the development of public finances in Sweden and other EU-countries during the financial crisis that began 2008. We evaluate to what extent Sweden and other EU-countries have managed to abide by the numerical rules in the SGP both before and under the financial crisis. In addition, we discuss the role of MTBFs as a mean to improve fiscal performance. Section 3 describes the Swedish MTBF and its background. In Section 4 we assess the performance of the Swedish MTBF. In Section 5 we discuss what constitutes an effective MTBF and to what extent the Swedish framework is designed in accordance with those findings. In Section 6 we briefly describe the content of the Swedish government's Code of Conduct for Fiscal Policy. Section 7 concludes.

2 Public finances in Sweden and the EU – A comparison

The financial crisis affected public finances in all EU countries. Still, there is a wide variety in public deficits 2010 (see Figure 1); from a small surplus in Estonia to –32.3 per cent in Ireland. It is therefore relevant to discuss the causes of these large differences between countries.

[1] Se also Boije, Kainelainen & Norlin (2010) and Boije & Fischer (2009).

Table 1

Comparison Between EU-countries with and without Surpluses in 2007
(percent of GDP)

	Net Lending 2010	Change in Net Lending 2007-2010	Change in Output Gap 2007-10	Stabilisation Policy Measures	Fiscal Rules Index
Surplus countries 2007	–4.1	–6.7	–7.8	9.2	1.2
Non-surplus countries 2007	–6.7	–4.7	–8.1	7.3	0.4

Note: Ireland has been excluded due to its extreme net lending in 2010 (–32.3 per cent of GDP). In 2007 its net lending was zero.
Source: European Commission (2009, 2010a), AMECO-database and own calculations.

2.1 Bailouts of financial institutions do not explain differences in net lending

One popular explanation to the differences is that it is connected to that some countries had to bail out financial institutions. This is certainly the case for individual countries like Ireland. Historical evidence shows that severe financial crises almost invariably are accompanied by massive increases in government debt. In a sample of 13 financial crises after World War II, described by Reinhart and Rogoff (2009), the increase in real public debt following the crisis averages 86 per cent. Most of these build-ups, however, are attributed, not to the cost of bank bail-outs, but mainly to decreased tax revenue and to increased government spending to fight the recession. IMF (2010) shows that the same factors largely explain today's deficits in the G7-countries, while support to financial institutions accounts for less than 10 per cent of the forecasted growth of government debt between 2008 and 2015.

2.2 The importance of securing surpluses during good years

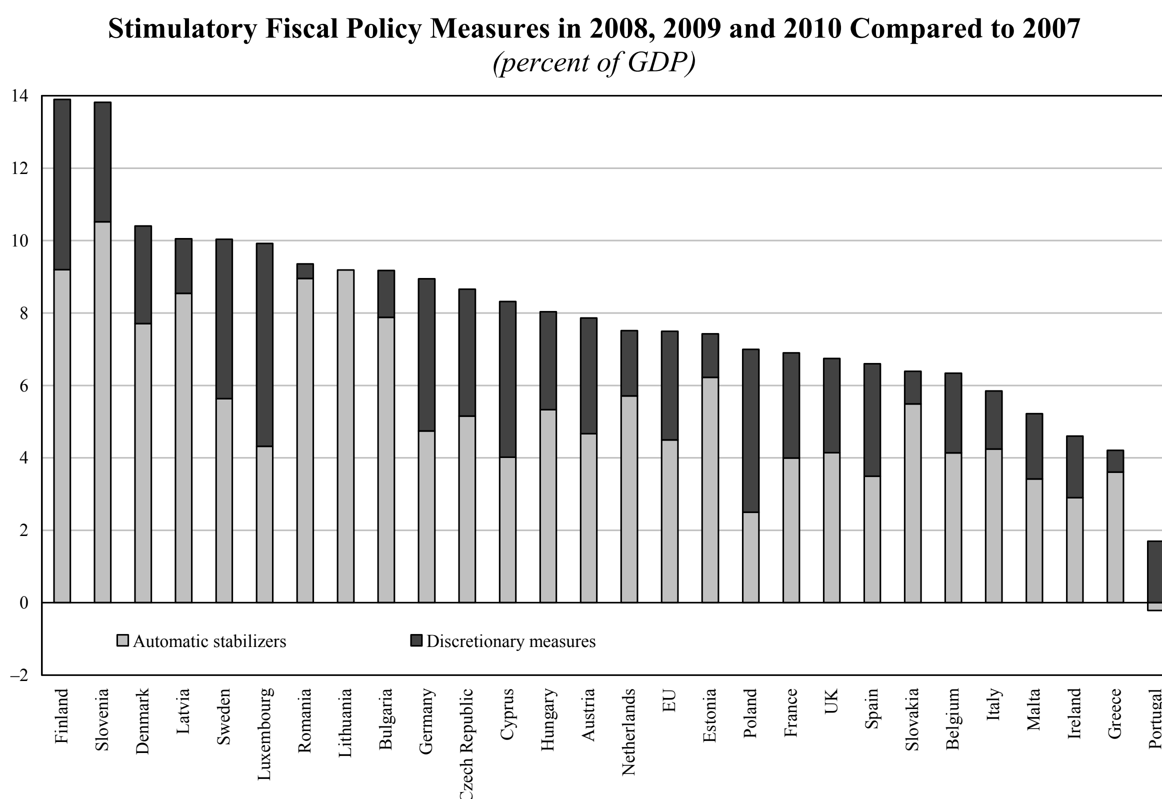
Empirical research shows a tendency for economic upswings to be followed by significant deteriorations in structural positions; when revenue is high, governments find it difficult to resist demands for increased spending or decreased taxes (Joumard and André, 2008). Institutions that promote surpluses in good times can therefore contribute to smaller deficits in bad times.

For the EU countries, there is substantial differences between the eleven countries that had surpluses in 2007 and the ones that had deficits already before the crisis (Table 1). Generally, the deficits for 2010 in countries that had surpluses before the crisis are substantially smaller at –4.1 per cent of GDP as compared to –6.7 per cent of GDP in the countries running deficits in 2007. This does not follow from a smaller decrease in net lending; net lending fell more in surplus countries. Output gaps widened about as much in both groups of countries. Furthermore, the surplus countries made larger stabilisation policy efforts (Table 1 and Figure 2).[2] In the eleven EU countries running surpluses in 2007, measures to meet the economic crisis have averaged 9.2 per cent of GDP as compared to 7.3 per cent in the other countries. Furthermore, the five countries with the largest deficits in 2010 had undertaken combined measures that average 6.6 per cent of GDP as compared to 10.0 per cent in the five countries with the smallest deficits in 2010.

[2] Stabilisation efforts are defined as the combination of automatic stabilizers and discretionary measures.

Figure 2

Stimulatory Fiscal Policy Measures in 2008, 2009 and 2010 Compared to 2007
(percent of GDP)



Source: European Commission (2010a), AMECO-database and own calculations.

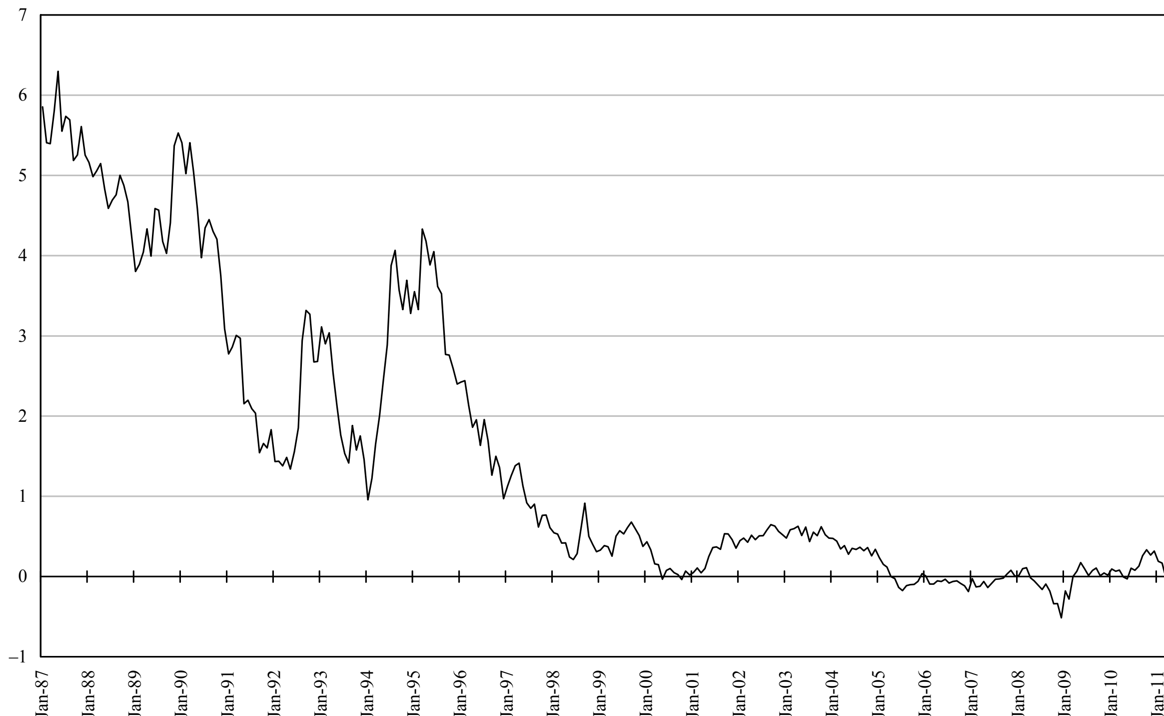
The conclusion from this simple comparison is that countries with surpluses in 2007 have done more to combat the crisis than the countries that ran deficits in 2007, yet the former still have smaller deficits. This illustrates the importance of maintaining surpluses in good years. The Swedish experience is interesting in this context. Even though the financial crisis affected Sweden to the same extent as other countries in terms of loss of GDP, the effect on the public finances has been less severe. In an international comparison, Sweden's current fiscal position is very strong. The deficit was limited to 0.3 per cent of GDP in 2010 and the forecast is that net lending will return to show a surplus in 2011. At the same time, Sweden is one of the EU countries that have pursued the most active contracyclical fiscal policy during the crisis (Figure 2). This combination was made possible by the substantial surpluses in the years preceding the crisis.

2.3 The effectiveness of stabilisation policy during the crisis

Surpluses in Sweden the years before the crisis and the resulting low public debt have given the financial markets confidence in the sustainability of the Swedish public finances, especially compared to the situation in the early 1990s and to that in many other EU-countries today. The interest rate spread to Germany has been close to zero since 2006 (Figure 3). This has been important, not only for the long term sustainability of public finances per se, but also for the effectiveness of the stabilisation policy measures implemented to combat the crisis. Thus, it is a pre-requisite for the effectiveness of stabilisation policy to secure surpluses during good years.

Figure 3

Swedish Interest Rate Spreads Against Germany for 10-year Bonds
(percent of GDP)



Source: Ecowin.

2.4 *SGP compliance*

Figure 4 shows that in 2010 Sweden was one of only three EU countries which was able to keep the deficit and debt within the SGP's numerical fiscal rules. Figure 5 shows that Sweden has abided by these numerical rules in every year since 2000. The debt ratio has been below the 60 per cent level and it is expected, despite the crises, to fall towards 25 per cent of GDP in 2014. Between 2000 and 2009, there are several countries, which as an average, stayed inside the target levels (Figure 6). Sweden, Estonia, Luxembourg and Finland, however, are the only EU countries that during this period never exceeded the SGP target levels.

2.5 *The role of the Swedish MTBF*

Our assessment is that the Swedish MTBF has played a key role in securing surpluses in good times and limiting deficits in downturns. In addition, it has contributed to low risk premia, and an effective stabilisation policy. The framework has also contributed to that Sweden all years has abided to the SGP rules. Existing empirical studies generally shows that tighter and more encompassing fiscal rules are correlated with stronger cyclically-adjusted primary balances.[3]

[3] See IMF (2009) for a brief overview of the literature. It's important to note that there are methodological difficulties in assessing the impact of fiscal rules on fiscal performance. In particular, both fiscal rules and improved fiscal performance could be affected by the omission of determinants of fiscal behaviour, such as political or budgetary institutions or processes. A stronger political commitment to fiscal discipline, for instance, could lead to both an improvement in performance and the adoption of rules.

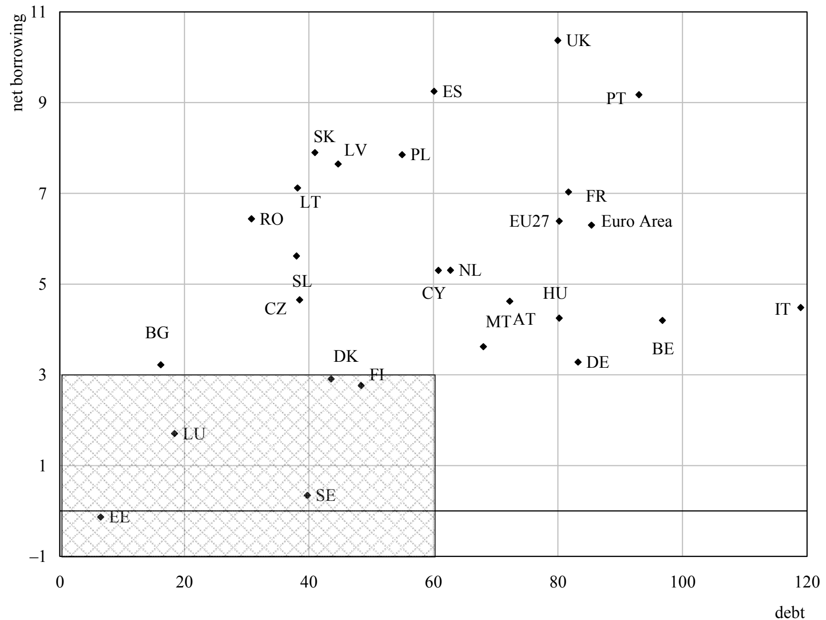
Furthermore, there is empirical evidence suggesting that strong fiscal rules lead to lower interest rate risk premia.[4]

It is clear, however, that a strong MTBF *on paper* does not guarantee sound public finances. The European Commission (2009) has constructed a fiscal rule index, which encapsulates the strength and coverage of domestic fiscal rules. The latest edition of this index describes the situation in 2008 (see Figure 7). According to the index, the fiscal rules were the strongest in the UK, Denmark and Bulgaria, while they were weak in Greece, Cyprus and Malta. An empirical analysis by the European Commission (2009) shows a link between the index and budgetary outcomes in the period 1990-2008. Moreover, Table 1 shows that EU countries that had surpluses before the financial crisis began, on average also had a considerable higher fiscal rule index as compared to the non-surplus countries. However, countries with a strong index-rating do not necessarily have strong public finances at present. The countries with a relatively high index-rating include the UK, Spain and Lithuania,

Figure 4

SGP Compliance in EU Member States, 2010

(percent of GDP)

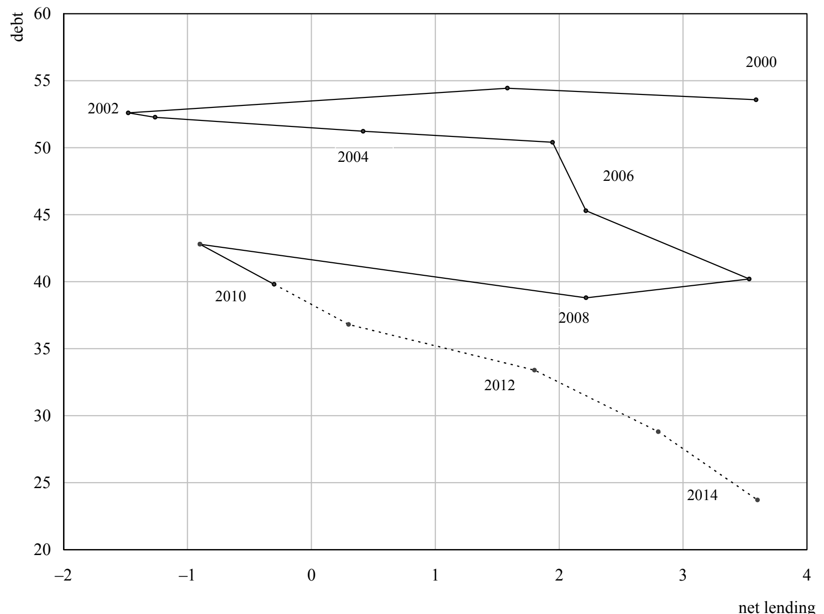


Source: AMECO Database.

Figure 5

SGP Compliance for Sweden, 2000-14

(percent of GDP)

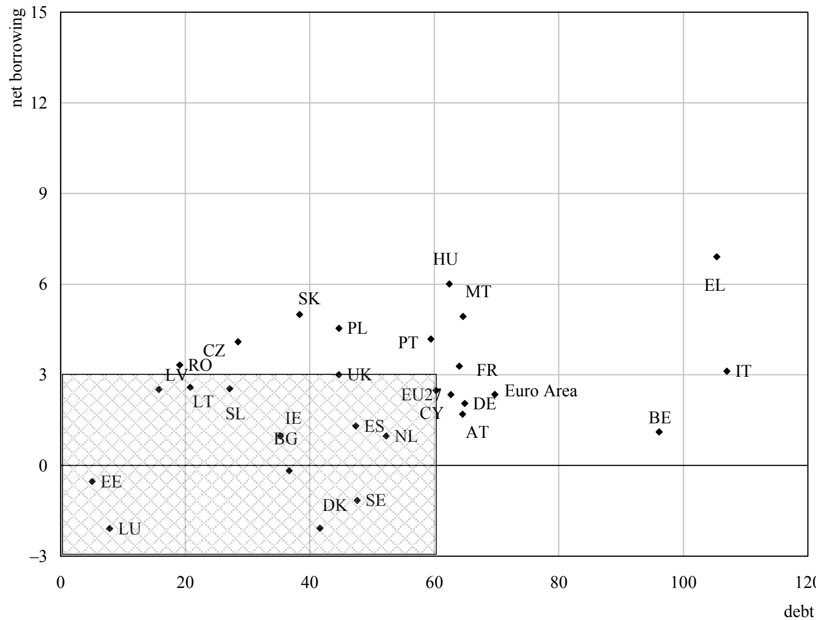


Source: Ministry of Finance and Statistics Sweden.

4 Iara and Wolff (2010).

Figure 6

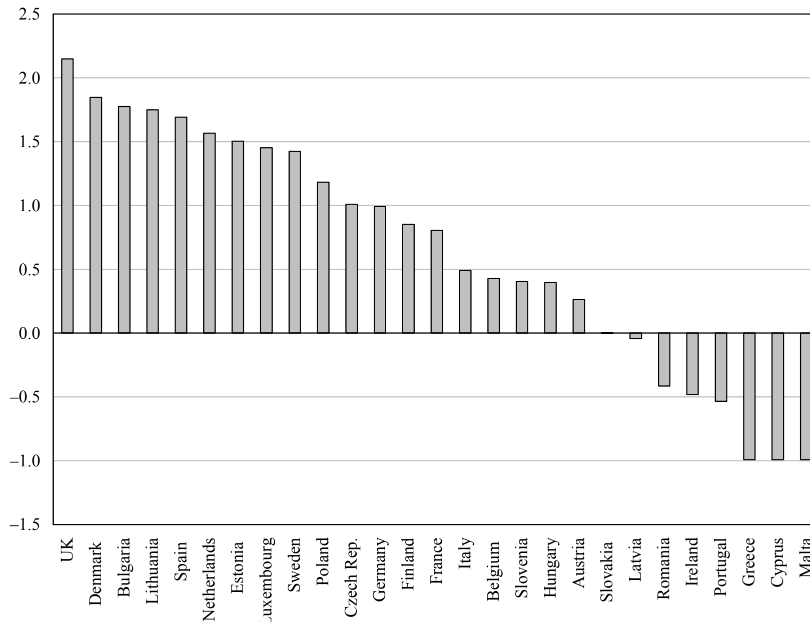
SGP Compliance in EU Member States, Average 2000-09
(percent of GDP)



Source: AMECO Database.

Figure 7

Standardized Fiscal Rule Index, 2008



Source: European Commission (2009).

countries in which public finances at the moment are weak.

Given the difference in experience of countries with strong fiscal rules on paper, it is, in addition to quantitative cross-country studies, valuable to study the fiscal frameworks in individual countries. Due to the strong fiscal position in Sweden since 2000, the Swedish experience can be interesting in the debate on how fiscal frameworks should be constructed. In the following section, we therefore describe the Swedish MTBF. We thereafter evaluate the framework and briefly discuss what constitutes an effective MTBF, and to what extent the Swedish MTBF corresponds to such a framework.

3 The Swedish MTBF

The MTBF is one part of the Swedish fiscal policy framework. It consists of a surplus target for *general* government, an expenditure ceiling for central government combined with a stringent top-down budget process, and a budget-balance requirement on local governments. The components of the framework are described in more detail in

Section 3.2-3.5 below. Section 3.1 gives a background to the framework.

3.1 Background

The main driving force behind Sweden's introduction of a MTBF was the economic crisis in 1992-94. Although the crisis was exacerbated by an international downturn, its causes were primarily domestic. In response to the crisis, Sweden's monetary and budgetary frameworks were thoroughly reformed. In the autumn of 1992, speculation against the krona, encouraged by earlier series of devaluations, forced the Swedish Central Bank (The Riksbank) to abandon the fixed exchange rate regime, whereupon the TCW exchange rate fell 20 per cent. Responsibility for monetary policy, with price stability as its objective, was transferred to the Riksbank.[5]

Fiscal policy initially aimed at consolidating the public finances. A substantial consolidation programme (7.5 per cent of GDP) was successfully implemented in steps between 1995 and 1998. This programme lowered real demand in the short term but enhanced the public finances' long-term sustainability. This strengthened business and household confidence, which together with falling real interest rates and the weak currency's stimulation of export demand partly counteracted the consolidation programme's initial negative effects on domestic demand.

The implementation of the consolidation programme was accompanied by the adoption of a new, firmer top-down budget process, including the introduction of multiannual nominal expenditure ceilings from 1997 and onwards. In 1997 it was also decided that a general government surplus target of 2 per cent of GDP over the cycle would be implemented in steps between 1997 and 2000. In addition, to strengthen the public finances at the local level (and to increase the probability of the surplus target being met for the general government sector as a whole), from 2000 local governments were required to plan for balanced annual budgets.

It is important to note that, to a large extent, Sweden's MTBF was introduced *after* the consolidation programme had been completed. While the MTBF is mainly intended to work as an anchor for future fiscal policy, at its introduction it was also a method for locking-in the fiscal adjustments that the consolidation programme had achieved. As pointed out by, for example, the IMF (2009), fiscal rules are more likely to be accepted when countries already have made some progress towards fiscal consolidation. One way of interpreting this is that when countries have recently experienced a fiscal crisis that necessitates fiscal consolidation, as in the Swedish case, political conviction that fiscal rules actually have a role to play may be stronger than otherwise.

3.2 The surplus target

The surplus target states that net lending shall be 1 per cent of GDP over a business cycle.[6] After proposal from the government, parliament made it mandatory by law for the government to present a medium-term target for net lending from August 1, 2010. The level of the target, however, is not subject to legislation.

The surplus target is to be met over a business cycle, which is intended to prevent a pro-cyclical fiscal policy. With an annual surplus as the target, fiscal policy would need to be contractive in a recession and vice versa; fiscal policy would then be pro-cyclical and not contribute to stabilisation of resource utilization.

[5] The Riksbank was not made legally independent until 1999 but in practice it became independent when monetary policy was delegated to it in the early 1990s.

[6] The target was originally 2 per cent of GDP. After a decision by Eurostat that part of the old-age pension system savings should be accounted as private savings, the target was technically adjusted to 1 per cent from 2007.

Over the years, various arguments have been used to motivate the surplus target, and the attributed weight to each argument have varied. Debt reduction was emphasised in the early stages, followed later by demographic issues. In the 2010 Spring Budget Bill, the government clarified that the target should contribute to:

1) long-term sustainable public finances so that citizens, business and financial markets maintain confidence in fiscal policy;
2) keep sufficient buffer in place to meet major economic declines and enable an expansionary fiscal policy without causing substantial and sustained deficits in the public finances;
3) intergenerational equality. In Sweden, as in many other countries, the older segment of the population will increase sharply over the coming decades. During demographically favourable years, relatively high savings translates into reduced national debt. Such savings mean that larger generation groups can contribute to the financing of their future medical and care services, while also contributing to fairness between generations;
4) economic efficiency. By enhancing conditions that make it unnecessary to raise the tax ratio (as a consequence of the demographic development), a surplus target contributes to economic efficiency.

The government has emphasised that maintaining the long-term sustainability of public finances is a necessary condition for achieving the other motives for the surplus target. If public finances are not sustainable, financial markets and households lose confidence in the government's ability to meet its commitments. As a consequence, the focus of fiscal policy would have to shift from promoting higher growth, employment and welfare to reducing debt. This is evident not least from what happened in Sweden during, and after, the crisis in the early 1990s.

International experience from the current financial crisis shows that there are good reasons to ensure that a buffer exists for coping with severe economic downturns and avoiding an unsustainable increase in debt. Having room for fiscal manoeuvring in such situations enables a strong fiscal policy. Against this background, the Swedish government has declared that it attaches great importance to the stabilisation policy argument provided that long-term fiscal sustainability is maintained. Support for this comes from Leeper (2009), who stresses the importance of maintaining a risk-free fiscal policy, *i.e.*, a policy that ensures that the probability of the economy approaching its fiscal limit is negligible, so that investors do not demand a risk premium for holding the government's bonds. The financial markets' reactions differ between different types of countries. The ability to maintain surpluses in good years is likely to be particularly important for small open economies with their own currency and with large automatic stabilizers, like the Swedish economy. Haugh *et al.* (2009) present empirical evidence, which indicates that in times of global financial stress, such economies often are more vulnerable in terms of risk premia. If financial markets and households lack confidence in the sustainability of public finances, fiscal stabilisation measures will be less effective or even counterproductive.

Regarding the surplus target's contribution to intergenerational equality and economic efficiency, the government announced in the 2010 Spring Budget Bill that the target should be used only to manage the part of the increase in the proportion of elderly that is due to temporary changes, *i.e.*, that it should not be used to manage the continual increase in average life expectancy. It also emphasised that the surplus target should not be used to pre-fund any future demand for a higher quality of publically provided services.

It is reasonable to assume that the relative weights attached to the various motives will change over time. In the 2010 Spring Budget Bill, the government therefore declared that the motives behind the surplus target and its level should be reassessed at regular intervals. However, it was also emphasised that the overhauls shall not be used to justify deviations from targets.

When Sweden introduced the surplus target, there was very limited published analysis concerning the appropriate level of a such target. The level was chosen on the grounds that net debt would be eliminated in the coming 10 to15 years. When this was achieved already in 2001, the level remained unchanged. Recently, however, a government report presented such an analysis (Finansdepartementet, 2010a). Given the motives specified by the government, the report concluded that there are no strong reasons for changing the current level of 1 per cent. Moreover, it concluded that at present, there were no major conflicts between the different motives for the target.

3.3 The expenditure ceiling

The Swedish expenditure ceiling covers the primary expenditures of the central government together with expenditure of the old-age pension system. The ceiling is set by Parliament on the basis of a government proposal. The ceiling was used by the government on a voluntary basis up to 2010. From 2010, the government is required by law to propose an expenditure ceiling for year $t+3$ in the Budget Bill for year $t+1$ (presented in the autumn of year t). For example, in the Budget Bill for 2010 (presented in the autumn of 2009), the government proposed a ceiling for 2012. The government is obliged by law to take necessary measures to secure that actual expenditures do not exceed the ceiling. The *practice* is that once a ceiling has been set, it shall not be changed, unless that is technically motivated.[7] This secures a medium-term planning horizon. It is *possible* to change set ceilings for non-technical reasons, but this has only occurred twice and on both occasions the ceiling was lowered.[8]

The ceilings are set in nominal terms (thus they are not adjusted for inflation). Normally the ceiling therefore include a buffer that can be used for expenditure arising from unforeseen cyclical factors and inflation. This buffer is called the budgeting margin. The government's practice has been for the budgeting margin to be at least 3 per cent of forecast expenditure for year $t+3$, at least 2 per cent for year $t+2$, at least 1.5 per cent for year $t+1$ and at least 1 per cent for the current budget year.

The Swedish budget process is characterized by a top-down perspective (see Section 3.4). The expenditure ceiling is the overarching restriction on the budget process in terms of total expenditure. Throughout the process, from the setting of the ceiling to the completion of the budget year, it is necessary to prioritise between different areas of expenditure within a given space. In addition, the ceiling's medium-term perspective provides conditions whereby temporary increases in revenue (due, for example, to cyclical factors) are not used to finance permanently higher expenditure. This also limits the risk of pursuing a destabilising (pro-cyclical) fiscal policy on the expenditure side.

Consequently, the expenditure ceiling constitutes an important policy commitment that promotes budget discipline and strengthens economic policy's credibility. It improves the probability of achieving the surplus target and promotes long-term sustainable finances. The level of the ceilings should also promote a desirable long-term development of central government expenditure. Together with the surplus target, the ceilings are central for controlling the overall level of taxation, and help to avoid a situation in which poor expenditure control necessitates gradually higher taxes.

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[7] The limiting effect of the ceiling shall be the same over time. Adjustments *shall* therefore be done for "technical reasons", for instance if responsibility for an item of expenditure is transferred from central to local government without affecting the level of expenditure in the general public sector.

[8] One may argue that the possibility of changing the set ceilings is a weakness of the framework. However, a *new* government must be able to choose a ceiling that is consistent with its priorities.

3.4 A stringent budget process

The top-down perspective in the Swedish budget process entails a procedure whereby different expenditure proposals are set against each other and spending has to be accommodated in the expenditure ceiling's and surplus target's predetermined limit on total expenditure.

In April the government submits a spring fiscal policy bill that describes the guidelines for fiscal policy, including an assessment of the suitable level of the expenditure ceiling in the end year in the forecast horizon. After parliament's decision on the spring fiscal policy bill the guidelines are transformed to a concrete budget proposal in September. The budget negotiations are hence concentrated to one occasion per year.

3.5 The budget process inside the government

The budget process starts with an forecast of expenditures for the different areas of expenditures and for the income side. The Ministry of Finance analyses these forecasts and makes an assessment on whether the forecasted development is consistent with the surplus target and expenditure ceilings. If not, proposals for budget strengthening are evolved. All ministries have a responsibility to deliver sufficient information to make priorities, but the Ministry of Finance coordinates this work, and is responsible for ensuring that the assessment is consistent for all expenditure areas.

The Minister of Finance has a strong position in the Swedish government. All proposals that has budgetary consequences must be cleared by the Ministry of Finance before they are announced. The Ministry of Finance is also responsible for that the budget proposal is consistent with the surplus target and the expenditure ceilings. At all points in the internal negotiations on the budget, the foundation for negotiations is a complete budget proposal. This means that negotiations are focused on prioritising between different areas of expenditures within the boundaries set by the surplus target and the expenditure ceiling. The Ministry of Finance also has the responsibility for setting guidelines for the budget process.

The guiding principle for expenditures is that increases shall be financed by an equivalent decrease in other expenditures. Furthermore, the financing of a reform must derive from a concrete measure and dynamic effects shall not be used to finance individual reforms (although the dynamic effects of all reforms are taken into account in the overall macro-economic forecast). The general rule is that all items are reported gross. Consequently, transactions cannot be hidden by reporting only net flows. Another important feature is "the completeness principle", meaning that every item which affects the public borrowing requirement will be included in the state budget. This results in a clear statement of government commitments and a better understanding of the state budget.

3.6 Parliament's processing of the budget

By law parliament's processing and resolution of the budget follows a distinct top-down perspective. The expenditures are presented under 27 headings. As a first step, Parliament decides on the spending plans for each of the 27 areas of expenditures and an estimate of the state budget revenues. In a second step, the various committees deal with appropriations for the expenditure items. Since the 27 expenditure areas have already been decided in the first step, they constitute a binding constraint in the second stage. It follows that, at this stage, an increased appropriation under one expenditure area has to be financed by a reduction of other appropriations in the same expenditure area. An important aspect of the Swedish budget process is that the government do not need a majority in parliament to vote for their budget proposal. The budget is passed unless a

majority unites behind a different proposal. This makes it easier for a minority government to pass the budget through parliament since the opposition has to agree on one single proposal.

3.7 The budget-balance requirement on local governments

The local government sector in Sweden is responsible for roughly 45 per cent of the general public sector's expenditures. To strengthen the budgetary process at local level, local governments are required by law to budget for at least balance. A local government that reports a deficit *ex post* has to correct it within three years. The budget-balance requirement applies to the financial result net of extraordinary items. It accordingly follows a different accounting practice from that of the surplus target, which is defined in accordance with the standard for national accounts (ESA 95).

The local government balanced-budget requirement is a *minimum* requirement. The Swedish Local Government Act stipulates that municipalities and county councils shall also comply with principles of good financial management. Thus, their budgets shall also take into account future costs such as major pension undertakings. There is no explicit sanction mechanism in the event of non-compliance with the balance requirement (apart from the response from the electorate).

4 The performance of the Swedish medium-term budgetary framework

In this section we briefly evaluate the performance of the Swedish MTBF since 2000 with an emphasis on the period 2006-10, the latter period covering the current government's preceding term in office and the crisis years.

4.1 The surplus target

When evaluating the surplus target, it is necessary to consider that the target is to be reached as an average over a business cycle. The National Audit Office (2008) and the Fiscal Policy Council (2009) have criticised the formulation of the surplus target for being too imprecise for stringent monitoring. They have argued that the current lack of a definition of the business cycle may give the government too much freedom, and that, consequently, the surplus target may not be a binding constraint. The government's use of several indicators to follow up the target and the absence of specified corrective measures to deal with slippages from the target, have also been criticised.

When the surplus target was introduced, there were no clear principles for monitoring compliance. Such principles have been developed gradually (and also changed) over time. The required surplus is to be achieved *on average over the business cycle,* but the length of the business cycle is not specified either *ex ante* or *ex post*. In recent years, three indicators have been used to assess compliance: (i) a backward looking 10 year moving average of net lending,[9] (ii) a centred seven-year moving average of net lending, capturing the current budget year, the three preceding years, and three "forecast years" following the current budget year, and (iii) the structural budget balance.[10] *In theory*, the structural budget balance can be regarded as the most relevant indicator.

[9] Before the 2010 Spring Budget Bill the government instead used average net lending since 2000 (the year the surplus target was introduced).

[10] Structural net lending is actual net lending adjusted for the GDP gap times an elasticity of 0.55, plus corrections for one-off effects and extraordinary tax income from capital gains.

Table 2

Public Sector Net Lending and GDP Gap
(percent of GDP and potential GDP)

	06	**07**	**08**	**09**	**10**	**11**	**12**	**13**	**14**	**15**
Net lending	**2.2**	**3.6**	**2.2**	**–0.9**	**–0.3**	**0.3**	**1.8**	**2.8**	**3.6**	**4.4**
Average since 2000*	1.0	1.3	1.4	1.2	1.0					
cyclically adjusted**	1.1	1.2	1.3	1.4	1.3					
Seven-year indicator	1.0	1.1	1.2	1.2	1.3	1.3	1.6			
cyclically adjusted**	1.4	1.7	1.8	1.9	2.1	2.3	2.7			
Structural BB	0.8	1.1	1.8	3.0	1.9	1.4	2.2	2.9	3.6	4.5
GDP gap	**1.8**	**3.2**	**0.5**	**–6.7**	**–3.8**	**–1.9**	**–0.7**	**–0.1**	**0.1**	**0.0**
Average since 2000	–0.2	0.2	0.2	–0.5	–0.8					
Seven-year average	–0.6	–0.9	–1.1	–1.1	–1.4	–1.8				

* Ten-year indicator from 2010.
** The indicator has been cyclically adjusted by the average GDP gap for the relevant time period times a budget elasticity of 0.55.
Source: Ministry of Finance.

However, measuring the structural budget balance is a highly uncertain matter, which is why, in its evaluation of the surplus target, the government uses several indicators.[11]

The first indicator has been used for retrospective evaluation. The "seven year moving average indicator" has been used as a forward-looking indicator "with memory". Although the retrospective indicator does cover many years, there is no guarantee that the average GDP gap in the relevant period is zero. The probability of the average GDP gap being non-zero is even higher for the seven-year moving average indicator. In the evaluation of these indicators, the government therefore takes into account the average GDP gap in the relevant periods. If the retrospective indicator, and the seven-year moving average indicator are both close to 1 over the relevant periods at the same time as the GDP gap on average is close to zero, those indicators indicate compliance. The structural budget balance is used to measure compliance in individual years. For compliance, the structural budget balance should be close to 1 per cent of GDP each year, unless discretionary stabilisation policy measures are warranted. For example, in a severe economic slowdown, the structural budget balance is allowed to (and should) be smaller than 1 per cent of GDP.

The practice has been that, given the values of the three indicators, the government makes an *overall* assessment of compliance, in which allowance is also made for the uncertainty of the assessment and the risk scenario; among other things, the risk of an asymmetric business cycle.

Table 2 shows the three indicators for 2006 to 2014. The most recent year with a final outcome is 2010. The backward looking ten year average is used for *ex post* evaluation. From 2001 to 2010, net lending averaged 1.0 per cent of GDP. If the 10 year average is adjusted for the GDP gap, the average is 1.3 per cent of GDP. The average net lending since 2000 (as well as the

[11] In can be interesting to note that this is analogous to the Riksbank's use of several measures of inflation. Se Boije *et al.* (2010) for a discussion on the pros and cons of the governments method to evaluate the surplus target.

Table 3

Expenditure Ceiling and Budgeting Margin
(billions of SEK)

	00	01	02	03	04	05	06	07	08	09	10
Expenditure ceiling	765	791	812	822	858	870	907	938	957	989	1024
Budget margin	5.0	4.7	0.4	2.9	2.4	5.7	11.8	27.9	13.6	24.4	38.5
percent of expenditure below the ceiling	0.7	0.6	0.0	0.4	0.3	0.7	1.3	3.1	1.4	2.5	3.9

Source: Ministry of Finance.

cyclically-adjusted figure) has, from 2006 and onwards, been at or above 1 per cent of GDP. This indicates that net lending has been somewhat above the surplus target during this period. Considered that fiscal policy always is forward looking and based on uncertain forecasts, this deviation from the target is not remarkably large.

The seven-year moving average indicator is forecasted to be at or slightly above 1 per cent of GDP for 2006-12. The cyclically-adjusted seven-year indicator on the other hand indicates a surplus substantially above the target. The structural budget balance is assessed to be above 1 per cent for all years except for 2006. In 2012-15, on average, net lending is forecasted to be substantially above 1 per cent of GDP. Based on these indicators the government's assessment in the 2011 Spring Budget Bill was that savings would be above the surplus target up to 2015, and that there therefore is a future scope for unfinanced measures. Due to the large uncertainty in the economic development over the coming years, the government did, however, emphasise that unfinanced measures should be undertaken only when it was certain that net lending would return to surplus.

This simple exercise does not prove that the surplus target has been a strictly binding restriction *ex ante* but it does show that the surplus target, *ex post*, has been respected over the years 2000-2010 and that, with current forecasts, it also is to be respected the coming years.

4.2 *The expenditure ceiling*

Table 3 shows that the expenditure ceiling has been respected in every year since 2000. It is also clear from the table that in some years the budgeting margin has been very small. During the period 2000-05, the (*ex post*) budgeting margin never exceeded 1 per cent of expenditures. In the past four years, the budgeting margin, on average, has exceeded 2 per cent of expenditures.

Both the National Audit Office (2008) and the Swedish Fiscal Policy Council (2009) have criticised the government for using "creative" accounting a number of times to avoid the ceiling to be exceeded; for example, expenditures have either been booked on the income side of the budget in the form of tax deductions (so called tax expenditures) or transferred from one year to another when the first year's margin under the ceiling was becoming too narrow.[12] This has occurred both under the current and the former government. For example the government transferred a payment to the municipalities of 7 billions SEK from 2010 to 2009 when the margin under the ceiling 2010

[12] For further discussion on this and other points of criticism on the use of the expenditure ceiling, see Boije *et al.* (2010).

Table 4

Net Lending and Result for the Local Government Secto
(billions of SEK)

	00	01	02	03	04	05	06	07	08	09	10
Net lending	1.5	–5.8	–14.5	–8.9	0.9	11.8	3.8	3.5	–3.6	–8.6	1.7
percent of GDP	0.1	–0.2	–0.6	–0.3	0.0	0.4	0.1	0.1	–0.1	–0.3	0.1
Result	1.4	1.3	–7.1	–0.8	2.2	13.3	15.2	14.1	7.9	13.3	19.1
percent of GDP	0.1	0.1	–0.3	0.0	0.1	0.5	0.5	0.5	0.2	0.4	0.6

Source: Ministry of Finance.

was forecasted to be very small. In some of these cases the government has presented these operations to the parliament in a transparent way, in other cases the government has failed to do so.

4.3 The balanced-budget requirement on local governments

Table 4 shows that, except for the years 2002-03, the local government sector as a whole has had a positive result. The general perception is that the balanced-budget requirement has contributed to a significant improvement in local government finances.

Although the balanced-budget requirement has contributed to improved finances for the local public sector, it has been criticised for contributing to a pro-cyclical policy at the local level. Since the municipalities and county councils are required to plan for balanced budgets each year, there is an obvious risk that they reduce expenditure when tax revenue falls in years with low capacity utilization and vice versa. The government has acknowledged this problem and recently appointed a committee to propose how this problem can be handled (subject to the restriction that the proposal shall not weaken the fiscal position of municipalities and county councils). Among potential solutions, the committee will analyse a mandatory “rainy day” fund to which municipalities and county councils would be obliged to contribute in “good” years, and from which they would receive payments in “bad” years.

4.4 Is it the framework or is it the Swedes?

As described above, Sweden generally has adhered to the MTBF both before and during the crisis. Is this a result of the construction of the framework or a result of that the framework has been operated by the Swedes? Our view is that well designed rules and budget procedures are important, but that strong political commitment is necessary for the MTBF to be effective. A well-constructed framework will not have the desired effect in the absence of political commitment to the framework. In Sweden, there is almost consensus among the political parties that the MTBF is an valuable fiscal policy tool, although there have been some disagreement regarding to what extent the framework should be binding by law.[13] The support for the framework derive from the experiences of the consolidation of the public finances after the fiscal crisis in the 1990s. This fiscally distressing period established an aversion to deficits, both among policy makers and the

[13] The exception is the left-wing party that is critical of many parts of the framework.

public. The fact that there have been no major deviations from the MTBF since it was established, has also created a "good" path dependence where deviations from the framework are politically costly.

5 What constitutes an effective MTBF?

In this section, we briefly discuss what constitutes an effective MTBF and to what extent the Swedish MTBF corresponds to such a framework. The economic literature does not provide any clear-cut answer as to what constitutes an effective MTBF. Some insights can although be drawn from the empirical literature:[14]

1) balanced-budget rules and debt rules contributes to better budgetary outcomes. For expenditure rules, an impact is found mainly in terms of restraining primary spending;
2) balanced-budget rules are more effective when they are combined with expenditure rules;
3) budget processes with a clear top-down perspective contribute to better fiscal performance;
4) fiscal councils enhance the effectiveness of fiscal rules;
5) transparent fiscal policies improve budgetary outcomes;
6) a strong legal foundation for rules and strict enforcement have a beneficial impact on fiscal performance.

On the whole, these empirical results support the construction of the Swedish MTBF. The first four points clearly correspond to the features of the Swedish framework. Regarding transparency, our assessment is that there has been a considerable improvement in recent years, but that the framework has a potential to improve further (see Section 6). The recent steps by parliament to make the use of the surplus target and the expenditure ceiling mandatory in a new budget law that regulates the budget process are in line with the first part of point 6.

Enforcement procedures should, according to the IMF (2009), rely on mandating corrective action and/or mechanisms that maximize the reputational cost of not taking action. Germany and Switzerland are examples of countries that use the first approach, while Sweden uses the second. A number of agencies participate in the external monitoring, for example, the Fiscal Policy Council, the National Financial Management Authority, the National Institute of Economic Research and the Audit Office. The Fiscal Policy Council, established by the government in 2007, has a special role in the monitoring of fiscal policy.[15] The council's main tasks is to assess whether fiscal policy is consistent with long-term sustainable public finances and the MTBF, especially the surplus target and the expenditure ceiling. Furthermore the council shall evaluate whether economic developments are in line with healthy long-run growth and sustainable high employment, evaluate fiscal policy in relation to the business cycle and examine the clarity of the stated grounds for economic policy and the motivations for policy proposals.

The Fiscal Council is formally an agency under the government, which appoints the eight members for a three-year period. The appointments are based on proposals from the Council itself. These proposals are made public, which means that the government's reputation is liable to suffer if it does not follow the proposals. It has so far followed the proposals of new members from the Council.

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[14] See Ayuso-i-Casals *et al.* (2008), Broesens and Wierts (2009), Debrun *et al.* (2009), Debrun *et al.* (2008), European Commission (2006), Holm-Hadulla *et al.* (2010), IMF (2009), Ljungman (2009) and OECD (2007).

[15] Debrun *et al.* (2009) show large effects of fiscal councils on budgetary outcomes.

It is likely that countries with a good public finance track record, where the memory of earlier fiscal crises has contributed to strong political support for the MTBF, can rely on reputational cost to a greater extent than other countries. It is also likely that this enables a more qualitative and flexible approach to the assessment of potential deviations from targets. However, *if* the memory of earlier fiscal crises fades and this gives rise to deliberate deviations from fiscal targets, it may be necessary, also in Sweden, to introduce a stronger corrective arm instead of just relying on reputational costs.

6 A Code of Conduct for fiscal policy

The past 20 years have brought significant progress in developing and describing the methods of monetary policy. This has been a major contributor to stabilising inflation at levels considerably lower than before. Even though there has been some progress has been made in developing and describing methods in fiscal policy, the gap to monetary policy in this aspect is still substantial.

Leeper (2009) has pointed to the large gains that could be achieved by, to a larger extent than today, anchoring fiscal expectations. The anchoring of fiscal expectations is important since economic agents need to form expectations on future policies to make economic decisions today regarding, for example, the appropriate level of investment. Central banks to a large extent communicate the information it possesses and thus helps the public to form its views about current and future states of the economy. To central banks, transparency is a means to enhance the effectiveness of monetary policy. Leeper (2009) argues that fiscal policy can learn from monetary policy in this aspect.

Although there are good reasons to increase fiscal policy transparency, and, in this work, learn from monetary policy, it is important to stress that there are important differences between fiscal and monetary policy, which necessarily means that the descriptions of the principles according to which each policy is conducted has to be significantly different. The decision-making process is much more complex for fiscal policy than for monetary policy, mainly due to that fiscal policy has a larger number of goals and available means than monetary policy. With this taken into consideration, there is still scope to improve communication on how fiscal policy is conducted.

The Swedish government has against this background recently increased fiscal policy transparency by presenting its fiscal policy framework in a special document aimed to work as a code of conduct for fiscal policy.[16] The purpose is not only to increase transparency, but also to strengthen the confidence for the public finances' long term sustainability. Another purpose is to through it comply with the (expected) requirements in the coming EU directive, setting minimum standards for national fiscal policy frameworks. The document is called "The Swedish Fiscal Policy Framework". It contains about 40 pages and is written in a non-technical manner. There are earlier examples of these kind of documents from the United Kingdom and New Zeeland. However, compared to these two examples, the Swedish document gives a more comprehensive description of how fiscal policy is conducted. Some inspiration to the description of the Swedish fiscal policy framework comes from the Riksbank's (2010) monetary policy strategy document. The Code of Conduct is to be seen as a steering-oar for fiscal policy. The Code itself says that if the government for some reason has deviated from the Code, it should motivate these deviations in the Spring Budget Bill (starting in 2012).

The Code of Conduct describes parts of the fiscal framework that are regulated in law, but also used practises and principles. Through the Code, the used practises and principles will be

[16] Government Offices (2011).

institutionalised. To keep the content of the Code updated, the intention is that it should be revised if there been major changes. If the Code is revised, the revisions must be clearly motivated in the new version of the Code.

6.1 Content of the Code

The Code includes the following six aspects of the fiscal framework:

1) the role of fiscal frameworks in fiscal policy making
2) the medium term budgetary framework (MTBF);
3) external evaluation;
4) stabilisation policy;
5) governmental interventions on financial markets;
6) openness and transparency.

The part of the Code that describes the role of fiscal frameworks in fiscal policymaking gives an account of the main targets for fiscal policy (not to be confused with the budgetary rules and targets). According to the Swedish Government, the main task of fiscal policy is to create the highest possible sustainable welfare by means of high sustainable growth and high sustainable employment (*the allocation target*), well-being for all (*the distributional target*) and economic stability (*the stabilisation target*). A prerequisite for achieving these targets is long-term fiscal sustainability. Since there are several goals for fiscal policy, it is inevitable that there will be conflicts between these goals. These conflicts must, of course, be handled by the elected politicians. In this complicated decision process, where the final decision often is a result of compromises, the Fiscal Policy Framework (as described by the Code of Conduct) work as a steering oar that promotes fiscal discipline and transparency.

The section in the Code covering the MTBF describes the different parts of the framework in a similar way as Section 4 above.

In the part of the Code covering External evaluation, the government emphasises the importance of “fiscal watchdogs”, both at the international and national level. Since there is no formal enforcement procedure based on mandating corrective action in the Swedish Fiscal Policy Framework, external evaluation contributes to a high reputational cost of not taking action in case of slippages from the fiscal targets. At the international level, the EU, OECD and the IMF are examples of fiscal watchdogs, where the EU-commission surveillance is particularly important. The evaluation by the EU commission is expected to be intensified over the next coming years with the proposals discussed for a new EU economic governance. On the national level, there are also several governmental agencies that monitors different parts of fiscal policy, *i.e.*, the Swedish Audit Office, The national Institute of Economic Research and the Swedish Fiscal Policy Council. In the Code, the government clarifies that the Fiscal Policy Council has a special responsibility in this monitoring.

Regarding stabilisation policy, the Code describes the different roles for monetary and fiscal policy as well as principles for how fiscal policy is used for stabilisation of the economy. The Riksbank (monetary policy) is regarded to have the main responsibility for stabilisation policy as Sweden has a flexible exchange-rate. Fiscal policy contributes to stabilisation policy foremost through maintaining confidence for the sustainability of the public finances. During normal business cycle fluctuations, fiscal policy also contributes to stabilisation through the automatic stabilisers and semiautomatic stabilisers (*i.e.*, active labour market policies). When there are very large swings in the business cycle (due to large demand or supply shocks), fiscal policy also may need to support monetary policy and the automatic/semiautomatic stabilisers through discretionary

measures. The Code says that if such discretionary measures are taken, they must be consistent with long-term sustainability of the public finances. Experience shows that many temporary measures often are difficult to reverse. The Code therefore stipulates that temporary measures that are difficult to reverse, should be avoided. If there is a scope for reforms, discretionary policies should instead focus on bringing forward structurally sound permanent measures.

The part of the Code covering governmental interventions on financial markets, describes the responsibilities of different governmental agencies as well as principles for governmental interventions. Even with good institutions, Sweden will not be immune to global financial crises. However, clearly defined mandates for different governmental agencies, as well as clear principles for governmental interventions in financial markets, are essential in preventing nationally induced financial crisis, and contribute to an effective handling of financial crises once they have occurred. In certain situations, governmental interventions can be motivated to prevent a financial system meltdown. The Code says that such interventions must be constructed in a way that minimises the long-term costs of the tax payers as well as moral hazard problems.

The part of the Code covering openness and transparency, describes principles for how fiscal policy is to be accounted for in the documents the government submits to parliament. It also provides general principles for forecasts and calculations of the effects of different reforms. For example, the Code stipulates that, if a reform is assumed to have significant economic effects, the government must reports its effects on GDP, employment and income distribution. The Code also stipulates that the government must present long-term sustainability calculations at least once a year.

7 Concluding remarks

In this paper, we have discussed, with reference to Swedish experience, how a well-designed fiscal policy framework can help to promote sound public finances. We have shown that the Swedish framework fulfils most of the criteria of what constitutes an effective framework. Furthermore, we have argued that the Swedish experience indicates that a fiscal policy framework can be essential for maintaining surpluses in good years. We have also shown that, on the whole, the framework has been respected. Our conclusion is that the framework has made a significant contribution to the enhancement of confidence in the long-term sustainability of public finances, which has kept risk premia small and enabled an effective stabilisation policy. We have also argued that the Swedish framework has contributed to Sweden, as one of a few European Union countries, being able, despite the financial crisis, to adhere to the SGP's numerical fiscal rules. This supports the view that national fiscal policy frameworks are likely to improve the performance of the SGP.

We have, however, also argued that a well-designed fiscal policy framework on paper is not a sufficient condition for fiscal sustainability and a responsible fiscal policy over the business cycle. Several countries, which prior to the crisis had a fiscal policy framework that ranked high *on paper,* performed badly during the financial crisis. For a fiscal policy framework to work properly, there must be a strong political belief that such frameworks actually matter, and a political commitment to respecting them. Such political commitment is likely to be stronger in countries, such as Sweden, with recent experience of fiscal crises. Seen from this perspective, in many countries today's fiscal crisis is likely to be a loud "wake-up call".

As recognised in the economic literature, there is a trade-off between fiscal rules that tie politicians to the mast, and rules that are sufficiently flexible to cope with changes in economic conditions. We have argued that countries with a good track record, where the memory of recent fiscal crises has contributed to strong political support for the fiscal policy framework, can rely on reputational cost to a greater extent than other countries. It is also likely that this allows a more

qualitative and flexible approach to the assessment of potential deviations from targets. However, *if* the memory of earlier fiscal crises fades and this gives rise to deliberate deviations from fiscal targets, it may be necessary to introduce a stronger corrective arm.

Finally, we have described the content of the Swedish government's Code of Conduct for fiscal policy, which serves to institutionalise and strengthen the fiscal policy framework further. This Code does not only contain the MTBF, but also describes the main targets of fiscal policy, the importance of external evaluation, responsibilities and principles for stabilisation policy measures, principles for governmental interventions on financial markets, responsibilities of the different agencies involved, and principles for openness and transparency in the accounting of fiscal policy.

We hope that this paper – which has described the Swedish fiscal policy framework, its background, our mainly positive experiences and recent improvements of it – can serve as an inspiration to countries that are in the process of introducing a fiscal policy framework.

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FISCAL PERFORMANCE AND DECENTRALIZATION IN EUROPEAN UNION COUNTRIES

Julio Escolano, Luc Eyraud,* Marialuz Moreno Badia,* Juliane Sarnes* and Anita Tuladhar**

This paper assesses the evidence on the impact of fiscal decentralization on overall fiscal performance in the European Union, taking into account fiscal institutional arrangements. We find that spending decentralization has been associated with sizably better fiscal performance. In contrast, revenue decentralization has had a negative impact, at variance with the normative literature. Intriguingly, transfers appear to weaken the improvement in fiscal performance associated with expenditure decentralization. We conjecture that resource rationing may have been used by the center to impose discipline on subnational governments. If so, the fiscal gains from expenditure decentralization may not be sustainable.

1 Introduction

Many European countries have embarked on fiscal decentralization programs over the last decades. They have reassigned spending and revenue collection responsibilities from the center to subnational (local and regional) governments. As a result, the spending carried out at the subnational level in the European Union (EU) has increased from 23 per cent of general government spending in 1995 to 26 per cent in 2009 with the revenue share increasing to a lesser extent.

The economic case for decentralization relies essentially on efficiency arguments. Subnational governments have more information and hence can better match policies with citizens' preferences (Oates, 1972). Another argument is that competition between jurisdictions limits the local tax burden and encourages cost-efficient provision of local public goods (Brennan and Buchanan, 1980). Finally, decentralization is likely to increase accountability and transparency in the delivery of public goods and services.

Yet decentralization could have drawbacks. In particular, subnational governments may not fully internalize the cost of local expenditure when spending decentralization is financed through a "common pool" of transfers from the center. In this case, they are more likely to overspend and lower their tax effort. This effect is aggravated if subnational authorities anticipate that their financing gap will be covered by the center, with bailout expectations "softening" the budget constraint felt at the local level (Rodden *et al.*, 2003). However, some institutional arrangements – e.g., fiscal rules – could in principle help overcome coordination problems between levels of government and strengthen fiscal discipline by correcting incentives, enhancing accountability and anchoring economic agents' expectations.

The empirical literature is inconclusive as to the impact of decentralization on fiscal performance. The purpose of this paper is to assess empirically this impact in the EU, examining explicitly the role of institutional arrangements covering subnational governments. This question

* IMF, Fiscal Affairs Department.

Authors' e-mails: JEscolano@imf.org, LEyraud@imf.org, MMorenobadia@imf.org, JSarnes@imf.org, and ATuladhar@imf.org

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The views expressed herein are those of the authors and should not be considered to represent those of the International Monetary Fund.

may now be timely given that many European countries are facing the challenge of restoring fiscal sustainability and financial markets are questioning whether consolidation efforts may be derailed by coordination problems in decentralized countries. Our findings suggest that spending decentralization has in fact been associated with stronger fiscal performance, especially when transfer dependency of subnational governments was low. On the other hand, revenue decentralization can create challenges as it limits the central government's ability to control subnational slippages.[1]

The paper is organized as follows. Section 2 briefly reviews the literature on the costs of fiscal decentralization. Section 3 describes the institutional features of subnational governments in the EU. Section 4 presents some stylized facts of decentralization and fiscal performance in the EU. Section 5 approaches these issues through econometric methods and analyzes the results. Section 6 concludes.

2 The economic debate on fiscal decentralization

In this section, we present some results from the literature on decentralization and fiscal performance. Most of the existing literature is of a theoretical nature or is based on case studies. Theoretical or normative contributions generally point to the risks of decentralization, especially where subnational spending is financed through transfers or local borrowing. However, the empirical literature does not yet provide clear-cut results. Possibly owing to data constraints, econometric cross-country work is scarce and focuses mostly on OECD countries.

The challenges of decentralization in terms of macroeconomic stabilization have long been highlighted in the normative literature. The widespread view is that countercyclical policies are more difficult to pursue in a decentralized framework (Ter-Minassian, 1997), because the center is deprived of some tax and spending levers (Tanzi, 1995); and subnational governments usually conduct procyclical policies (Tanzi, 2000; IMF, 2009). From an empirical standpoint, the evidence is scant although there are some case studies illustrating the procyclicality of local budgets (Rodden and Wibbels, 2009).

In addition, decentralization may also affect the capacity of countries to reduce chronic deficits. Subnational governments are often suspected of conducting looser fiscal policies, with coordination failures creating "deficit bias" (Oates, 2006). In addition, decentralization may deteriorate the central government performance. This is clearly the case when central governments bail out subnational authorities that become excessively indebted. It can also take more subtle forms, for instance, when high subnational borrowing or difficulties in implementing consolidation plans in a decentralized framework result in higher risk premia for the central government.

However, the cross-country econometric evidence on the effect of decentralization on fiscal performance is mixed. Rodden (2002) finds that revenue decentralization deteriorates the general government balance whereas Neyapti (2010) finds that revenue and spending decentralizations improve it. Afonso and Hauptmeier (2009) report that a higher degree of spending decentralization worsens the primary balance (for high debt levels) while revenue decentralization does not matter. Thornton (2009) also finds no significant impact of revenue decentralization. Baskaran (2010) adopts a different approach by assessing the impact on debt rather than on the fiscal balance; it

[1] Subnational spending is local and regional government spending excluding transfers paid. Subnational revenue is defined as the revenues of local and regional governments excluding transfers received, and transfers are net current and capital transfers received from the other levels of government.

finds that expenditure decentralization significantly reduces public indebtedness, while the effect of tax decentralization is insignificant.[2]

The design of the institutional framework seems crucial to reap the benefits of fiscal decentralization. Three institutional features have received particular attention:

- *Transfer dependency*. Rodden (2002) argues that higher reliance on transfers reduces the general government overall balance, in particular when subnational borrowing is not constrained. In addition, subnational spending funded by transfers is found to be additional to central government spending, not a substitute (Fornasari *et al.*, 2000). Transfer growth may become endogenous, with deficits bringing about more grants, which in turn generate higher deficits (De Mello, 2007). Thus, allowing subcentral governments to access own revenue through local taxation is often seen as essential to promoting fiscal discipline.
- *Subnational borrowing autonomy* can also undermine the fiscal discipline of local governments, especially when they resort to "soft" financing – for instance, when bonds are sold to the public banking system or to state-owned enterprises (Oates, 2006). Some studies find that restricting subnational authorities' access to borrowing – either through cooperative arrangements, market discipline, or formal rules – is associated with better fiscal performance (Rodden, 2002; Plekhanov and Singh, 2007).
- *Fiscal rules* may offset some of these negative effects by addressing coordination problems between levels of government (Sutherland *et al.*, 2005; Ter-Minassian, 1997 and 2007, Ter-Minassian and Craig, 1997). However, the empirical literature does not find conclusive evidence that subnational rules affect the general government performance. In particular, Debrun *et al.* (2008) find that rules applying to subnational governments have no significant impact on the cyclically-adjusted primary balance of the general government, in contrast to rules pertaining to the general and the central government. Afonso and Hauptmeier (2009) report the same result with the general government primary balance.

3 Institutional features of european subnational governments

The role of subnational governments varies significantly in the EU. Relatedly, subnational government spending – as a proportion of general government expenditure – ranges widely from less than two per cent in Malta to almost two-thirds in Denmark.[3] The relationship between the center and the subnational governments differs reflecting the distribution of political power, economic functions, and institutional arrangements. We examine briefly some of these features in this section.

3.1 Subnational government structures and economic functions

In general, the share of subnational expenditure in total government spending is higher in federal countries, but some unitary countries also have a high level of spending decentralization. The great majority of EU countries are unitary. Only Austria, Belgium, and Germany are organized

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[2] On a related issue, based on a comparative analysis of successful and failed consolidations, Darby *et al.* (2005) shows that high level of expenditure decentralization reduces the occurrence of successful consolidations; the more decentralized countries rely less on durable expenditure cuts and more on short-lived revenue hikes, probably because decentralization makes coordinated cuts more difficult to achieve.

[3] Expenditure shares are to date the most common way of describing the spending power of subnational governments. In this paper, fiscal decentralization is measured as the share of subnational spending in total general government spending, unless noted otherwise. Countries are divided in three groups of about equal size according to their degree of decentralization. High-decentralization countries have spending share above 33 per cent; medium-decentralization countries have spending shares between 25 and 33 per cent; while low-decentralization countries have spending share less than 25 per cent.

Table 1

Features of Subnational Governments

Sub-national Government Tiers	Country	National Government	Decentralization (2009)
One	BUL	Unitary	low
	CYP	Unitary	low
	LUX	Unitary	low
	MLT	Unitary	low
	SVN	Unitary	low
	EST	Unitary	medium
	LTU	Unitary	medium
	LVA	Unitary	medium
	FIN	Unitary	high
	GRC	Unitary	low
Two	IRL	Unitary	low
	PRT	Unitary	low
	SVK	Unitary	low
	AUT	Federal	medium
	CZE	Unitary	medium
	HUN	Unitary	medium
	ROM	Unitary	medium
	DNK	Unitary	high
	NLD	Unitary	high
	SWE	Unitary	high
Three	FRA	Unitary	low
	GBR	Unitary	medium
	ITA	Unitary	medium
	POL	Unitary	medium
	BEL	Federal	high
	DEU	Federal	high
	ESP	Unitary	high

Sources: CCRE-CEMR EU subnational governments: 2009 key figures, Dexia February 2011; authors' calculations.

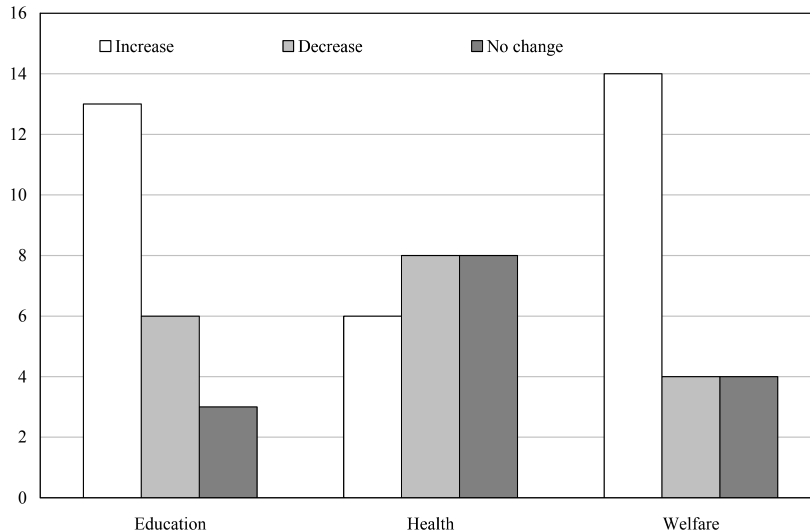
on a federal basis (see Table 1). While these federal states have a slightly higher level of decentralization, the classification into unitary and federal refers only to the distribution of political power, which does not necessarily coincide with the distribution of economic resources or the level of fiscal decentralization. Hence, there are medium-decentralization federal countries, such as Austria, as well as highly decentralized unitary countries, such as Denmark, Finland, or Spain.

More decentralized countries tend to have more tiers of subnational government (Table 1). About one-third of the EU27 countries have one single level, while the rest have two or three tiers. In general, larger countries with a larger population or surface area tend to have more tiers and a higher number of administrative entities.

The main areas of subnational government expenditure are education, health, and social welfare. While most countries have assigned to the subnational levels at least some responsibility for preschool, primary, and secondary education, universities are mainly in the realm of the center. Nevertheless, in some countries university education is also assigned to the subnational level. Furthermore, some hospitals and basic healthcare are usually assigned to subnational tiers. The same is true for the execution of general social welfare services, such as social housing (see

Figure 1

Trends in Subnational Expenditure Shares, 1995-2008
(number of countries)



Sources: Eurostat and authors' calculations.

Appendix 1). Between 1995 and 2008, subnational expenditure shares for education and social welfare have risen, while the subnational expenditure share of health has decreased in the majority of countries (Figure 1).[4]

3.2 Control mechanisms

To control subnational government deficits, it is common to find fiscal rules – mainly borrowing or balanced budget rules – applying to subnational entities.[5] The number of fiscal rules has increased substantially at the central and general government levels in the European Union. Nonetheless, the majority of fiscal rules are applied at the local government level (Appendix 2). Budget balance rules are more prevalent in EU15 countries, while debt or borrowing rules are common among the new member states (NMS). Expenditure rules, on the other hand, are rare at the subnational level. In some countries this may reflect that, once budget balance rules are imposed, subnational governments do not have much flexibility on spending as they often depend on grants from the central government. Subnational fiscal rules are more prevalent in countries with higher decentralization and when subnational governments are more reliant on own revenues than on transfers.

Fiscal rules for both the central and subnational governments are stronger in more decentralized economies (Figure 2). Not surprisingly, rules at the central government level are also strong for low levels of decentralization where spending is mostly concentrated at the center. But central government rules are weaker in the case of medium-decentralization economies; in these economies, subnational governments are also more reliant on transfers from the center.

Nevertheless, the strength of these rules does not necessarily reflect their effectiveness. Although most countries have fiscal rules on subnational government levels, sanctions in case of rule infringement are often weak, and the central government retains considerable discretion in addressing a breach in rules. Moreover, breaching of the rules does not preclude a bailout by the central government. In the past, lack of control over subnational governments' fiscal performance has resulted in subnational bailouts in at least nine EU countries (Appendix 2). Subnational bailouts have more frequently occurred in countries with a higher number of administrative tiers.

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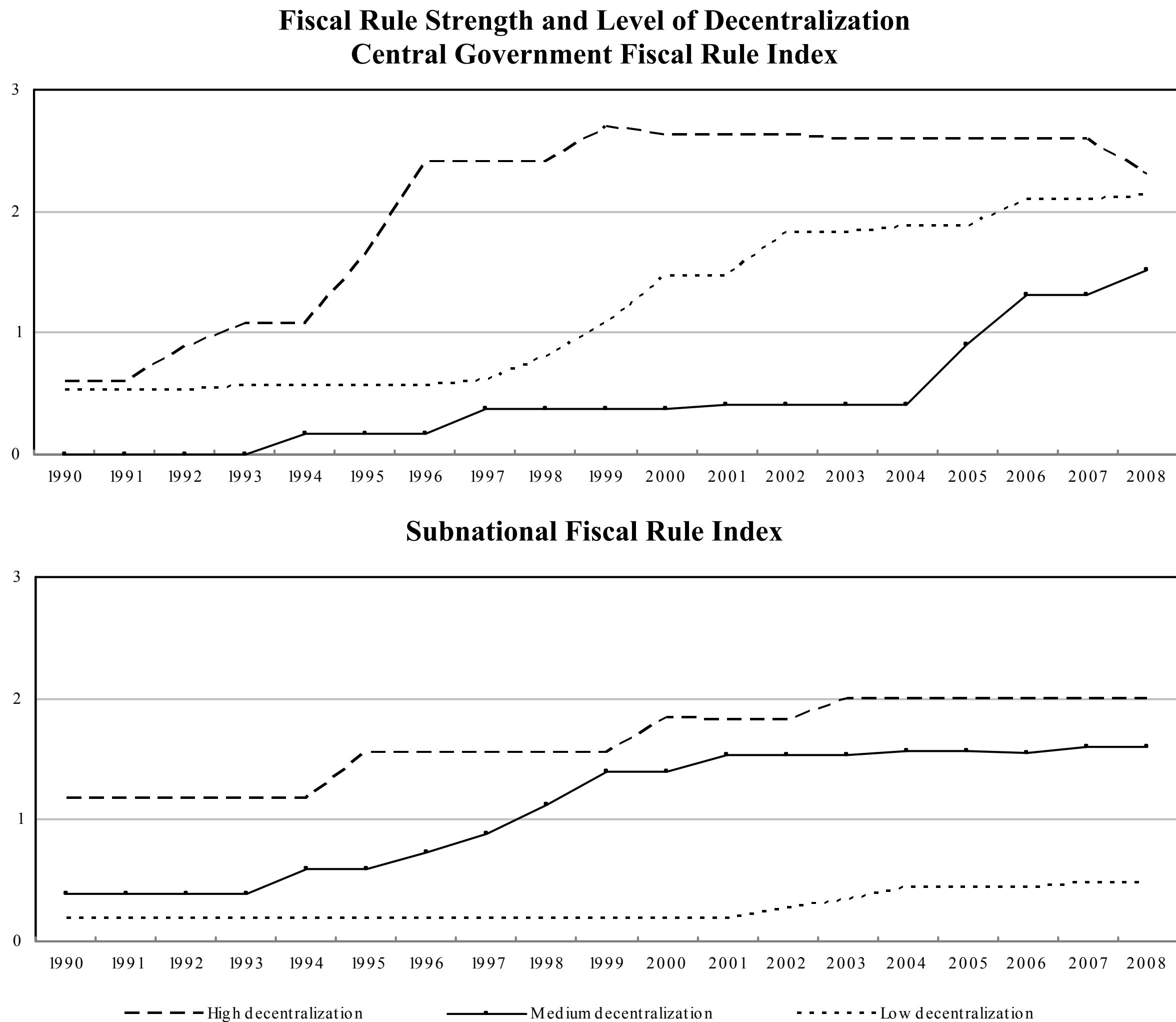
[4] Overall, eight countries have reduced the subnational expenditure shares for health, three of which significantly by 15-20 percentage points (Estonia, Hungary, and Romania). In Ireland this trend is particularly pronounced: in 2005 the total health budget was reassigned to the center, causing the subnational expenditure share to drop from 95 per cent to zero. This is consistent with the trends described in Saltman (2008).

[5] The fiscal rule indices used in the paper come from the European Commission Fiscal Rule Index database (European Commission, 2009). Overall fiscal rules comprise all rules applying to either the general, central, or subnational governments.

Figure 2

Fiscal Rule Strength and Level of Decentralization



Sources: Eurostat, European Commission and authors' calculations.
Note. The fiscal rule index measures the strength of the rule based on its legal basis, coverage, strictness of monitoring and enforcement (including through sanctions and escape clauses), and media visibility.

Coordination between the central and subnational governments in budgetary procedures is limited. Less than one-third of countries have formal coordination arrangements.[6] Also, in the majority of countries, the budget law only includes fiscal targets for the central government. In only a small proportion of countries, subnational levels are explicitly targeted by the medium-term budgetary frameworks.

4 Stylized facts on decentralization and fiscal performance

In this section, we present some stylized facts regarding the impact of fiscal decentralization on fiscal performance in the EU. In addition, we try to explain what institutional factors – namely

[6] See European Commission database on medium-term fiscal frameworks.

the degree of revenue autonomy, transfer dependency, and presence of fiscal rules – affect fiscal performance.[7] We use fiscal data from Eurostat covering the years 1995-2008 and look at different indicators (balance and debt) to assess the performance of the general government.[8] The main findings are as follows:

Stylized fact No. 1. Spending decentralization is associated with better fiscal performance at the general government level (Figure 3).

Over the period 1995-2008, cyclically-adjusted general government fiscal balances were higher among more decentralized countries such as Denmark, Sweden and Spain, and much lower in less decentralized countries such as Greece, Malta and Slovakia (Figure 4, Panel A).[9] Moreover, increases in spending decentralization are not associated with increases in debt (Figure 4, Panel B). Nevertheless, fiscal performance varies considerably among countries with a medium level of decentralization, in particular, among the NMS. For example, several eastern European economies such as Czech Republic, Hungary and Poland have higher deficits, while Estonia and Bulgaria have much lower deficits. On average, overall fiscal balances in countries with medium and low levels of decentralization are respectively 2 and 2½ percentage points of GDP below those of countries with high decentralization.

The relatively favorable general government fiscal performance for more decentralized countries reflects strong fiscal positions at the center. Subnational governments have a close-to-balance fiscal position irrespective of the degree of decentralization (Figure 3). This low deficit is not surprising as subnational governments are often constrained in their ability to borrow – either due to fiscal rules or market rationing – and are generally reliant on transfers from the center with spending being closely related to the availability of transfers. Given this, fiscal indiscipline at the subnational level would be reflected in higher deficit at the center as a result of transfers. However, this is not borne out by the data: on average, central government fiscal performance seems stronger in highly decentralized countries.

How can the central government control overall fiscal performance in the context of decentralization? We explore two potential channels: first, through unfunded mandates whereby more spending responsibilities are assigned to subnational governments but are not matched by commensurate resources (transfers or own revenues) and second, through the use of fiscal rules.

Stylized fact No. 2. Expenditure decentralization has outpaced the decentralization of resources to subnational governments (own revenue and transfers).

Subnational spending rose by 3¾ percentage points as a share of general government spending between 1995 and 2009, whereas the average increase in subnational own revenues and transfers accounted for only 2½ percentage points (Figure 5). Since rising own revenue sources did not kept up with the increase in subnational spending, vertical imbalances – measured by the gap between spending and revenue decentralization – increased over time. While transfers also generally increased, they fell behind the widening vertical imbalances, resulting in larger subnational deficits. This suggests unfunded mandates and rationing of resources to subnational governments. That is, subnational governments would have been forced to implement expenditure savings – particularly if borrowing was constrained. In turn, decentralization of spending responsibilities without commensurate transfers and reassignment of tax instruments may have improved the fiscal position of the center and thus, of the general government.

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7 Revenue autonomy is measured by the share of subnational own revenues (*i.e.*, adjusted for central government transfers) in general government revenues; transfer dependency is measured by the share of transfers received by subnational governments in total subnational revenues.

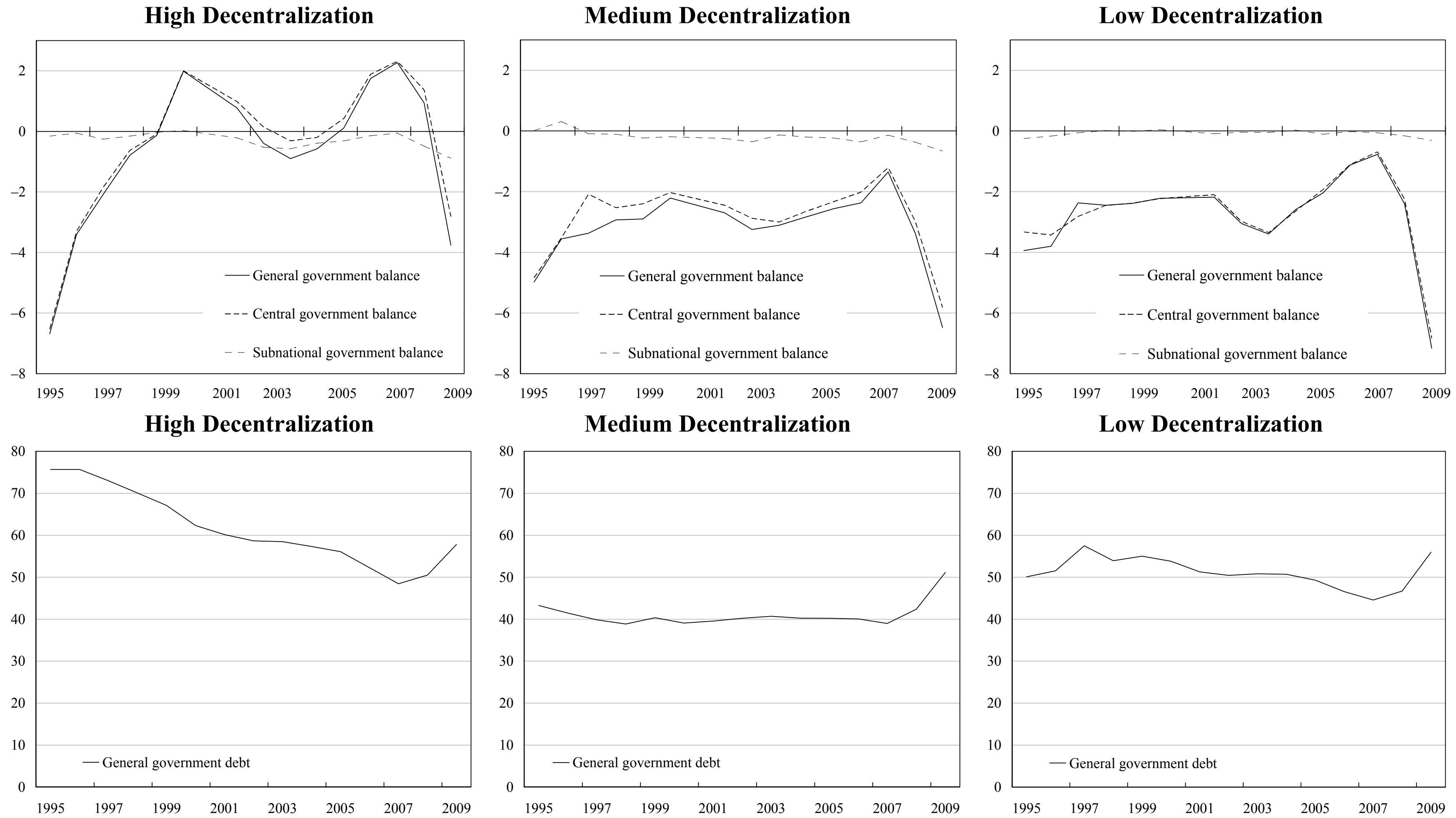
8 For a description of the data and definitions, see Appendix 3.

9 This positive relationship is also evident when measured against overall balance or cyclically-adjusted primary balance.

Figure 3

Average Fiscal Balances by Level of Decentralization in the European Union, 1995-2009

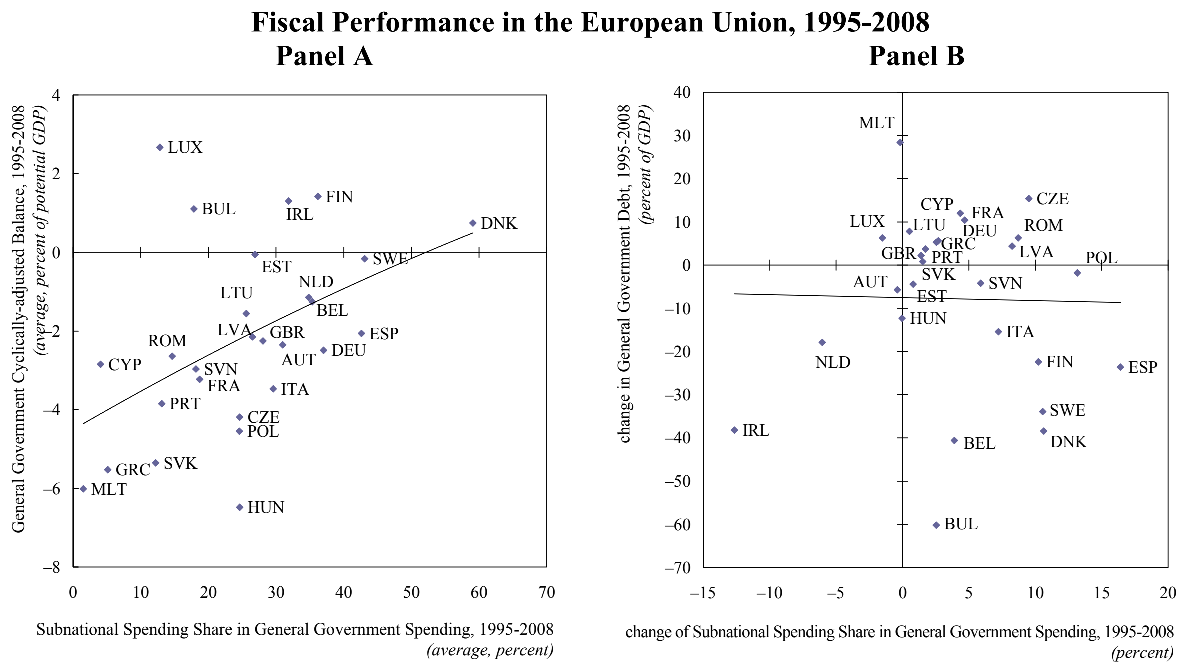
(percent of GDP)



Sources: Eurostat and authors' calculations.

Figure 4

Fiscal Performance in the European Union, 1995-2008



Sources: Eurostat; European Commission, IMF and authors' calculations.

Stylized fact No. 3. Subnational rules do not appear to have an effect on fiscal performance.

Although the overall fiscal rule index[10] has a positive relationship with the general government balance, the subnational fiscal rule index does not show a clear relationship (Figure 6). The absence of a strong correlation between the strength of subnational fiscal rules and fiscal performance could also indicate that the rules are not always effective due to weak implementation and bailouts as mentioned earlier.

5 Econometric evidence

To assess more formally the effect of decentralization on fiscal performance, we estimate a fiscal reaction function. This specification follows Bohn (1998) and Debrun *et al.* (2008). In this model, a country's fiscal policy can be described as the response of the general government primary balance to (1) cyclical fluctuations; (2) general government debt; and (3) institutional and political determinants. The estimated equation is:[11]

$$PB_{it} = \alpha_0 + \beta\, PB_{it-1} + \gamma\, d_{it-1} + \phi\, gap_{it-1} + Dec_{it}'\delta + x_{it}'\lambda + \eta_i + \varepsilon_{it}, \tag{1}$$

where the indices i, t denote countries, and years, respectively; PB is the primary balance to GDP; d is the debt-to-GDP ratio; gap is the output gap;[12] Dec is a vector comprising, depending on the

[10] The overall fiscal rules index includes all rules on the general, central, or subnational governments.

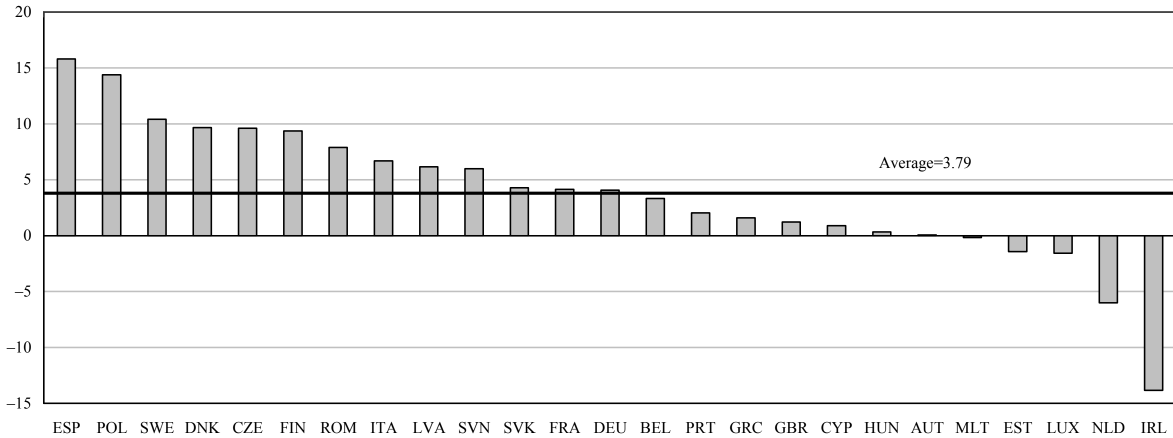
[11] We use EU27 data for 1990-2008 constituting an unbalanced panel (reflecting data availability).

[12] The output gap is defined as actual GDP less potential GDP as a percent of the latter. In particular, positive gap values indicate that the economy is operating above potential.

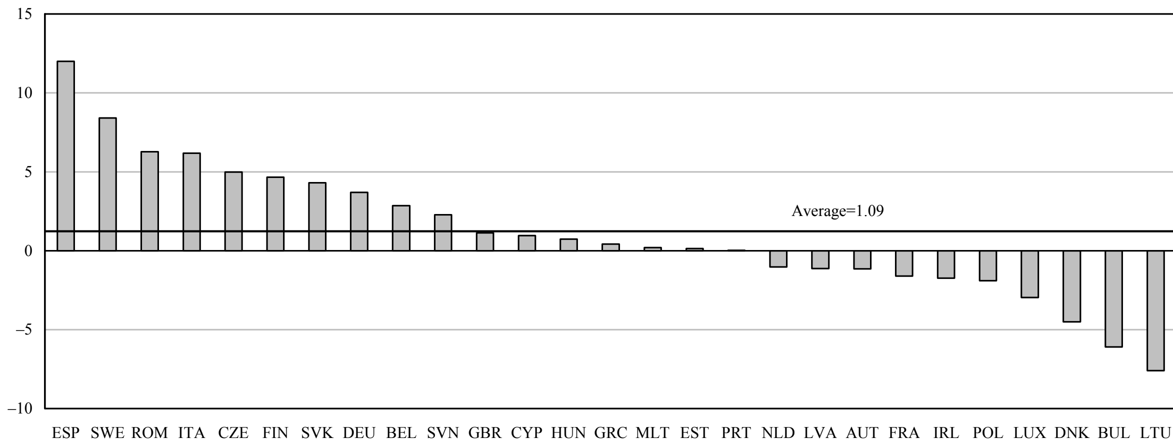
Figure 5

Increase in Spending and Revenue Decentralization
(percent of general government spending)

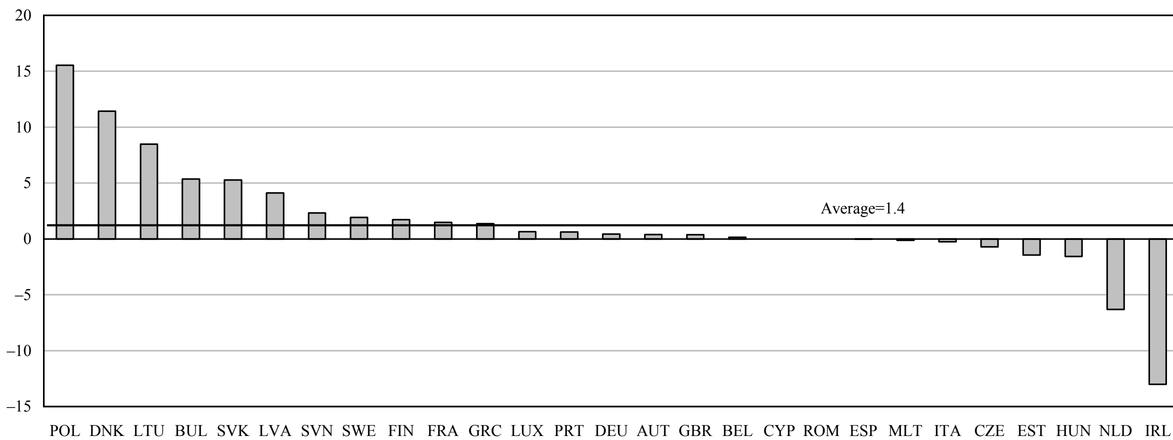
Change in Share of Subnational Spending, 1995-2009



Change in Share of Subnational Revenue, 1995-2009



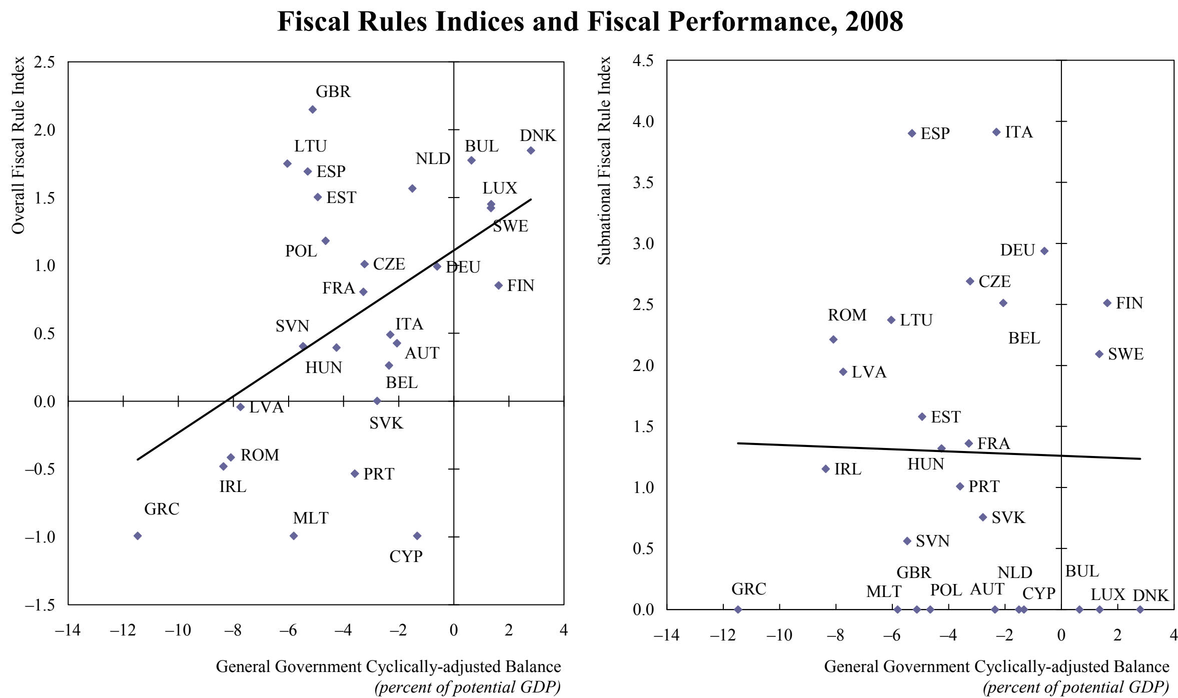
Change in Share of Net Transfers, 1995-2009



Sources: Eurostat and authors' calculations.

Figure 6

Fiscal Rules Indices and Fiscal Performance, 2008



Sources: Eurostat; European Commission and authors' calculations.

specification, spending decentralization (subnational spending as a ratio of general government spending), revenue decentralization (subnational own revenues as a share of general government revenues), transfer dependency (transfers to subnationals as a share of total subnational revenues), and interactions among these variables; x denotes other control variables, including relevant political and fiscal institutions; η_i represents country-specific fixed effects; and ε_{it} is a time- and country-specific error term. In line with Galí and Perotti (2003), we use the cyclically-adjusted primary balance as the dependent variable to capture a country's discretionary fiscal policy. In this model, we expect γ to be positive as long as the government reacts to the existing stock of debt to ensure long-run solvency. A positive (negative) value for ϕ would indicate fiscal policy is countercyclical (procyclical). The impact of fiscal decentralization is, however, ambiguous ex ante (as discussed before). A positive (negative) value for the estimated coefficients in δ would indicate that decentralization improves (hampers) fiscal performance.

The model is estimated using the bias-corrected Least Square Dummy Variable (LSDVC) estimator proposed by Bruno (2005). With standard estimation methodologies, the inclusion of fixed-effects in dynamic panels creates a bias. In particular, even though the within transformation eliminates the η_i, by construction the transformed error term ($\varepsilon_{i,t} - \frac{1}{T}\sum_{t=1}^{T}\varepsilon_{i,t}$) is still correlated with the lagged dependent variable. The bias (which affects all variables) is a function of T, and only as T tends to infinity will the within estimators be consistent. To correct for this problem, we use the LSDVC estimator which approximates the bias to construct a consistent estimator. This method is superior to Instrumental Variables (IV) and Generalized Method of Moments (GMM) in narrow samples (small time dimension relative to the number of units in the panel) as it is the case here.

Table 2

Fiscal Decentralization and Fiscal Performance[1]

Estimator	LSDVC (1)	LSDVC (2)	LSDVC (3)	FE (4)
Lagged dependent variable	0.575*** *(0.0515)*	0.552*** *(0.0532)*	0.504*** *(0.0516)*	0.336*** *(0.0402)*
Lagged government debt	0.0455*** *(0.0134)*	0.0448*** *(0.0134)*	0.0563*** *(0.0136)*	0.0083 *(0.0105)*
Lagged output gap	–0.263*** *(0.0423)*	–0.270*** *(0.0419)*	–0.304*** *(0.0416)*	–0.282*** *(0.0356)*
Spending decentralization	0.0730** *(0.0366)*	0.165*** *(0.0539)*	0.562*** *(0.146)*	0.801*** *(0.115)*
Revenue decentralization		–0.203*** *(0.078)*	–0.563*** *(0.152)*	–0.685*** *(0.116)*
Transfer dependency		–0.0337 *(0.0206)*		
Spending decentralization *x* Transfer dependency			–0.00485*** *(0.00154)*	–0.00651*** *(0.00119)*
Parliamentary election	–0.479** *(0.193)*	–0.492** *(0.192)*	–0.445** *(–0.19)*	–0.445*** *(0.171)*
Constant				–5.882*** *(1.008)*
Number of observations:	322	322	322	322
Number of countries	27	27	27	27
Fixed effects (*F*-test)				8.48***

Robust standerd errors in parentheses. *** p<0.05, * p<0.1

[1] Dependent variable is the General Government primary cyclically-adjusted balance. LSDVC accounts for the fixed-effects small sample bias in dynamic panels.

5.1 Baseline results

Overall, the estimates suggest that decentralization improves fiscal outcomes. In particular, spending decentralization seems to improve fiscal performance irrespective of the model specification (Table 2), in line with stylized fact 1. As expected, there is significant degree of persistence in the CAPB and our results are consistent with the stabilization response to debt developments. However, in contrast with other studies (see Debrun *et al.*, 2008; and Galí and Perotti, 2003), there is evidence of a procyclical fiscal policy, as indicated by the negative coefficient of the output gap. Concerning political variables, the results suggest that there is an electoral cycle in Europe, as fiscal performance worsens on election years.[13]

[13] Other political and institutional variables were originally included in the regression (different measures of government and political fragmentation; government stability; ideology; existence of autonomous regions; euro entry; and EU accession). The size of the economy was also included in the regression. However, since none of these variables were significant they were dropped to keep a parsimonious specification.

Nevertheless, not all aspects of decentralization are positive. First, transfer dependency diminishes the positive impact of spending decentralization on fiscal performance (Table 2, column 3). A possible reason for this result is that subnational governments do not fully internalize the costs when an increase in spending is financed through transfers from the center. Second, the fiscal position deteriorates with the degree of revenue decentralization (Table 2, column 2-3). Given our results, it is natural to ask how is it possible that higher spending decentralization improved overall fiscal performance, but own revenue decentralization or transfers did not. The results would be consistent with the idea that, once spending is decentralized, the only lever the center has left to maintain fiscal discipline at the subnational level is controlling the resources available to subnational governments; losing this lever could hurt the fiscal position. While the results do not provide a verdict on this issue, we conjecture (as discussed above) that tight subnational government resource constraints (own revenue and transfers) were used as rationing mechanisms by the center, contributing to better overall fiscal performance – and that when they were not used in that manner, overall fiscal performance improved to a lesser extent or deteriorated.

To assess whether these results vary with the institutional setup, we analyze the role of fiscal rules and the importance of coordination among different levels of government.

- First, we include an *overall fiscal rule index* measuring the stringency of rules-based fiscal governance in our baseline specification. Although our estimates show that the overall fiscal rules improve performance in line with the results of the literature (Table 3, column 1), *central and subnational fiscal rules* do not matter when considered separately (Table 3, column 2), consistent with stylized fact 3. The positive effect of overall fiscal rules may not be very robust, however, as discussed below. This could potentially reflect that rule implementation is weak, or that rules are introduced where fiscal performance is weaker in the first instance.[14]
- Second, we test whether the effect of spending decentralization depends on the *existence of rules constraining borrowing* at the subnational level. We do not find any significant impact (Table 3, column 3). One potential explanation is that subnational entities are constrained in their access to market irrespective of rules and, thus, spending decisions (and the corresponding impact on overall fiscal performance) are not determined by the their statutory ability to borrow. Similarly, *budget-balance rules* at the subnational level do not seem to matter either.
- Finally, to assess the importance of vertical coordination, we add an interaction between spending decentralization and a dummy variable that takes value 1 if there is a *formal coordination mechanism* with the subnational governments in the medium-term budgetary framework. This interaction effect turns out not to be statistically significant.

5.2 Robustness checks

In this section we discuss several sensitivity analyses which were performed to check the robustness of the key results reported above (Table 4). We begin by estimating the model with the general government balance as the dependent variable, and find a similar message as in our baseline specification. Next, we use changes in general government debt as a measure of performance. This variable may be more accurate in capturing the true fiscal performance, as debt increases in many European countries exceeded their fiscal deficits after the introduction of the Stability and Growth Pact (Buti *et al.*, 2007), possibly indicating the use of accounting loopholes to circumvent fiscal rules. The latter would be consistent with a loss of significance of the fiscal rules

[14] Our results should be interpreted with caution since we do not take into account explicitly the potential endogeneity of fiscal rules (*i.e.*, governments with stronger preference for fiscal discipline are more likely to adopt stronger fiscal rules). Debrun *et al.* (2008) finds negligible the potential estimator bias introduced by reverse causality in a similar model.

Table 3

Do Fiscal Institutions Matter?[1]

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Lagged dependent variable	0.498***	0.504***	0.508***	0.505***	0.504***	0.505***	0.500***
	(0.0514)	*(0.0516)*	*(–0.052)*	*(0.0519)*	*(0.0519)*	*(0.0519)*	*(–0.051)*
Lagged government debt	0.0585***	0.0537***	0.0565***	0.0559***	0.0563***	0.0562***	0.0580***
	(0.0137)	*(0.0145)*	*(0.0136)*	*(0.0135)*	*(0.0136)*	(0.0136)	*(0.0136)*
Lagged output gap	–0.320***	–0.312***	–0.301***	–0.303***	–0.304***	–0.304***	–0.319***
	(0.0431)	*(0.0444)*	*(0.0427)*	*(0.0419)*	*(0.0425)*	*(0.0414)*	*(0.0438)*
Spending decentralization	0.529***	0.567***	0.583***	0.567***	0.562***	0.560***	0.534***
	(0.148)	*(0.147)*	*(0.152)*	*(0.144)*	*(0.146)*	*(0.147)*	*(0.154)*
Revenue decentralization	–0.555***	–0.556***	–0.559***	–0.566***	–0.564***	–0.561***	–0.558***
	(0.152)	*(0.158)*	*(0.153)*	*(0.149)*	*(0.152)*	*(0.151)*	*(0.156)*
Spending decentralization x Transfer dependency	–0.00462***	–0.00497***	–0.00504***	–0.00490***	–0.00486***	–0.00484***	–0.00466***
	(0.00155)	*(0.00155)*	*(0.00159)*	*(0.00151)*	*(0.00154)*	*(0.00153)*	*(0.00158)*
Parliamentary election	–0.466**	–0.458**	–0.446**	–0.446**	–0.443**	–0.445**	–0.467**
	(0.191)	*(0.192)*	*(0.192)*	*(–0.19)*	*(–0.19)*	*(0.193)*	*(0.191)*
Overall fiscal rule index	0.349*						0.345*
	(0.195)						*(0.204)*
Central fiscal rule index		0.0835					
		(0.118)					
Subnational fiscal rule index		–0.212					
		(0.247)					
Spending decentralization *x* Subnational debt rule			–0.00902				
			(0.0112)				
Spending decentralization *x* Subnational budget balance rule				–0.0162			
				(0.0555)			
Spending decentralization *x* Central debt rule					–0.00268		
					(0.013)		
Spending decentralization *x* Central budget balance rule						0.00000211	
						(0.00749)	
Spending decentralization *x* Coordination dummy							–0.0221
							(0.144)
Observations	322	322	322	322	322	322	322
Number of countries	27	27	27	27	27	27	27

Standard errors in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.1$

[1] Dependent variable is the General Government primary cyclically-adjusted balance.

Table 4

Robustness Checks

Dependent Variable	General Government	Change in debt	CAPB	CAPB	CAPB	CAPB	CAPB
			EU15	NMS	Before 1999	1999-2008	Excl. 2008
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Lagged dependent variable	0.403***	0.373***	0.533***	0.433***	0.0617	0.549***	0.485***
	(0.0462)	*(0.0598)*	*(0.0588)*	*(0.0808)*	*(–0.105)*	*(0.0661)*	*(0.0463)*
Lagged government debt	0.0367***	–0.176***	0.0415***	0.0714***	0.076	0.0606***	0.0583***
	(0.0124)	*(0.0326)*	*(0.0161)*	*(0.0258)*	*(0.0632)*	*(0.0192)*	*(0.0147)*
Lagged output gap	–0.123***	0.277***	–0.379***	–0.305***	–0.225	–0.288***	–0.296***
	(0.0417)	*(0.0922)*	*(0.0704)*	*(0.0732)*	*(0.177)*	*(0.0419)*	*(0.052)*
Spending decentralization	0.948***	–1.086***	0.699***	0.392	0.761**	0.844***	0.489***
	(0.1380)	*(0.322)*	*(0.157)*	*(0.306)*	*(0.325)*	*(0.172)*	*(0.148)*
Revenue decentralization	–0.901***	0.820***	–0.728***	–0.388	–0.678**	–0.881***	–0.502***
	–0.142	*(0.315)*	*(0.169)*	*(0.263)*	*(0.328)*	*(0.174)*	*(0.147)*
Spending decentralization *x* Transfer dependency	–0.00847***	0.0102***	–0.00684***	–0.00311	–0.00646**	–0.00808***	–0.00429***
	(0.0014)	*(0.00348)*	*(0.00161)*	*(–0.0028)*	*(0.00316)*	*(0.00173)*	*(0.00151)*
Parliamentary election	–0.509***	0.109	–0.39	–0.536	0.49	–0.671***	–0.421**
	(0.1840)	*(0.46)*	*(0.245)*	*(0.38)*	*(0.357)*	*(0.252)*	*(0.185)*
Overall fiscal rule index	0.464**	–0.0994	–0.164	0.889**	0.583	0.785**	0.351
	(0.1920)	*(0.609)*	*(0.269)*	*(0.415)*	*(0.391)*	*(0.312)*	*(0.225)*
Observations	322	300	195	127	65	235	295
Number of countries	27	27	15	12	22	27	27

Standard errors in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.1$

variable when the change in debt is used as left-hand side variable – since the deficit, rather than the debt, was typically considered the most binding constraint in showing compliance with fiscal rules. Indeed, overall fiscal rules turn out to be no longer significant. Consistent with our previous results, we find that spending decentralization reduces debt accumulation and that this benefit is reduced when transfer dependency is high. Also, revenue decentralization induces higher debt increases (or lower debt reductions).

The panel approach raises the question of whether the results hold for different subsamples. Thus, we explore whether the impact of fiscal decentralization in the countries that joined the EU in 2004 or thereafter (NMS for short) is similar to the remaining 15 countries (EU15). In this case, we find that the decentralization variables lose their significance in the sample of NMS countries although results still hold for the EU15 (Table 4, columns 3-4). As a flip-side, fiscal rules only matter in NMS countries. Nevertheless, these results should be interpreted with caution as the NMS sample is too short and there is not as much variation in the measures of decentralization among those countries (all highly decentralized countries are EU15 members).

To control for the stability of our estimates over time, we split the sample in 1999 – the first year of the Stability and Growth Pact (SGP). No major difference emerges between the two sample periods except for the role of fiscal rules that lose significance before the introduction of the SGP. This result is clearly driven by the EU15 countries and could possibly indicate that, in the run up to the euro, fiscal discipline was observed even in the absence of rules. To eliminate the potential effect of the recent crisis we exclude the year 2008 from our sample and find that all results remain unchanged. Finally, excluding one country at a time to control for possible outliers does not significantly alter our estimates except for fiscal rules that are not significant in most cases.[15]

6 Conclusions

This paper provides new evidence on the impact of decentralization on fiscal behavior, focusing on the EU. Our paper contributes to the literature in two main respects. First, we look at different dimensions of fiscal decentralization (expenditure and revenue decentralization, as well as transfer dependency) and their interactions. Second, we take into account whether fiscal institutions geared toward maintaining budgetary discipline among subnational entities can offset the potential fiscal risks of decentralization.

Our results show that fiscal decentralization may improve fiscal performance. First, we find that spending decentralization improves the fiscal position of the general government. This is consistent with the efficiency arguments in favor of spending autonomy. Nevertheless, high transfer dependency reduces the positive effect of spending decentralization. Moreover, revenue autonomy tends to significantly weaken fiscal performance at the general government level. As discussed below, these results could be evidence that resource rationing by the central government has been used to ensure budgetary discipline on subnational governments.

Results on subnational fiscal rules suggest that they have not played a material role on fiscal performance. A possible explanation is that fiscal rules in the EU might be relatively weak since the center has considerable discretion in addressing breaches to the rule. To the extent that rules are being breached due to politically sensitive spending that is difficult to control (e.g., health care), the central government may need to compensate the subnational governments – thus rendering the rules nonbinding. These findings are, however, subject to caveats as the numerical fiscal institutions' indicators used in the econometric analysis may not capture well the complexities of interactions between the center and the subnational levels of government.

15 Results are not reported here in the interest of brevity.

Our findings appear consistent with the hypothesis that decentralized countries in the EU were able to improve fiscal performance by rationing the resources of subnational governments. This, if proven the case, could call into question the medium-term sustainability of fiscal gains obtained by decentralization. There are at least two problems with this fiscal consolidation "model". First, by transferring spending responsibilities to subnational governments without increasing their revenue autonomy, the center cannot credibly commit not to bail them out in the future. And second, the success of resource rationing in prompting subnational budgetary discipline rests on the existence of de facto or de jure limits to subnational government borrowing. Thus, the effectiveness of rationing is likely to erode over time as borrowing becomes easier due to increasing financial sophistication of subnational governments and financial market development. Also, statutory borrowing ceilings (or tight transfers from the center) could also come under pressure as unfunded mandates become politically unsustainable.

APPENDIX 1

Table 5

Expenditure Assignments to Subnational Governments in the European Union

ONE TIER

	BUL	EST	LTU	LUX	LVA
EDUCATION	• Preschool education • Primary and secondary education • Vocational training	• Preschool education • Primary and secondary education	• Primary and secondary education (except teachers' wages)	• Primary and secondary education • Vocational training • Higher education	• Primary and secondary education (except teachers' wages)
HEALTH	• Hospitals • Public health • Tertiary care and psychiatric hospitals • Polyclinics • Some primary care and drugs	• Public health • Polyclinics • Municipal hospitals • Primary care	• Hospitals • Primary health care, ambulance services	• Hospitals • Personal health	• Tertiary care • Polyclinics medicine • Some primary care
WELFARE		• Welfare services • Care for the elderly • Other social assistance	• Temporary social benefits • Day care • Care for the elderly • Care for the homeless • Care for the handicapped	• Welfare homes	• Care for the homeless • Care for the disabled • Care for orphans

TWO TIERS

	AUT	CZE	DNK	HUN	IRL	NDL	PRT	ROM	SWE
EDUCATION	• Preschool education • Primary and secondary education • Vocational training • Adult education	• Preschool education • Primary education and (executive function only for) secondary education	• Preschool education • Primary education and secondary education • Adult education	• Preschool education • Primary and secondary education	• Making nominations to vocational education committees and harbours • Processing of higher education grants	• Primary and secondary education • Vocational training • Higher education • Adult education	• Primary and secondary education	None	• Primary and secondary education • Vocational training • Higher education • Adult education
HEALTH	• Hospitals • Personal health	• Hospitals • Public health	• Public health • Hospitals • Personal health	• Basic healthcare	• Veterinary services only	• Hospitals • Personal health		None	• Hospitals • Personal health
WELFARE	• Family welfare services • Welfare homes	• Social welfare services	• Social welfare services • Family welfare services • Welfare homes	• Family welfare services • Welfare homes • Care for the elderly • Care for the disabled • Care for the homeless • Social housing		• Family welfare services • Welfare homes			• Family welfare services • Welfare homes

THREE TIERS

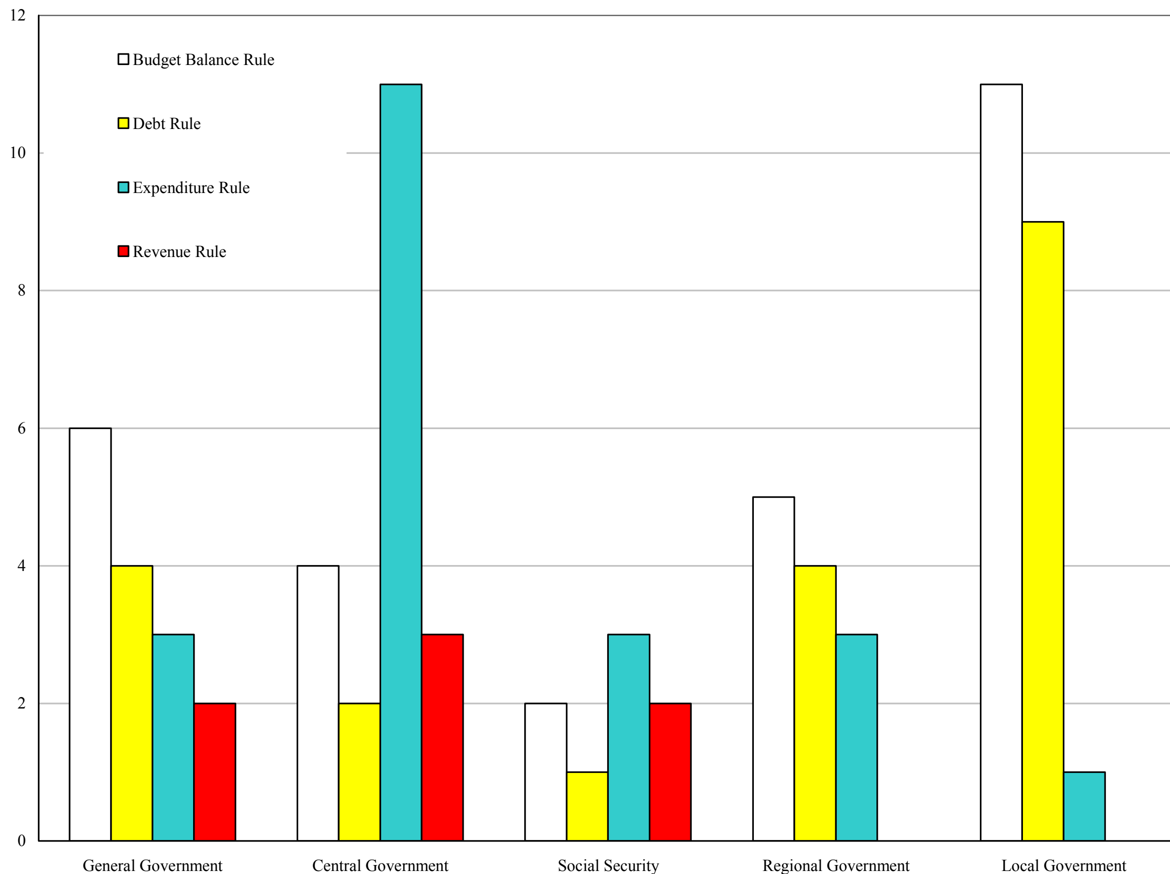
	BEL	DEU	ESP	FRA	GBR	ITA	POL
EDUCATION	• Preschool education • Primary and secondary education • Vocational training • Adult education • Higher education	• Preschool education • Primary and secondary education • Adult education • Higher education	• Cooperation increation, building and maintenance of schools	• Preschool education • Primary and secondary education • Vocational training • Higher education • Adult education	• Preschool education • Primary and secondary education • Vocational training • Higher education • Adult education	• Preschool education • Primary and secondary education • Vocational training • Adult education	• Preschool education
HEALTH	• Hospitals • Personal health	• Hospitals • Personal health	• Primary care	• Hospitals • Personal health	• Hospitals • Personal health	• Hospitals • Personal health	None
WELFARE	• Family welfare services • Welfare homes	• Family welfare services • Welfare homes	• Promotion and social rehabilitation	• Family welfare services • Welfare homes		• Family welfare services • Welfare homes	

Sources. World Bank Database of Qualitative Decentralization indicators; Monasterio Escudero and Suárez Pandiello (2002), McLure and Martínez-Vázquez (2000), Vigvari (2008) and OECD (2010).

APPENDIX 2
FISCAL RULES AT THE SUBNATIONAL LEVEL IN THE EUROPEAN UNION

Figure 7

Fiscal Rules in the EU Member States by Type of Rule and Level of Government, 2008



Source: European Commission Services.

Subnational fiscal rules are mainly budget balance rules or debt rules (Figure 7). Both of these rules have nearly doubled between 1990 and 2005. Budget balance rules are the most common for both sub-national governments as well as for the total general government. But, in contrast to that of central government level, expenditure rules are uncommon at the sub-national level. Subnational government rules appear to be more prevalent in countries with higher decentralization and lower transfer dependency.

The proportion of countries imposing sanctions on sub-national governments' non-compliance with a fiscal rule varies significantly by the type of rule in question. In more than one fifth of the countries there are no predefined sanctions at all. While the infringement of a budget balance requirement is sanctioned by more than three quarters of the countries, barely two thirds of those featuring a borrowing constraint, and only a third of those with expenditure or tax limitations penalize non-compliance. Moreover, a large proportion of the possible sanctions are fairly weak or provide a wide margin for discretion – such as giving the central government the option to "recommend actions".

Table 6

Sanctions and Escape Clauses by Type of Fiscal Rule
(percent of total rules in the sample)

Sanctions[1]						
Rule type	**Impose Financial Sanctions**	**Sanction Officials**	**Mandate Actions**	**Constrain Actions**	**Other**	**Not Predefined**
BBR	0.26	0.04	0.26	0.35	0.26	0.22
BC	0.21	0.05	0.37	0.26	0.21	0.26
EL	0.27	0.00	0.18	0.27	0.18	0.55
TL	0.00	0.00	0.11	0.00	0.22	0.67
Escape Clauses[2]						
	Shock to Local Economy	**Shock to Local Revenues**	**Natural/Other Disaster**	**No Escape**	**Other**	**Not Predefined**
BBR	0.13	0.09	0.30	0.30	0.13	0.35
BC	0.05	0.05	0.26	0.26	0.05	0.47
EL	0.00	0.00	0.18	0.18	0.00	0.64
TL	0.00	0.00	0.00	0.00	0.00	1.00

[1] applies to 26 countries.
[2] applies to 24 countries.
Note: BBR = Budget Balance Rule; BC = Borrowing Constraint; EL = Expenditure Limit; TL = Tax Limit.
Source: European Commission Fiscal Rules Questionnaire.

Only a few countries have absolutely no "escape clauses" allowing for the sub-national government's (temporary) infringement of fiscal rules. Escape clauses mainly apply in cases of natural or other disasters, or shocks to the subnational government's revenues or to the local economy (Table 6). Less than a third of the countries imposing a budget balance requirement do *not* allow for its temporary infringement under any circumstances. In contrast, this is the case for only about a quarter of countries when it comes to borrowing constraints. In six other cases, escape clauses are not predefined and decided upon on an *ad hoc* basis.

In recent times, subnational governments had to be bailed out by the higher level of government in at least nine EU countries. When a subnational government is faced with a large deficit, it has to either raise taxes to increase its revenues or drastically cut expenses. Due to the common lack of tax autonomy and the high proportion of expenditures mandated by law, subnational governments often do not have much room for maneuver and often turn to – ultimately unsustainable – debt financing. Subnational bailouts have more frequently occurred in more decentralized countries with a higher number of administrative tiers. While only one quarter of the countries with one level of sub-national government have experienced a subnational bailout, the share rises to 44.4 per cent for countries with two tiers and to about two thirds for countries with three tiers of subnational government. Examples include the German federal government's bailout of two Länder and the bailout of Swedish municipalities in the 1990s (Table 7).

Table 7

Selected Episodes of Subnational Bailouts in the European Union

Country	Bailout Details	Consequences
DEU	• 1992: German Constitutional Court upheld claims of Bremen and Saarland for financial assistance from federal government • 1993: 5-year contract stipulating annual payment of additional grants to the two states (earmarked for reduction of public debts) • States committed to keep annual expenditure growth below 3 per cent and had to deliver regular reports on progress of fiscal consolidations to federal and other state governments • The target of reducing debts from DM 16 billion in 1992 to DM 11.5 billion in 1998 was missed (debts remained at 16 billion); 1999 extension of the grants until 2004 (but declining annually); further transfers after 2004 excluded	• No differences in credit risks of German states; Germany cannot rely on market discipline to enforce fiscal prudence on state governments
ESP	• When democracy was restored in Spanish city councils in the late 1970s, initial public finance system largely remained in place; its low tax collection capacity and the rising demands of citizens led to overspending and over-borrowing • 1980: The center assumed 50 per cent of the local authorities' debt burden without solving the systemic problem • 1983: Central government covered by grants the current deficits; granted local governments an absolute freedom for setting tax rates	• Spanish constitutional court declared anti-constitutional the rule granting local government tax autonomy to this extent • Local governments had to return the tax revenues thusly collected, again, aggravating their financial position • In 1988, wide ranging reform of local finances was enacted
HUN	• 1999: one-third of all localities applied for deficit grants, which are available for local governments who have deficits through no fault of their own or local governments that go bankrupt; • Even though grants are made only to assist governments in covering mandatory tasks, deficit grants provided for a soft budget constraint in the system, as local governments are able to increase their grant revenues through behavioral changes	• Since 1996-1997, the central government has improved transparency and strengthened audit procedures
ITA	• 1977: Increase of transfers from the center by 300 per cent; simultaneous introduction of fiscal rules, e.g., expenditure limitation and borrowing constraints • 1978: center assumed responsibility for debts accumulated by municipal governments before 1977	• Tight control of local expenditures did not solve the soft budget-constraint problem • Public finance reforms in the 1990s reduced the role of transfers and increased revenue and spending autonomy of local governments to induce responsibility
SWE	• 1992 city of Haninge turned to the central government for financial assitance because it was was unable to take care of the debts of the city-owned housing company • 1995 central government assumed responsibility for the debt owed by housing company and extended an extral loan the company • Central government gave an extra grant to the city to pay back the remaining debts of the housing company • The city lost almost all its shares in the company to the center and was mandated to raise its local tax by one percentage point	• Haninge case found numerous imitators: in 1998, 87 of a total 288 municipal governments had applied at least once for financial assistance

Sources: Ter-Minassian and Craig (1997); von Hagen *et al.* (2000); Monasterio Escudero and Suarez Pandiello (2002); Jourmand and Knogsrud (2003); Wetzel and Papp (2003); Pettersson-Lidbom and Dahlberg (2005); Plekhanov and Singh (2007).

APPENDIX 3
DATA SOURCES AND DEFINITIONS

Fiscal data

We use fiscal data from Eurostat covering the years 1990-2008. The data set is an unbalanced panel including all EU27 countries for which data for the period were available. This yielded a sample with about 12 observations per country on average. The number of countries is substantially lower at the beginning of the sample, particularly for NMS as coverage for subnational fiscal statistics has only improved over time. Throughout the paper all subnational measures are calculated by aggregating the regional and local government subsectors (S1312 and S1313 in ESA95). The following variables are used in the econometric analysis:

Spending decentralization. Subnational spending (excluding transfers paid) in percent of general government spending.

Revenue decentralization. Subnational revenue (excluding transfers received) in percent of general government revenue.

Transfer dependency. Subnational net transfers received (both current and capital) in percent of subnational revenue.

CAPB. General government cyclically-adjusted primary balance calculated as follows:

$$capb = r\left(1+gap\right)^{-(\varepsilon_r-1)} - g\left(1+gap\right)^{-(\varepsilon_g-1)}$$

where r is primary revenue in percent of GDP; g is the primary expenditure in percent of GDP; *gap* is the output gap; ε_r the is the elasticity of revenue with respect to the output gap; and ε_g is the elasticity of expenditure with respect to the output gap.[16]

Debt. Gross general government debt in percent of GDP.

Macro data

The macroeconomic data needed to calculate the output gap were taken from the IMF's *World Economic Outlook* database.

Political data

Data on political institutions are based on the World Bank Political Database (see, Thorsten *et al.*, 2001).

Fiscal institutions

Data on fiscal rules and medium-term budget frameworks come from the European Commission and are available at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm

[16] Where available, elasticities are taken from Girouard and André (2005). In other cases, revenue elasticity is assumed to be 1 and expenditure elasticity is assumed to be 0.

Fiscal rules

The overall fiscal rule index used in the paper comes from the European Commission Fiscal Rule Index database (see EC, 2009). The strength of the rule is constructed based on its legal basis, coverage, strictness of monitoring and enforcement (including through sanctions and escape clauses), and media visibility.

Based on the indices available for the central, social security, regional and local government level rules, we construct two series for the *central* (combining central and social security) and *subnational* (combining regional and local) government levels. The aggregation technique seeks to use the same methodological principle as Debrun *et al.* (2008), placing a higher weight of 1 on the strongest rule and a weight of ½ on the remaining rules.

Medium-term budget framework

For the econometric analysis we construct a dummy variable that takes value 1 if there is coordination with subnational levels of government in the preparation and status of the Stability and Convergence Program.

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COMMENTS ON SESSION 2
FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

Carlo Cottarelli[*]

I have been asked to comment on three papers. Two of them – the one by Barnes and the one by Larch, Pench and Frayne – are very similar in terms of coverage, dealing both with the reform of the EU fiscal governance system, while the third deals with the progress in strengthening fiscal sustainability in Greece under the program supported by EU and IMF financing.

Let me start with a few words on the paper on Greece. It is a very useful description of the progress made so far and of the challenges faced by the Greek authorities. Several implementation risks remain and my IMF colleagues working on Greece from the IMF's European Department or those from the IMF's Fiscal Affairs Department dealing with technical assistance to Greece in the fiscal area would perhaps be in a better position to comment on this. Here the point that I want to raise relates to what I would call the elephant in the room, an elephant that the paper does not address but that is in the mind of all investors. The elephant is the question: all these reforms are fine but can some form of default or debt restructuring be avoided?

My answer to this question is: yes. I have already expressed this view in the past but I would like to reiterate briefly why I think this is so:

- First, debt is high, but the extent to which this is a problem depends on the interest rate that is being charged on debt. Unlike countries that defaulted in the past, the average interest rate on Greek debt is not high at present. The high interest rates on the secondary market are irrelevant as Greece is not borrowing at those rates. Moreover, the maturity of Greek debt before the crisis was the second longest maturity among advanced countries (after the U.K.), so Greece is still benefitting from low pre-crisis rates. Finally, the support from the IMF and the EU allows Greece not to go back to the market for some time. This should give time to investors to revise their expectations if they see the program being implemented successfully.
- Second, the problem of Greece is a large primary deficit, which would have to be corrected even if a large haircut were applied on existing debt. One can do the math and see that, even assuming a haircut of 50 per cent, the correction in the primary balance would not be much lower with respect to a scenario in which there is no default.
- Third, while defaulting would reduce somewhat the extent of fiscal adjustment needed, default also has costs for the economy. First, access to markets for several years would be much more difficult for Greece. Second, default is a tax and has negative implications for the income and wealth of bondholders. About 30 per cent of central government debt is held domestically and this is not a trivial percentage. Moreover, even taxing the foreign bondholders is not without costs both economically – for example, bank problems in the rest of Europe caused by a Greek default would spill over to Greece as well – and politically – as other countries could complain.

There are several other reasons why I do not regard default as inevitable, but if you are interested you can read a paper on this issue that we published a few months ago in the IMF Staff Discussion Note series.[1]

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[*] IMF.

[1] See *Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely*, by Carlo Cottarelli, Lorenzo Forni, Jan Gottschalk, and Paolo Mauro. Available in http://www.imf.org/external/pubs/ft/spn/2010/spn1012.pdf.

Let me move to the other two papers, both dealing with EU fiscal governance. All agree it needs to be fixed, although I believe that in the absence of the SGP, things could be much worse: there has been perhaps too much SGP-bashing recently.

Both papers describe developments and express views on the quality of the SGP reforms. So I guess I will have also to express views on what is happening in this area.

In general, the reforms are an important step forward but it is not a secret that they fall short of what the Commission itself had initially supported. In some respects, they also complicate significantly the monitoring of policies, although this was in part inevitable to make the monitoring more meaningful.

I support many aspects of the reforms and here I will focus only on what I find more problematic. Let me start with some relatively technical points.

To fix the preventive arm, the EC proposes to address the tendency to spend revenue windfalls in good times by introducing a cap on total expenditure growth, corrected for changes in taxation. This makes sense. However, the remaining difficulty is to assess potential growth and this is a key issue. It is in my view likely that a good chunk of the extra spending that took place in the pre-2008 good times was due primarily to an overestimation of potential growth, rather than to non-growth related revenues. It is therefore critical to estimate how much of the temporary revenue buoyancy would have been captured if the new approach were followed, using the potential growth estimates existing at that time.

On the corrective arm, operationalizing the debt criterion is a priori a good idea. However, I have three concerns about the specific approach followed (1/20th of the excess debt). First, nobody will achieve the 60 per cent target following this rule, as it works only asymptotically, and it is not clear why this approach was followed as simple alternative formulations could be found (for example, reductions specified in percentage points for various debt brackets). Second, for countries starting with very high debt and facing a sizable interest rate growth differential, the implied primary level would be initially huge. For example, for a country with a debt-to-GDP ratio of 150 per cent and facing a growth-adjusted interest rate of 300 basis points, the new debt rule requires an initial primary surplus of 9 per cent of GDP. Third, and this is my main problem, the targeted decline in debt is unadjusted for cyclical factors, which is inconsistent with the attention to cyclical considerations underscored in the paper. Moreover, I do not understand the explanation given in the paper for this shortcoming, namely that there are no good ways to cyclically adjust the debt ratio. Well it may be difficult but is not impossible. The U.K. Treasury did it: it is basically enough to find a year, far back in time, when the cyclically adjusted and the headline debt ratio could be regarded as close. Moreover, and more importantly, here the issue is to cyclically adjust not the level of the ratio but the change in the debt ratio, which depends primarily (although not exclusively) on the deficit which can be easily cyclically adjusted. The debt stock also enters the formula but it can be shown that only very large mistakes in assessing the initial level of the debt ratio would affect the results. It is therefore much worse to disregard this issue altogether than to have a less-than-perfect treatment.

Also on the corrective harm, it is not clear what the Commission intends to do regarding systemic pension reform that affect the intertemporal distribution of pension deficits, for example the creation or the elimination of a fully-funded component. This is a key issue at the moment and we have recently published a paper to discuss possible solutions to this problem.[2]

[2] See *A Fiscal Indicator for Assessing First and Second Pillar Pension Reforms*, by Mauricio Soto, Benedict Clements, and Frank Eich. Available in http://www.imf.org/external/pubs/ft/sdn/2011/sdn1109.pdf.

But these are relatively technical points. The two key issues that have weakened the SGP are:

- First, that the enforcement of the SGP has been subject to political capture by the Council. This by the way led the Commission to adopt a legalistic approach to fiscal surveillance narrowly focused on fiscal deficit numbers. Economic judgment was often left aside by fear of a clash with the Council, a fact that is implicitly acknowledged by the authors when they argue that surveillance was incomplete. And a fact that explains why the new SGP involves more parameters than the old (for example a numerical target for the decline in the debt ratio), thus adding complication.
- The second is the absence of crisis management and resolution capabilities: even the safest buildings and aircrafts have emergency exits... but not the SGP. This issue is not really discussed at length in the paper.

We know that reforms have been implemented to address these issues. But how effective are they?

Here my main concern relates to the enforcement mechanism. It is clear that the key issue is the role of the Council. The reverse majority rule is one interesting approach but it is not extended to all decisions taken by the Council, in particular to the critical decision to place a country under Excessive Deficit Procedure (EDP). So the decision to start the EDP itself would still be governed by the old qualified majority process. Altogether, it remains to be seen whether the implementation of the SGP – including of the critical parts that have not been reformed – will in the future be more effective than in the past.

COMMENTS ON SESSION 2
FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

Vítor Gaspar[*]

Discussion of "Bond Yield Spreads and Numerical Fiscal Rules at the National Level" by Anna Iara and Guntram B. Wolff, and of "Crisis Prevention, Crisis Management and Sovereign Debt Restructuring" by Werner Ebert and Christian Kastrop

The economic constitution of the euro area assumes that macroeconomic stability is a necessary condition for sustainable growth and employment creation. For most advanced economies public finances are threatened by long run developments, associated with the demographic transition and the prospect of population declining. The global crisis and the policy response it entailed led to an immediate accumulation of public debt to unprecedented levels in peace time. In this context fundamental fault lines in the Maastricht architecture were revealed. Specifically, Maastricht rested on three key features: first, fiscal sovereignty; second, the impossibility of sovereign default; third, the absence of a crisis management mechanism. Unfortunately, once the second element is questioned the full triangle falls apart: national sovereignty, no bail out and no default cannot simultaneously hold up under stress.

At the time of the Public Finance Workshop (31 March-2 April, 2011) sovereign risk was a salient feature of euro area bond markets, dominating everything else in the cases of Greece, Ireland and Portugal. The rules and procedures for budgetary discipline in the euro area, agreed at and after Maastricht, aimed at supplementing market discipline. The Delors Report famously stated that market discipline could not be fully relied upon because it was likely to be too slow and weak (in tranquil times) and too sudden and disruptive (under stress). A chart displaying bond yield differentials, for euro area sovereigns, during the last decade one illustrates the empirical phenomenon that the rules and procedures in place were designed to avoid. The failure of governance in the euro area is, therefore, undeniable.

Relevant policy questions include:

- Will the euro area and its Member States successfully overcome the crisis?
- Will rules and procedures in the euro area deliver sound fiscal policies in all Member States?
- Will it prove possible to reconcile financial integration and financial stability?

These questions imply looking at:

- National frameworks for budgetary discipline and financial stability;
- European rules, procedures and organizations involved in crisis prevention; and
- International and inter-governmental mechanisms for crisis management and resolution.

The presentations by Anna Iara and Christian Kastrop address fundamental aspects of these issues.

The paper by Iara and Wolff brings new evidence to bear on the European Commission's traditional view that numerical fiscal rules are instrumental for achieving sound budgetary outturns (see, for example, European Commission, 2006). The new twist, explored by Iara and Wolff, is to look at the question of how have numerical fiscal rules influenced the evolution of sovereign debt yields? Given the central role of bond yields and bond yield differentials in the context of the

[*] Banco de Portugal.

sovereign debt crisis in the euro area, the policy relevance of the question does not require further elaboration.

The authors rely on a wonderful database on national fiscal governance compiled and made available by DG-ECFIN (European Commission).[1]

Iara and Wolff conclude that national numerical rules matter and that they have a significant quantitative impact. Specifically they find that the effect can be up to 100 basis points on sovereign yield differentials, in periods of elevated risk and risk aversion. As already said, the research is perfectly timed and it is highly relevant from a policy viewpoint. The results are totally in line with my prior opinions. In other words, the authors' findings are in line with my prejudices.

The interpretation of the empirical results is, however, difficult. The difficulty comes from joint endogeneity. To be concrete, consider the following two questions:

- Do markets assess the authorities' commitment to budgetary solvency on the basis of numerical fiscal rules?
- Does market credibility reflect some other institutional and political fundamentals that correlate with the existence of numerical fiscal rules?

The point is that if a country is serious about budgetary discipline, and, in particular, about budgetary adjustment and consolidation, it will set itself numerical budgetary targets. However, in the absence of such serious commitment, the setting of targets *per se* is unlikely to help very much. The identification of the effect of numerical fiscal rules requires the control of all other possible influences. The attempt to control for these effects requires that the possibility of endogeneity be considered when choosing the estimation method. Equally important, the results will depend on the information set used (as relevant control variables). It is very hard to draw a complete list. It would suggest that a natural starting point would be a list of determinants of systemic risk.

In the end, I think that the authors already contribute significantly to a central and timely policy debate. I am looking forward to further progress in their important research.

The focus of Werner Ebert and Christian Kastrop is even broader. Their presentation provides a critical overview of the comprehensive package of legislative initiatives, laying the foundations for the new architecture for fiscal and financial stability in the euro area. The relevance of their question cannot be overstated. The task of building new foundations for lasting stability while the crisis is ongoing makes Otto Neurath's image apt (paraphrasing): it is like rebuilding a boat, on the open sea, while floating on it. Ebert and Kastrop argue that the proposals on the table constitute significant improvements on the current framework. I agree. They also ask whether the next version of the Stability and Growth Pact (they label it SGP 3.0), as complemented by the European Stability Mechanism and Financial Market regulation and supervision is up to the task of preventing and managing systemic financial risk in the euro area. They also comment on broader issues at European and global level but I will not consider these aspects in my comments.

My own thinking on these issues has been influenced by Jean Tirole (2010). One of his punch lines is: "Crisis resolution is never pretty. The choice is between the bad and the ugly." Avoiding such unpalatable trade-offs requires careful institutional design *ex ante.* Unfortunately it is the case that political rewards associated with careful long term institutional design are meagre. If this is true it follows that some of the main difficulties are political. It may, however, be the case that in order to make it possible to sustain official creditors' involvement in current crisis management, a fundamental redesign of the overall framework is necessary.

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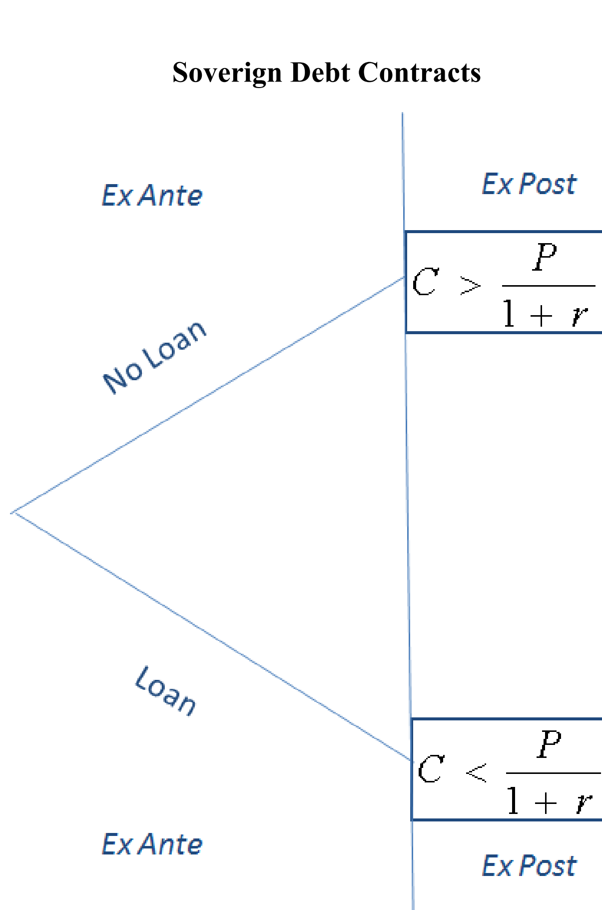
[1] The database is available at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

Figure 1

Sovereign Debt Contracts



Following Jean Tirole, it is natural to start by looking at a loan contract. The enforcement of a standard loan contract between private entities is relatively straightforward. Often private lending relations involve the pledging of collateral. If the borrower defaults it is then relatively straightforward for the lender to obtain control over the agreed collateral. Enforcement, if necessary, is ensured through the national court system. Irrespective the pledging of collateral defaults in advanced economies are regulated by bankruptcy law. In some countries the specificities of these cases are recognized as justifying the organization of special bankruptcy courts.

Interestingly this leads us to a major difficulty in the area of sovereign debt. Sovereignty gives to each country supreme legal authority within its borders. Sovereignty implies that foreign governments cannot impose the fulfillment of contractual obligations, within the boundaries of a state, without the collaboration of the relevant national authorities. In particular, sovereignty denies creditors the right to exercise their rights, inside national borders, by, for example, seizing assets or interfering with revenue flows. This leads to two related questions:

- How do lenders induce the sovereign ever to repay?
- How is it possible that sovereign borrowers can tap substantial amounts of funds?

Let us consider a very simple framework, used by Schulz and Weingast (2003) – see Figure 1. Assume that in case of no-repayment the sovereign incurs a penalty, P (we disregard for the time being what such a penalty may be). If we further assume a one-shot credit relation, it must be the case that a rational sovereign will repay if the penalty exceeds the principal plus interest [$C(1+r)$]. Otherwise the sovereign will default.

Our question above suggests that it is up to the creditors to devise a penalty that will induce the sovereign to repay. However, assuming that there is competition in the credit market and that alternative opportunities for investment exist, the opposite is true. The problem of devising an appropriate penalty is the sovereign's. In its absence the sovereign does not have a commitment mechanism and, therefore, no credit will be granted. The stronger the penalty, the more effective the commitment mechanism, the greater the sovereign's borrowing limit. In the extreme case where the penalty is zero, no rational sovereign will ever repay a loan, and no rational lender will ever

Figure 2

Debt Adjustment and Private Sector Involvement

"Ex Ante"
"Ex Post"
Future
Borrowing
Interim
Liquidity Shock
Solvency Concerns
Interim
Future payoffs
What about policies?
Transparency
Monitoring
Solvency requirements
Liquidity requirements
Covenants
Liquidity provision
Macro-adjustment conditionality
Incentive structure
Debt restructuring (PSI)
The end game provides incentives at all stages – backward induction

provide one. This explains the fundamental insight emphasized by Jean Tirole: institutions are about making credible to investors that they will recover their investment (in addition to a competitive return). In these conditions it is borrowers who benefit from investors' protection. Investor protection allows borrowers to access financing in competitive terms. Otherwise financing will not be available.

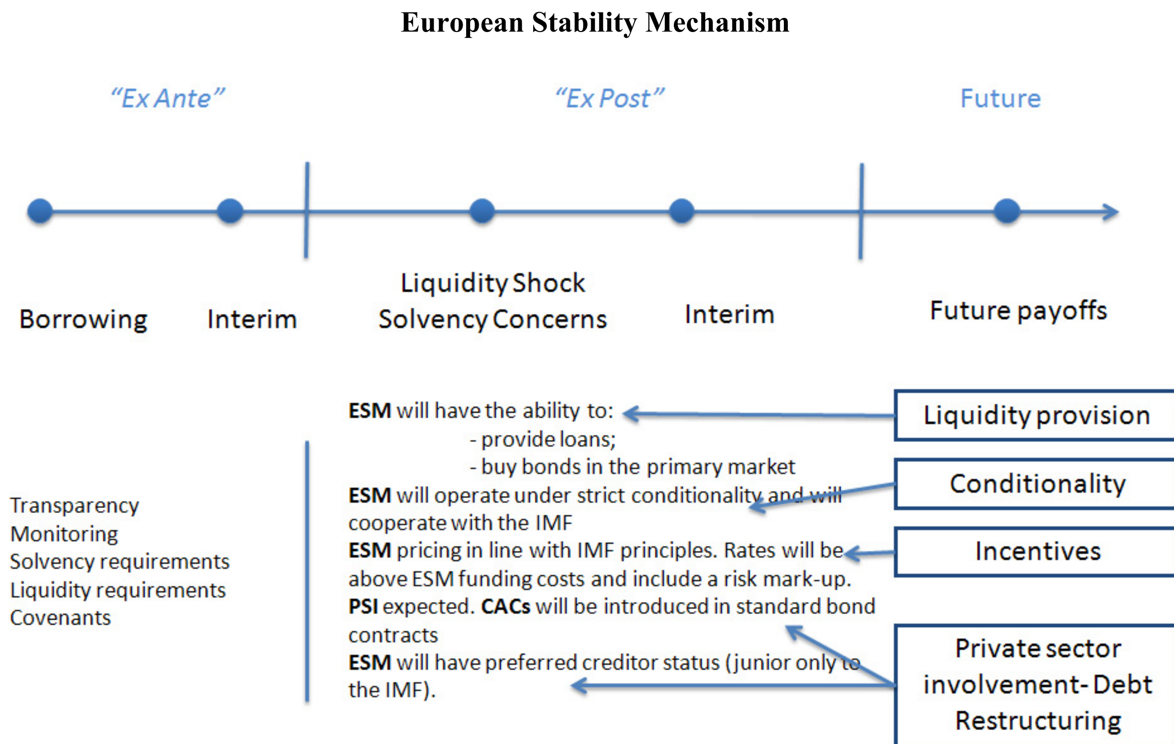
Figure 1 illustrates a number of important points. Let us focus on only two. First, in order to be able to understand a credit relation it is necessary to think about the end game and to work out the implications for credit transactions by backward induction. Second, the architecture of Maastricht, assuming national competence for budgetary policy, no crisis management mechanism and the impossibility of sovereign default is inconsistent. The potential for inconsistency to create havoc is unleashed as soon as the risk of sovereign default becomes a salient driver of trends in bond markets. Even a superficial and sloppy examination of developments in bond markets, since the beginning of 2010 (and even earlier), leads to the conclusion that this is the case.

Figures 2 and 3 are inspired by a diagram from Tirole (2010).[2] My reading of Jean Tirole suggests that, despite important differences, there are a number of important common features and policy principles that apply similarly in the case the borrower is a country or a systemically important bank. The sequencing in Figure 2 is straightforward. *Ex ante* borrowing occurs. In the contract stage it is possible to agree on debt covenants, including liquidity and solvency requirements and also to specify transparency requirements, in order to facilitate monitoring. After the *ex ante* stage a disturbance may occur that signals potential liquidity or solvency problems. For substantial disturbances liquidity and solvency become dominant concerns triggering a crisis. Under these conditions it is necessary to enter crisis management and resolution mode, including macroeconomic adjustment, liquidity provision, financial support, debt restructuring and private

[2] Many versions of the diagram are included in Tirole (2006).

Figure 3

European Stability Mechanism



sector involvement. As in Figure 1, only the specification of the end game allows one to work out whether a credit relation is viable (and on what conditions).

Figure 3 makes it clear that the European Stability Mechanism addresses the standard questions raised in mechanism design. First, the ESM is able to deal with liquidity shortages. The ESM has the ability to provide loans and to buy bonds in the primary market. Second, the ESM will operate under strict conditionality and will cooperate with the IMF. Therefore the requirements for macroeconomic adjustment will be in line with standard IMF practices. The disbursement of financial assistance in tranches provides incentives for the country to comply with conditionality. Third, the pricing of loans by the ESM will also follow standard IMF practices. Rates will be above the ESM funding costs and will include a mark-up. The second and third elements aim at controlling sovereign moral hazard. Fourth, ESM financing decisions will be based on a judgment on whether the sovereign is facing a problem of liquidity or a problem of solvency. If, according to the best judgment possible, based on preparatory work by the European Commission (in a procedure involving the European Central Bank) and the IMF, the problem is of liquidity, the government of the country concerned will be asked to endeavor to obtain commitments by private creditors that they will not diminish financing amounts outstanding. In contrast, in case of solvency problems, orderly private sector involvement is called for. Losses to private creditors provide incentives for proper monitoring on the lenders' part. Fifth, the ESM will enjoy preferred creditor status (junior only to the IMF). Preferred creditor status on the past of official creditors matches private sector involvement. In the Conclusions of the March European Council, private sector involvement is to be considered on a case-by-case basis. Such an approach may be called a contractual approach.

I think it is fair to say that the European political system delivered answers to key policy questions. It did address head-on the inconsistent trilogy underlying the Maastricht architecture.

However the question: “Are the answers any good?” remains relevant. Ebert and Kastrop argue that an overall systemic approach would be called for. In such an approach, the excessive deficit procedure, the excessive imbalances procedure, systemic risk, regulation and supervision of financial markets and organizations and crisis management would be much more than mere complements – they would be designed as integral parts of the same framework. Clearly, in this context, the interdependence between the domestic banking system and the general government finances is a major source of macro-systemic risk. The authors’ point is very well taken, though, I think, the presentation is lacking in details.

There are two points that I think can be elaborated further. Both explore parallels and differences between private and sovereign bankruptcy. In the early 2000s, the IMF (IMF, 2002 and 2003 and Krueger, 2002) proposed the creation of an international bankruptcy procedure for sovereigns. The starting point is to start from laws, regulations and practices for corporate reorganization. The reason is that liquidation of a sovereign state cannot be foreseen from a legal point of view. Sovereign default is fundamentally different from corporate default, on three accounts:

First, there is no legal code (in domestic law) foreseeing liquidation of sovereigns debtors. Corporate recovery proceedings take place under the shadow of possible liquidation. There is no international recognized process for handling sovereign defaults or restructuring operations.

Second, the concept of sovereign immunity protects the sovereign’s assets even if held outside the territory.

Third, the idea of reorganization proceedings is to maximize the value of the firm as a going concern. That may entail transfer of control to creditors through debt-equity swaps. No such a mechanism is available for sovereigns.

Nevertheless it may be useful to look carefully at a well ordered corporate reorganization procedure. It involves mainly four features:

- First, a stay on creditor enforcement pending the negotiations – to preserve the value of the firm as a going concern and to solve creditors collective action problems.
- Second, provisions protecting creditors during the stay.
- Third, mechanisms facilitating new financing during the proceedings – seniority clauses for new financing.
- Fourth, Provisions binding all creditors to an agreement acceptable to some well-defined majority.

The two points I want to stress are as follows. First, the combination of an announcement that no debt issued before 2013 would be restructured and that private sector involvement would be sought after that date violates principle 3 for a well-ordered scheme and makes market access difficult for countries under an adjustment program (or countries that may fall under such program). Clearly access to fresh market financing is difficult to make compatible with the possibility of sovereign default, uncertainty about the implications of such an event, sizable official support and seniority of official financing. It is difficult to imagine a rational investor engaging in such a game. Second, there are reasons to believe that given potential systemic implications from sovereign restructuring and other complications it is highly uncertain that a contractual case-by-case approach will be enough to anchor expectations about the end game. Neurath’s boat applies.

As I have argued in the discussion, open questions going forward include at least the following:

- Will the emerging permanent architecture prove effective and enduring? Will it make sovereign debt crisis less likely? Will it help contain systemic and contagion effects in the event of a crisis?
- Will it facilitate adjustment and contain financial stability spillovers in the context of the current crisis?
- Will the process lead to sound, prudent and robust national budgetary frameworks in all Member States?
- Will politics in Europe deliver this time?

Positive answers should underpin the success of the euro area going forward. It was very fortunate for me to be asked to comment on two papers that motivate such a comprehensive reflection on the governance of the euro area for macroeconomic and financial stability.

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COMMENTS ON SESSION 2
FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

Philipp C. Rother[*]

Discussion of "The Importance of Fiscal Policy Frameworks – Swedish Experience of the Crisis" by Robert Boije and Albin Kainelainen (Ministry of Finance, Sweden), "Implementing Germany's New Constitutional Fiscal Rules" by Jürgen Hamker (Bundesbank) and "Fiscal Performance and Decentralisation in European Union Countries" by Julio Escolano, Luc Eyraud, Marialuz Moreno Badia, Juliane Sarnes and Anita Tuladhar (IMF)

The three papers share a favourable characteristic, which is that they are well-written and highly informative for the discussion of the importance of fiscal rules for fiscal performance at the national level. The following discussion is structured by three questions that are addressed in the papers: What can fiscal policies do? How can fiscal rules help? What can we learn for other countries?

What can fiscal policies do?

Looking at the first question, history provides interesting examples of how the correction of fiscal imbalances can contribute to macroeconomic stabilisation. For 1993, fiscal data for Sweden point to severe imbalances. The deficit ratio amounted to 11.2 per cent of GDP, the expenditure ratio was close to 20 percentage points of GDP above the average of the current euro area countries and the debt ratio had risen by almost 39 percentage points of GDP over the preceding three years. This had happened in an adverse economic environment of a financial crisis requiring substantial government intervention in the financial sector and with real GDP contracting by more than 4 per cent over the same period. According to these parameters, the situation in Sweden in 1993 was not much different from that of today's crisis countries in the euro area.

A look at the current situation in Sweden shows how much appropriate fiscal policies, in combination with wide ranging structural and institutional reforms, can achieve. According to the European Commission Spring 2011 forecast, Sweden will be the only EU country showing a fiscal surplus (excluding one-off measures) and rank fifth in terms of its debt ratio. It achieved primary fiscal surpluses in excess of 5 per cent of GDP over the period 1997-2001. These remarkable achievements rest on the foundation of a sound and comprehensive set of fiscal rules that is constantly being adapted.

How can national fiscal rules help?

The paper by Boije and Kainelainen provides and excellent overview of the beneficial impact that sound and well-implemented fiscal rules can have on the fiscal situation. In this regard, three elements appear of particular importance.

- First, such rules can ensure the conduct of sound fiscal policies in economic good times, leading to a safer starting position in terms of fiscal balance and debt when the economic cycle turns. And, indeed, the recent crisis has shown that many of the fiscal problems were caused not only by the sharp downturn of fiscal balances in response to the economic and financial crisis, but importantly also by weak fiscal positions at the start of the crisis, reflecting inappropriate policies during the preceding boom. Somewhat differently from the paper, I would not see a major impact of fiscal rules on the performance of public finances during the crisis. The data

[*] European Central Bank.

suggest that the existence of fiscal rules does not explain to a major extent differences in the increases in deficits in the crisis. Moreover, it should be noted that several countries effectively suspended (parts of) their fiscal rules during the crisis to give government more flexibility to react on the crisis.

- Second, appropriate rules instil a political cost for policy makers planning to deviate from the given guidance. In this regard, while the paper clearly lays out the implications of Sweden's rules-based framework for the considerations of decision makers, it would be interesting to learn more about the reasoning behind the envisaged greater formalisation of the rules. Intuitively, while a greater formalisation of fiscal rules (e.g., putting them in the constitution instead of in conventional laws; setting up legally binding sanctions) should be expected to ensure greater compliance, experience suggests that some of the countries with successful fiscal rules had a framework of a relatively vague and legally non-binding nature.
- Third, and in my view importantly, transparent rules invite outside scrutiny of the government's behaviour. While this additional effect may be relatively small in countries where transparency of the public accounts is well enshrined, the effect may indeed be quite important where this is not the case. Eventually, policy makers can be held to account only if there is transparent information on the costs and benefits of their actions complementing fiscal rules with accounting and reporting obligations, possibly combined with independent monitoring agencies.

One question arising from this paper is whether fiscal rules should stay unchanged over time or whether they need to be adapted on an ongoing basis. The experience described in the paper suggests in the case of Sweden a constant adaptation of the rules was useful and perhaps even necessary to ensure their effectiveness. Further research could investigate if these ongoing changes reflect a process of convergence towards an optimal set of rules or if a constant evolution of rules is a necessary ingredient for a successful rules-based fiscal framework.

What can we learn for other countries?

The paper by Hamker may serve as a very detailed and comprehensive reminder that even when fiscal rules are established with the best intentions and with broad political support loopholes will always remain and risk to be exploited. Overall, the paper gives a wide-ranging overview of the new set of fiscal rules in Germany, which are enshrined in the constitution and apply at the federal as well as the state level. It is indeed most interesting to read about all the possible ways to circumvent the spirit of the rules while remaining nominally in compliance. Of note, such manoeuvring will most likely generally precede any outright violation of the rules, which can eventually not completely be ruled out.

These considerations lend support to one of the key findings of the fiscal rules literature that is also reflected in the paper by Boije and Kainelainen: to be of value, fiscal rules need to be simple enough to allow the general public (including the media) real time monitoring of the government's performance relative to the rules. Given that enforcement of the rules via the legal channel is generally difficult and certainly in most countries very time-consuming, an immediate sanction for divergent government behaviour can most likely come only via public opinion. In this regard, a possible lesson from the German approach is that setting up an effective framework may be more difficult the more dispersed is the implementation of fiscal policies across different layers of government.

With regard to learning from country experiences, in particular regarding the impact of expenditure decentralization to lower levels of government, the paper by Escolano *et al.* provides further food for thought. Based on an empirical analysis for the EU member states, the paper finds that (i) a higher share of spending decentralisation is associated with higher general government primary balances whereas revenue decentralisation has a negative impact on general government fiscal positions; (ii) higher transfer dependency tends to reduce the positive effect of expenditure

decentralisation (interaction term) and (iii) neither the central government fiscal rules index nor the subnational fiscal rules index have a statistically significant effect on the primary balance whereas a higher score in the overall rules index tends to improve the primary balance.

These results suggest that fiscal rules at the subnational level seem to contribute little to overall fiscal performance, while the arrangements on the (non-) devolution of revenues and expenditures play an important role. Looking ahead, the paper interprets the findings as pointing to an unsustainable trend in fiscal decentralisation as the transfer of expenditure obligations without commensurate revenue sources will hit limits.

From an econometric angle some issues could be addressed in more detail in the paper. Most notably, the issue of endogeneity and possible reverse causality in the regression would deserve some attention. Governments with strong fiscal positions may find it easier to devolve expenditure to lower levels of government which could enable them to cater better for local preferences. Thus, the strength of the general government fiscal position would drive the amount of expenditure decentralisation and not vice versa as conjectured in the paper. More on the technical side, the coefficient on the interaction term of spending decentralisation with transfer dependency, while statistically significant, appears to be very small. Here, an economic interpretation of the size of the impact of the coefficient on overall fiscal outcomes would be useful.

From a policy perspective, the results seem to support the old wisdom of "divide and rule": with expenditure devolution, a strong central finance minister faces a potentially wide range of spending ministers who may find it difficult to form coalitions among themselves and thus have relatively weak negotiating power. In such an environment, rules at the subnational level may indeed be unnecessary. In this regard, an interesting direction for further research could be the question to what extent revenue devolution combined with encouraging tax competition at the subnational level could bring further economic benefits. After all, regional and local authorities could compete with each other not only with respect to expenditure policies but also with regard to taxation with a possibly overall beneficial effect on the economy.