THE GOOD, THE BAD AND THE UGLY:
STRENGHTS AND WEAKNESSES OF THE NEW EUROPEAN FISCAL FRAMEWORK

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Under substantial market pressure, policymakers have proposed a diverse set of far-reaching changes to the basic European fiscal architecture. The adoption of the so called "Six-pack", "Two-pack" and the agreement on the Fiscal Compact made the fiscal framework more complex, but the proponents highlighted their main benefits in higher transparency at national level, more local ownership and stricter enforcement mechanisms. This paper´s objective is to critically assess the new framework, its initial implementation and to identify potential shortcomings. The well-known Kopits-Symansky criteria represent the basis for the review. We also formulate fifteen recommendations, which aim at a simpler, more internally consistent system where flexible interpretation is not necessary to eliminate tensions between various elements of the framework.

1 Introduction

"A camel is a horse designed by a committee"

Alec Issigonis

If one looks at the current fiscal framework in Europe, path dependency is visible at first sight. Many incremental changes over the last almost two decades have resulted in a very complex web of rules, procedures and surveillance mechanisms, which can be meaningfully described only on more than one hundred pages.[1] In comparison, the fiscal framework in the United States (and many other existing federations) is much simpler. We argue that this complexity is a price paid for the low credibility of the no-bail-out clause in the European Treaty. In addition to that, changes adopted very quickly under the pressure of financial markets made the system even harder to understand for the general public.

This paper looks at the current European fiscal architecture not primarily from the point of view of its historical evolution, but rather through the lens of a well-established set of criteria for fiscal rules. The Kopits-Symansky[2] criteria are useful in identifying the main strengths and weaknesses of the framework. As a second test, we have decided to draw tentative conclusions based on available empirical evidence. In our view, despite the fact, that many of the major changes have been legislated only recently, it is useful to evaluate the new architecture not only from theoretical but also from practical point of view.

There have been several changes to the system which clearly go in the right direction ("the good"). The main advantages of the new framework are in the recognition that synergies between fiscal rules and independent fiscal institutions (IFIs) can be more effective in eliminating the deficit

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[1] European Commission (2013).

[2] Kopits and Symansky (1998).

bias. It is possible to have a more complex set of rules, if there is a trusted and independent entity to check the compliance with them. Among the good features one should mention also more weight put on stock variables (debt). Last but not least, more automatic enforcement mechanisms and higher transparency at the national level are further key improvements.

The "ugly" part of the current architecture is the overregulation in terms of fiscal rules. Six – sometimes inconsistent – rules are more than the usual case in well-functioning federations. One can also mention the numerical benchmark for changes in the structural balance (deviation from the medium-term objective – MTO), which is while theoretically sound, empirically extremely hard to evaluate in real-time. Two different evaluations of deviations from MTO (one by the Commission and one by the local independent fiscal institution)3 can create confusion and might complicate the communication of basic messages to policy makers and the general public.

The paper identifies also several shortcomings ("the bad"). Inconsistencies within the SGP and between the Pact and the Fiscal Compact are the most serious ones. There is also a motivation to adopt one-off and temporary measures in order to end the Excessive Deficit Procedure (EDP), since the underlying fiscal position plays no role in the decision of the Council. The definition of the structural balance is another problem both because of the narrow concept of the output gap (for example no role for absorption or financial cycles) and because of the lack of clear and consistent definition of one-offs and temporary measures. Introduction of the so called "investment clause" and the very benevolent implementation of the new rules in 2013 have been identified as another weakness.

Based on the critical assessment, the paper offers fifteen recommendations for further improvements. Among the main proposals one can mention a) the abolishment of the expenditure benchmark and the investment clause, b) the utilization of synergies between the SGP, Macroeconomic Imbalance Procedure (MIP) and crisis resolution mechanisms, c) the improvement of the definition of one-offs, d) the widening of the mandate of IFIs and e) the use of structural budget balance estimates when ending the EDP.

The paper is organized as follows. The second section describes the main features of the new fiscal architecture in Europe. The third section evaluates the system through the lens of the Kopits-Symansky criteria. Section 4 deals with implementation issues, while Section 5 offers an overall assessment and recommendations for further improvements. Section 6 concludes.

2 The new European fiscal framework

In this section we briefly describe the original set-up and the main changes recently legislated to the European fiscal framework. Important innovations were adopted in all three main parts of the system: numerical fiscal rules, transparency requirements and institutional set-up.[4]

When setting up a fiscal framework one should take into account many important aspects, however one trade-off stands out as the most critical one: flexibility versus credibility. Usually the practical implementation of enforcement mechanisms is a litmus test in this regard. If the rules are strong only "on paper", they would gradually lose their credibility. On the other hand, strong enforcement of a very rigid rule would lose public backing. The problem can be rephrased also in the general context of the "rules" versus "discretion" debate. Originally, policymakers in the EU

[3] The EC will act based on the Stability and Growth Pact, while the local IFI will follow domestic rules (transposition of the Fiscal Compact). Since output gap is unobservable and model dependent, it is likely that the two estimates of structural budget balances will differ.

[4] Including procedures and surveillance mechanisms.

opted for a collegiate decision-making among peers rather than for a (quasi-)automatic implementation of the rules. As the events in 2003 clearly showed, when countries both judge and are being judged, it is almost impossible to fine big countries (given the distribution of voting rights). The result was that the rules were eroded and the implementation de facto gradually moved away from rules towards discretion. What we see now is a step back towards less discretion and more rules. However, as Wendorff (2014) argues, a very complex set of rules with many exemptions and exceptions might paradoxically mean *more* room for discretion. According to Wendorff, in that case "the rule becomes a bargaining process." This is dangerous in a monetary union, since negotiations behind closed doors to affect outcomes can easily undermine the credibility of the framework in the eyes of financial markets.

The original architecture of the European Monetary Union rested on three main pillars. First, the ECB was established as an independent monetary authority with clear focus on a union as a whole. Second, the Treaty included a no-bail-out clause to avoid free-riding behavior and possible negative spillovers. Third, this objective was strengthened by fiscal rules via the adoption of the Stability and Growth Pact (SGP) to avoid gross policy errors. Clearly, these safeguards failed to ensure sound public finances mainly in good times[5] and were not credible in the eyes of financial markets.[6] The set-up was not better outside the fiscal arena. As Quaden, Smets and Langenus (2013) show there was only very soft coordination of macroeconomic policies and a coherent framework was lacking also as far as banking supervision is concerned. The ECB was not designed to be the real lender of last resort. The initial assumption was that endogenous convergence inside a monetary union together with market-discipline will do the job.

The European debt crisis quickly uncovered the major shortcomings of the initial set-up and put enormous pressure on policymakers to adopt changes to restore the credibility of the single currency. Since the no-bail-out clause was viewed by financial markets from the beginning as not credible (and the crisis proved them right)[7] and the ECB was reluctant to step in without safeguards, the only possibility was to adopt *more* fiscal rules and to *promise* stricter enforcement in the future. The final result is depicted on Figure 1.

Three important pieces of legislation were gradually implemented. The adopted "Six-pack"[8] and "Two-pack" added additional layers of complexity to the SGP. The stated objective was to make the European rules "smarter" and more credible. Moreover, an intergovernmental treaty (TSCG)[9] was signed among members of the European Union,[10] which was necessary for the ECB to launch its OMT program to finally calm down financial markets.[11] There is a fundamental difference between the TSCG and the changes in the SGP, since the former is not part of the EU setting. Even though there is some convergence in content, important differences exist between the two. A good example is the inclusion of the European Court of Justice, a new "guardian" of implementation, which may not necessarily have the best possible expertise to judge these matters.

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5 Calmfors (2005).

6 Altough, one can argue that low spreads in the boom phase could also reflect mispriced risk.

7 We clearly regard activities of the EFSF as de facto bailouts, even if some argue that there were no bailouts de jure (but only official loans).

8 All important legislation can be found through this link:
http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm

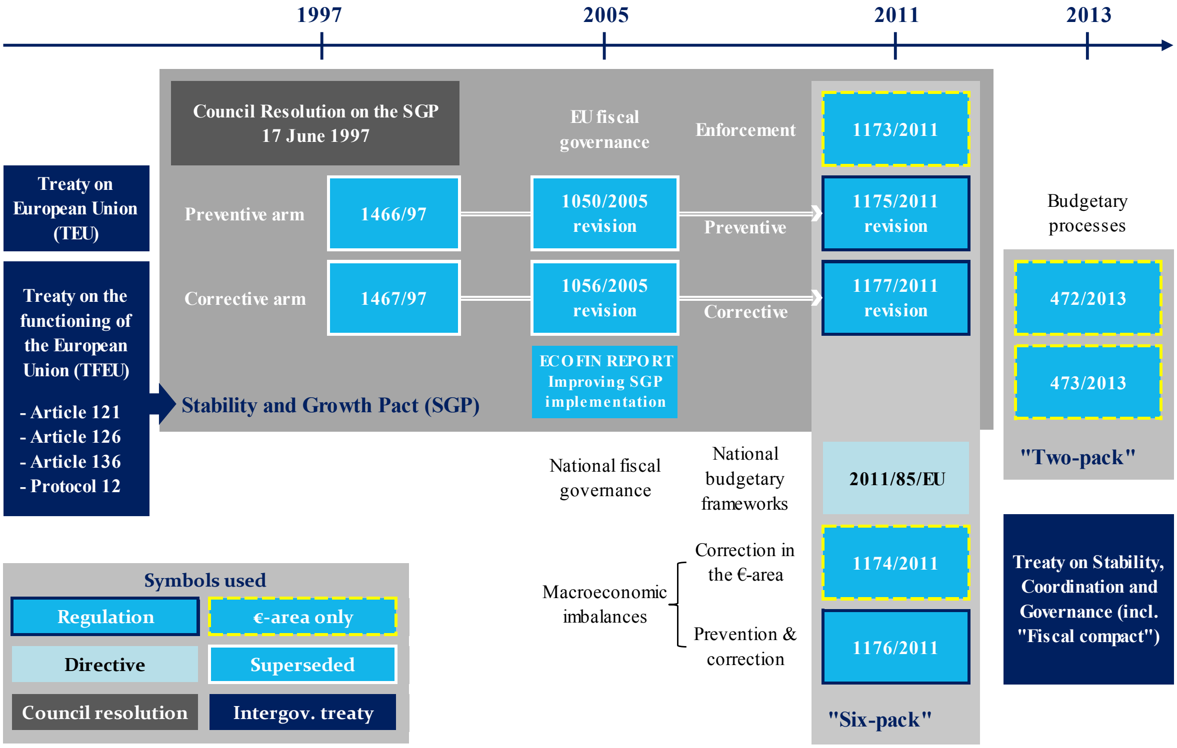
9 Treaty on Stability, Coordination and Governance (the part on stability is the so called Fiscal Compact).

10 With the exception of the UK and Czech Republic.

11 Draghi (2011).

Figure 1

The Evolution of the European Fiscal Architecture



Source: Adaptation from EC (2013).

Here we briefly describe several important features of the new Stability and Growth Pact.[12] First, not only fiscal developments but also macroeconomic imbalances are now monitored based on the new Six-pack. Second, the importance of national budgetary frameworks is recognized through the adoption of the Directive 2011/85 on requirements for budgetary frameworks of the Member States. Third, the Two-pack delegates more power to the center to control the budgets of individual Member States. Fourth, there is now a possibility to impose sanctions in the preventive arm of the Pact and finally, there was a shift in power from the Council to the European Commission via the reverse qualified majority voting.

2.1 *Numerical fiscal rules*

Compared to the usual case in existing federations (Allard *et al.*, 2013) the number of numerical fiscal rules in Europe is significantly higher. Federations employ two constraints on average, while the euro area has six. Of course Europe is not a conventional federal structure, but simplifications seem to be possible. The EMU has a following set of numerical fiscal rules:[13]

- excessive deficit – actual deficit over 3 per cent of GDP;
- excessive debt – actual debt over 60 per cent of GDP;

[12] Detailed description is available in EC (2013).

[13] In order to concentrate on the big picture, all rules are presented here in a simplified form without all the ifs and buts.

- benchmark structural adjustment – 0.5 per cent of GDP;
- debt reduction rule – reduction of the excess over 60 per cent of GDP by one-twentieth a year
- medium term objective – close to balance in structural terms (structural deficit up to 0.5/1 per cent of GDP);
- expenditure benchmark – constraint on the real growth of adjusted expenditures.[14]

Moreover, there is a numerical definition of "significant deviation" from the MTO or the path towards it based on the evolution of the structural balance and the expenditure benchmark. To allow for more flexibility, two general escape clauses were defined. The first is related to "unusual event outside the control of the Member State", while the second to "severe economic downturn". Some form of flexibility is provided also with the so called "investment clause",[15] which allows back-loading of structural adjustments if certain criteria are met.

Apart from fiscal rules at the European level, according to the newly adopted Six-pack, Member States should have their own fiscal rules on a multi-annual horizon. The legislation also specifies that these should be monitored by functionally independent local bodies.

2.2 *Rules for transparency*

Information requirements for Member States have also increased with the reform of the fiscal architecture. The Directive on requirements for budgetary frameworks of the Member States put more emphasis on reporting tax expenditures, contingent liabilities, public corporations, capital injections and other extra-budgetary operations. The new framework addresses also the macroeconomic forecasts on which the budget figures are based. According to the Two-pack, independent fiscal institutions should produce or endorse these assumptions.

2.2 *Institutional set-up*

Significant changes have been carried out also in the institutional set-up. The role of the European Commission and independent fiscal institutions has increased considerably. The former now has the power to recommend adjustments in draft budgets of the Member States and its role in the EDP procedures has also strengthened. The latter are expected to be involved in the macroeconomic forecasting procedure and should also check the compliance with fiscal rules at the national level.

The shift of power towards technocratic bodies is a step in the right direction; however it also moves the political battlefield. More political pressure and lobbying are expected to influence the decision of the EC and since the abolishment of independent watchdogs is not an easy option anymore, one should expect greater political pressure in the selection of members of fiscal councils. In others words, more checks and balances might be necessary in the implementation phase. Possible options are: some form of involvement of IFIs in the SGP procedures or for example stricter professional requirements for candidates as far as the nomination of members of fiscal councils is concerned. We will elaborate more on the possible options for institutional set-up in Section 5.

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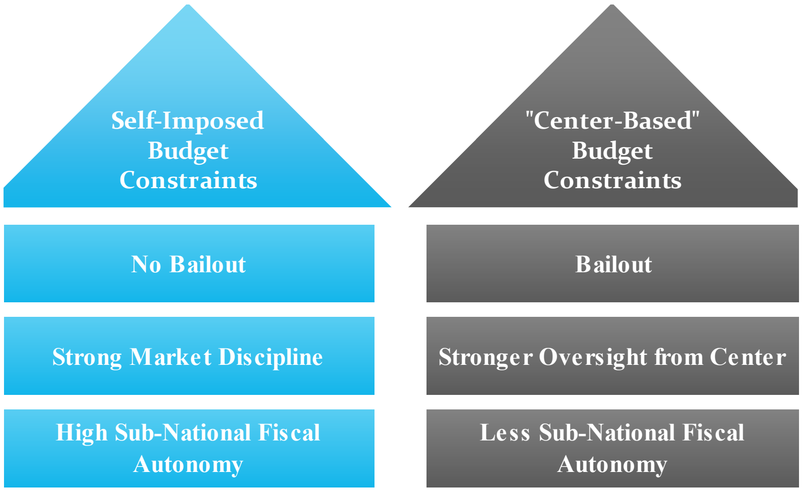
[14] The adjustment includes discretionary measures on the revenue side.

[15] The investment clause is not part of the new legislation, but rather the way the European Commission interprets minimum structural adjustments in the preventive arm of the Pact. In order to prioritise spending in investment - which support sustainable growth - the EC would "explore further ways within the preventive arm to accommodate investment programmes". Government investment in projects co-financed with the EU was decided to be eligible expenditure under this flexible interpretation.

Figure 2

Two Possible Arrangements of Fiscal Discipline



Source: Adapted from Allard *et al.* (2013).

3 Evaluation of the new fiscal framework

In this section we evaluate the European fiscal framework from two different angles. The first is a more general question of the relationship between the center and individual regions or states.[16] As we are going to argue, it is crucial to take into account these relationships when deciding about the fiscal architecture. The second aspect is the core of this paper – the evaluation of the framework compared to a benchmark represented by the Kopits-Symansky criteria.

3.1 Division of power

The usual theoretical argument to have strong fiscal frameworks is the well-known deficit bias. There could be several reasons for this bias (see Calmfors and Wren-Lewis, 2011 or Wren-Lewis, 2013), but the set-up of a monetary union is more complicated, since common-pool problems can arise not only for local reasons but also at the level of the whole union.

There are several ways, federations are dealing with this "common-pool squared" problem (Allard *et al.*, 2013, Wyplosz, 2013). One extreme is to rely on pure market discipline. In this case, there is no formal coordination mechanism, but a strict and credible no-bail-out principle at the central level. The deficit bias at the local level is then usually dealt with self-imposed fiscal rules or procedures. The US model is very close to this type of arrangement.

The second extreme is direct control by the center. The German set-up[17] can be reasonably well approximated by this model. In this case bail-out is not prohibited, but the free-riding is

[16] Here the center means federal level or in case of the European Union a supranational entity (*i.e.*, the European Commission).

[17] Or one can mention the new Spanish framework.

contained by heavy involvement of the center in local budgetary decisions through *ex ante* rules and procedures.

Despite current improvements, the problem of the European framework is that on the one hand pure market discipline is not credible and on the other hand substantial involvement of the center in national budget decisions are at odds with the national sovereignty principle guaranteed by the Treaty.[18] Therefore in the short run (when changes in the Treaty are not realistic) the only possibility was an overregulation with fiscal rules and stricter enforcement mechanisms (a move from a more market controlled regime toward more oversight from the center). In other words this is the price Europe had to pay for the non-credibility of the no-bail-out principle and the failure of the former SGP. If substantial changes to the Treaty are not possible in the longer-run, the pendulum will have to swing back toward more market discipline. In that case at least partial resuscitation of the no-bail-out clause (via private sector involvement, CACs, bail-ins or other mechanisms)[19] seems to be necessary for survival.

Now we turn to the evaluation of the European framework based on a set of well-established criteria.

3.2 The European framework an the Kopits-Symansky criteria

Kopits and Symansky (1998) defined a set of eight criteria to assess fiscal rules. Ideally, a fiscal rule should be well defined, transparent, adequate, consistent, simple, flexible, enforceable and efficient. Of course, since there are important trade-offs among these criteria, it is impossible to score high on all these aspects. The important point is to balance the fiscal rule along these characteristics to achieve the desired outcome. Kopits and Symansky do not attach weights to individual criteria; however one can argue that in case of a monetary union the flexibility vs. enforceability trade-off is the most important.

Table 1 represents the evaluation of the current European fiscal framework[20] based on these criteria.[21] The new framework is strong as far as transparency and flexibility is concerned, while it scored not very well on simplicity, enforceability and consistency. Weak links were identified also in the definition of some rules. The assessment was more neutral in case of adequacy and efficiency.

3.2.1 Transparency

One of the strengths of the European framework is transparency at the national level. New requirements to provide more detailed information in key budgetary documents and the establishment of independent fiscal institutions have helped to better assess the underlying fiscal position of individual Member States. Improved understanding of possible risks (public enterprises, contingent liabilities, etc.) and day-to-day analysis of budgetary developments at local level also have the potential to limit creative accounting practices in the future. Voters might also benefit from higher transparency, since it will be easier to distinguish bad luck from bad policy.

[18] According to Quaden, Smets and Langenus (2013), some weakening of the national sovereignity principle is already visible in the Two-pack: *ex ante* assessment of euro area countries´s annual budgets by the EC or for example the generalisation of the conditionality in the current troika programmes.

[19] Some of these mechanisms were used in the case of Greece and Cyprus, however they are not part of the framework yet.

[20] It is important to note that here we evaluate the whole fiscal framework and not just fiscal rules.

[21] Rather positive evaluation of the original SGP *vis-à-vis* the Kopits-Symansky criteria can be found in Buti and Giudice (2002).

Table 1

The European Fiscal Framework through the Lens of the Kopits-Symansky Criteria

Positive	Neutral	Negative
Transparency +	Adequacy	Simplicity – –
Flexibility +	Efficiency	Consistency –
		Definition –
		Enforceability –

Source: Author.

Important innovation is that the new SGP grants greater powers to Eurostat to audit statistics and the possibility of fines for statistical misreporting. After the experience with Greece, these measures are necessary not only from a transparency but also from a credibility point of view.

There are three countries (Ireland, UK and Slovakia), where detailed analysis of the inter-temporal public sector net worth by independent fiscal institutions contribute to an even more transparent presentation of fiscal accounts. Not only flows but also stocks are under better scrutiny. As Horváth and Ódor (2009) show regular balance sheet analysis not only improves transparency but can also mitigate bad incentives in fiscal policymaking.

On the other hand there are still some areas, where transparency can be improved (mainly at the EU level). If we focus on fiscal rules, the identification of one-offs is one of the most opaque procedures. Another area for greater transparency is the definition and calculation of discretionary revenue measures (DRM). In *ex ante* evaluations, the figures from the stability programs are taken into account, in *ex post* exercises it is not clear who should provide the relevant data. It is hard to imagine that the European Commission has the capacity, data and models to check all the discretionary revenue measures in all member states. Finally, the definitions of "good" and "bad" economic times are also very vague.

3.2.2 Flexibility

Fiscal rules should be flexible enough to accommodate significant shocks beyond the control of policy makers. There are several provisions in the new European fiscal framework, which serve this requirement relatively well.

More focus on structural budget balances via the SGP and the Fiscal Compact might give the authorities the needed flexibility in periods of normal business cycle fluctuations. On a top of that, there are two escape clauses to deal with "unusual events" and "severe economic downturns". Another innovation in the Fiscal Compact is that independent fiscal institutions should play an important role in triggering these escape clauses.

There is also a possibility in the preventive-arm of the SGP to take into account investment needs of the Member States. When assessing the compliance with minimum structural adjustment, countries can adjust their figures to co-financing of investments in projects financed by EU funds. However, there are at least two problems with this "investment clause". The first is that it creates inconsistency with the Fiscal Compact (there is no such provision there) and second, the calculation of the deduction in the first year makes no economic sense. From the *change* in the structural balance the *level* of co-financing is deducted. In other words, even countries with a year-on-year *reduction* of investments can benefit from this clause.

Greater flexibility can be found also as far as the evaluation of effective action is concerned. The EDP procedure is not stepped-up if the country delivered the required adjustment but the economy moved in the other direction. Three factors are taken into account: a) the impact of revisions to potential output (α), b) the impact of revisions to output composition and revenue windfalls/shortfalls (β) and c) impact of other unexpected events on the general government situation (γ).

It is worth noting that the risk of being too flexible should not be underestimated. Escape clauses and other provisions granting exceptions and exemptions should be applied in a consistent manner and only in well-defined circumstances. Otherwise too much flexibility can undermine the enforceability of the whole system. As Calmfors (2005) put it "rules that are not clearly defined or which are open to interpretation from time to time can never command legitimacy". Wendorff (2014) goes even further by describing European rules as: "there is an impression that they are designed with a search for exemptions in mind." We come back to a benevolent application of rules in the fourth section.

The degree of flexibility is also directly linked to simplicity via the "rules versus discretion" debate. If one wants high flexibility, but no discretion,[22] it is not possible to have simple rules. The fundamental problem lies in the difficulty to design rules to many possible states of the world. Unfortunately the current European framework is an attempt to achieve this very ambitious goal. In our view, at the end, either the high degree of flexibility or the national sovereignty principle has to be given up to have a fully functional and internally consistent system.

3.2.3 Enforceability

Enforceability of the SGP has been a weak point since its inception. The 2005 reform of the Pact was explicitly provoked by the lack of ability to enforce the rules when two big countries breached them. The recent amendments made significant changes with respect to enforceability. More automatic sanctions can help to increase compliance with fiscal rules. It is however important to note, that it is too early to assess the enforceability of the new SGP, since it was adopted only recently. Unfortunately, the first phase of implementation described in the next section raises some question marks regards enforceability.

We have identified two areas for future improvement. The first is that reverse qualified majority (RQMV) is still not the benchmark in many important decisions of the Council. For example qualified majority voting (QMV) is used when deciding about the existence of excessive deficits or in case of evaluation of non-effective action.[23] The second possibility for improvement is to impose more harsh sanctions in the preventive arm. The major failure of the SGP in the past was lax budgetary policy in good times. Moreover it is also less counter-productive and more credible if one imposes fines in good times rather than in recessions.

Kopits (2014) stresses that in order to have sufficiently enforceable rules; the authorities should have an operational target under their control. From this point of view the European framework is relatively weak. Although the Six-pack recommends some form of medium-run fiscal framework at local level, the requirement is rather general.

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22 The national sovereignity principle is in conflict with discretionary decision at the EC level.

23 However, it should be evaluated positively, that the signatories of the Fiscal Compact have agreed to follow RQMV also in these important cases.

3.2.4 Adequacy

According to Kopits and Symansky, fiscal rules should be also adequate with respect to the specified goal. In the European case, rules are in place for the headline deficit, structural deficit, debt and real expenditure growth. To assess this criterion, one needs to define the basic objective first. The documents laying down the origins of the SGP explicitly mention "potential negative spillovers" but also sound public finances in general.

Despite the fact that the 3 per cent headline deficit limit has been the most well-known rule among policymakers,[24] it is clearly not adequate to ensure sound fiscal performance in the long-run, since it has no information on the underlying fiscal position.[25] Structural budget balances and debt levels are much more informative in this respect. Therefore one should evaluate positively that the new framework put much more emphasis on debt figures. In principle from the remaining three indicators (structural deficit, debt level or expenditure benchmarks) each one of them alone can be part of an adequate fiscal rule (depending on the exact definition). Three different rules for the same purpose clearly point towards over-regulation and unnecessary confusion. In the next paragraphs we highlight the main strengths and weaknesses of these three indicators. We are going to argue that *at least* one of them (the expenditure benchmark) can be abolished without too much negative effects.

From a theoretical point of view, structural budget balances represent a nice option to limit non-responsible fiscal behavior. However, several criteria have to be met in order to successfully operationalize this concept in a fiscal rule:

- reliable real-time estimate of the output gap has to be available on a policy-relevant horizon;
- one-off and temporary measures should be excluded;
- the level of the structural balance target has to reflect long-term sustainability issues.

We are going to show that further improvements are necessary to fulfil all these requirements.

First and foremost, the definition of the output gap is very narrow, focusing only on the link established via the Phillips curve. As several papers show (Borio *et al.*, 2013 and 2014, Bornhorst *et al.*, 2011, Lendvai *et al.*, 2011 or Benetrix and Lane, 2011) absorption cycles, financial cycles or commodity price cycles can have substantial effect on potential (or sustainable) output beyond normal business cycle fluctuations. Interestingly the new Six-pack offers a unique possibility to link[26] the output gap estimates and other cyclical factors to the analysis conducted in the Macroeconomic Imbalance Procedure.

Second, the empirical performance of output gap estimates and structural budget balances is generally poor as is illustrated on next figures (more on this topic in Annex 1). The uncertainty is so large that *yearly* evaluation of significant deviation from the MTO or the path toward it is more an art than a science.[27]

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[24] Kopits (2014) states that while governments in the EU as well as European Commission officials tend to communicate mostly in terms of headline figures; the finance minister in Chile communicates almost solely in terms of the structural budget balance.

[25] The usual argument for the 3 per cent deficit limit is that it is consistent with the 60 per cent debt target at 5 per cent potential nominal growth. In our view, 2 per cent for potential growth and 1.75 per cent for inflation is a more realistic assumption, which yields to not 3 per cent but 2.8 per cent deficit limit. Moreover, this calculation does not take into account stock-flow adjustments, costs of aging or the fact that 60 per cent debt may be too high for small and open economies. Woo (2014) is even more pessimistic about future growth prospects of the euro area and calculates that with 3 per cent nominal GDP growth, the SGP deficit limit is consistent with nominal debt at 100 per cent of GDP.

[26] The link between potential ouput estimates and analysis of macroeconomic imbalances is not expected to be formal. We proposing only to use the same information sets.

[27] Both the level of the structural balance and its yearly change is relevant for the identification of significant deviations. While the level is important for the deviation from the MTO, the change is relevant for the minimum structural adjustment.

To illustrate this point quantitatively we looked at different vintages of output gap estimates by the European Commission. In our simple evaluation exercise we selected four measures to evaluate these estimates:

a) AS[28] – absolute difference between the estimate for year t in autumn t+1 compared to spring t+1; in other words the difference between the first two estimates available after the completion of year t when deviation from the MTO can trigger correction mechanisms;
b) SS – absolute difference between the estimate for year t in spring t+2 compared to spring t+1;
c) LS – absolute difference between the estimate for year t in the last vintage compared to spring t+1; in other words difference between the last available and very first vintage after the completion of year t;
d) LA – absolute difference between the estimate for year t in the last vintage compared to autumn t+1.

Comparison of estimates during one-year (from spring t+1 to spring t+2) is important because of *credibility*, while differences between first estimates and the last vintage are more about *robustness*: changes in views over time, when more data points are available.

The upper panel of Figure 3 illustrates that the average revision (since the 2004 Autumn forecast; the first available vintage) to estimates of the *change*[29] in output gap for the new Member States is 0.45 percentage points in the first six months, while the average difference between the last and first estimate is 0.74 percentage points. The same statistics for the old Member States (since the 2003 Spring forecast) are 0.30 and 0.55 percentage points respectively.

Another illustration of the same point is on Figure 4, where we have tracked the evolution of the output gap and cyclical components through different vintages of European Commission forecasts (starting with the Spring 2003 forecast) for the same year. We selected years 2000, 2001 and 2002 for this exercise since we wanted to discard periods mostly affected by the financial crisis. From all the vintages for these years we calculated the difference between the highest and the lowest estimate to indicate the degree of uncertainty.

The average difference in this sample (25*3=75 observations) was 2.2 percentage points; in some cases more than 4 percentage points. In other words, the "historic output gap"[30] has changed as much as 2 per cent of potential GDP. We repeated the calculation for the *change* in the output gap which is also relevant indicator from policy perspective. The result was, that for the old MS, the average difference between the most optimistic and most pessimistic estimate was 0.52 per cent of GDP with changes in signs in 13.3 per cent of cases. As far as new MS are concerned, the average difference was slightly higher (0.52 per cent of GDP), but the sign has changed through different vintages in 40 per cent of cases. In other words, in many instances it was not even clear whether there was an increase or a decrease in the cyclical component.

The uncertainty around the change in the cyclical component (CC) is not the only problem with the estimation of minimum structural adjustment (ΔSB). One should also look at the definition and application of rules for identification of one-offs (OO) and revisions in headline deficit figures (B).

$$\Delta SB = \Delta B - \Delta CC - \Delta OO \qquad (1)$$

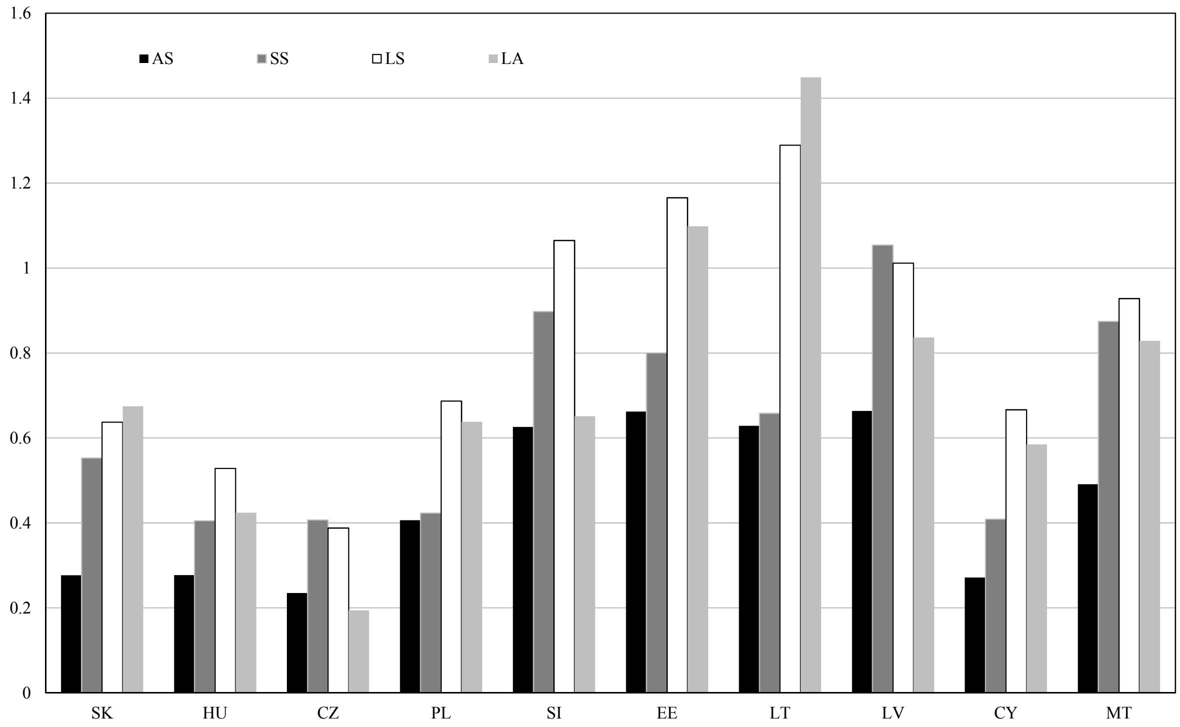
[28] A=autumn, S=spring, L=last.

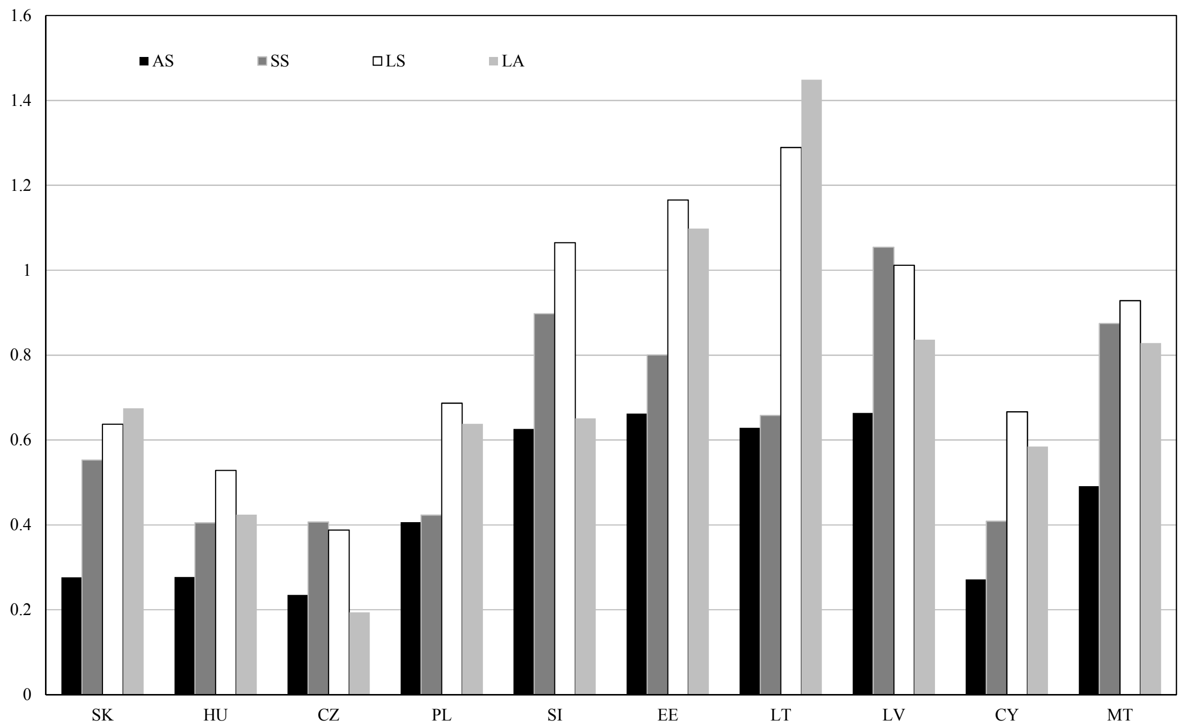
[29] Average changes to the *level* of the output gap can be found in the Annex 1. They are substantially more volatile than changes to differences in the OG.

[30] These are all *ex post* estimates for 2000, 2001 and 2002.

Figure 3

Real-time Estimates of Changes in the Output Gap (ΔOG)
(percent of GDP)

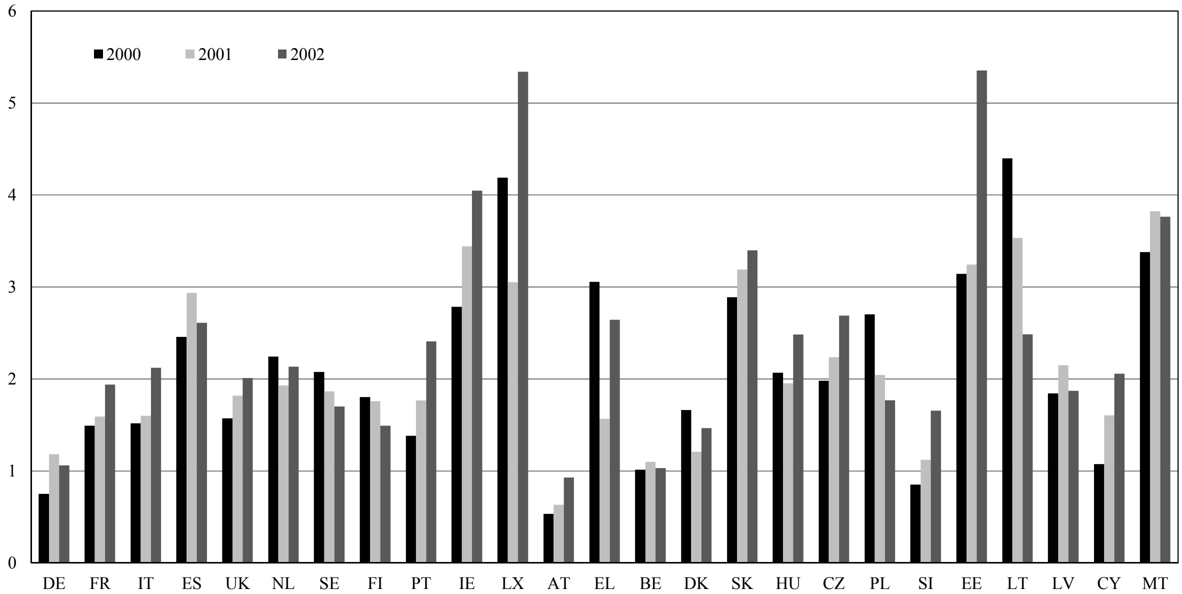




Source: EC, CBR.

Figure 4

Difference Between the Lowest and Highest Output Gap Estimates of the European Commission Since Spring 2003
(percent of GDP)



Source: EC, CBR.

Figure 5 illustrates the relative distribution of revisions to government data notifications on a six-month horizon (between the October and April notifications). Seven years of data for 27 countries were available for this exercise (only revisions to figures for the last available year were considered). It should be noted that these revisions can arise not only from changes to nominal government balance data, but also because of revisions to GDP figures. While the average revision is relatively small (-0.05 per cent of GDP), the standard deviation is significant (0.45).

Table 2 highlights the uncertainty in estimating the change in the structural balance in case of Slovakia.[31] On a six-month horizon between the first and second estimate for year t, the median change was 0.2 percentage points, while over time the estimates changed more than 0.5 per cent of GDP.

Here we should mention that the corrective part of the SGP is *not* based on the most up-to-date estimates of the output gap, but rather takes into account numbers available at the time of issuing recommendations. On the one hand it might reduce uncertainty and provide more flexibility; on the other hand it can weaken the credibility of the framework if actual estimates are very different from those made few years ago (which is often the case). Moreover, as far as the Fiscal Compact is concerned every ministry of finance and local IFI is free to use its own methodology; there is no requirement to use old estimates in the evaluation exercise. For these reasons we argue, that bottom-up evaluation of effective action should be more important than top-down approaches.

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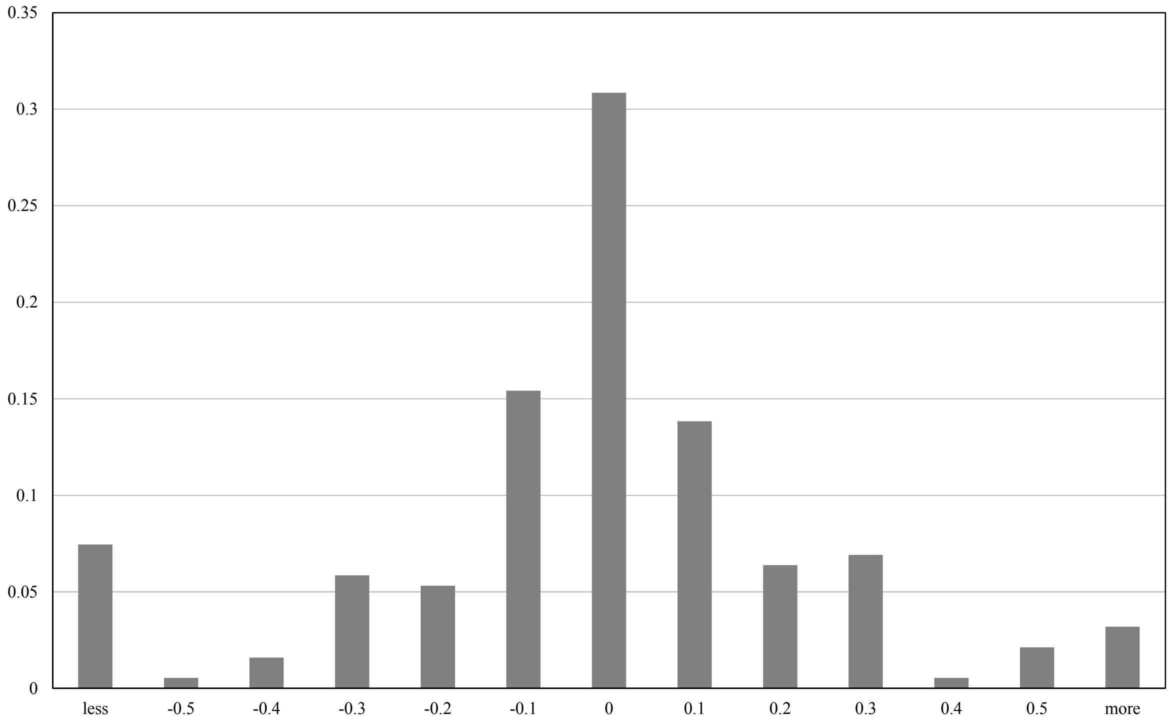
31 We did not have the data for one-offs in case of other countries, and therefore it was not possible to compare different vintages of SB estimates for all the members of the EU.

Figure 5

Relative Frequency of Revisions in Notified Government Data (October vs April for year t–1)
(percent of GDP)



Source: Eurostat, CBR.

Table 2

Average Absolute Revisions to SB Changes in Slovakia
(EC methodology, percent of GDP)

Changes	2006	2007	2008	2009	2010	2011	MIN	MAX
AS	–0.2	–0.2	–0.3	–1.4	0.2	–0.2	–1.4	0.2
SS	0.0	–0.6	–0.1	–1.4	0.2	–0.3	–1.4	0.2
LA	0.9	–0.4	0.8	0.2	–0.3	–0.1	–0.4	0.9
LS	0.7	–0.6	0.5	–1.2	–0.1	–0.3	–1.2	0.7
Absolute							**AVG**	**MED**
AS	0.2	0.2	0.3	1.4	0.2	0.2	0.42	0.20
SS	0.0	0.6	0.1	1.4	0.2	0.3	0.43	0.25
LA	0.9	0.4	0.8	0.2	0.3	0.1	0.45	0.37
LS	0.7	0.6	0.5	1.2	0.1	0.3	0.58	0.55

Source: CBR.

The third problem with the structural budget balance is that there is no detailed and consistent definition of one-off and temporary measures. The break-down of one-off measures identified by the EC is not even publicly available! At first sight the identification of one-offs seems almost trivial; however in our view this procedure is more tricky than it seems at first sight. The definition in the Code of Conduct (EC, 2012) is very general: "one-off and temporary measures are measures having a transitory budgetary effect that does not lead to a sustained change in the inter-temporal budgetary position". In the footnote there are some examples: sales of nonfinancial assets; receipts of auctions of publicly owned licenses; short-term emergency costs emerging from natural disasters; tax amnesties; revenues resulting from the transfers of pension obligations and assets.

The definition is further clarified in the Public Finances in EMU (EC, 2006) and in Larch and Turrini (2009). It mentions several common features of one-offs: a) temporary influence on the deficit (one or a very limited number of years); b) non-recurrence of measures; c) only measures with significant impact should be considered (above 0.1 per cent of GDP) and d) no deficit-increasing measures should be excluded (with some exceptions). There is also an indicative and open list of one-offs in the public finance report.

The application of this definition in practice is however not without problems. There are important borderline cases and because of capacity constraints it is not always easy for the EC to spot all one-offs in real time.[32] The following examples illustrate this point:

- repaying or assuming old debt is not always a one-off according to the EC; in autumn 2011 the estimate of the Commission for one-offs in case of Slovakia was –0.8 per cent of GDP, while one-year later for the same period +0.5 per cent of GDP (the huge difference is mainly due to repayment of old liabilities);
- by decreasing the contributions to a fully funded pension pillar not much happens with the inter-temporal budgetary position (more revenue for the government now but also more future liabilities); despite the above mentioned definition it is not identified as one-off;
- sales of oil reserves or dividends from asset revaluations were not regarded as one-off by the EC in some vintages of estimates for Slovakia.

In our view, independent fiscal institutions can play an important role to identify all the measures without impact on the inter-temporal budgetary position in real-time. To increase the transparency of the whole process, fiscal councils and the EC should publish detailed principles for identifying one-offs with clear examples. It is interesting to note, that the EC warned to implement series of large one-offs already in 2006 by pointing to the case of Portugal between 2002 and 2004 (EC, 2006).

Fourth, the medium-term objective only partially reflects the estimated costs of aging. The current coefficient is 33 per cent. While pension debt is not necessarily equals to public debt, it is in our view important to internalize the costs of ageing (in the no-policy-change scenario on a long-term horizon) as much as possible to increase the awareness of policymakers and the general public.

All in all, the uncertainty involved in real-time estimates of the cyclical component together with frequent changes in the headline deficit figures and the problems of the identification of one-offs make the use of structural budget balances for a numerical policy evaluation purposes on a yearly basis highly problematic. In many cases the uncertainty around the estimates of the change

[32] In many cases the EC has to rely on information provided by the Member States, which might represent a problem if the national authorities are not transparent enough.

in structural balance is higher than 0.5 per cent of GDP, which is the benchmark against to which it should be evaluated according to the Fiscal Compact.[33]

From the above discussion is clear that several improvements are needed to fully operationalize the structural balance rule on a yearly horizon. In our view the SB is more suited for rules over longer horizons (to ensure that bygones are not bygones) or as *ex ante* guiding point for nominal expenditure limits at national level.

Another candidate for an adequate fiscal rule is a numerical criterion for the debt of a country. Despite the fact that optimal debt level is not well-defined in the academic literature (Wren-Lewis, 2013) the empirical lesson from the last crisis is clear: "…this suggests the need for both a more comprehensive approach to measures of public debt and lower values for what constitutes "prudent" official debt-to-GDP ratios" (Blanchard *et al.*, 2013). The problem with debt limits is mainly in the definition. Should we use gross or net debt figures? How should we incorporate contingent and implicit liabilities into the analysis? What is a sufficient room for maneuver in case of severe economic downturns? What to do with the differences between small and big countries and their tax raising and growth potential? How to react to short-term economic fluctuations affecting the denominator?[34] It also raises the question of differentiation, which is not easy to reconcile with the requirement for equal treatment inside the EU.

More focus on debt figures in the SGP is a step in the right direction; however the debt reduction rule is effectively targeting 60 per cent of GDP which might be too high for small and open economies. More focus on the stock-flow adjustments is also welcomed, because it eliminates at least the differences coming from the holding of the most liquid assets.

In our view there is a rationale to treat the 60 per cent rule in a similar vein than the 3 per cent deficit rule – as a maximum possible in case of adverse effects and not as a target. Incorporation of a minimum absolute reduction of debt (above a certain prudent limit below the 60 per cent threshold) might help to overcome this problem. For example one can use the wording from the Fiscal Compact: "where the ratio of the general government debt to GDP at market prices is significantly below 60 per cent of GDP and where risks in terms of long-term sustainability of public finances are low". The Commission via the aging report should assess whether these conditions are met to exempt the country from further reductions of debt. It is also important to recognize the links between debt levels and sustainability. If a country implements reforms with gradual long-term impacts (*i.e.*, indexation of pension age to life expectancy) there is less need for "pre-funding" of ageing costs via lowering actual debt figures.

The third rule is the so called expenditure benchmark. Basically it is a similar concept as a change in the structural deficit, since it is expressed in real terms and is also adjusted to discretionary revenue measures. At the end the growth rate of the adjusted expenditures should be such that the minimum structural adjustment toward the MTO is ensured.

Let us look first at a very simple case, where the potential growth of the economy is stable; there are no EU funds, public investment as a share of GDP is also stable and there are no one-off measures.

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[33] The situation is even worse when the precision vis-á-vis the threshold for average two-year deviation (0.25 per cent of GDP) is considered.

[34] The debt-to-GDP ratio is very sensitive to factors outside the control of the government.

Table 3

Simple Revenue and Expenditure Structure

Revenues	Expenditures
R^C – cyclical revenues	E^C – cyclical expenditures
R^S – structural revenues	E^{INT} – interest expenditures
	E^{RES} – residual expenditures

Minimum structural adjustment (MSA):

$$\frac{R_t^S - E_t^{INT} - E_t^{RES}}{NGDP_t} - \frac{R_{t-1}^S - E_{t-1}^{INT} - E_{t-1}^{RES}}{NGDP_{t-1}} \geq 0.005 \quad (2)$$

$$\frac{E_{t-1}^{RES}}{NGDP_{t-1}} - \frac{E_t^{RES}}{NGDP_t} + \left[\left(\frac{R_t^S}{NGDP_t} - \frac{R_{t-1}^S}{NGDP_{t-1}}\right) + \left(\frac{E_{t-1}^{INT}}{NGDP_{t-1}} - \frac{E_t^{INT}}{NGDP_t}\right)\right] \geq 0.005 \quad (3)$$

If structural revenues grow in line with nominal GDP and interest expenditures compared to GDP are stable or small, the term in square bracket is close to zero.

Expenditure benchmark (EB):[35]

$$\frac{E_t^{RES} - E_{t-1}^{RES}}{E_{t-1}^{RES}} - DEF_t \leq POTG - \frac{0.005}{PG} \quad (4)$$

$$PG = \frac{E_{t-1}^{RES} + E_{t-1}^{C}}{NGDP_{t-1}} \quad (5)$$

If we assume that the cyclical component on the expenditure side is small (only unemployment benefits are considered) we can write:

$$\frac{E_{t-1}^{RES} - E_t^{RES}}{E_{t-1}^{RES}} * \frac{E_{t-1}^{RES}}{NGDP_{t-1}} + (DEF_t + POTG) * PG \geq 0.005 \quad (6)$$

$$\frac{E_{t-1}^{RES}}{NGDP_{t-1}} - \left[\frac{E_t^{RES} * (1 + DEF_t + REALG_t)}{NGDP_t} - (DEF_t + POTG) * \frac{E_{t-1}^{RES}}{NGDP_{t-1}}\right] \geq 0.005 \quad (7)$$

$$\frac{E_{t-1}^{RES}}{NGDP_{t-1}} - \frac{E_t^{RES}}{NGDP_t} * \left[1 + (NOMG_t)(1 - \frac{E_{t-1}^{RES}}{E_t^{RES}} * \frac{NGDP_t}{NGDP_{t-1}})\right] \geq 0.005 \quad (8)$$

[35] DEF is a GDP deflator, PG means primary balance to GDP ratio and POTG refers to potential GDP growth.

The square bracket is close to one, so the expenditure benchmark in this simple case is conceptually the same as the minimum structural adjustment.

A numerical example might shed more light. Let us assume structural revenues at 50 per cent of GDP (55 in year t and 50 in year t–1), 8 per cent potential growth and 2 per cent deflator and no interest expenditures and unemployment benefits. The country is making an adjustment on the expenditure side, which yields a change in the nominal value of expenditures from 55 units in year t–1 to 59.4 in year t. GDP in year t–1 is 100.

The criterion for the minimum structural adjustment is the following (MSA):

$$\left(\frac{55-59.4}{110}\right)-\left(\frac{50-55}{100}\right)=\frac{55}{100}-\frac{59.4}{110}=0.01\geq 0.005 \tag{9}$$

The expenditure benchmark (EB):

$$\frac{-59.4+55}{55}*\frac{55}{100}+0.1*\frac{55}{100}=\frac{55}{100}-\frac{59.4}{110}*\left(1+0.1-0.1*\frac{55*110}{59.4*100}\right)>\frac{55}{100}-\frac{59.4}{110} \tag{10}$$

So in this case the minimum structural adjustment automatically ensures the fulfillment of the expenditure benchmark.

In more realistic cases there is a growing confusion between the two indicators, because of the following *major* differences:

- One-offs are reflected in the MSA but not in the calculation of the EB.
- Discretionary measures[36] on the revenue side are important for EB, while the overall change in structural revenues are reflected in MSA.
- Interest expenditures are excluded from the EB but not from the MSA calculation.
- EB is based partially on trend potential growth while the MSA on actual potential growth.
- Using semi-elasticities,[37] the cyclical component of expenditures is significant in MSA but very small in EB.
- Fluctuations in investment expenditures in small countries are reflected in EB but not in MSA.

What are the benefits of the expenditure benchmark? According to its proponents, the objective was to use another rule based on *trend* potential growth since the actual estimates are surrounded by substantial uncertainty. Besides that, the EB might help to save revenue windfalls. We argue that these points - while valid - cannot justify the introduction of the EB, since both could have been addressed inside the old framework. It would have been much easier to use historical averages and trends in the output gap calculations. As far as the windfalls are concerned, they are actually considered when evaluating effective action in the corrective arm of the SGP (β). The price in terms of confusion and inconsistencies seems to be too high for the limited benefit. Therefore we argue for abolishing the expenditure benchmark.

This discussion raises also the general question of calculating the consolidation effort (when effective action is judged). The top-down approach focuses on the change in structural balance ignoring the no-policy change (NPC) scenario. While the bottom-approach starts with the NPC and specifies the measures to reach the target, without considering cyclical components or one-off measures. A combination of the two approaches can be found in CBR (2013) and Novysedlak and Bugyi (2014), where the NPC is adjusted to cyclical movements and one-offs. In our view this

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[36] It is also not entirely clear who should calculate the impact of these measures *ex post*.

[37] Mourre *et al.* (2013).

modified bottom-up approach is useful in assessing effective action and independent fiscal institutions might play a role in calculating these scenarios together with the likely impact of the proposed measures.

3.2.5 Efficiency

Ideal fiscal rules should be supported by efficient policy action. Kopits and Symansky explicitly mention problems with potential one-off measures and according to them "a fiscal rule may be viewed as a catalyst for fiscal reforms that would be necessary anyway to ensure sustainability".

We identified two important points when assessing efficiency of the new fiscal architecture. The first is related to the excessive deficit procedure. Since the abrogation of EDP is not based on the estimate of structural balance, there is a motivation to adopt one-off and temporary measures in the medium-run, which does not supports long-term sustainability. For example introduction of an extraordinary tax in year t and sale of assets in year t+1 together with a promise of more structural reforms in t+2 can lead to the abrogation of EDP in spring t+1 even if the structural deficit is well worse than 3 per cent of GDP.

The second important point is the encouragement of structural reforms. As it was mentioned earlier, the calculation of the MTO partially reflects estimated costs of ageing. Apart from that structural reforms with "verifiable positive impact on the long-term sustainability of public finances" are taken into account in the preventive arm of the Pact. In our view this topic is important especially if there are significant trade-offs between growth and austerity in the short run. In that case, gradual, but very important reform of the pay-as-you-go (PAYG) pillar should be preferred compared to immediate adjustment (with the same impact on long-term sustainability). It might beneficial to incorporate this principle into the evaluation of effective action taken especially in bad economic times.

3.2.6 Simplicity

One of the most important weaknesses of the new European framework is lack of simplicity. There are so many rules and procedures, that it takes a considerable effort to read and understand all the relevant legal texts and technical notes. On the other hand it is important to stress that this criterion is not as important as it was in the past, when independent institutions were not present to "translate" the messages into ordinary language.

One of the main recent trends in international fiscal frameworks has been the utilization of possible synergies between rules and independent fiscal institutions. Simple rules without "guardians" can be easily circumvented, while fiscal councils without rules are less effective to reduce the deficit bias (although they can raise the transparency of fiscal accounts).

Here the question of a European fiscal watchdog pops up. According to Wendorff (2014), "it would be a productive idea to shift the task of assessing fiscal developments, plans and compliance with fiscal rules to an independent institution, that has a clear and only focus on that task, which does not have several other policy goals and which is outside the regular European bargaining process." In our view, with much more simple rules and without an objective to fine-tune national budgetary developments, it is not necessary to create and independent European body. The EC can serve this purpose relatively well.

3.2.7 Consistency

Fiscal rules should be internally consistent. This is unfortunately not always the case as far as the European fiscal framework is concerned. We have identified 4 groups of potential inconsistencies.

First, there are potential tensions between the SGP and the Fiscal Compact. The basic idea behind the Compact was to transpose the preventive arm of the Pact into national legislation "preferably" of constitutional nature. We have mentioned earlier the problems with estimating potential output and structural budget balances. Now there will be two sets of numbers: one calculated by the European Commission based on the commonly agreed methodology and one estimated by a local independent fiscal institution. While at the European level the "one-size-fits-all" methodology is essential, for a local IFI it is better to use a tailor-made methodology to the country in question. Moreover IFIs are better equipped to identify one-offs and discretionary revenue measures in the budget. The danger is that there can be two different policy messages derived from the same rule. In that case the public will be confused and the credibility of the whole framework suffers.

Another potential problem is the use of the so called "investment clause" in the SGP. There is no such thing in the Fiscal Compact, what again can lead to blurred policy messages.

A minor difference is that the FC sets a more ambitious MTO than the SGP for euro area members.

The last potential source of inconsistency between the SGP and the FC is related to deadlines. In the FC the timetable to reach structurally balanced budgets is fixed, while SGP procedures allow some postponements.

Second, as it was shown above, there are significant differences in the definition of the expenditure benchmark compared to the minimum structural adjustment despite the fact, that they are conceptually almost the same. Different treatment of one-offs, interest expenditures or for example cyclical components on the expenditure side can create confusion.

Third, there is a theoretical inconsistency between the excessive debt limit (interpreted as a maximum) and the debt reduction rule (target). In times of decreasing potential growth,[38] this inconsistency will only increase. One should note that in order to "prefund" the costs of ageing, debt ratios should rapidly decline below the 60 per cent of GDP limit (Balassone *et al.*, 2011).

Fourth, there can be potential inconsistencies between the minimum structural adjustment and the debt reduction rule (through one-offs or stock-flow adjustments) – for example via privatization revenues.

3.2.8 Definition

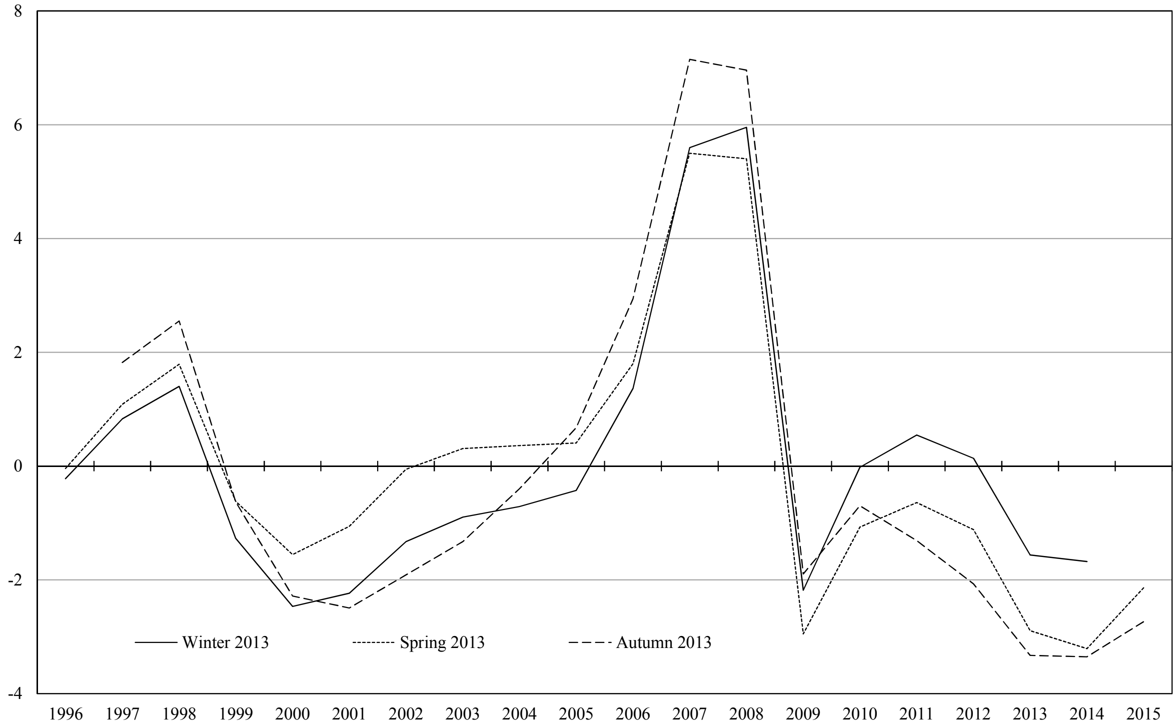
The final criterion to assess fiscal rules is that they should be well-defined to avoid ambiguities and ineffective enforcement. Since the whole framework is very complex and partially is based on unobservable variables it is almost impossible to fill all potential gaps for judgments.

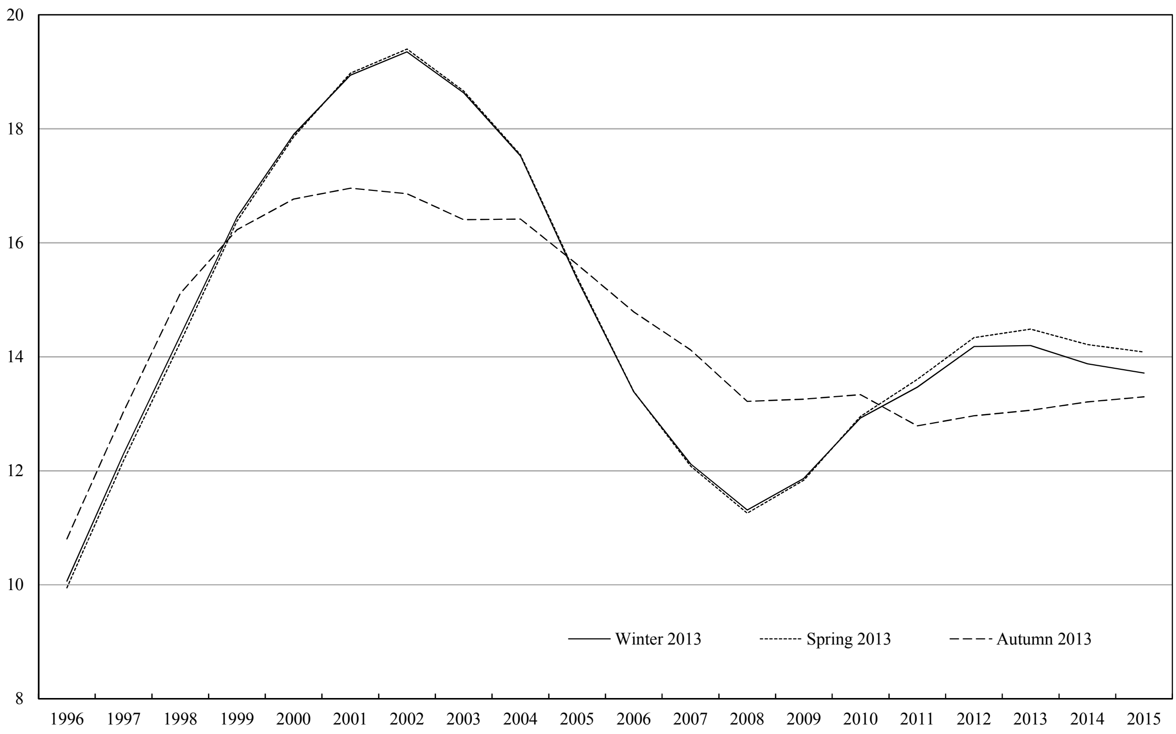
Next figures illustrate the last three vintages of output gap forecast for Slovakia. Basically, all of them are based on the same – commonly agreed - production function methodology. For 2011 the three output gap estimates are +0.5, –0.6 and -1.3 respectively. For 2012 we get similar picture with estimates ranging from +0.1 to –2.1. One can spot substantial differences also in the

[38] For example because of aging or long economic slump.

Figure 6

Output Gap and NAWRU Estimates for Slovakia
(European Commission)





Source: EC.

NAWRU[39] estimates. It is important to note that in these cases the main differences in outcomes are *due to technical factors*, which are hard to explain to policymakers and the general public:

- between the winter and spring vintages: TFP trend filtering changed from HP filter to Kalman filter;
- between the spring and autumn vintages: changes in upper bands for trend and cycle innovation variances in NAWRU estimation.

Another possibility for improvement is the definition of one-off and temporary measures. While "foolproof" definition is not possible, at least there should be clear detailed principles and examples available to reduce substantially the room for subjective judgments. The EC should make the list of one-offs public.

There is also a case for better definition of good and bad economic times or discretionary revenue measures (DRM). Since the MSA is differentiated via the phase of the economic cycle, it should be spelled out more clearly what we mean by "good" and "bad" times.

As far as the headline deficit rule is concerned, its definition is clear, although better coverage of public enterprises and other special purpose vehicles inside the public sector would be definitely a step in the right direction. The new ESA2010 might enlarge the borders of the general government sector.

The definition of the debt criterion is very simplistic, since it ignores liquid assets, implicit liabilities, accrual interest, trade credits or for example debt related to PPP projects. On the other hand it is clearly unrealistic to expect far reaching changes, since it is one of the most well-known rules among citizens.

4 The first phase of implementation

The price for a non-credible no-bail-out clause was that the European fiscal framework had to be significantly changed in three waves (Six-pack, Fiscal Compact and Two-pack). It is too early to draw far reaching conclusions based on more or less one year of experience; however some preliminary lessons can be identified.

There were interesting changes in moods depending on the intensity of pressures invoked by financial markets. At the beginning of the crisis, more and more rules and austerity plans were announced to regain the credibility of the basic fiscal architecture. After the decision of the ECB to introduce the OMT, markets calmed down and the European debate switched to "growth versus austerity" mode. It clearly illustrates the difficulty to design a credible and strict system, which on the one hand guarantees sustainability, but on the other hand allows for enough flexibility in bad times. Generally speaking it is hard to achieve two goals (consolidation and growth) with one instrument (the SGP), especially if that instrument was defined in a strict way to calm the markets. Maybe there is a room independent fiscal institutions can play in designing the speed of consolidation in the future.

The change in the mood is clearly visible in the Council decisions in Spring 2013. One can draw three tentative conclusions based on these decisions:

- relatively easy abrogation of the EDP procedures;
- benevolent extension of deadlines;

[39] The difference between the NAIRU and NAWRU is that the latter uses wage inflation instead of price inflation to calculate the natural level of unemployment.

- appearance of different treatment of member states.

All three can hurt the credibility of the framework.

On the first point it is a bit surprising to see that the structural deficit is not relevant when deciding about the abrogation of EDP. It is sufficient to have the deficit close to the reference value in year t-1 and to have forecasts of headline deficit below 3 per cent of GDP in year t and t+1 (no sufficient margins for unexpected events are required). The EDP for Italy was abrogated with a deficit of 3 per cent of GDP in 2012 and a forecast for 2013 at 2.9 per cent of GDP. In case of Lithuania the deficit in 2012 was 3.2 per cent of GDP, but the margin over the reference value could be explained by the costs of implementing a fully-funded pillar of the pension system. The case of Hungary was also interesting. It left the EDP with a growing trajectory of deficit forecasts for 2013 and 2014 (2.7 per cent and 2.9 per cent of GDP respectively). The most telling case was however the launch of EDP for Malta in spring 2013. The country left this procedure only few months earlier (December 2012) with an estimated structural deficit of 3.6 per cent of GDP! So it was not really surprising that the excessive deficit has popped-up again.

It was clear at the beginning of year 2013 that many countries were not able to cut their deficits below the reference value in the deadlines set by the Council. According to the new rules it is possible to extend the deadline, if countries delivered the effort, but the worsening of their economic situation has prevented them to fulfil their obligations. The wording of the law for the extension period is “one year as a rule”. The cases of Spain, France, Poland and Slovenia show that there was no problem to extend the deadline by two years. There are no guarantees that next time it can be 3 or more years if one would like to avoid harsh sanctions.

As far as the evaluation of different member states is concerned, the initial experience with the new framework makes it difficult to reconcile the application of the rules with the principle of equal treatment. We argue in this paper that this is because the Commission has been pursuing a multitude of goals with only one instruments, with the weight on those goals varying across countries given their diverse circumstances. Some countries received one-year extension, others two years and some others had to stick to the original deadline. The case of Belgium is also interesting since it is the only country where the EDP was stepped-up. The deficit in 2012 was at 3.9 per cent of GDP but from which the cost of saving the banking sector was 0.8 per cent of GDP (clear temporary effect). The Commission´s budget deficit forecast for Belgium was 2.9 per cent of GDP in 2013. So the situation in economic terms was almost identical to those countries for which the EDP was abrogated.

The first phase of implementation of the two-pack was without significant media attention. Countries submitted their Draft Budgetary Plans (DBPs) and the Commission evaluated those. There are two points to highlight. First, the quality of DBPs was very diverse. For example Germany sent few pages of tables, while Slovakia a fully-fledged document describing budgetary trends in detail. Second, the overall assessment of the EC used the usual technocratic language of “broadly compliant” or “risk of non-compliance” what can hardly evoke policy responses from the individual Member States.

Some other features of the Two-pack and the Fiscal Compact are only waiting to be implemented. At this stage it is impossible to say, to what extent the “preferably” constitutional nature of the FC will be really binding at local level and how the potential inconsistencies between the FC and the SGP will be resolved.

From the perspective of an independent fiscal institution, it is not clear what is the path toward the MTO, against to which the deviation should be calculated. The general expectation was that the 2013 Stability Programs will define these trajectories. However, for example in case of Slovakia, 2018 was the year identified by the Ministry of Finance to reach the MTO. The Council

Conclusions disputed this and recommended 2017. Now it is unclear what should be the benchmark for the first year of implementation of the Fiscal Compact.

5 Recommendations for further improvements

When designing fiscal frameworks in a monetary union, systemic considerations should be preferred to incremental changes. As we have shown, broadly speaking, there are two general models: one relying on pure market discipline (USA) and one on more central control (Germany or Spain). In order to put the single currency on a more sustainable footing, it is in our view necessary to go back to this fundamental debate. In the last two decades we have witnessed mainly incremental changes and compromises, resulting to internal inconsistencies and extreme complexity. Now it is time to break this path-dependency and to go back to first principles. We argue that the euro area should be rebuilt on principles closer to the US model of decentralized fiscal discipline.

In both models of fiscal discipline cases it seems to be necessary to have a well-functioning banking union and the lender of last resort functions should also be clearly defined. Moreover, it is important to solve the legacy debt issue in some countries before implementing further far-reaching changes. Table 4 highlights the main differences between the two possible arrangements.

Table 4

Fiscal Discipline in the Euro Area

Decentralized Model	Centralized Model
Banking union	
Real lender of last resort	
Strong no bailout rule (restructuring, PSI, bail-in, etc.)	Bailouts possible
Domestic fiscal rules in the forefront	SGP or discretion
Strong local IFIs	
EC monitors to avoid "gross errors"	Federal ministry of finance
No borrowing at the center	Eurobonds against federal revenue

Source: Author.

The current European fiscal architecture is in between the two models and therefore it must almost inevitably rely on inconsistencies (central enforcement vis-à-vis national sovereignty). Since currently there is no substantial public support[40] for transferring more power to the center, it seems to be more important to build a functional decentralized system of fiscal discipline. Based on

[40] It is not even clear whether there is such thing as "European public". Different countries have very different attitudes toward fiscal issues.

the above-mentioned recommendations, the decentralized system of fiscal discipline would have these features:

- strong no-bail-out rule;
- no complex web of rules at the central level, no attempts to fine-tune fiscal developments from the center;
- local rules and local IFIs would play the most important role, it is an error to impose one-size-fits-all *operational* (yearly) rules for every member state;[41]
- the EC would check only maximum limits on debt and deficit ("gross errors").

Even if there is no political will to go back to first principles, there are possibilities how to improve the *current* framework. The assessment based on the Kopits-Symansky criteria has identified several avenues for further improvements. Some of them would require changes to the Treaty. These are currently unrealistic; however it might be useful to keep them in mind if there is a window of opportunity to make substantial changes in the future. The second type of recommendations does not require changes in the legislation, but rather they point toward different interpretation of existing rules or procedures or make methodological proposals. These can be implemented in a medium-term horizon.

There are also recommendations which require changes to the institutional set-up. In some cases there are different technical solutions how to achieve the desired outcome. This question is especially relevant when potential greater involvement of independent fiscal institutions in European procedures is considered. IFIs are a heterogeneous group with widely different origin, mandate and resources. Currently the European fiscal framework assumes that each euro area member country should have an IFI. Moreover it prescribes three important tasks to carry out by these institutions: macroeconomic forecasts, a role in activation of correction mechanisms and escape clauses. To avoid question marks over the independence of local fiscal councils one has to carefully balance the costs and benefits when granting more power to IFIs in the future. In our view it can be done in four ways (initially the informal set-up is the most likely scenario):

- informal – the EC will use the analytical results of IFIs when available (for example when identifying one-off measures or evaluating effective action via the bottom-up methodology);
- semi-formal – the European legislation can require more tasks carried-out by IFIs without taking into account the capacity constraint of local councils (like in the case of macroeconomic forecasts); as in the "informal" case, the EC will not be obliged to use the output of IFIs;
- formal – the EU budget would finance additional tasks required to avoid capacity constraints; moreover there would be strict professional requirements laid down in EU legislation for the selection of council members;[42] in this set-up the EC would use the analysis of IFIs in SGP procedures;
- de-centralized – the first line of defence against the deficit-bias would be at the national level: local IFIs would monitor compliance with local rules (preferably constitutional). The role of the EC in this set-up would be to step-in only in case of "gross policy errors".

Based on the evaluation in Sections 3 and 4 our recommendations are the following (not necessarily in the order of importance):

1) Get rid of some of the fiscal rules. The first option to consider is the expenditure benchmark. In our view it is basically the same concept as the minimum structural adjustment, but it adds

[41] Operational rules can depend on the political regime of the country: presidential vs. parliamentary arrangements, coalition vs one-party governments, etc.

[42] In extreme cases the EC would have the power to nominate one council member.

some degree of confusion to the framework because of different treatment of various budgetary items compared to the MSA. Moreover, expenditure limits are better to set-up locally. A more radical solution to the overregulation would be focusing on debt levels only via the target for structural budget balances (see recommendation 4). In that case the debt reduction rule could be also eliminated.

2) Improve the definition of one-offs and temporary measures. Set out clear principles with detailed examples to reduce the inconsistent treatment across years and Member States. The EC should make the list of one-offs publicly available. Since local IFIs have more detailed knowledge, they might play an important role in timely detection of ad-hoc and temporary measures.
3) Link the SGP and MIP via the output gap. Currently the output gap calculation is linked mainly to stable inflation. However, the recent experience shows that "beyond-inflation" concepts can be helpful in real-time evaluation of underlying trends in the economy. Incorporation of absorption or financial cycles in our view might substantially improve the precision of estimates. The Macroeconomic Imbalance Procedure can signal early on potential problems related to current account or domestic credit developments.
4) Differentiate more medium-term targets based on sustainability. We recommend increasing the weight of the aging costs in the determination of the MTO.
5) Restore the credibility of the no-bail-out clause as much as possible. Private sector involvement, partial restructuring or bail-ins seems to be essential to limit the risk of contagion between banks and the sovereign and also among sovereigns. Private investors should remain responsible for their investment decisions.
6) Encourage nominal expenditure ceilings at local level. As we have shown, the uncertainty around current estimates of structural budget balances is huge, so it is very hard to numerically evaluate deviations from goals on a yearly basis and to activate correction mechanisms. Better way would be to use structural estimates more loosely, *i.e.*, in setting nominal expenditure targets *ex ante*. Their evaluation *ex post* would be then straightforward. Moreover, nominal expenditure ceilings are better suited to become an operational target than other budgetary aggregates.
7) Abolish or redefine the investment clause. The current definition has no economic meaning and it is in potential conflict with the Fiscal Compact.
8) Use the estimate of the structural balance in ending EDP. It seems to be a mistake not taking into account the evolution of structural budget balances when abrogating the excessive deficit procedure. It motivates to adopt one-off and ad-hoc measures on a medium-term horizon.
9) More voting with reverse qualified majority. Despite the recent increase of automaticity of sanctions, there are still important decisions to be taken by qualified majority voting (existence of excessive deficits or evaluation of effective action).[43]
10) Involve IFIs in evaluating effective action. Fiscal councils might play a role in *ex ante* evaluation of the measures incorporated in the next year´s budget. This bottom-up approach can complement or replace the *ex post* evaluation of the structural budget balance. The main advantage is to focus directly in policy decisions and present an independent costing for them.
11) Set a minimum nominal effort (in GDP points) in the debt reduction rule above certain prudent level below the 60 per cent threshold. The definition of a country-specific prudent level can be borrowed from the wording of the Fiscal Compact. The European Commission can check the fulfillment of these conditions via its Ageing Report. This recommendation is an alternative to recommendation 4.

[43] Fortunately the Fiscal Compact is expected to partially fill this gap.

12) Increase the severity of sanctions in the preventive arm. It can be more credible and also sounder if one applies financial sanctions in good times and not during recessions.
13) Allow for effective action through gradual reforms in bad economic times. With the problem of aging it is maybe more preferable to improve sustainability through structural reforms than through immediate cuts in current or capital expenditures (this recommendation affects both the SGP and the FC).
14) Introduce professional requirements for IFI council members to avoid politically motivated nominations. Consider partial funding of local IFIs from the EU budget to ensure adequate capacities for the tasks defined in EU legislation.[44] However, full independence (functional and financial) outside EU matters should be retained.
15) Apply the rules less benevolently and more uniformly across countries in the future in order to gradually increase the credibility of the new framework.

Implementing the above-mentioned 15 recommendations might improve the score of the European fiscal architecture *vis-à-vis* the Kopits-Symansky criteria. Without losing too much on “flexibility” it seems to be possible to score higher on “simplicity”, “consistency” and “enforceability”. The greater involvement of local IFIs together with more weight on national rules should also improve “adequacy”.

6 Conclusions

One can draw six broad conclusions from this paper.

First, when designing fiscal frameworks, systemic considerations should be preferred to incremental changes. It is important to notice that the effectiveness of the framework depends on many things outside purely fiscal issues. As we have shown, success can be achieved only if one takes into account the overall set up of a monetary union: the character and credibility of resolution mechanisms or for example the analysis of macroeconomic imbalances.

Second, do not set rules if you cannot measure them. Moreover do not attach correction mechanisms to something you cannot measure. The definition of the numerical benchmark for significant deviation is really a game changer. It is one thing to calculate ex ante structural deficits, since it is impossible to have meaningful budgetary plans without an idea about major trends in the economy, but ex post evaluation of deviations in real time with correction mechanisms attached is a completely different exercise. Now it is possible to ask questions like “who is responsible for the welfare consequences of the correction mechanisms if the independent institution´s estimate turns out to be wrong?” And as we have shown we are currently not in a position to estimate the change in the structural budget in real time with sufficient precision. It seems to be a mistake to rely on fine-tuning of budgets from a central level.

Third, simplify. Some features of the new system can be considered as “unnecessary ornaments”. For example the expenditure benchmark, the investment clause or the debt reduction rule is a good candidate for future simplifications.

Fourth, IFIs might play an even more important role in the European fiscal architecture. We have identified possible involvement of fiscal councils in a) medium-term consolidation strategies (deficit targets), b) ex ante and/or ex post assessment of consolidation efforts, c) definition and application of rules for one-off and temporary measures and d) fiscal policy research. The first task clearly needs further investigation, but the remaining three are feasible in the medium-run. In a

44 Depending on the institutional set-up; in the informal case it is not necessary.

fully decentralized model, local IFIs (together with preferably constitutional national rules) can replace the EC as guardians of fiscal sustainability in a monetary union.

Fifth, put even more emphasis on debt and sustainability. The debt limit at 60 per cent of GDP should be understood more as maximum limit and not as a target (at least for small and open economies). Fiscal sustainability issues should play a more important role in setting the medium term objective.

Finally, appearance of unequal treatment and too much flexibility can hurt the credibility of the framework. It is especially important in the first years of application of the new rules. Deploy SGP to deal with consolidation goals and address other objectives (growth) primarily through new instruments (e.g. through the EU budget) or via National Reform Programs.

ANNEX 1
EVALUATION OF ESTIMATES OF CYCLICAL COMPONENTS

The Fiscal Compact made the estimation of structural budget balances more important. It is not about average figures or over-the-cycle concepts anymore, but a yearly numerical evaluation of the deviation of the SB from the MTO or the path toward is required. If the deviation is higher than 0.5 percentage points in one year or 0.25 percentage points in two years (on average) correction mechanism should be triggered with possible welfare implications. This change implicitly assumes that it is possible to calculate structural budget balances in *real time* with sufficient precision. This annex shows that this crucial assumption might be too optimistic given current methodology.

The change in the structural balance can be decomposed into three components. i) change in the headline balance (B), ii) change in the cyclical component (CC) and iii) change in one-offs and temporary measures (OO).

$$SB = B - CC - OO$$

$$\Delta SB = \Delta B - \Delta CC - \Delta OO$$

Due to data availability, here we focus on the second component (the average revisions to notified data can be found in the main text – figure 5). The commonly agreed methodology uses an aggregated approach to calculate cyclical components. The estimate of the output gap is multiplied by a measure of elasticity (recently there was switch from overall budget sensitivity to semi-elasticities).

$$CC = \varepsilon * OG$$

$$\Delta CC = \varepsilon * \Delta OG$$

First we focus on the history of output gap estimates on a policy relevant horizon. For a given year t, the spring t+1, autumn t+1 and spring t+1 are the most relevant estimates from a credibility point of view. To assess reliability and robustness, we also compared these first estimates for year t with the latest vintage available, to see the change in the figures when more data points are available.

Next figures show these simple statistics calculated from autumn 2004 for the new MS and from spring 2003 for "old" MS. The most stable estimates over time were in case of Austria (less than 0.5 percentage points), while the least stable ones were for the Baltic States (more than 2.5 percentage points).

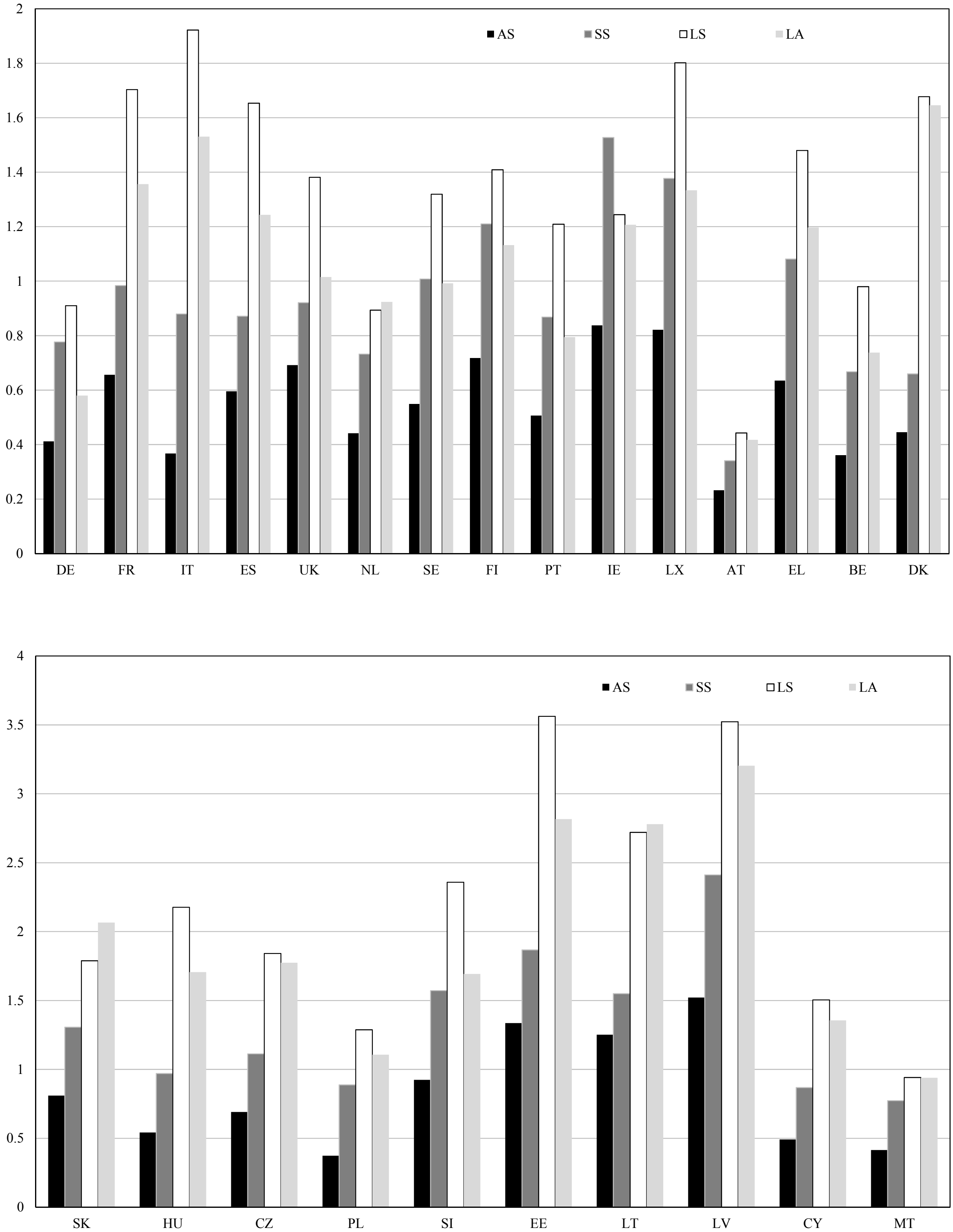
The level of output gap can be of course more volatile than the *change* in OG, which is relevant for the calculation of the structural adjustment. Figure 3 in the main text illustrate the revisions to changes in the output gap.

To get more data points for our analysis, we have decided to use all available vintages for three specific years (2000, 2001 and 2002). These years were not affected by the recent financial crisis and at the same time they represented a history even for the first vintage. Figure 4 in the main text show the substantial volatility of output gap estimates for 2000, 2001 and 2002 through the different vintages. The statistics we used is a difference between the highest and the lowest forecast for the given year. The average difference was 2.2 percentage points. The next figure shows the same statistics for the change in the output gap.

If we multiply these changes by the respective budgetary elasticity (Table 5), we get an average difference between the highest and lowest estimate of the cyclical component at 0.22 percentage points with a standard deviation of 0.16 percentage points.

Figure 7

Changes in Output Gap Estimates



Source: EC.

Table 5

Country-specific Budget Sensitivities

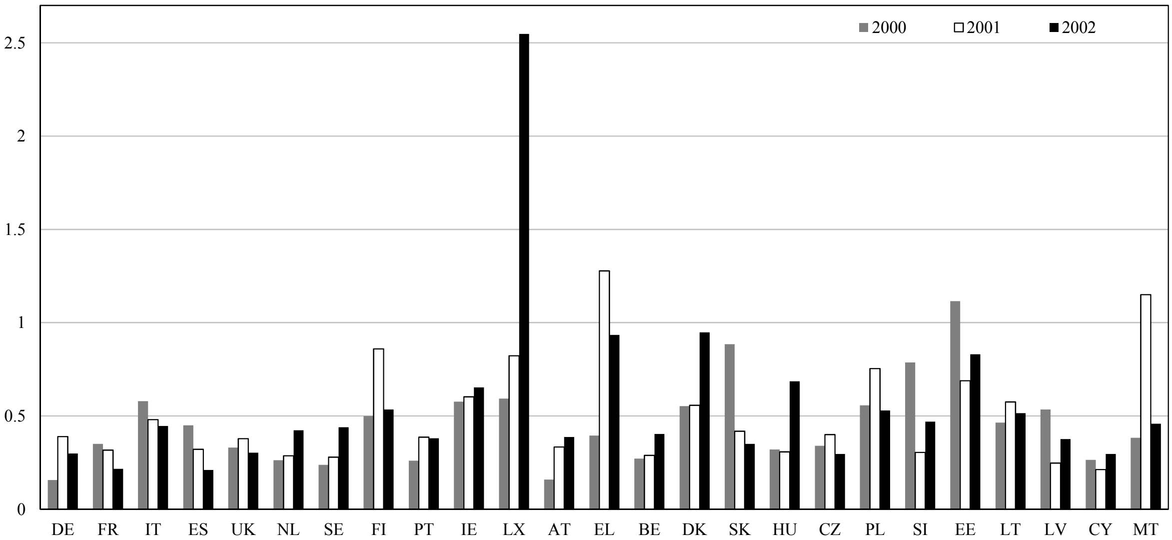
DE	FR	IT	ES	UK	NL	SE	FI	PT	IE	LX	AT	EL	BE	DK
0.51	0.49	0.5	0.43	0.42	0.55	0.58	0.5	0.45	0.4	0.49	0.47	0.43	0.54	0.65

SK	HU	CZ	PL	SI	EE	LT	LV	CY	MT
0.29	0.46	0.37	0.4	0.48	0.31	0.27	0.28	0.4	0.36

Source: EC.

Figure 8

Difference Between the Lowest and Highest Estimates of the European Commission for the Change in the Output Gap



Source: EC, CBR.

The last uncertainty is the – often ignored – estimation of elasticities. The commonly agreed methodology uses constant semi-elasticities. These are based on strong assumptions: no changes to the structure of revenues and expenditures, no legislative changes, no time-varying elasticities throughout the business cycle[45] and ignorance of some items on the expenditure side (for example pension or interest expenditures).

The bottom line from the analysis in this paper is that all four components of the structural balance (headline balance, elasticity, output gap and one-offs) are surrounded with high uncertainty and therefore the practical implementation of rules based on these estimates is very challenging in real-time with the current methodology.

[45] Relevant mainly for the corporate income tax and VAT.

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