PANEL DISCUSSION

SHORTCOMINGS OF EU FISCAL RULES AND INSTITUTIONS AND POSSIBLE WAYS FORWARD

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I will structure my discussion around three blocks:

1) The appropriate design of a fiscal rule, and how the Stability and Growth Pact (SGP) can be characterised against such ideal design. In this connection I will briefly discuss a possible alternative route the evolution of the European Union (EU) fiscal framework could have taken;
2) How fiscal rules should be applied to concrete cases and which form their enforcement should take. Taking the functioning of the SGP as a reference, I will relate its perceived shortcomings to a critical missing element, namely, a robust institutional set-up;
3) Possible ways forward to the development of an institution-based model to the steering of fiscal policy in Economic and Monetary Union (EMU), specially, examining how the fiscal council model could be adapted to the EU context.

1) Theory and experience converge to suggest that the appropriate design of a fiscal rule should combine the objective of debt sustainability with that of cyclical stabilisation. Concerning debt sustainability, while theory strictly requires a positive reaction of the primary surplus to increases in the debt ratio and remains inconclusive on the optimal debt objective, there seem to be strong reasons for having in place a mechanism inducing convergence to a prudent debt level. These reasons are probably stronger in the context of a monetary union, in the light of the externality created by each country in isolation facing in normal times a potentially flat demand curve for its debt, and hence an incentive to excessive indebtedness, while being potentially at risk of being shut out of the markets in times of crisis .There seems also to be a clear case for fiscal rules to include a counter-cyclical element, unless one believes in the absolute power of monetary policy to stabilise the economy (or the absolute impotence of fiscal stabilisation). Again, the case for fiscal policy stabilisation is probably stronger in a monetary union, as monetary policy is not available to offset country-specific shocks.

   The resulting rule can thus be described as a fiscal reaction function, whereby the target fiscal variable reacts according to a debt feedback mechanism (ensuring that debt cannot permanently deviate from the adjustment path toward the "anchor" debt level) and to a measure of the cyclical conditions. Views can reasonably differ on the parameterization of the rule, specifically, the value of the "anchor" debt level; the speed of convergence toward it implicit in the feedback mechanism; and the form of the reaction function to the cyclical conditions. Carnot (2014) provides a neat formulation of such a "rule of thumb" for fiscal policy. Andrle *et al.* (2015) propose a similar approach. Both papers also argue for the superiority of an expenditure growth benchmark as the operational target of the fiscal rule, expenditure being the variable most directly connected with policy decisions (with adequate safeguards against offsetting measures on the revenue side): in this sense the ideal fiscal rule can be described as an expenditure rule.

   How can the SGP be characterised against the fiscal rule model that has been outlined above? With a number of approximations, the Medium-Term Objective (MTO), which is the key concept of the SGP, can be described as a cyclically-adjusted "balance norm", inducing the convergence of debt to the 60 per cent of GDP Maastricht threshold. Cyclical stabilisation is not incorporated in the MTO as an independent objective but enters into consideration when measuring the gap between the "norm" and the actual balance, which countries are expected to steadily reduce. This has at least two practical implications: except in exceptional

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circumstances, the fiscal policy stance is expected to be restrictive until the debt convergence balance norm is achieved; conversely, once the norm is achieved, countries are dispensed from any other constraint on the conduct of fiscal policy, irrespective of cyclical conditions. It follows that the SGP is likely to envisage or allow pro-cyclical fiscal policies in a wider set of circumstances than it may be desirable. As to the operational variable, after its last reform, the SGP envisages a "two-pillar" approach, where the traditional metric for gauging the adjustment towards the MTO, namely, the change in the structural balance, has been flanked by the (deviation from the) expenditure benchmark, which effectively amounts to an expenditure rule (adjusted for net measures on the revenue side). This should be taken as a move in the right direction, although the co-existence of two operational targets is less than ideal from the point of view of transparency and communication.

One may recall at this point that the SGP, and in particular its so-called preventive arm introducing the concept of MTO, represents an innovation with respect to the original EMU fiscal framework envisaged by the Maastricht Treaty (1991). This introduced the numerical criteria for deficit and debt, and a step-wise procedure for their enforcement, but left considerable room for judgement at each stage, with Member States with deficit in excess of the 3 per cent of GDP threshold in practice receiving annual recommendations on how to reduce it. It was only in the run-up to the introduction of the single currency that the view prevailed that the excessive deficit procedure (EDP) should be made as "automatic" as possible, with Member States being given strict deadlines for the correction of the excessive deficits, under the threat of sanctions, and that moreover Member States should pursue a medium-term objective of close to balance or in surplus, with annual examination of the programmes for its achievement (van den Noord et al. 2008). It is tempting to imagine a different evolution of fiscal surveillance, where the Maastricht criteria would have served as potential flashpoints for identification of "gross errors" in fiscal policy, in the original spirit of the Treaty, while guidance for the normal conduct of fiscal policy could have evolved along the lines of the model outlined above; or, alternatively, it could have been devolved to national fiscal councils, under EU supervision, along the lines of the proposal of Odor and Kiss (2015). The recent set-up of fiscal councils under the impulsion of the intergovernmental Fiscal Compact and other pieces of EU legislation associated to the so-called Six-Pack (2011) and Two-Pack (2013) may eventually lead to a greater role for national independent bodies in prescribing fiscal behaviour. An immediate result of the Fiscal Compact, however, is that of effectively hampering any further evolution of the SGP in the sense of remedying the shortcomings that have been identified above, since it mandates the incorporation of a particularly restrictive version of the MTO in national constitutions or provisions of equally binding character.

2) The issue of the appropriate design of fiscal rules, while the most attractive from the economists' point of view, is arguably less important than that of the application of the rules to concrete cases and the manner of their enforcement. This is the area where the weaknesses of the EU fiscal framework are probably most apparent, but at the same time an insufficient appreciation of the true nature and causes of such weakness is pervasive. Complexity is probably the most frequent criticism of the EU fiscal framework, with multiple and overlapping rules affecting different fiscal aggregates the most cited illustration. Less widely appreciated is the role of the implementing and interpretative body that has grown around this elaborate set of rules: it is practically impossible to infer from the texts of the SGP how the rules will be applied to concrete cases without a detailed knowledge of the Code of Conduct on its implementation endorsed by the Council and the more comprehensive (and regularly revised) Commission's *Vademecum* (European Commission, 2013). As regards enforcement, the EU fiscal framework is characterised by the uneasy coexistence of two elements: an *ex ante* quasi-political peer pressure apparatus, implemented in the annual process of recommendation-setting known as the European Semester (followed by the assessment of national draft budgetary plans), and an *ex*

post quasi-judicial sanctioning mechanism, including the potential imposition of heavy fines on non-compliant Member States, which has however never been implemented in practice. It would be challenging to argue that the singular lack of implementation of the latter element owes to the unique effectiveness of the former.

What most critics of the SGP tend to miss is that both the complexity of the rules, and even more of their application, and the perceived lack of effectiveness of their enforcement, are not so much the result of exogenous policy choices, in terms of faulty design or biased implementation, as an endogenous feature of a system characterised by a lack of a central authority able to provide ultimate guidance and enforce the rules. Lack of central authority may be said to be a common feature of the EU governance, where the legal monopoly of initiative on the part of the Commission is balanced by the decision-making power of the Member States in the Council. It was therefore natural for the framers of the Maastricht Treaty to opt for a system of proscribing rules for fiscal policy, with the essential goal of protecting the central price-stability objective of the common monetary policy, while acknowledging the unwillingness of Member States to give up freedom of choice on matters of tax and expenditure, which are central to national sovereignty. A special recognition of the place of fiscal policy at the heart of sovereignty is to be found in the Treaty provision (Art. 126(10) TFEU) that, by way of exception to the normal functioning of the EU model of governance, excludes the right, on the part of the Commission or a Member State, to bring before the Court of Justice cases of Member State's failure to comply with its EDP obligations. Recognising the sensitivity of an issue is however not the same as finding a solution to it. In the case of fiscal policy, the absence of a common authority has been compounded by a lack of mutual trust among Member States and between the Member States and the Commission, which has probably deepened since the Great Recession and the different narratives that have emerged of it. Lack of mutual trust demands that every rule be either of a simplicity that makes it inadequate for the purpose or be complemented by endless specifications as to its application; in both cases, it makes highly contentious any attempt at its subsequent enforcement. Rather than as a sequence of mistaken views on the working of fiscal policy, as some of its academic critics would have it, the evolution of the SGP, from its initial attempt to put fiscal policies on "automatic pilot" to the current surfeit of "smart" rules, may suggest the conclusion that, in the absence of a robust institutional set-up, any fiscal framework may be condemned to oscillate between the Scylla of 'stupid rules' and the Charybdis of the "complete contract". In other words, the direction of causation between complexity and lack of ownership is not so much from the former to the latter as the other way round. Therefore aiming at dealing with the issue of complexity by proposing to streamline the rules without simultaneously addressing the institutional issue is equivalent to curing the symptoms while ignoring the root cause of the disease.

3) The need for a robust institutional set-up to sustain (or, in the view of some, replace) the working of fiscal rules has long been recognised by some academic critics: the natural parallel is that with monetary policy, where an early view stressing reliance on rules constraining the growth of monetary aggregates was replaced by a consensus on delegating the conduct of monetary policy to an independent central bank (Wyplosz 2002). A very significant recent development is that the call for a move from a system of "rules" to one of "institutions" has apparently become the line of the European Central Bank (Draghi 2015). The overall process and the concrete steps through which such a momentous change could take place are however left unspecified, producing the impression of discontinuity between the present unsatisfactory working of decentralized fiscal policies under far from ideal rules and a distant future of sovereignty sharing under common institutions. It is clear that the institutional model that has imposed itself for monetary policy would need strong modifications before its eventual adoption for fiscal policy: in a monetary union even more than in a national setting entrusting fiscal decision-making to an independent body does not seem readily feasible, or at least attuned with

democratic politics as we know it, even if it were possible to separate the distributional function of fiscal policy from its macroeconomic role. The growing literature on fiscal councils, while generally dismissive of the case for the delegating fiscal policy *powers*, highlights the *influence* that independent bodies can have on fiscal policy, essentially by raising the reputational costs for the government of running unsound fiscal policies (IMF 2013). However, the translation of the national model of fiscal council at European level is not straightforward. On the one hand, in the absence of a fiscal capacity at EU level, there is no EU equivalent of a national fiscal policy as the proper subject of influence on the part of an EU fiscal council. If, on the other hand, national fiscal policies were to be the subject, on which the EU fiscal council should pass judgment, then its field of action would be already potentially overcrowded by the presence of national fiscal councils and, not least, the European Commission in its role as "guardian of the Treaty" and, by extension, the EU fiscal framework. A viable division of labour would have to be found, bearing also in mind the "constitutional" constraints coming from the Treaty and Fiscal Compact.

It has been suggested above that in principle it would be possible, consistent with the Treaty provisions and arguably best in line with their original spirit, for the Commission and the Council to retreat from the day-to-day (micro-) management of fiscal surveillance and focus on the "gross errors" in fiscal policy. Already the evolution of the rules and even more of the practice of fiscal surveillance points in the direction of greater discretion on the part of the Commission and the Council. Further developments in this direction would demand the elimination of strictures in the corrective arm (e.g. the obligation to always open an EDP if certain conditions are not satisfied and the persisting obstacles to reviewing EDP recommendations in the light of changed economic circumstances); concerning the preventive arm, whose enforcement capacity remains relatively weak even after the recent reforms, it would be important to gain greater discretion in assessing the occurrence of a "significant deviation" from the MTO or the adjustment path towards it, particularly in the critical cases of apparent "overachievement" of the MTO owing to revenue windfalls (and hence consistent with imprudent policies on the spending side).

In the light of the shortcomings of the current situation analysed under 2) above, establishing the credibility of the Commission vis-à-vis Member States in the critical function of identifying "gross errors", with a wider margin of discretion than under the present rules, that the Commission itself be flanked by an independent body possessing the qualities – in particular, strict operational independence from politics, mandate restricted to fiscal surveillance – that are typically associated to a fiscal council. In turn this would raise the delicate institutional question of how to organise the co-existence of such a body with the decision-making power attributed by the Treaty to the Commission and the Council. A number of solutions may be envisaged: the fiscal council could provide advice on the balance of "relevant factors" underlying the case for a surveillance decisions (e.g. whether or not open an EDP or issue a new recommendation under the same procedure) before the Commission initiates it; alternatively, the fiscal council effectively prepare all surveillance decisions for endorsement by the Commission. It is interesting to note that the latter model has been effectively applied to allow for centralised banking supervision and resolution in the euro area context of the banking union: in particular, the creation of, and the attribution of extensive powers, to the Single Resolution Board, was made compatible with the preservation of the Commission powers that cannot be validly transferred to other bodies without changing the Treaty. For the fiscal council to perform an effective role it would be essential that the principle of "comply or explain" applies, in turn requiring that the Commission explains publicly the reasons for departing from the fiscal council advice, and that the fiscal council be involved with adequate resources upstream of the decision-making process.

A further question that the set-up of a fiscal council at EU level would raise concerns its relationship with the already (recently) established national fiscal council (technically, independent fiscal institutions (IFIs). Substantial disagreement between the EU-level and the national IFIs on the assessment of a country situation against the background of the commonly applicable fiscal framework would risk undermining the bodies' authority and that of the framework itself (although it has to be recognised that the risk already exists under the current set-up, especially with the tasks conferred to IFIs by the Fiscal Compact). A way forward could involve the creation of a European system of IFIs, with the EU-level IFI representing the "federal" interest, including providing the final advice to the Commission. The arrangements put in place for the banking union, in particular, the set-up of the Single Resolution Board, which works in close cooperation with the national resolution authorities, could provide *mutatis mutandis* a model for the working of the European system of IFIs compatible with the existing Treaty.

An eventual change of the Treaties would allow removing further shortcomings of the current model: in particular, replacing the distinction between "preventive" and "corrective arm" of the SGP, and the resulting plurality of rules and target aggregates, with the model of fiscal rule outlined under 1); and replacing the sanction-based model for the enforcement of fiscal rules, with greater *ex ante* intrusive powers on the part of the EU level (e.g. veto on national budgets) in case of serious and persistence failure to comply with the rules. The superior design of a fiscal rule effectively coupling the objective of debt sustainability with that of cyclical stabilisation should contribute to its acceptance, at least in terms of "output legitimacy". In turn, this should facilitate the shift from a "proscribing" to a "prescribing" approach to fiscal governance (although the extraction of sovereignty implied by such a move as a EU veto on national budgets would probably to remain reserved for behaviours endangering the sustainability objective). If the thrust of the analysis that has been presented is correct, however, it follows that, in terms of robust policy sequencing, it may be unwise to wait for an overall "constitutional" change before addressing the issue of the absence of an authoritative referee in the system and the corrosive effect that this absence is bound to have on the working of even the best-thought fiscal rule.

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RULES VS DISCRETION IN THE EUROPEAN FISCAL FRAMEWORK

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The Monetary Union, as designed by the Maastricht Treaty in 1991, rests on a rule-based approach. Except for a few commentators in favour of market mechanisms, this approach has been rarely questioned. Over the last quarter of century, a continuous debate concerned instead the most desirable design of the rules.

This situation has changed with the crisis. Many observers have questioned whether a purely rule-based governance is viable in the long run. The debate opened up to broader issues, including the end-point of the Union, the design of European institutions and how to achieve greater accountability and democratic legitimacy. At the end of 2012, the European Commission (with its *Blueprint*) and the four Presidents[1] contributed to the discussion. As you all know, some of their indications seem to have been somewhat side-stepped, but the quest for a better economic governance in the Euro Area is going on and a new Four Presidents' Report should be unveiled next June.

In what follows, I will not tackle these broader themes but I will largely focus on the issue of rules vs. discretion and its implications.

Given the nature of this workshop, I will stick to fiscal issues, but let me briefly mention another situation in which we find a conflict between rules and discretion, in the area of monetary policy. The prohibition of monetary financing imposed on the ESCB by the Treaty[2] had the rationale to protect the integrity of monetary policy, enhancing its autonomy. Its unintended effect, during the crisis, was to unduly constrain the actions of the ECB preventing a more effective and timely reaction to the risk of deflation.

The new framework induced by the crisis

As a reaction to the crisis, new fiscal rules have been introduced and exceptions and "relevant factors" have been added. **Together with its stringency, the complexity of the system has increased.** As we have just heard in this room (today, but the same message was conveyed by three distinguished panellists during last year's workshop), there is a widespread feeling that some streamlining is needed.

One of the reasons behind the proliferation of fiscal rules is probably the **insufficient trust** among member states, which may have been partly justified by the well-known episode of statistical misreporting. The revision of the rules was also a reaction to their failure to deliver sound public finances in every country.

At the same time, the introduction of exceptions and "relevant factors" was deemed necessary to **avoid that such a complex set of rules became a straightjacket** in bad times, also

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[1] The report "Toward a Genuine Economic and Monetary Union" was drafted by the President of the European Council in close collaboration with the President of the Commission, the President of the ECB and the President of the Eurogroup.

[2] "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments." Art. 123 of the Treaty on the Functioning of the European Union.

given the large uncertainty concerning the effects of fiscal policies, the wide margins of error in measuring the government structural budgetary position and the difficulties in defining in practical terms what fiscal sustainability is. Subsequent events suggest that it was a sensible decision.

Rather paradoxically, **discretion has also increased**. While before it depicted itself as just the “guardian” of the rules, the Commission has started to have an active role in interpreting them.

The system is now less transparent. The general public can understand the 3 per cent limit; with some imagination it may grasp the concept of a balanced budget in structural terms; but I believe it is at loss with the “minimum linear adjustment” required to satisfy the debt rule and similar subtleties.

Consequences of the current framework

More than in the past, **rules are under attack**, both from those who believe that they should be tightened and from those who think that they are too stringent.

A possible explanation of this discontent is the fact that the **rules may still be too pro-cyclical**, both in good and in bad times, notwithstanding the efforts to address this issue. In the current situation – the aftermath of a deep downturn in many economies – critics of the rules stress that they are too stringent and leading to pro-cyclical prescriptions. The critics on the opposite side are instead worried by the discretionary margins used in the interpretation of the rules by the European authorities (Commission as well as Council) in an effort to avoid their pro-cyclicality.

The problem cannot be easily solved modifying the rules by making them less pro-cyclical, because the current cyclical position is assessed with a large degree of uncertainty. When a signal is not accurate, it is not optimal to react fully to its indications.

Complexity and lack of transparency have **reduced the accountability of national politicians**.

Possible ways forward

We have gone probably too far in trying to draw up a “complete contract”: a certain degree of discretion could be beneficial if the institutions and procedures are adequately designed and more discretion may also allow for simpler and more transparent rules. In what follows I will outline these themes.

Reconsidering institutions and procedures. - We all agree that the political dimension in the fiscal domain is unavoidable. Therefore, the final, political, decisions will still have to rest in the hands of the Council. My point is that, for the sake of transparency, its decision need to be based on a proposal formulated as much as possible on purely economic grounds, reflecting the rules as well as a wide range of elements.

I also believe that in the last, difficult years, the European Commission did a great job and that its technical skills, which have been progressively strengthened, match its tasks.

The issue I want to take up is the widespread perception that “political” elements played a role in the decision process already when the proposals of the Commission were defined. This contamination (or perception of it) may partly reflect the way Commissioners are appointed, *i.e.*, through a bargaining among member states. The recent emphasis given to electoral results, while justified on other grounds, probably increased this impression. A political balancing of national

views seems also to underlie the current governance, featuring a supposedly lax Commissioner supervised by a supposedly hard-liner Vice-President.

Overall, in the current arrangement, instead of having a political decision based on a purely technical proposal (rule-based and economically sound), we have two decisions which rarely differ, because the political element is, at least partially, already included in the proposal.

How can we avoid this? One possibility is to **separate this task from the other activities of the Commission** creating a new institution with a specific mandate and therefore high accountability (in this respect, the ECB is the obvious model). This institution would represent a sort of European fiscal council, which would also oversee and coordinate the national ones. A similar idea was set forth by Karsten Wendorff last year at this conference and, more recently, by the Monthly Bulletin of the Bundesbank, though the details are still restricted to readers knowledgeable in German.

Evidently, separating the task of fiscal (and macroeconomic) surveillance from the many tasks carried out by the Commission would lead to greater transparency, but also to some duplication and additional costs.

While I find the paper presented by Odor and Kiss full of thought-provoking insights – I find problematic the suggestion to attribute large responsibilities to the National Fiscal Councils, leaving to the European institution a residual role, limited to exceptional circumstances. The reason of my reservations is that the externalities arising from participation in EMU imply limits that, in many cases, are more stringent than those which are optimal from a strictly national viewpoint. Such limits could be effectively overseen only by a supranational authority as we cannot expect national institutions to fully internalize in their decisions the interests of the other member states.

Reconsidering the rules

A simple but robust system could include the requirement to achieve and maintain a balanced budget in structural terms (or, alternatively, on the Medium Term Objective as currently defined) and the 3 per cent threshold as an upper bound for the deficit. In other terms, **we could go back to the state of the rules in 1997** (or, if we retain the MTO, to the pre-crisis framework), keeping however the various procedural improvements introduced since. I believe that no other rule is necessary. When there are no large and systematic stock-flows, the debt rule is redundant in normal times – as the respect of a balanced budget in nominal terms guarantees already a sizeable reaction of the debt ratio; the debt rule is instead binding in very bad times, but in this case its prescriptions would be damaging, as it would ask for a large pro-cyclical adjustment.

As for the expenditure rule – which is given a pivotal role in the excellent IMF paper just presented – I reckon it can be an important instrument at the national level, but its use seems problematic in a multilateral framework. As Daniele Franco argued last year in this conference, an expenditure growth ceiling would constrain social preferences, without directly targeting the fiscal variables which cause externalities. If citizens' preferences change in favour of increasing the size of the public budget, an expenditure growth ceiling may unduly hamper the adjustment.

Of course, the very incomplete contract I have outlined should be overseen by an accountable European authority enjoying a degree of discretion. In particular, this authority should make sure that the spirit of the covenant is respected; for example, overseeing the size and nature of stock-flows.

Summing up

Rules have carried us forward a long way, but it was naïve from the start to believe that they could be mechanically applied in all possible contingencies.

A certain degree of discretion must be accepted. This is also the opinion set forth by President Draghi in his recent speech when discussing the fiscal framework (Frankfurt, 16 March 2015): “Rules can only really be credible if they are applied with very little discretion. Otherwise as soon as they actually bind, countries will find reasons not to follow them. But having no discretion is also not optimal, as circumstances will always arise that the rules did not foresee. There is thus an inevitable trade-off between credibility and flexibility”.[3]

Accepting discretion may also allow us to **reconsider the rules**, making them simpler and more transparent.

But discretion should also be exercised through **well-designed institutions and procedures**. We have to ponder on whether the current arrangements are fully optimal in this respect. As stressed by President Draghi in the above mentioned speech: “We need to move from rules to institutions”.

3 https://www.ecb.europa.eu/press/key/date/2015/html/sp150316.en.html