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