How to Enforce Fiscal Discipline in EMU: A Proposal

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1. Introduction

Nowadays it is generally acknowledged that the Stability and Growth Pact (SGP) did not enforce sustainable fiscal policies in the Member States of the euro area. Not so long ago, this was different. Even the then vice-president of the ECB, Papademos, argued in 2003 that "a comparison of the rules and procedures of the Stability and Growth pact with [characteristics of successful fiscal policy rules] … shows that the European fiscal rules perform reasonably well, which may lead us to conclude that they are – in principle – suited to ensure fiscal discipline" (Papademos, 2003, p. 75).

Inman (1996) has identified certain characteristics of successful fiscal policy rules at the state level in the US. Using his classification, we show that the SGP suffers from two serious weaknesses: a politicized decision-making process and lack of effective instruments to enforce that Member States adjust their fiscal policies if needed (Section 2).

European policymakers have taken several steps to improve upon fiscal governance, including the introduction of the six-pack and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG). The so-called six-pack, consisting of five Regulations and one Directive, does not only cover fiscal policy surveillance, but also macroeconomic surveillance under the new Macroeconomic Imbalance Procedure. In the fiscal field, the six-pack reinforces both the preventive and the corrective arm of the SGP. The articles in Title III of the TSCG referring to fiscal policy are generally referred to as Fiscal Compact. The two most important elements are a balanced budget rule, including an automatic correction mechanism, and a strengthening of the

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excessive deficit procedure. In Section 3 we argue that these recent steps are a clear improvement, but do not sufficiently address the fundamental weaknesses of the fiscal governance mechanisms in place in the euro area.

In Sections 4 and 5 we outline and motivate our preferred solution (see also de Haan et al., 2012). Drawing on the analysis of Alesina and Tabellini (2007), our preferred long-term solution is to delegate the enforcement of European budgetary rules to a fully independent Budgetary Authority (Section 4). This will redress the first shortcoming of the current rules in place (i.e. its politicized nature). Next, we will argue that well-designed Eurobonds can be a very effective instrument to enforce budget discipline further in the long run (Section 5). We propose centrally issued Eurobonds for the full public debt, under the condition that Member States will no longer be allowed to independently raise funds in the money or capital markets. The Budgetary Authority will distribute the necessary (Eurobond) funding to the Member States, but only if they have sustainable fiscal policies as defined in the Maastricht Treaty or implement a strictly monitored adjustment programme. As even these well-designed Eurobonds may still cause a moral hazard problem, this full mutualisation of risks on Member States' government debt is only sustainable after other safeguards have been strengthened significantly to prevent that these risks arise. In particular, the enforcement of rules by the Budget Authority should be well established, and Member States should first reduce their debt towards a much lower level than is currently the case. Other required safeguards include a banking union with strong European supervision, and a stricter European enforcement of rules to prevent macroeconomic imbalances. These requirements imply that this far-reaching form of Eurobonds cannot be used as a crisis instrument. The final section offers our conclusions.

2. The SGP: An Assessment[1]

The Maastricht Treaty and the Stability and Growth Pact (SGP) as adopted in 1997 stipulate that euro area Member States have the obligation to avoid excessive government deficits (based on a deficit criterion and a debt criterion, which are assessed against the reference values of 3% and 60% of GDP, respectively). The SGP provides the details for the multilateral surveillance and the excessive deficit procedures. It consists of two Council Regulations on the strengthening of the surveillance and co-ordination of budgetary positions[2] and on speeding up and

1 This section heavily draws on de Haan et al. (2004).
2 Council Regulation No. 1466/97, O. J. 1997, L209/1.

clarifying the implementation of the excessive deficit procedure[3], tied together by a corresponding European Council Resolution.[4] Regulation 1466/97 gives Member States a goal of a medium term budgetary position of close to balance or in surplus. Regulation 1467/97 arranges the excessive deficit procedure (EDP) and is intended to ensure the correction of excessive deficits in case they do occur.

Table 1 shows how well the SGP performs on characteristics of successful fiscal policy rules as identified by Inman (1996) based on research on fiscal rules in US states. We first summarize these characteristics after which we discuss the scores of the SGP.

The potentially most important distinguishing attribute is whether the rule involves ex ante or ex post accounting. *Ex ante rules* apply only at the beginning of the fiscal year, i.e. fiscal policy intentions, whereas *ex post rules* apply to fiscal policy outcomes. The US experience suggests that ex ante rules are weak, while ex post accounting rules are strong. A second attribute is whether politicians can put a certain rule aside if they think this to be appropriate. The US experience suggests that weak rules allow such an override; strong rules do not.

The third attribute of enforcement can be described along three dimensions: access to complain about adherence to the rules is closed or open, the enforcer is partisan or independent, and the penalties are economically insignificant or significant. According to Inman (1996), the US experience suggests that strong rules have open access to a review panel or court to allow all potentially affected parties to claim a violation; closed access weakens the rules. Further, for a strong rule the enforcing review panel must be independent of – i.e. not connected by partisan obligations to – the political bodies setting deficit policies. Also, if a violation is found, penalties must be enforceable and large enough to induce the political bodies setting deficit policies to prefer the balanced budget outcome to a deficit and the associated penalty. Finally, allowing the rule to be amended by current political interests – the same interests preferring larger deficits – may weaken the rule.

Table 1 presents our assessment of how well the SGP does fare according to the criteria of Inman (1996). With regard to the specification of the rule, as far as the ex post character is concerned, there is a clear distinction between the multilateral surveillance and the excessive deficit procedure. The latter refers to *ex post* reporting. However, the stability programmes that countries have to submit under the surveillance procedure are based on the plans for future national measures in the field of economic policy and refer thus to *ex ante* reporting. So under the

3 Council Regulation No. 1467/97, O.J. 1997, L 209/6.

4 Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997, O.J. 1997, C 236/1.

excessive deficit procedure, the Member States are primarily judged on the basis of realised fiscal performance, even though planned budget deficits can also be a reason for the Commission to initiate the excessive deficit procedure, while under the multilateral surveillance they are judged on the basis of policy intentions.

Table 1: Aspects of Effective Fiscal Policy Rules: An Assessment of the SGP

Specification	Weak rule	Strong rule	Surveillance	Excessive deficit procedure
Rule				
Timing for Review	Ex Ante	Ex Post	Ex Ante	Ex Post
Override				
Majority Rule	Allowed	Not Allowed	Allowed	Allowed
Enforcement				
Access	Closed	Open	Closed	Closed
Enforcer	Partisan	Independent	Partisan	Partisan
Penalties	Small	Large	None	Large (but never imposed)
Amendment				
Process	Easy	Difficult	Very difficult	Very difficult

As to the second criterion: the ECOFIN Council is in charge. Based on a proposal of the European Commission, the ECOFIN has to decide whether an excessive deficit exists in a Member State, and if so which steps will then be taken. If a Member State does not take (sufficient) action to redress an excessive deficit, sanctions may be imposed. Sanctions include the requirement for the Member State concerned to make a non-interest bearing deposit, which, if non-compliance persists, is eventually turned into a fine. Critics of the SGP pointed to a major weakness of the rules in place: the ECOFIN will not automatically impose sanctions, as each step requires a discretionary decision by the Council. And the same ministers who are responsible for drafting national budgets and who may therefore be accused of breaking the rules also have to decide whether one of their colleagues breaches the same rules. In our view, this has to be considered as the most severe weakness of both parts of the SGP.

Access is clearly limited, since the Council will only take decisions on the basis of a proposal of the European Commission. If the Commission comes to the conclusion that an excessive deficit exists or may occur, it addresses an opinion to the Council, which takes a decision on whether or not an excessive deficit exists.

Regarding the application of sanctions, the same argument that has been made with respect to the possibility for an override by the Council can be made. The sanctions due to breaching the deficit criterion are quite tough, if applied. However, the ECOFIN will not automatically impose sanctions, as a discretionary decision by the Council is required. In practice, sanctions have not been imposed in the EDP. In addition, even if imposed, fines aggravate the budgetary imbalances they intend to prevent. The sanctions in the multilateral surveillance procedure are even weaker, relying mostly on moral suasion and peer pressure ("naming and shaming").

The amendments of the SGP as introduced in 2005 brought even more discretion and flexibility into the corrective arm, although the preventive arm became slightly more stringent (Amtenbrink and de Haan, 2006). As to the latter: Each Member State will present its own country-specific medium-term objective (MTO) in its stability programme. These country-specific MTOs will be differentiated and may diverge from the close to balance or in surplus requirement depending on the current debt ratio and potential growth. The adjustment effort should be greater in good times and could be more limited in bad times. As a benchmark, the Member States should pursue an annual adjustment in cyclically adjusted terms, net of one-off and temporary measures, of 0.5 per cent of GDP.

Under the revised EDP, when assessing and deciding upon the existence of an excessive deficit, the Council can consider an excess over the reference value resulting from a severe economic downturn as exceptional if the excess over the reference value results from a negative growth rate or an accumulated loss of output during a protracted period of very low growth relative to potential growth. When evaluating whether a Member State's deficit exceeds the 3% limit, the Commission has to take into account numerous factors related to the development of the medium-term economic position, such as the implementation of the policies in the context of the Lisbon agenda, policies to foster research and development and innovation, fiscal consolidation efforts in economic 'good times', debt sustainability, public investment, financial contributions to international solidarity, fiscal burdens related to European unification, pension reforms and the overall quality of public finances.

Finally, with regard to the question of whether the rule can be changed a differentiation has to be made between the provisions included in the EC Treaty and the Protocols annexed thereto and the two Council Regulations. An amendment of the rules on the multilateral surveillance and excessive deficit procedure as laid down in Art. 99 et seq. EC would require an amendment of the EC Treaty itself and thus, needs the consent of all Member States. To the extent to which the excessive deficit procedure is laid down in Council Regulation 1467/97, an amendment requires an unanimous decision by the Council. Only the rules on the multilateral surveillance procedure, to the extent to which they are laid down in Council Regulation 1466/97, can be amended by a qualified majority vote in the Council. Fundamental amendments of the multilateral surveillance and excessive deficit procedure thus in principle require a consensus between all Member States which is not easily achieved.

3. Changes Due to the Six-Pack and the Fiscal Compact[5]

The so-called six-pack reinforces both the preventive and the corrective arm of the SGP. For instance, it defines quantitatively what a 'significant deviation' from the MTO or the adjustment path towards it means in the context of the preventive arm. Moreover, the six-pack enables that an EDP may be launched if a country does not meet the rule for the government debt ratio (i.e. the ratio is above 60% of GDP and does not diminish towards the Treaty reference value at a satisfactory pace). Financial sanctions are imposed in a gradual way, from the preventive arm to the latest stages of the EDP, and may eventually reach 0.5% of GDP. Most importantly, the six-pack introduces reverse qualified majority voting (RQMV) for decisions on most sanctions. RQMV implies that a recommendation or a proposal of the Commission is considered adopted by the Council unless a qualified majority of Member States votes against it, thereby strengthening the position of the Commission vis-à-vis the Council, and making it more likely that sanctions will be imposed.

The two most important elements of the Fiscal Compact are a balanced budget rule, including an automatic correction mechanism, and a strengthening of the excessive deficit procedure. The contracting parties commit to implementing in their national legislation a fiscal rule, which requires the general government budget to be in balance or in surplus. This rule requires that the annual structural balance should be in line with the country-specific MTO with a lower limit of a structural deficit of 0.5% of GDP. (This limit is 1% if the government debt-to-GDP ratio is significantly below 60% and risks to long-term fiscal sustainability are low.)[6] The balanced budget rule must include a correction mechanism, which is automatically triggered in the event of significant observed deviations from the

5 This section draws upon de Haan et al. (2012).

6 As pointed out by the ECB (2012), in practice the new balanced budget rule will not be more ambitious than the EU regulation already demands, since all euro area Member States currently have an MTO that equals a structural deficit of 0.5% of GDP or less.

MTO or the adjustment path towards it (with escape clauses for exceptional circumstances). Under the Fiscal Compact there should be "rapid convergence" to the MTO, but the time frame is still to be specified in a proposal by the Commission. The Commission has also been given the task of proposing common principles for the correction mechanism.

The balanced budget rule must be introduced in the national law of the countries concerned within one year after the TSCG enters into force. This must be done in a binding and permanent way, preferably at the constitutional level. The European Court of Justice (CoJ) may impose a financial sanction (0.1% of GDP) if a country does not properly implement the new budget rules in national law and fails to comply with a CoJ ruling that requires it to do so.

The Fiscal Compact also strengthens the Excessive Deficit Procedure of the SGP, in particular by increasing its automaticity if a euro area Member State is in breach of the deficit criterion. Most importantly, at each stage of the Excessive Deficit Procedure euro area Member States will support the Commission's proposals or recommendations in the Council if a euro area Member State is in breach of the deficit criterion, unless a qualified majority of them is against it. In practice this means that if a euro area Member State breaches the deficit criterion, reverse qualified majority voting applies to all stages of the EDP. The introduction of this voting commitment for important procedural steps, such as the opening of an excessive deficit procedure, the decision whether a euro area Member State has taken effective action, and a possible stepping-up of the excessive deficit procedure, increases the automaticity of procedures compared to the reinforced SGP (ECB, 2012).

Unfortunately, reverse qualified majority voting will not be applied following a breach of the debt criterion by a euro area Member State. As argued by de Haan et al. (2012), it seems that European policymakers still have to learn the lesson from the sovereign crisis that debt levels are more important than deficits when it comes to the sustainability of the currency union. Furthermore, as pointed out by the ECB (2012), for the new rules to work it is crucial that the Commission uses its increased influence by taking a rigorous approach when assessing fiscal deficits and avoids politically influenced decisions.

Even though we consider the Fiscal Compact a step in the right direction, it does not sufficiently redress all the shortcomings of the SGP identified earlier. Furthermore, "its effectiveness and credibility remains subject to a strict implementation of fiscal policy surveillance by the Commission and a limited use of political discretion by the Council" (ECB, 2012, p. 93). That is why we argue in favour of further steps curtailing national fiscal sovereignty.

4. Independent Enforcement

The SGP (in both its original and its new form) combines a rule-based approach to fiscal discipline with some room for discretion. The well-known 3% of GDP limit on the budget deficit can, for instance, be sidestepped in case of a severe economic downturn. As pointed out by Lane (2010), the 2009 crisis has illustrated the importance of such an escape clause.

Whether the escape clause is invoked is ultimately decided upon by politicians (the ECOFIN Council). The politicized nature of the SGP's enforcement has been the source of much criticism (see Section 2). Should the enforcement of fiscal rules therefore be placed in the hands of independent bureaucrats? The introduction of an independent Budgetary Authority is seen as controversial, as fiscal policy is thought to be at the heart of the political decision-making process (Buti et al., 2002).

Alesina and Tabellini (2007) argue that from a perspective of economic efficiency, independent bureaucrats are preferable for tasks that have the following features: (i) differences in performance are due to individual talent or technical ability; (ii) the preferences of the public are stable and certain, so that flexibility is less valuable; (iii) time inconsistency is likely to be a relevant issue; (iv) the nature of the policy is such that politicians can strategically distort policy choices in favour of short term objectives and against long term welfare; (v) the stakes for organized interest groups are large, or the legal system is well-designed so that corruption is not widespread; (vi) side payments to compensate the losers are undesirable and irrelevant, or bundling of different aspects of policy management and a comprehensive approach is unimportant. The reverse applies to the attribution of prerogatives to politicians.

When it comes to the enforcement of the SGP, technical ability is crucial. Before one can judge whether a violation of, for instance, the 3%-threshold for the budget deficit has been caused by economic circumstances or too lenient fiscal policy, one at the very least needs to be capable of judging the state of the business cycle and the effects thereof on the fiscal balance. As pointed out by Benetrix and Lane (2013), the credit crunch and the resulting strong deterioration of public finances in several European countries also illustrates the need of taking into account the financial cycle in judging the appropriateness of the fiscal policy stance. This requires expert judgement.

It also seems reasonable to argue that the public has relatively stable preferences for sustainable public finances. Time inconsistency is as much a problem for fiscal policy as it is for monetary policy, as is well documented in the literature (see e.g. Von Hagen and Harden, 1995; Blinder, 1997; Fatás and Mihov, 2002). Due to the possibility of extracting rents for the government, the stakes for organised groups in fiscal policy are also large, while side payments to the "losers" of fiscal discipline seem unwanted too.

It is therefore fairly safe to say that based on the criteria of Alesina and Tabellini (2007), the enforcement of fiscal rules needs to be placed in the hands of independent bureaucrats rather than in those of politicians. For European countries, this is not as controversial as it may seem. In practice, many countries have already restricted the discretion of politicians on fiscal matters, for instance via fiscal rules (Wyplosz, 2012). This goes especially for EMU Member States, which already agreed to give up an important part of their budgetary autonomy under the Stability and Growth Pact. Our proposal would make these existing restrictions more binding, but would not create any new restrictions. A strong case can therefore be made to delegate the enforcement of fiscal rules in the euro area to an independent Budgetary Authority.

5. Effective Instrument

Eurobonds have been proposed by several economists and politicians. Eurobonds are understood here as centrally issued, jointly guaranteed bonds for financing the euro area Member States' public debt. As discussed extensively by de Haan et al. (2012), the most important objection against Eurobonds is that due to the fact that other euro area countries explicitly assume liability for other countries' debt, there is a moral hazard problem: countries lose the incentive to take care of their public finances. How then can Eurobonds be used an instrument to enhance fiscal discipline?

In our view, Eurobonds can be an effective instrument if countries can no longer enter the capital and money markets on their own initiative. This implies a complete centralization of debt issuance in the euro area accompanied by a common liability for that debt. The introduction of Eurobonds, even if they fully replace national bonds, still causes a moral hazard problem as a Member State may be tempted to free ride on other Members' legal obligations to assume its debt in case of default. It is for this reason that a centralized 'Eurobonds only' scheme will have to include measures to effectively and credibly enforce fiscal discipline.

This is where the independent Budgetary Authority comes in. This authority not only enforces the fiscal rules, but is also the sole issuer of Eurobonds. It thereby has the exclusive authority over the granting of loans to Member States. The authority should be able to increasingly intervene in the fiscal policy of countries that break the agreements. In the fiscal framework, much more attention will be given to the level of government debt. Access to Eurobonds will in principle be limited to countries meeting the requirement of a "debt ceiling" of 60% of GDP (de Haan et al., 2012). After Member States have brought back their debt ratio and do not exceed the debt ceiling, Member States retain the autonomy to determine the size and composition of their national budgets, within the boundaries set by the SGP. The debt ceiling should be enforced by placing Member States exceeding the ceiling in a form of receivership. Such countries would, for instance following a severe economic shock, be temporarily allowed to take on extra debt (not on their own, but via the Budgetary Authority), under the strict condition that they adhere to a budgetary correction program. A Member State would be allowed to define the program itself, subject to feasibility and efficacy review by the Authority. If the corrections proposed by the debtor nation were insufficient, the Authority would be able to impose corrections. Any country that failed to satisfy the requirements would be denied access to additional finance and would therefore have no choice but to immediately take further austerity measures. In a system where Eurobonds would be the sole finance vehicle, such a sanction would be much more credible than anything that is currently imposed on problem countries, because countries would have no access to finance except via the new Budgetary Authority.

As even these well-designed Eurobonds may still cause a moral hazard problem, this full mutualisation of risks on Member States' government debt is only sustainable after other safeguards have been strengthened significantly to prevent that these risks arise. In particular, the enforcement of rules by the independent Budget Authority should be well established, and Member States should first reduce their debt towards a much lower level than is currently the case. Other required safeguards include a banking union with strong European supervision, and a stricter European enforcement of rules to prevent macroeconomic imbalances. These requirements imply that this far-reaching form of Eurobonds cannot be used as a crisis instrument.

6. Conclusions

Using the classification of Inman (1996), we show that the SGP suffers from two serious weaknesses: a politicized decision-making process and lack of effective instruments to enforce member states to adjust their fiscal policies if needed. We argue that the Fiscal Compact as recently agreed upon by most EU Member States is a step forward in enhancing fiscal discipline in the euro area for two reasons. First, it entails fiscal adjustment rules and these rules will be enshrined in national law. Second, under the Fiscal Compact the euro area Member States will at each stage of the EDP support the European Commission's proposals or recommendations in the Council if a euro area Member State has an excessive deficit, unless a qualified majority of them is against it. In practice, this means that reverse qualified majority voting (RQMV) applies to all stages of the EDP, thereby to some extent reducing the discretionary powers of the Council. However, we argue that these changes are not sufficiently far-reaching to redress the major weaknesses of the EU's fiscal governance mechanism. More independent enforcement is needed, and our preferred long-term solution would be to delegate the enforcement of European budgetary rules to a fully independent Budgetary Authority. Once the enforcement by this authority is well-established and government debts have declined towards 60% of GDP, fiscal discipline could be strengthened even further by introducing well-designed Eurobonds, i.e. centrally issued Eurobonds for the full public debt under the condition that Member States will no longer be allowed to independently raise funds in the money or capital markets. The independent Budgetary Authority only distributes funds to Member States if they have sustainable fiscal policies as defined under the SGP or if they properly implement a strictly monitored adjustment programme. Not only will such a system impose fiscal discipline, collective financing based on Eurobonds will also prevent speculative attacks on debt of individual euro area Member States as occurred during the recent crisis in the euro area.

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SUMMARY

Based on Inman's (1996) classification of successful fiscal policy rules, we argue that the Stability and Growth Pact suffers from two serious weaknesses: a politicized decision-making process and lack of effective instruments to enforce that Member States adjust their fiscal policies if needed. Although recent changes in the European Union's governance of national fiscal policy are considered to be an improvement, we argue that they do not address these shortcomings sufficiently. More independent enforcement is needed, and our preferred long-term solution would be to delegate the enforcement of European budgetary rules to a fully independent Budgetary Authority. Once the enforcement by this authority is

well established and government debt-to-GDP ratios have declined towards 60%, fiscal discipline could be strengthened even further by introducing well-designed Eurobonds as the capstone of EMU. We propose centrally issued Eurobonds for the full public debt under the condition that Member States will no longer be allowed to independently raise funds in the money or capital markets. The independent Budgetary Authority only distributes funds to Member States if they have sustainable fiscal policies as defined under the SGP or if they properly implement a strictly monitored adjustment program.