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Should rules continue to rule?

Policy brief on the political economy dimensions of the FIRSTRUN project

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After the succession of reforms of economic governance enacted in response to the sequence of crises since 2007, the EU economy is showing welcome signs of returning to more stable growth. It is therefore tempting to infer causality, although the sheer extent of the turmoil of the last decade invites caution in drawing too emphatic a conclusion. Certainly, significant gaps in the policy architecture have been filled and there is something of a consensus that the upshot is a more robust and resilient framework. Equally, the process is visibly incomplete and several recent contributions to the policy debate advocate still more reforms in fiscal policy arrangements and their linkages to other policy domains.

Although further reforms are expected as part of a long-run strategy to increase the resilience and effectiveness of euro governance, experience suggests it is not enough to improve the design of mechanisms and procedures. What is often missing is solutions to the many, difficult political economy complications of running EMU and implementing what is agreed. These include: the political will to accept constraints; the modalities of ensuring compliance and enforcing rules and, where necessary enforcing rules and decisions; and legitimation from the standpoints of stakeholders unconvinced by policy demands seen as being imposed by unaccountable bodies. This ambivalence tends to be accentuated where doubts arise about the analytical foundations of the policy approach. It has proved to be especially salient in relation to the fiscal and other rules central to euro governance today, and the doubts engendered about the legitimation of these obligations on governments.

This policy report has a number of aims, the principal one being to draw together the findings of Work Package 6 (WP6) of the *FIRSTRUN* project[1], the final 'deliverable' foreseen in the work programme of this part of the overall project. This research investigated the political economy factors likely to facilitate or hamper effective coordination, and to appraise the strengths and weaknesses of the principal EMU governance developments in response to the years of crisis. Although many of the reforms in question are about refining how fiscal discipline is achieved and diminishing the risks of fiscal and other macroeconomic imbalances, they also alter the mix of power and responsibilities.

Second, therefore, the report brings out certain key challenges for policy-makers – revealed by the WP6 research and other work – at both EU and national levels, in managing what the national level often perceives to be overly intrusive scrutiny. In various ways, the ability of elected politicians to set fiscal policy, especially, has been circumscribed. Yet, despite successive rounds of proposals emphasising the need for democratic legitimacy to be enhanced in the emerging policy framework, the WP6 findings suggest effective answers remain elusive.

Drawing on the findings from other participants in the *FIRSTRUN*, the report goes further by assessing what has been achieved in governance reform and what remains to be settled. It

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highlights some of the continuing divisions among leading contributors to the debate on the future of European integration, generally, and economic governance more specifically, and discusses the practicalities of key proposals. A last aim is to identify contentious features of the policy framework, posing the question of whether they add enough value to be retained, and to put forward recommendations for the evolution of the governance of EMU.

The first part of the report summarises the political challenges examined in WP6 of the FIRSTRUN project and explains their salience for assessing governance reform. It starts by examining how the balance of powers and responsibilities among key actors has evolved and explores the implications for legitimation of the various mechanisms. This is followed by an overview of the problems revealed by the years of crisis and the resulting reforms, leading into a discussion of the implementation of fiscal and other rules. The report then turns, in part 2, to the search for solutions and the obstacles to be overcome. Part 3 draws out conclusions and offers a number of recommendations.

1. Governance of EMU: political economy and legitimation challenges

A fiscal framework has to reconcile a range of aims. It has to ensure the sustainability of public finances while also being responsive to what citizens and tax-payers want, when they want it. Taxes and public expenditure are at the heart of the contract between the people and the state, and they reflect political choices about the extent of redistribution and the range of provision of public goods, raising knotty issues of accountability and legitimacy. At the same time, fiscal policy is a key instrument of macroeconomic management and, as was strikingly evident during the euro crisis, fiscal discipline became a principal focus of attention.

The political dimension of governance reform is considered in WP6 and elsewhere in the *FIRSTRUN* project from different perspectives. The WP6 paper by Begg (2015) argues that legitimacy considerations are likely to prove crucial, however persuasive the economic case for some proposed reforms. While monetary policy and other major public interventions, such as competition policy, are by no means devoid of distributive impact – consider, for example, how low interest rates penalise savers to the benefit of borrowers, or tough competition policies shift economic activity between localities – the interplay between tax and spending policies is pivotal in electoral campaigns. Complementary work by Thirion (2016) summarises the debate on fiscal union, stressing the continuing gaps in the policy architecture and some of the political economy constraints inhibiting reform. He contrasts the support from academic commentators and supranational institutions for a more substantial EU (or EMU) level fiscal capacity for stabilisation purposes with the ambivalence shown by most Member States.

Against this backdrop, several political economy considerations explored in WP6 arise. A first is whether a governance structure in which recent reforms have reinforced the top-down control over the budgetary process is sufficiently accountable and legitimate. The European Commission has acquired significantly more power in steering the budgetary process, without a concomitant increase in accountability, and Member States potentially face not just greater intrusion, but also the prospect

of more easily applied sanctions. Decisions on spending and taxation, which lie at the heart of democracy, are subject to the influence of non-elected officials, notably at EU level, who do not bear the political costs of their decisions. Instead they are borne by nationally elected politicians who have seen their freedom of manoeuvre circumscribed.

A second, associated change is the establishment of independent fiscal councils as watchdogs, many of them as a direct result of formal obligations as part of EMU governance reforms. Although it is too soon to undertake a wide-ranging assessment of their impact where they have only recently been established, they add a new dimension to national policy debates. Case studies undertaken in WP6 shed some light on this (Begg et al., 2017). Third, there is the matter of whether rules are effective and, perhaps more importantly, lead to appropriate policy choices, especially in exceptional circumstances.

The EU is often, albeit sometimes unreasonably, said to be plagued by a pervasive democratic deficit. In this regard, Scharpf (2009: 176) notes that there are differences of degree between what he calls the liberal and republican traditions of governance – 'the Union appears as the extreme case of a polity conforming to liberal principles which, at the same time, lacks practically all republican credentials'. A fourth issue is, therefore, how legitimacy can be enhanced, in the construction of a more political union or through new governance mechanisms. The WP6 research points to a system in flux, as the various actors adjust to the new institutional structures. These include a more explicit role for heads of state and government: the European Council has assumed a more executive role, with regular points in the annual cycle in which it has to give a steer, and periodic interventions on specific subjects. As a result, it has, effectively, become the pinnacle of economic policy coordination, to some extent displacing the sectoral Council formations.

1.1 An 'expenditory' state: an emerging mode of governance?

In the distinctive setting of the EU and Eurozone, questions of political oversight and of legitimation arise about the accretion of power over national policies of what are often castigated as non-elected bodies. A particular democratic concern is that national parliaments have had their role diminished as a result of the governance reforms, even though the Lisbon Treaty ostensibly reinforced their positions. One explanation is that the urgency of crisis management and the need for strong central action allowed no opportunity for parliamentary oversight. Especially where difficult rescue programmes were required, it is easy to see that parliaments lost their ability to shape policy preferences. In Greece, for example, it can be argued that the terms of the Memoranda of Understanding behind the three macroeconomic adjustment programmes gave Greek legislators very little choice in law-making, although an obvious retort is that the magnitude of the problems required exceptional action.

The EU, with a budget limited to around one percentage point of GDP, is an unusual polity when viewed through the lens of fiscal federalism. While the EU budget is large in cash terms, at some €150 billion per annum, its characteristics preclude many of the functions of a state assigned to the highest tier of government in a federal country. The EU level sought instead to exert influence

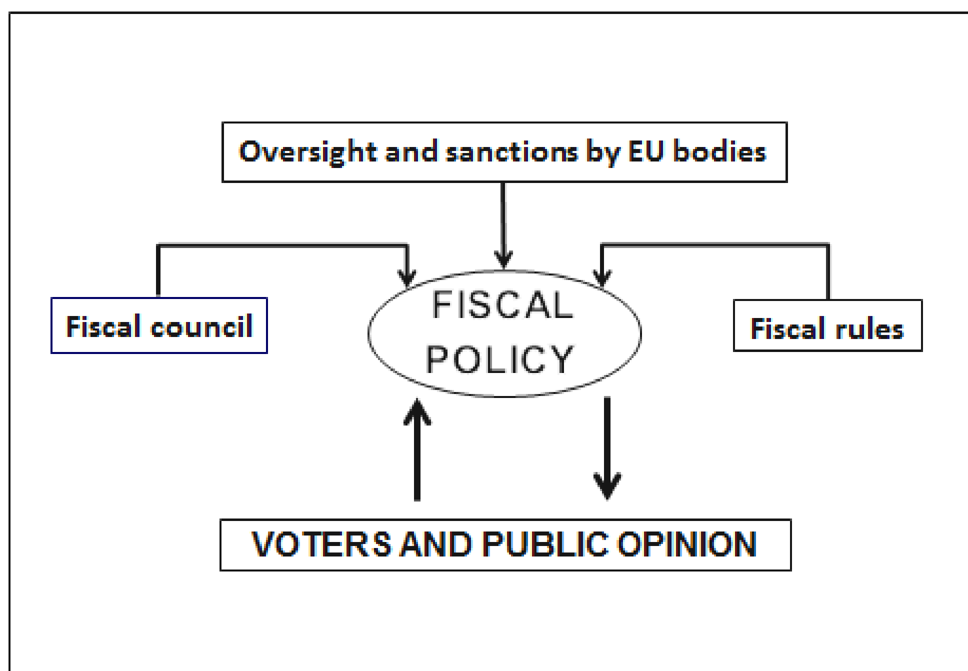
by other means and, through the advance of rules to create the single market, the then novel concept of the 'regulatory state' came to the fore, as explained by Majone (1994).

Taking inspiration from this approach, a *FIRSTRUN* paper by Begg (2015: 10) suggests a further governance innovation is emerging with characteristics affording the EU a fresh opportunity to exercise an increased influence. He calls this the 'expenditory' state. As set out in figure 1:

> 'the conjunction of fiscal rules, fiscal councils and the increased role of the EU level in constraining national budgetary policies can be seen as a wide-ranging transformation of the governance of fiscal policy, altering the relationship between voters and governments through the actions of other actors'

In this conceptualisation, the exercise of control by democratically elected national bodies is eroded not just because of the increased power of the supranational bodies over fiscal policy, but also because rules limit the discretion governments have and the advent of fiscal councils limits their capacity to make decisions. As a result the direct channels of accountability to voters are much more blurred. In legitimacy debates, it is argued that the taking away of direct democratic oversight (input legitimacy) may be warranted if the outcome is satisfactory (output legitimacy). The delicate governance question nevertheless arises of whether the 'expenditory' turn goes too far in this regard in a policy domain with undeniable distributive consequences.

Figure 1 The emerging 'expenditory state' fiscal framework in the EU



Source: Begg (2015)

Although the need to reconcile legitimation and effective governance has repeatedly been acknowledged – not least as one of the four pillars of both the Four and Five Presidents reports (European Council, 2012; Juncker et al., 2015) – there is ambiguity about what is needed to make progress. The option of conferring a greater role on the European Parliament in holding the Commission, in particular, to account for actions affecting Member States seems alluring. The implicit logic is that an executive actor at EU level should be accountable at EU level, but it overlooks the broader erosion of national political discretion of the expenditory state. An implication for policy development is that the shifts inherent in the drift of fiscal policy call for a more profound rethinking of legitimacy. Specifically, the notion of 'throughput legitimacy' (Schmidt, 2013) – meaning validation of how judgements with far-reaching ramifications for the national authorities are made by non-elected bodies – deserves attention.

One of the ironies of the recent developments in economic governance is, as stated by Fabbrini (2013: 4), that 'although, in reforming the EMU, state governments have consistently discarded the federal model as being too centralized and centripetal for Europe, they have ended up establishing a regime that is much less respectful of state sovereignty than the U.S. federal one'. But it is one based more on executive than representative power.

Some governance innovations, such as the obligation under the two-pack for Eurozone members to submit their budgets in advance to Brussels, undermine one of the core functions of national legislatures (Auel and Höing, 2015) of determining the budget. Conditions imposed by lenders to release loans, such as from the ESM, often mean that there is little choice but to implement tough fiscal consolidation policies. Yet as examination of implementation (as part of WP6) shows, the process does not seem to be effective (Begg, 2017b).

The responses of national parliaments have been very varied and, as assessed by Auel and Höing (2015), hard to relate to potential explanatory variables, such as the extent of euro-sceptical influence or the innate strength of the parliament relative to the national executive. They nevertheless conclude that when the nation's credit rating is in jeopardy, parliaments take a greater interest, although they also find that weaker parliaments in countries facing severe financial problems seem to lose interest. One option is to try to de-politicise fiscal policy (and, by extension, surveillance and enforcement of macroeconomic imbalances), thereby shifting the balance from input to output legitimation (Tuori, 2015). The alternative, which he regards as difficult because of the weakness of the elected bodies (both the European Parliament and the very limited role of national parliaments), relative to intergovernmental decision-making, is to try to enhance the democratic oversight of these policies.

However, Tuori also bemoans the absence of a European demos, a necessary pre-condition for democracy to hold sway, and argues that the crisis, because it accentuated national divisions, worsened the prospects of one emerging. Begg et al. (2015), similarly, argue that sustainable integration has to take more account of citizens, not least by finding way of making (difficult) structural reforms politically acceptable by enabling them to be owned by the Member State enacting them. The policy challenge is evident, but solutions have proved hard to find.

1.2 Diagnosis of problems and the resulting responses

There are two principal explanations for the euro crisis: for some commentators it was the result of policy failures; for others it is that the design of the euro was flawed, so that problems were inevitably going to arise. According to Schuknecht et al. (2011: 5) 'the sovereign debt crisis in the euro area is a symptom of policy failures and deficiencies in – among other things – fiscal policy coordination. It reflects the as yet unresolved challenge of how to place public finances on a sufficiently sound footing in EMU'. They use the expression 'consolidation fatigue' to describe the decline in commitment to fiscal discipline, and argue that it was exacerbated by the unsustainable flows of tax revenue from overheating construction sectors in some countries.

For Baldwin and Giavazzi (2015: 19), drawing on explanations put forward by a range of leading economists, the explanation for the euro crisis was neither particularly novel nor unsurprising. They assert that the main culprit is 'too much public and private debt borrowed from abroad. Too much, that is to say, in relation to the productive investment financed through the borrowing'. The direct result was a widening of macroeconomic imbalances, especially visible in the current account of the balance of payments. Germany and the Netherlands ran persistently large surpluses throughout the 2000s – and still do, although the counterparty is now the rest of the world (including the UK, with its deficit having averaged over four percent of GDP between 2013 and 2017), rather than Eurozone partners – while Spain, Portugal and Greece had unsustainable deficits. It was not sovereign debt as such which was to blame, but the fact that (in contrast to Japan from the early 1990s onwards) it was borrowing from abroad, whether private (Ireland and Spain) or public (Greece).

By contrast, those who question the design cast doubt on many different characteristics, including the manner in which responsibility for different areas of policy is divided, the absence of vital policy instruments and the unresolved issue of how much political union is feasible. What is not in doubt on both sides is that the euro crisis exposed profound flaws in the economic governance of both the EU and the Eurozone. Although many of the shortcomings have been amply investigated, there are differing views on how much significance to accord to particular elements.

Yet, with the benefit of hindsight, many of the design flaws are now reasonably well-understood, even though there are continuing disputes about how best to correct them. They included institutional weaknesses, a lack of crucial policy instruments and a failure by most governments to understand that being part of a currency union could not be achieved by a 'business-as-usual' approach to economic policy-making. It is easy to forget that in 2009/10, gaps in the policy framework included:

- The absence of adequate crisis management provisions and of a mechanism for bailing out Member States facing severe market pressures
- An inappropriate structure for bank regulation and for dealing with bank failures
- Reluctance to countenance debt mutualisation
- Limited integration of private risk-sharing across Member State borders because of the limited form of financial integration

As the magnitude of the challenges facing the EU became more evident after the unsatisfactory initial handling of the Greek 'problem' in late 2009 and early 2010, various temporary and permanent measures were rapidly introduced. Some emerged as a result of emergency meetings (such as the establishment of the two funds – the European Financial Stability Mechanism and the European Financial Stability Facility - agreed over a single frantic weekend; others from more extended and (in some cases) protracted negotiations. Collectively these measures put in place a substantially different policy framework from the first decade of the euro, yet it is widely agreed still to be incomplete.

Proposals for broadening and enhancing the scope of surveillance while also making it more credible, based on a variety of rules, were brought together in what has become known as the 'six-pack' consisting of five regulations and one directive. Two of the six were the creation of a macroeconomic imbalances procedure (MIP), with the rest focusing on fiscal discipline. Further reforms (the Fiscal Compact) in the separate inter-governmental Treaty on Stability, Coordination and Governance (TSCG) oblige Member States to introduce domestic fiscal rules designed to strengthen fiscal discipline and, by so doing, to enhance compliance with the SGP. The also include the expectation of creating an independent fiscal council.

There were, nevertheless, continuing disagreements about what might be called the policy paradigm. Many commentators have argued that the simultaneous pursuit of fiscal consolidation by too many Eurozone governments led to a collective fiscal stance that was too restrictive. In this vein, many critics of the EU approach condemned the austerity turn in policy-making (Blyth, 2012 and 2013). Behind the headlines is the question of how the economy reacts to public sector retrenchment, notably how much GDP falls in response to a public sector consolidation. This fiscal multiplier effect became especially controversial when an IMF study revealed that previous assumptions had been substantially too optimistic about the negative consequences of a fiscal adjustment (Blanchard and Leigh, 2014). Although their evidence suggests implicit multipliers of around 0.5 were used by many forecasters when the true figure was over 1, Blanchard and Leigh still argue that this does not invalidate fiscal consolidation as a policy prescription. They also observe that such multipliers are unlikely to be stable and may revert to pre-crisis values in due course. Similarly, et al. (2015) find there is considerable uncertainty about the value of this multiplier and, moreover, the evidence they survey suggests that it is unlikely to be stable.

1.2.1 Whether and how to coordinate: a question of trust?

In a monetary union, particularly one with European economic and monetary union's (EMU) unique characteristic of having a supranational currency without political union, a further challenge is policy coordination. The constraints written into the Stability and Growth Pact are partly about steering Member States towards sound policy[2], but partly also about two distinct forms of policy coordination. The first is ensuring compatibility between monetary policy and the

[2] It should, though, be acknowledged that there are many critics of EMU's stability-orientated policy model who query the received view on what is 'sound'

collective fiscal policies of euro area members, although longstanding differences about whether such 'policy mix' considerations are important should be noted. A second rationale for coordination is that there can be spillover effects from policy actions in one country to another; again, the extent and significance is disputed, as documented in a *FIRSTRUN* overview by Alcidi et al. (2015).

Proponents of the 'OHIO' philosophy – keep your 'own house in order' maintain that, so long as policy-makers fulfil their mandates, good policy will result. However, certain recent reform initiatives have sought to emphasise collective action (CAlifornia?) on EU fiscal policy. Bénassy-Quéré and Ragot (2015) advocate reforms to the semester process to arrive early in the annual cycle at agreement on a collective euro area fiscal stance. Only once that is settled should attention turn to national positions. Their recommendation implies a form of negotiation between countries with fiscal room for manoeuvre and those without it, but they do not elaborate on how to achieve it.

As Paul Krugman (2012) and Paul De Grauwe (2013, 2017) stress in different ways, the members of the euro area lack the monetary or fiscal to cope with severe shocks. By contrast, countries with separate currencies retain some scope to monetise debt and to ease monetary conditions, whether by aggressive interest rate cuts or some form of quantitative easing. Fiscal transfers and other forms of risk-sharing (for example common debt instruments) could attenuate budgetary stress by, essentially, shifting the burden either to other levels of government or to partners. However, the difficulty is, arguably, one of trust. Coordination and the rules through which it is pursued can be understood as a means of tying the hands of partners, but it also reflects a lack of confidence in their willingness to act in the common interest. As a result risk control tends to dominate risk-sharing. An obvious policy implication is to move towards a closer fiscal union in the EU.

1.2.2 The deeper roots of mistrust

There is another dimension of trust to consider. After the years of crisis, faith in political leadership has been shaken leading to suspicion of the motives of decision-makers and the rise of political movements opposed to economic integration. These opponents articulate a broad sense of dissatisfaction, rather than offering a convincing alternative model of governance. But their perspective also points to what has been expressed in WP6 as a 'deep variable' which has not been given sufficient attention. According to De Grauwe (2016: 249), a deeper reason for the lack of trust is the inability of the EU to protect those who lose from closer economic integration both at the EU level and globally. He also criticises the EU for reducing 'the capacity of national governments to take on the role of protector, while nothing has been done to create such a mechanism at the EU level'. He cites inappropriate fiscal rules and onerous structural reforms as principal factors.

A connection with the 'expenditory state' can be made because fiscal and other rules aggravate matters where they not only enshrine flawed economics, but are perceived to neglect the interests of citizens. In this respect, legitimation of the process also has to be factored-in to reform

of governance, that is a fleshing-out of 'throughput' legitimacy in response to more intrusive oversight. Failing this, De Grauwe (2017: 127) poses a stark choice; either a rapid move towards true political union will have to occur – a federal Eurozone – or there will be reversion to national currencies. He asserts that citizens and elected governments 'will reject a system in which vital decisions are taken by anonymous and unreliable markets and unelected officials'.

Doubts about how key components of governance obligations have been arrived at add to the challenge. For example, De Grauwe (2016) points to the dubious economic reasoning behind debt targets which ignore how the debt is used. Public investment can boost growth by easing supply-side constraints. Crude targets for the ratio of the public deficit or debt to GDP can lead to misguided policy prescriptions. Simply put, citizens need to see more than output legitimacy to be reassured and there are continuing risks emanating from the limited transparency (or, perhaps, the sense of certainty in the analytic reasoning) about the thinking behind EU-level demands and recommendations. The trust deficiency is explored, in a CEPR study[3] which concludes:

> 'More transparency and accountability at the level of the European institutions are clearly needed. National and EU officials have given lip service to these ideas but taken little concrete action. They should not take improving economic conditions and the receding populist tide for granted'

Three main policy implications can be derived. First, where rules and other facets of governance risk damaging the losers from globalisation, they should be revisited, irrespective of the aggregate macroeconomic arguments. Second, debt rules in particular should be reconsidered because they too readily neglect the asset side of the public balance sheet, militating against the kinds of public investment that might be used to assist the losers. The third is that the balance between the market and governments in the governance of the euro may need to be both recast and better regulated. Although there is an expectation of an increased role for private sector risk-sharing, the other side of the coin is the loss of national autonomy. De Grauwe (2017: 123) makes the point succinctly in his assertion that EMU's current framework

> 'has seriously weakened national governments vis-à-vis the financial markets. This leads to a dangerous supremacy of the latter, which in time will undermine social consensus as to the advantages of the market system'

1.3 Political and executive shortcomings

Several authors, such as Stiglitz (2016), argue that many of the woes afflicting Europe are self-inflicted, reflecting the hubris of introducing a common currency with too little regard for the institutional requirements to make it viable. Aizenmann (2016: 10) explains how disruptive closer financial integration can be: 'unlike commercial trade, inter-temporal trade of financial assets may lead to growing exposure to abrupt reversal of flows over time, thus testing the viability of a shallow currency area'. He also argues that severe asymmetric shocks can detract from the

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[3] https://voxeu.org/article/populism-and-trust-europe

benefits of currency union over time unless there is closer integration and pooling of insurance mechanisms. For the Eurozone, however, such policy integration is much harder because of divergent national interests. This implies that EMU will remain vulnerable without a greater degree of fiscal union and failed to anticipate the wider ramifications of member states hit by more severe asymmetric shocks. Specifically, it can be argued that the corollary of forgoing autonomy in certain aspects of macroeconomic policy is to create an obligation on the monetary union as a whole to offer support if a member is hit by problems.

Using a phrase borrowed from his former Bruegel colleague, Nicolas Véron, Pisani-Ferry (2014) observes that the EU has an executive deficit rooted in the shortcomings of its economic governance institutions, not least in lacking the means to manage crises. His analysis leads to the conclusion that fair weather mechanisms could not cope when the mercury dropped. He is also robustly critical of the adequacy of annual monitoring, noting that Spain moved from an annual budget surplus in 2007 to a deficit in excess of ten percentage points of GDP just two years later. With hindsight, it is easy to see how reliance on the tax yield from over-heating financial or construction sectors could lull finance ministries into complacency about public revenues, but the link between imbalances and fiscal sustainability was not convincingly made by those charged with macroeconomic surveillance.

For Jabko (2015: 71) there is an 'unresolved contradiction between a full integration of monetary policy and a weak integration of other economic policies'. He attributes this to the fundamental disagreement embodied in the Maastricht treaty on what political union should encompass, with the outcome of being unable to resolve the underlying differences in preferences. According to Jabko (2015), the long-standing differences between France and Germany go a long way to explain the subsequent inability to resolve the euro crisis, a theme also stressed by Pisani-Ferry (2014). Though not much discussed, the political economy consequences of unsatisfactory implementation of rule based governance mechanisms can be regarded as a particular difficulty. At the risk of over-simplification, it boils down to incompatible views about whether there should be discretion in macroeconomic management – especially fiscal policy – or an insistence on rules.

Decision-making and the distribution of responsibilities also matter. During the crisis years, there was often a reluctance to intervene quickly or sufficiently decisively, yet ambiguity about which body should take the lead. Pisani-Ferry recounts part of the tale

> 'Tim Geithner, the U.S. Treasury Secretary in the first Obama administration, was very keen on keeping in touch with whoever matters in the economic and financial world. To this end, he frequently called and met foreign counterparts, officials of the International Monetary Fund, and major market participants, but when trying to get in touch with the euro area, he faced the famous (although wholly apocryphal) Henry Kissinger question: What is Europe's telephone number?
>
> Geithner's public record reveals the answer he found: from January 2010 to June 2012 he had 58 contacts with Jean-Claude Trichet and Mario Draghi, in their capacity of president

> of the European Central Bank, 36 with Wolfgang Schäuble, the German finance minister, 32 with successive French finance ministers, 11 with Olli Rehn, the European Commission's man for Economic and Monetary Affairs, a few others with the ministers of finance of the countries in crisis, and two only with his official counterpart Jean-Claude Juncker, then president of the Eurogroup.'

He concludes that in 'the eyes of the U.S. government, the institutional body that matters in Europe is the ECB. Then come national governments, especially Germany and France. Then the Commission. And far behind, the man who supposedly embodies the role of euro-area finance minister.' At the time Pisani-Ferry was writing, that man was Jean-Claude Juncker, now President of the European Commission, but the critique is of the position rather than the office-holder(s).

1.4 Fiscal and other rules

The advantages of rules as a means of curbing politically-motivated departures from good economic governance have been extensively studied and considerable effort has gone into establishing the optimal design of such rules, building on the framework of Kopits and Symansky (1998). Current debate on fiscal rules is part of a wider reassessment of the role of fiscal policy in economic governance. As IMF (2017: 2) observes, 'discretionary fiscal policy was, in general, not seen as an effective tool for macroeconomic stabilization' for four main reasons. These are its slowness to act, the political resistance to reversing stimulus measures (implying a deficit bias), the reluctance of governments to use windfall tax receipts to consolidate public finances and the perception that financial markets prefer more disciplined policies. These policy debates have influenced the current structure of EMU governance, although latterly doubts about the efficacy of rules have grown. In particular, research conducted in WP6 highlights implementation of rules, as opposed to the design of them, as problematic (Begg, 2017a).

At the supranational level, rules bear most on fiscal policy and now go considerably beyond the simple provisions in the original Stability and Growth Pact, as adopted in 1997, consisting of an objective of a fiscal position 'close to balance or in surplus' and a nominal deficit threshold of 3% of GDP. Successive refinements have led to more complex measurement, notably to take account of the economic cycle, the addition of a debt criterion and a revised approach to ensuring compliance. Member States have to agree medium-term objectives (MTO) which prescribe pathways to more sustainable fiscal positions, and the *vade mecum* – the manual explaining how the SGP is to be implemented – now stretches to 220 pages, half of which is annexes (Commission, 2017a). The procedure is set out in detail, albeit leading to arguably very cumbersome mechanisms.

1.4.1 Evolving rules

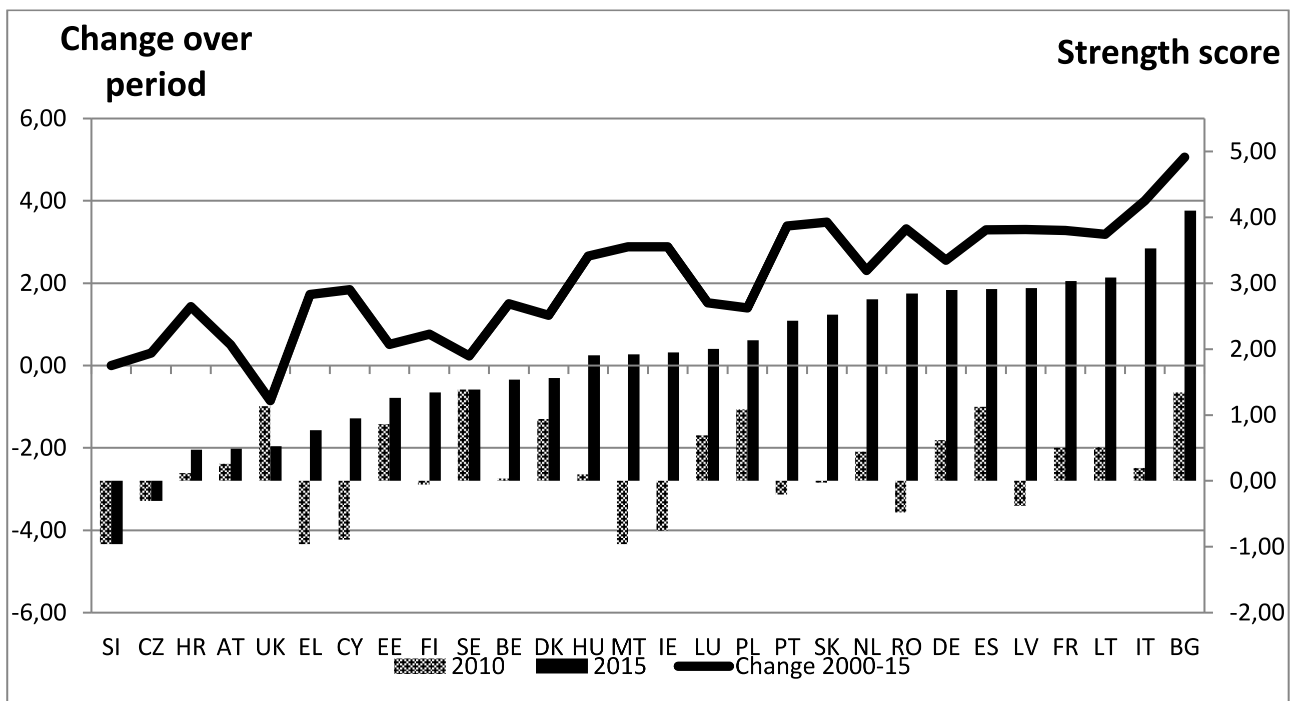
Reform measures undertaken in response to the euro crisis sought to reinforce EU rules while also pushing Member States to have complementary national rules. The consequence has been a proliferation of rules bearing on fiscal policy, with the number of them rising nearly tenfold across the EU between 1990 and 2015 to reach an average of four per Member State. These rules,

examined in a number of outputs of EP6 and other work packages of the *Firstun* project, are of four distinct types:

- *Balanced budget* refers to constraints on the public sectors current position
- *Debt* is about thresholds on the aggregate debt of general government, typically expressed as a proportion of GDP
- *Expenditure limits* set a ceiling for a certain definition of public spending
- *Revenue* specifying how any windfall gains in government revenue should be used.

According to DG Ecfin of the European Commission, rules have become not only more numerous, but also stronger over the years, at least on paper. As can be seen from figure 2, all Member States with the exception of the UK are adjudged to have strengthened their fiscal rules between 2010 and 2015 (bars on the chart, right hand axis), taking those previously weak above the Commission benchmark. It is also noticeable that some of the biggest changes (the line on the chart, left hand axis are in Member States, such as Italy and Spain, which endured acute fiscal pressures.

Figure 2 **Strength of fiscal rules**



Note: for an explanation of the strength index, see source

Source: European Commission, DG Ecfin: Fiscal Rules Database, Begg (2017b)

The core objectives of rules include not just meeting the headline targets, but also improving long-term fiscal sustainability, not least in relation to the known challenges of an ageing population. This aim poses methodological as well as policy design challenges. For example, Lassila (2017) shows in a *FIRSTRUN* project case study of Finland that how social security funds are treated can greatly affect the results. However, in another paper for the *FIRSTRUN* project on the effects of

fiscal rules, Kuusi (2017a: 37) concludes that 'the EU's fiscal framework is a difficult target for economic modelling because of its hierarchical, juridical structure, and the large amount of discretion that is used when the rules are applied'. He finds that a disjunction between forecasts and out-turns makes it difficult to trace the effects of rules, but that modelling the trends can help to make rules more attuned to circumstances.

1.4.2 Application of fiscal rules: the implementation challenge

A recurring difficulty with EU rules, as well as coordination mechanisms such as the Lisbon and Europe 2020 strategies, has been in ensuring that implementation lives up to expectations. The problems are not just about whether governments are assiduous in applying rules, but also about whether the measurement tools are up to the task. In the revised SGP after 2005, for example, there was a switch from the nominal deficit to the structurally-adjusted deficit, an ostensibly sensible answer to the tendency for rules to function in an overly pro-cyclical manner. The structural adjustment requires estimates of the output gap, but the huge uncertainty about the best methodology for measuring it has posed significant problems for the optimisation of fiscal policy.

The findings of research by Kuusi (2017b), derived from another work package of the *FIRSTRUN* project, that uncertainty about the output gap has weakened the counter-cyclical effects of fiscal policy give cause for concern. He also finds that the heterogeneity of experience has been considerable. Drawing on his finding, an obvious policy implication is to cast doubt on the wisdom of common rules. While he does not comment directly on what this might entail for reform of fiscal governance, Kuusi concludes that:

> "the development of new, powerful fiscal indicators and the designing of policies to deal with the output gap ambiguity should continue to be a key policy priority in the EU".

If judged purely by the budgetary indicators of EU Member States today, especially public debt, the evidence presented in a WP6 paper by Begg (2017a) suggests the verdict on EU fiscal rules would not be positive, even making allowances for the difficult circumstances of recent years (see also, Andrle et al., 2015). A possible caveat is that while rules are not strictly being met, they may have exerted a restraining effect (Reuter, 2015): the speed limit may have been exceeded, but the mere fact of a limit persuades drivers to drive somewhat more slowly.

The implementation shortcomings are not, though, only about out-turn indicators. Some of the instances of fudging, such as the 'fines' of zero euros on Portugal and Spain in 2016, damaged the credibility of rules (Begg, 2017a). Case studies undertaken in four Member States – Italy, Poland, Slovakia and the UK – as part of the *FIRSTRUN* project, looking at how fiscal and other macroeconomic rules are working in practice, identified various shortcomings, because governments often seek to exploit exceptions to rules if they see advantages in doing so. The policy implication is that, although rules are potentially useful where governments struggle to adopt time-consistent policies, their effectiveness depends on the quality of implementation.

Doubts about the economics underlying rules have been a factor, not least where they have led to fiscal policy tighter than was warranted at a time of enduring stagnation, making commitment to rules more grudging. Differing national perspectives exacerbated the difficulties, as Buti (2016) stresses, also making it harder to agree on alternative approaches at the EU level. Among the concerns are: the continuing bias towards pro-cyclicality of the rules: the absence of incentives for tighter fiscal policies in good times, capable of building buffers against future downturns; and the lack of emphasis on public investment. In addition, the dilemma associated with exceptions to the rules is that governments will always find more reasons to avoid them than is compatible with coherence. Tolerance of deviation from rules can undermine their efficacy, especially in the absence of what Portes and Wren-Lewis (2015) call an 'implementation incentive'. This can arise when there is no real penalty for failing to comply and even the possibility of blame shifting by governments.

The case study evidence also suggests a more insidious political economy dimension to these concerns, namely the perception that enforcement is avoided when it becomes politically inconvenient, possibly to the selective advantage of favoured Member States. As the Italian and British cases demonstrate, repeated resort to escape clauses, manipulation of what are often technically complex data (aggravating a lack of transparency) or frequent amendment of rules can become the norm rather than the exception.

1.4.3 Escape clauses

One of the vexed questions around rules is whether they should, somehow, be 'bent' to allow countries (for example, if they are at risk of being caught in an austerity trap in which falling GDP makes attaining a fiscal target harder) more room for manoeuvre. France and Italy have been especially antagonistic towards an overly rigid interpretation of the rules and they have, on the whole, found sympathy from Jean-Claude Juncker. However, striking the right balance between sensible flexibility and excessive laxity is no easy task. The Commission solution was to issue 'guidance' on the circumstances in which it is prepared to turn a blind eye to departures from agreed fiscal targets or rules (European Commission, 2015).

The document is at pains to stress that it is about interpretation rather than changing the rules. Almost comically, it cites as a precedent guidance issued in 2004 concerning advertising on television. The guidance covers three contingencies.

- First, it notes the shortfall in investment in the EU, highlighted in successive Annual Growth Surveys (the latest is European Commission, 2017b) and signals that policies which boost investment will be favourably regarded. Specifically, if a country contributes to the European Fund for Strategic Investment (EFSI, a flagship policy of the Juncker Commission) and, by so doing, has a one-off increase its deficit or debt, the fact that it does not alter the underlying structural values for these variables will be regarded as acceptable. The logic is that, precisely because it is one-off, it does not alter the sustainability of fiscal policy. This reasoning can be defended for the deficit but is more dubious for the debt, because an increase in debt would have an enduring effect on the level of future debt service charges, unless (as discussed above) the assets funded by the public investment generate a sufficient return.

- Second, it allows for structural reforms that offer the prospect of higher growth or lower future demands on the public purse – pension reforms, for example – even though they push up short-term spending
- Cyclical conditions are the third, with more leeway granted in periods of economic slowdown in the pace at which the MTO is approached, though there is also an expectation that the pace will be more rapid in periods of above trend growth.

Although the document stresses that there should be equal treatment for all countries, it also argues that this should not mean a one-size-fits-all approach and the decision on whether or not to initiate disciplinary measures (notably placing the country into the excessive deficit procedure) must reflect an economic assessment. Hard-line 'austerians' can be expected to regard even this limited resort to fiscal discretion as contrary to the spirit of fiscal rules. In effect, what the guidance does is to explain the 'margin of interpretation', taking into account three sets of criteria:

For policy-makers at the EU level, the ensuing challenge is how to reconcile common rules and legislative provisions with heterogeneity in both national circumstances and outlooks. The resort to MTOs provides part of an answer by customising what countries are asked to achieve, but the targets are still predicated, notably, on the standard rules of the SGP. Nevertheless, a specific challenge is the shift of key parameters affecting fiscal sustainability. When the Maastricht convergence criteria of a three percent of GDP deficit and a sixty percent general government debt were adopted, average nominal growth was five percent. These three numbers represent a steady state. Today, however, with inflation quiescent and real growth in the Eurozone barely attaining two percent, maintaining a steady state requires lower debt and/or deficit ratios. Thus, to keep a debt ratio of sixty percent of GDP steady when nominal growth is two percent, the deficit would need to be 1.2% of GDP. Equally, Member States with much higher nominal growth can sustain higher deficit and debt ratios.

One other fiscal governance innovation, the obligation on Eurozone Member States (but not the remaining EU members) to submit their draft budgets in advance to the Commission for scrutiny, is linked to compliance with the SGP. Reading the assessments from these annual exercises highlights the tensions around the interplay between compliance and enforcement. As table 1 shows, a pattern has emerged in which some countries are consistently compliant while others are most often in the category of at risk of non-compliance, yet no action other than shaming seems to be taken. After five years of the process, this must raise doubts about its effectiveness in shaping the choices made by national decision-makers

1.4.4 Macroeconomic imbalances

Some of the shortcomings in economic governance revealed by the years of crisis had nothing to do with fiscal policy, other than in the indirect sense that flows of tax revenue were predicated on unrealistic expectations of the success of over-heating parts of the economy. Thus, in both Ireland and Spain, excesses in property markets – the result of regulatory failings – were to blame for the severe economic crises these countries suffered. The answer at EU level was to institute the

macroeconomic imbalances procedures, modelled on the SGP in having both preventative and corrective arms, with the aim of forestalling other forms of macroeconomic imbalance.

The rationale for the MIP is that imbalances in areas other than the public finances can be just as damaging to an economy as poor fiscal discipline. Ireland and Spain are prime examples of runaway investment in property leading to a need for a sharp correction in property prices which then destabilises the economy, yet in the run-up to the euro crisis they both had robust public finances in the form of low debt and budget surpluses. Once the crisis hit, it became clear (as in the UK) that the revenue from taxing the property and financial sectors was unreliable and its subsequent collapse contributed to the wider economic difficulties. The problem was aggravated by the state offering guarantees to the banks, leading to fiscal problems. For this reason the surveillance of macroeconomic imbalances makes sense.

Table 1 Commission assessments of draft budget plans for following fiscal year

Year Assessment	2013	2014	2015	2016	2017
Compliant	DE, EE	DE, IE, LU, NL, SK	DE, EE, LU, NL, SK	DE, EE, LU, NL, SK	DE, FI, LT, LV, LU, NL
Broadly compliant [or 'no margin for slippage' - only used in 2013]	BE, FR, NL, AT, SI, SK	EE, LV, SI, FI	BE, IE, FR, LV, MT, SI, FI	IE, LV, MT, AT, {FR}	CY, EE, {ES}, IE, MT, SL
At risk of non-compliance	ES, IT, LU, MT, FI	BE, ES, FR, IT, MT, AT, PT	ES, IT, LT, AT, PT	BE, IT, CY, LT, SI, FI, {ES, PT}	AT, BE, {FR}, IT, PT, SI
Subject to Adjustment Programme	EL, IE, CY, PT	EL, CY, LT	EL, CY	EL	EL
Not in Euro	LV, LT				

Source: Own elaboration from European Commission reports, updated from Begg (2017b)
Imbalances also occur when a country achieves too big a surplus on the current account of the balance of payments, even though it faces far less of a need to adjust a country with a trade deficit because – as Germany and China have shown over many years – it can just accumulate the cash, in contrast to a country facing a payments deficit which could eventually go bust. Nevertheless, deficits and surpluses are, by definition, two sides of the same coin and one of the challenges for the MIP is to find ways of putting pressure on the surplus countries to adjust. This led to tension between creditor and debtor countries during the negotiations and, to no-ones' great surprise, a compromise that means that it is harder to discipline surplus countries. Repeated pleas for surplus countries to use their 'fiscal space' for the common good have not been well-received by them.

The macroeconomic imbalances procedure makes use of a range of indicators to determine the risks facing Member States, but these indicators are both diverse and differ in the extent to which

they can be relied upon to identify looming imbalances. Complementary *Firstrun* research by Domonkos et al (2017), which also fed into the case studies carried out as part of WP6, shows that some indicators are much more relevant than others, but also that the usefulness of specific indicators varies from country to country. For example, they find credit indicators to be poor predictors of problems, while slow rather than rapid house price increase is more of a cause for concern. By contrast, indicators of external performance of the economy perform better, as does both youth and overall unemployment rate. Generally, the results are better for the euro area countries than for the other EU Member States.

The scoreboard is only one component of the assessment and Commission sources consulted informally during WP6 research stress that it is not used mechanically. A more general concern is the use of lagged values for key indicators, with the scoreboard based on data from year t-2 making it backward, rather than forward looking (Begg, 2017a). Domonkos et al (2017) also highlight the overlap between indicators and the possibility of significant data revisions as potential shortcomings in the approach. Compliance, enforcement and policy reactions are facets of implementation shown by Begg et al. (2017) in case studies of four countries to be deficient. Key findings are that the MIP is not very visible in national policy discourse, allowing governments to escape scrutiny, and the results of the annual assessments do not seem to have led to notable policy adjustments.

Two policy implications arise from these findings. First, even in the first, early-warning, stage of the MIP process, more account needs to be taken of national specificity to reflect the heterogeneity of national circumstances. This could entail selecting indicators best-suited to capture the specific national risks. The second policy issue is whether the whole MIP process can be made more relevant to national policy-making. If not, it is open to the charge of irrelevance and might as well be discontinued. A broader concern is the credibility and legitimacy of a process in which a Member State could face the sanction of financial penalties for imbalances which it has only a limited capacity to redress.

2. The search for enduring solutions

In the search for improved EU economic governance, there is an acceptance that the *status quo* is untenable, but widely differing views on the direction and extent of further reform, alongside some scaling-back of the ambitions set for Eurozone governance. In the 2012 Four Presidents' report (European Council, 2012), advocacy of fiscal union was prominent and much closer coordination among member states was envisaged. There were explicit plans, together with a relatively tight timetable, for common debt instruments and an additional fiscal capacity to enhance the scope for fiscal stabilisation. In setting out three phases for action, the Commission blueprint (Commission, 2012) even called for the "creation of a proper fiscal capacity for the EMU" in eighteen months to five years from 2012 – meaning by 2017 – and envisaged the longer term creation of an EMU budget with the right to borrow. Common deposit insurance was considered a key part of banking union and the report explicitly mentioned the European Stability Mechanism

(ESM – the permanent fund established in 2012 to take over the temporary funds set-up to provide bailouts to countries under fiscal stress) serving as a financial backstop for both common deposit insurance and bank resolution. The language included phrases such as “pooling of risk” alongside “pooling of decisions on budget”.

By the Five Presidents’ report, published in 2015, some of the more far-reaching, but also contentious, proposals associated with fiscal union had quietly been dropped, although there was still an emphasis on a fiscal stabilisation capacity. Some relatively low key proposals from the five presidents envisaged for a first phase of reform have since been implemented. They include the establishment of a new, though only advisory, European Fiscal Board (now operational) charged with oversight of fiscal policy with a mandate to monitor compliance with common fiscal rules and to foster coordination of fiscal policies. The new Board has, inter alia, published guidance on the appropriate fiscal stance for the Eurozone (European Fiscal Board, 2017), as well as individual countries. In this regard, recent tensions between larger EU countries (notably France, Italy and Spain) and the application of EU rules reflect doubts about the constraints on fiscal discretion.

But the more weighty reforms were to have been set out, as stated in the report, “in a White Paper in spring 2017 assessing progress made in Stage 1 and outlining the next steps needed, including measures of a legal nature to complete EMU in Stage 2”. There was, indeed, a White Paper from the Commission, but it is not on how to complete EMU and neither it, nor the subsequent reflection paper (Commission, 2017c), identified a schedule for specific measures. The implication is that some of the tough choices about how to recast EMU were being avoided.

Even so, there has been a revival of interest in more active fiscal policy stemming in part from a reappraisal of the macroeconomic policy mix. With interest rates at record lows, monetary policy is likely to be at (or even beneath) the zero-lower bound (ZLB) at which it ceases to have much potency as a counter-cyclical tool. Although unconventional measures (primarily variations on quantitative easing) have manifestly stretched the ZLB, it has also been pointed out that low interest rates make the case for public investment stronger. According to the IMF (2017), there are three rationales for renewed interest in active fiscal policy:

- Sustaining economic recovery
- Supporting growth promoting policies
- An increased priority to social objectives

The first two are central to macroeconomic debates about managing the economy. There are, nevertheless, concerns about debt levels. The IMF FISCO index – capturing the relationship between the budget balance and the trend of nominal GDP – suggests a greater willingness to use fiscal policy for stabilisation purposes over the last twenty years. At a time when public investment rates have been low, the case is stronger still. In addition, well-targeted public spending can be used to smooth structural reforms, while its absence may diminish the effect of such reforms. The debate on the quality of public finances derives from these and similar considerations (Deroose

and Kastrop, 2008), but there is an evident tension between these considerations and adherence to numerical rules as discussed above in relation to escape clauses.

2.1 The policy mix and stabilisation capacity

One of the more intractable issues in the economic governance of EMU is whether it needs explicit mechanisms to achieve a well-judged macroeconomic policy mix and, if so, how to agree on an optimal mix. Irrespective of whether or not the policy mix should be part of EMU governance, there has always been a concern that the fiscal policy of the Eurozone as a whole is almost accidental because it is the result of independent decisions by the (now) nineteen national budgetary authorities. Some of us (Begg and Green, 1998: 131-2) warned even before the launch of the euro that this could become a problem. Behind this is the question of the extent to which the fiscal policy decisions of one country spill over to others, either by suppressing demand (running an excessive surplus) or by having too big a deficit, leading to overheating. There is also a feedback to monetary policy which has to be considered, even if no formal coordination with fiscal policy is envisaged.

The Eurozone is unlike other currency areas in lacking its own fiscal stabilisation capacity. Although the large size of the public sector in EU Member States means that automatic stabilisers can have powerful effects at the national level in smoothing aggregate demand or mitigating regional shocks, unlike many other jurisdictions where such a role is limited, they do not function so effectively across national borders. Unlike established federations or unitary states, characterised by a substantial central government budget, the EU has a budget small as a proportion of GDP (1%), very limited in scope and obliged to balance each year.

Although the EU can borrow in very narrowly defined circumstances, such as the balance of payments facility, it is not able to engage in deficit financing of the economy. This means neither automatic stabilisers nor discretionary fiscal policy at EU level can be used to stabilise the economy. There is, though, a project related borrowing capacity, mainly via the European Investment Bank and, with the creation of the European Stability Mechanism (ESM) in 2012, a means of borrowing to deal with funding crises at the national level. Rinaldi and Nunez-Ferrer (2017: 22) nevertheless argue that a stabilisation function is a *de facto* objective of the EU budget and describe some of the ways it is supposed to achieve this goal, including through spending programmes likely to be sensitive to the economic cycle. However, their analysis is sceptical about what is achieved: they assert that the fact 'a stabilisation function is present within the EU budget does not imply that it actually works or provides a sufficient response to the several shocks affecting the economies of European countries'.

There is no realistic prospect of the EU budget acquiring a more extensive stabilisation role. Indeed, as Begg (2018) shows in a WP6 analysis, there is a strong status quo bias in the negotiation of the Multi-annual Financial Framework which frames the EU budget.

2.2 Private sector risk-sharing

The comparative lack of private risk-sharing in Europe accentuates the stabilisation challenge facing the EMU. While measures to construct a capital markets union (CMU) are expected to facilitate greater effectiveness of private shock absorption mechanisms, there may also be increased risks. Other work for the *FIRSTRUN* project by Alcidi, D'Imperio and Thirion (2017) finds that in the euro crisis years, private capital flows amplified, rather than mitigated, asymmetric shocks, mainly in the countries in greatest difficulty in Southern Europe. This was in contrast to the earlier years of the euro when private flows had a positive effect in absorbing shocks. It meant fiscal policy was the main source of shock absorption, but even so played only a limited role.

Two policy implications flow from these findings. The first is that although capital market integration in Europe is envisaged, it will only become a reliable means of absorbing shock if complemented by EU level savings institutions. Second, if fiscal policy is the remaining option, it is likely to need supranational capacities – reinforcing the arguments put forward in some of the recent policy proposals by the EU institutions. Another piece of *FIRSTRUN* work, by Lavoine (2017), emphasises the need for social protection reform to be undertaken alongside capital market integration, but he also finds disparate reactions in different Member States.

2.3 Fiscal councils

A significant governance innovation, stimulated by the wave of reforms initiated at EU level, has been the establishment in nearly every Member State of a fiscal council or similar independent agency charged with monitoring national fiscal policy. Although many of these new bodies started with considerable goodwill, an assessment by Jankovics and Sherwood (2017) draws attention to a number of common challenges they face, prompting questions about their future role. The WP6 case studies (Begg et al., 2017) find that some councils are exerting a valuable influence, but also that they are facing challenges from governments.

An intriguing policy question is whether fiscal councils mainly complement or substitute for fiscal rules. Their function can be as just one of several means of monitoring what governments do, alongside parliamentary committees, the European Commission through the semester process, the IMF and the OECD. However, where they work best, they have a distinct advantage through combining expertise with national ownership of the process. International bodies may have the former and national parliaments the latter, but as agencies accountable to the national level fiscal councils could be regarded as having the optimal mix of legitimacy and independent expertise.

Where fiscal councils can go further is in advising on the appropriateness of fiscal policy, given the scope for rules to result in policy diverging from what is optimal. However, their ability to do so is diverse and is affected by their mandates and their legal position. In some cases, there is a formal basis for what Jankovics and Sherwood (call the 'comply or explain principle'. If the government is adjudged not to be meeting expectations (this will usually mean fiscal rules, but could be some other component of a fiscal framework), it is obliged to give a public explanation, typically within a specified time period. A dilemma for fiscal councils is, however that they are not decision-makers:

as Beetsma and Debrun (2018) put it, they 'are mainly watchdogs that must bark when political masters misbehave but can never bite them'[4].

In modelling fiscal councils, Beetsma and Debrun (2016) emphasise the asymmetries in information between elected politicians and voters. They find true independence to be pivotal in achieving the aims of fostering good policy and curbing deficit biases, but identify under-resourcing and insufficient access to information as obstacles. In a simple cross tabulation of independence and extent of remit, they show the diversity among the 31 fiscal councils in their sample. Two-thirds have what they regard as the desired design of sufficient independence and a broad enough remit, but one in four has both limited independence and a narrow remit.

While the input of a fiscal council can widen debate on the strategy and execution of fiscal policy, making governments more accountable, awkward questions of implementation are bound to arise. Repeated criticism of government by a fiscal council, even if entirely consistent with the latter's mandate, could lead to three distinct reactions with political economy ramifications. First, in an uncertain macroeconomic setting, projections of even short-term economic prospects are prone to errors. Fiscal Councils examined inWP6 research (Begg et al. 2017) tend to be more cautious than governments. If these projections prove to be systematically too pessimistic, the Council's credibility may be undermined – what might be called the 'crying wolf' risk.

A second risk could be described as the public relations or visibility challenge. Some fiscal councils have been able rapidly to become prominent in national public debates, including being solicited by the media, while others struggle for oxygen. Appearances before parliamentary committees or being quoted by opposition parties can cement the position of the council in the national debate and contribute to enhanced national ownership of policy decisions – seen by the likes of Kopits (2016) as vital given the limited impact of EU rules – but failure to do so can result in anonymity. This 'political relevance' risk could be compounded if government are also able to place obstacles in the path of the councils, such as by restricting access to data or providing too little time or resources to enable the council to carry out its assessments effectively. Begg et al. (2017) find evidence of some governments trying to do this.

The third risk is more pernicious: governments may actively seek to neutralise the council. In this regard, the appointments process to the Council is crucial. If governments or the political parties behind them are able to pack the council with members expected to be less willing to be critical, the benefits of independent scrutiny will be jeopardised. Apart from the Hungarian case (documented by Kopits, 2011), there is already anecdotal evidence of other councils being compromised in this way: what might be called an 'emasculation' risk. Strong governments can, in principle, also seek to constrict the remit of the council or resist a widening (for example, to include primary responsibility for official forecasts) considered to be consistent with good practice. Taken together, these three risks highlight a potentially significant weakness of independent – and maybe dubiously accountable – institutions.

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[4] https://voxeu.org/article/independent-fiscal-councils-and-conduct-fiscal-policy-insights-new-ebook

2.4 Recasting the EU's fiscal constitution

The EU has a variety of influences on public finances, ranging from its own budget to the various ways in which it affects national budgetary policy. The connection are explicitly affirmed in the paper on new budgetary instruments (Commission, 2017d); it recalls that 'deepening the economic and monetary union and modernising the EU public finances are key strands of the debate on the future of Europe initiated by the Commission's White Paper of March 1st 2017'. A more general perspective on this is afforded by considering the EU's fiscal constitution (Dolls et al., 2016). In a theoretical exploration of fiscal constitutions, Persson and Tabellini (1996) conclude the EU is more likely to resolve the conflict between moral hazard and risk-sharing through inter-governmental bargaining than the sort of federal arrangement exemplified by the US, where voting is the solution.

Running through all these arguments is ambiguity about the definition of fiscal union. Dolls et al (2016) argue for a form of fiscal union combining a sovereign insolvency procedure and an insurance mechanism to mitigate asymmetric shocks. But they also stress the importance of democratic legitimation of potential changes. An obvious policy consideration is that such legitimation will be especially vital if moves towards fiscal union entail systematic fiscal transfers from creditor to debtor countries. The detailed proposals of Dolls et al. (2016: 221) would restrict transfers, but they nevertheless emphasise the constitutional significance of establishing even moderate mechanisms:

> 'The possible establishment of a sovereign insolvency procedure for the euro area is sometimes debated as if it were a minor technical or a mere crisis management issue. This reflects a fundamental underestimation of the importance of this issue. The decision for or against such a procedure is nothing less than a far-reaching decision on Europe's fiscal constitution'.

The EU is clearly some way short of being a federation, but Blöchliger and Kantorowicz (2015: 30) assess its fiscal constitution using a methodology they have applied to true federations. They find the EU's fiscal constitution to be 'moderately decentralized and less coherent than those of most federal countries'. They note the high autonomy of Member States in fiscal policy and also draw attention to the autonomy of Member States in tax and spending decisions, but highlight the stringent rules through which policies are coordinated and monitored. They assert that the recent changes have reinforced fiscal governance, although the corollary that the shift towards the expenditory state described above is an unequivocally positive development is open to dispute. Stronger governance without complementary accountability struggles for legitimacy.

A rationale for fiscal union is, partly, about dealing with stabilisation challenges at the European Union, national, and even regional levels and partly about the pooling of risk in the common interest. But it is also about legitimating the loss of control over key policy areas. Much the same argumentation was advanced about moving from German (specifically, Bundesbank) hegemony in monetary policy by establishing the pooled sovereignty of the euro.

In the great majority of national systems, lower tiers of government are typically subject to quite binding rules and monitoring by the central government. As noted, these functions are, in practice, extensive in the fiscal arrangements of the EU, having been significantly strengthened in response to the years of crisis. Hence, the EU's present fiscal constitution – especially for the Member States participating in the euro – does not combine the stabilisation capability envisaged in fiscal federalism models with the control and oversight of lower tiers. As a result, the macroeconomic policy armoury is deficient and is the backdrop for some of the proposals for reform.

2.5 Santa Claus?

Some new ideas, albeit with only limited scope for achieving much in stabilisation, were put forward in the package issued by the Commission on 6th December 2017, apparently informally labelled the 'Saint Nicholas' Package (SN) in reference to the date[5]. The package develops a number of ideas already signalled in the Five Presidents' report and the 2017 Reflection Paper on EMU (Commission, 2017c). Box 1 summarises what is proposed. It includes proposals for funds to promote structural reforms, to support convergence towards euro membership and to assist in coping with an asymmetric shock. However, the figures signalled are in hundreds of millions of euros for the first two and there appears to be an expectation that loans rather than grants will be the main means by which the third is realised. The political timidity behind these orders of magnitude means they will not be game-changers.

The reasons for caution are understandable. Potential creditor countries fear they will invariably be contributors to any such fund and worry about moral hazard if debtor nations sense an easy means of keeping public spending above sustainable levels. Critics also include those who doubt the value of fiscal activism, despite recent analyses suggesting a greater need for fiscal policy when interest rates are at the zero lower-bound.

The main 'roadmap' document in the package (Commission, 2017e: 3) notes how closely intertwined the economies of the Eurozone and the non-participating countries already are, and calls for a more efficient and democratically accountable EMU. Recalling how many of the new instruments and procedures introduced in recent years were in response to crises, the next statement in the document is noteworthy: "this has sometimes led to a multiplication of instruments and an increased sophistication of rules, which is a source of complexity and creates risks of duplications".

There are several politically sensitive features of the SN package. First, the division between the Eurozone and other Member States could be tricky. The document quotes Juncker's statement from his September 2017 *State of the Union* address 'we do not need a budget for the euro area but a strong euro area budget line within the EU budget' in support of the contention that no parallel budgetary capacity would be needed. But it does not explain how to justify having a budget line not applicable to all Member States.

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[5] These are described in the Communication on 'New budgetary instruments for a stable euro area within the Union framework' , Brussels, 06.12.17, COM(2017) 822

Box 1 **The components of the 'Saint Nicholas' Package**

A proposal for the establishment of a European Monetary Fund (EMF) anchored in the Union legal framework;

A proposal to integrate the substance of the Treaty on Stability, Coordination and Governance (TSCG) into the Union legal framework, taking into account the appropriate flexibility built into the Stability and Growth Pact and identified by the Commission since January 2015;

A Communication on new budgetary instruments for a stable euro area within the Union framework;

For the period 2018-2020,

targeted changes in the Common Provisions Regulation to mobilise EU funds in support of national reforms

a proposal to strengthen the Structural Reform Support Programme

A Communication on a European Minister of Economy and Finance.

Source: elaborated from Commission (2017d and 2017e)

The proposal to create an EMF has a number of objectives. The first is to bring the ESM into the legal order of the EU, instead of it being a separate inter-governmental agreement, and there are signals that the decision making will move from unanimity to some form of qualified majority. This could be seen as a rationalisation similar to the anticipated integration of the TSCG (notably the fiscal compact) into the legal order. Second, the proposed EMF would be the fiscal backstop to the single resolution fund, and thus contribute to the strengthening of banking union. A third function will be to contribute to the oversight of Member State finances, something seen as desirable by German commentators such as Bundesbank President, Jens Weidmann[6], concerned about the Commission being too lax. The text is, however, vague on some other potential functions of the new body.

The proposals on fiscal stabilisation and new budgetary instruments are likely to prove at best marginal. What they expose above all is the continuing tension between risk-controlling and risk-sharing, discussed extensively in WP6 and other work packages of the *FIRSTRUN* project (Begg, 2017b). The idea of a euro finance minister, likely to emulate the role of the high representative in spanning the Commission and an executive role in the Council, does seem to have found favour.

6 https://www.bundesbank.de/Redaktion/FR/Standardartikel/Presse/Contributions_externes/2017_12_15_weidmann_faz.html

However, as Daniel Gros comments[7], the proposals on what the new minister would do and the new fiscal instruments are 'fluffy'.

If any additional fiscal capacity gains favour, a number of governance considerations will have to be examined. They include how the new instrument would be administered and revenue raised, for whom and under what legal framework. Despite the stated wish to use the EU budgetary framework, new instruments may be outside the existing EU framework as a separate inter-governmental arrangement, but could be designed to be integrated after a certain period. The modalities of scrutiny and accountability would have to be established and the relationships with existing EU mechanisms and institutions clarified.

What is less evident in the SN package is how accountability can be enhanced and, thus, how to adapt to the emergence of the 'expenditory' drift in governance and the 'deep variable' discussed above. The political disconnection between the EU level and citizens is, unsurprisingly, a source of mounting concern among political leaders and decision-makers, but is unlikely to be eased by still more powers at the EU level. Gros concludes his comments in rather acidic manner: 'all in all, the Commission might have more appropriately entitled its package: "A modest proposal to enhance the European Stability Mechanism".'

3. Conclusions and recommendations

"Believing in progress does not mean that any progress has yet been made" – Franz Kafka

The EU has invested considerable effort, resources and political capital into a system of economic governance reliant on rules. Despite the encouraging evidence of an enduring recovery in the economic performance of the Eurozone and the wider EU, the macroeconomic policy framework for EMU remains incomplete. Key outstanding issues include: how to complete banking union; the means by which an effective role for fiscal policy in macroeconomic stabilisation is attained while maintaining fiscal discipline, and the more tricky matter of how to legitimate the measures in place. Research by WP6 and others involved in the *FIRSTRUN* project sheds new light on many of these issues. Specifically, three questions can be posed about what is now in place or envisaged in fiscal policy and the surveillance of macroeconomic policy:

- Which of the existing and proposed policy arrangements are essential for EMU to function effectively?
- What could be regarded as steps too far?
- Are there elements of governance still missing or in need of reform?

Plainly, many theses could be written about these questions, complementing the vast existing literature. The more limited concluding ambition of this report is to take stock and to suggest the most pressing priorities in the form of s number of recommendations.

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[7] https://www.ceps.eu/publications/comprehensive-emu-reform-or-tinkering-margins

3.1 The fiscal constitution

The governance of EMU has come a long way during the crisis years, but many would argue not far enough. Thus, in a high profile contribution published in Le Monde and Suddeutsche Zeitung on 8th February 2016, François Villeroy de Galhau and Jens Weidmann, the Presidents of the French and German Central Banks, called for far-reaching governance reforms. They note, in particular that:

> "The present asymmetry between national sovereignty and common solidarity is a threat to the stability of our monetary union. Regrettably, the coordination framework that was put in place as a safeguard was unable to prevent public finances from worsening and economic imbalances from building up, as was demonstrated not least by the Greek crisis".

Villeroy de Galhau and Weidmann suggest one way forward is through closer economic and political integration, but also leave open the option of a retreat to national action. They support integration because it "appears to be the most straightforward solution to restore confidence in the euro area, as it would foster common strategies for public finances and reforms, and thus growth. To that end, euro-area member states would clearly have to allow a comprehensive sharing of sovereignty and powers at the European level, which, in turn, would require greater democratic accountability".

The abiding danger, nevertheless, is of public finances being balkanised, with one strand of policy-making focusing on fiscal sustainability, a second dealing with the EU's own finances and a third concerned with macroeconomic policy, while yet another dimension of policy is the microeconomics of tax and spending policies. These functions compete for the attention of policy-makers in national settings, but tend to be run by common political and institutional actors, notably through the Ministry of Finance. In the EU, by contrast, the channels are more separate, with the EU budget in one policy 'silo' (DG Budget and the sectoral DGs which implement the principal budget lines, with the corresponding EP committees) and the macroeconomic surveillance in another (DG Ecfin and the Econ committee) in another.

While there has been some drift towards coordination under the Commission Secretariat-General, through its role in the semester process, the process itself has had questionable results. As research by Alcidi and Gros (2016) reveals, compliance with country-specific recommendation is poor. This reflects a continuing ambiguity about the purpose and expectations of policy coordination. A blunt conclusion is that what is an extensive and time-consuming exercise has limited added value.

Recommendation 1: *a roadmap should be developed for better integration of the EU role in the different strands of fiscal policy, with the aim of arriving at a coherent fiscal constitution for EMU.*

Recommendation 2*: the value of existing policy coordination mechanisms should be appraised and redesigned to ensure it has genuine added value for the conduct of Member State policies*

3.2 A new fiscal capacity or a different approach to stabilisation?

Despite widespread agreement on the need for a more comprehensive macroeconomic stabilisation capacity, agreement on how to achieve it is elusive. In essence, the conflicting views on the balance between risk control and risk-sharing are yet to be reconciled. One view, typically associated with Germany and other creditor countries, is that risk must first be substantially reduced by effective application of rules and other agreed instruments for constraining national policy-makers to pursue sound macroeconomic policies. The other – which can be ascribed to France, Italy and other southern member states – is that risks need urgently to be shared to confer more room for manoeuvre on euro area members trapped into low growth trajectories. Without such risk-sharing, they will struggle to resolve their economic challenges and could aggravate divergence in macroeconomic performance, complicating euro area policy-making.

A larger EU budget (as a proportion of GDP), was hinted at by Commission President Jean-Claude Juncker in his 2017 State of the Union address[8], and stated explicitly in his Sorbonne speech by Emmanuel Macron: 'nous avons besoin d'un budget plus fort au cœur de l'Europe, au cœur de la zone euro' [we need a stronger budget at the heart of Europe, at the heart of the Eurozone]. But stiff resistance must also be expected and it is noteworthy that the 'non-paper' from the Germany finance ministry[9] on 'paving the way towards a stability union' is robust in rejecting an additional fiscal capacity at EU or Eurozone level as 'economically unnecessary for a stable monetary union'.

The proposals in the Saint Nicholas Package would go some way to fill the governance gaps, but they will manifestly be controversial, contested and, in all probability, be adopted (in the time-honoured EU fashion) only slowly and in a watered-down form. They are also relatively unambitious. The proposed new fiscal instruments are calibrated in hundreds of millions, whereas the funding gaps revealed by the euro crisis are of the order of tens of billions – that is a hundred times larger.

Recommendation 3*: for stabilisation purposes, new fiscal instruments will need to be much larger than envisaged in the Saint Nicholas package by at least an order of magnitude*

Recommendation 4*: the importance of private sector risk-sharing mechanisms should be stressed, but have to be seen as part of a package with public instruments*

Recommendation 5*: legitimation concerns about using the EU budget and administrative resources for the benefit only of Eurozone members have to be addressed*

3.3 Design of rules, their implementation and the incentives for compliance

Much of the academic interest in rules has been on their design and the importance of well-aligned incentives. The many developments in EU rules (replacing nominal deficits with structurally adjusted deficits, altering the enforcement modalities to more graduated escalation of sanctions, bringing in a debt criterion and so on) testify to the influence of new thinking. Yet as

[8] In, it should be noted, a departure from the original version of the official text of his speech
[9] http://media2.corriere.it/corriere/pdf/2017/non-paper.pdf

rules have proliferated and become more complex, they have come in for growing criticism. They are still prone to pro-cyclicality and there is often a dilemma opposing appropriateness and compliance. Cleverly designed escape clauses can help, but the more they introduce flexibility, the greater the risk the principle of a rule will be undermined. There is growing agreement on some aspects of reform. It is, for example, now broadly accepted that the EU system of fiscal rues has become too complicated. Even the German "non-paper" contains the following intriguing observation:

> "The IMF is right to conclude in its Art. IV consultation that the European fiscal rules have unfortunately become much too complex and less predictable. This is why we have to develop these rules further, with the debt rule at least on an equal footing with the deficit rule. As long as national debt is on a declining path, national deficits could be treated flexibly". If this prescription is followed, it would represent a conspicuous shift away from the principles behind the original SGP which ignored debt and set rigid limits for deficits.

Similar points are made by a group of fourteen leading French and German economists in CEPR *policy insight* no. 91 (Bénassy-Quéré et al. 2018):

> 'The current approach to fiscal discipline – an attempt to micromanage domestic policies through complex and often divisive fiscal rules – needs to be replaced by a combination of streamlined rules, stronger institutions, and market-based incentives, with the aim of strengthening national responsibility'.

Their solution is to move away from rules on the structural deficit to an expenditure rule combined with targeting a long-term reduction in debt. The reasoning is that this would reduce the pro-cyclicality of rules and mean governments having to act on a variable they directly control, on the presumption that, in downturns, a fall in revenue is outside their direct control. Implicitly, automatic stabilisation would arise from the fluctuations in tax receipts. Yet, even if rules can be well-designed and offer adequate incentives to Member States, they will struggle if enforcement is lax.

The evidence reported by Begg (2017a) and Begg et al. (2017) suggests this aspect of economic governance is both neglected and crucial. A more insidious consequence of lax enforcement is the persistent attempts, and evident willingness, of governments to circumvent rules. Buti (2016: 11) highlights some of the tensions between better enforcement of rules and the need for enough discretion to provide flexibility in specific circumstances and argues for 'a complementary relationship between rules and institutions, not a relation of substitutes'. Taking a cue from Kopits (2012), the solution may be to opt for national rules on the grounds of 'ownership': unless national policy-making systems and the decision-makers central to them have a stake in making rules work, they are likely to be ineffectual. However, there may also be a case for enhancing the role of the new European Fiscal Board to include oversight of the spillover effects of national decisions.

Recommendation 6*: the proliferation and complexity of fiscal rules should be rationalised with the emphasis placed on debt sustainability and on national rules*

***Recommendation 7**: institutional relationships are crucial to the implementation of rules and should be recast to ensure a better balance between enforcement, compliance and appropriateness*

***Recommendation 8**: recognising that the macroeconomic imbalances procedure is having only a limited impact on national policy choices, it may be better to revert to softer form of coordination with a greater emphasis on carrots than sticks*

3.4 Broader political economy of governance

A theme of many of the contributions to the debate on the future of economic governance is the deficient legitimacy of curbs on national autonomy, whether self-imposed in the form of national rules, or resulting from agreements reached at the EU level. There is also, in the way governance is evolving, great scope for differing sources of legitimacy to be in conflict, as explained by Commissioner Pierre Moscovici[10]: what a Greek government adduces to justify its actions will rarely correspond to what the governments of creditor nations rely on; nor is it clear how the EU level fits into the picture.

The problem is to find answers which reconcile the desire for collective discipline, portrayed as being in the common interest, with national autonomy and democratic choice. It may, in the end, be an unattainable aspiration. Moreover, as pointed out by Bellamy and Weale (2015), there may be a perverse effect of supranational obligations such as the fiscal compact or the macroeconomic imbalances procedure of undermining, rather than strengthening the commitment. If blame is, or is capable of being, shifted to the EU level for unpopular policies, national policy-makers may have a political incentive to go into battle with the EU level.

A particular sensitivity is how to factor fiscal councils into legitimation and accountability. One option (Larch, 2016) could be to separate the stabilisation aims of fiscal policy more explicitly from its allocative and distributive functions, with the fiscal council more extensively engaged in setting targets for the stabilisation dimension. As independent expert organisations, they can play a valuable role in appraising fiscal prospects and informing national debate, but they cannot be a substitute for political discretion. However, unlike the monitoring function of the Commission (or other external bodies such as the IMF), which often overlaps with what fiscal councils do, the latter have the considerable political advantage of being at the same level of governance as the government.

***Recommendation 9**: although legitimacy concerns around the evolution governance have repeatedly been highlighted, they have yet to be adequately addressed and should be accorded higher priority*

[10] http://www.institutdelors.eu/media/discoursmoscovicimacifenjdisep2015.pdf?pdf=ok

Recommendation 10*: fiscal councils can become significant actors in economic governance, but their role within the governance framework has to be better developed and integrated with the monitoring and surveillance emanating from the EU and international institutions*

3.5 A final word

'You cannot run a single currency on the basis of rules and statistics alone. It needs constant political assessment, as the basis of new economic, fiscal and social policy choices' – Jean-Claude Juncker.[11]

Although the WP6 findings on implementation raise profound concerns about the political economy factors affecting the implementation of rules, as opposed to their design, rules will undoubtedly continue to be part of the EU economic governance framework, but an over-arching message from this report and, more generally, from the *FIRSTRUN* project is that reliance on them will not be enough to guarantee sustainable public finances, let alone macroeconomic stability. Despite efforts to refine rules and to extend their reach, notably to include sources of imbalance other than public finances, they are dogged by shortcomings in implementation and compliance. As a consequence, as Begg (2017b: 12) concludes, governments 'are not only adept at circumventing them, but garner popular support for doing so. Rules-based governance in the EU may, therefore, have reached its limits, implying something more, or perhaps something different, is needed'.

The corollary is that seeking further to redesign or recalibrate rules as the cornerstone of EMU reform is likely to offer a false prospectus. Instead, what is needed is better definition of the EU's fiscal constitution and, within it, of how the different elements of public finances are brought together. Rules may still have a place but a more limited one and, because of the implicit contract between voters and tax-payers, on one side, and decision-makers on the other, the political dimension of fiscal policy has to be centre-stage.

Recommendation 11*: although the complicated political economy of Europe inevitably makes it hard to agree solutions, greater urgency is needed in advancing the recasting of economic governance*

[11] 2015 State of the Union address, op. cit

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