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A PROPOSAL TO REVIVE THE EUROPEAN FISCAL FRAMEWORK

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Highlights

- Pro-cyclical fiscal tightening might be one reason for the anaemic economic recovery in Europe, raising questions about the effectiveness of the EU's fiscal framework in achieving its two main objectives: public debt sustainability and fiscal stabilisation.
- In theory, the current EU fiscal rules, with cyclically adjusted targets, flexibility clauses and the option to enter an excessive deficit procedure, allow for large-scale fiscal stabilisation during a recession. However, implementation of the rules is hindered by the badly-measured structural balance indicator and incorrect forecasts, leading to erroneous policy recommendations. The large number of flexibility clauses makes the system opaque.
- The current inefficient European fiscal framework should be replaced with a system based on rules that are more conducive to the two objectives, more transparent, easier to implement and which have a higher potential to be complied with.
- The best option, re-designing the fiscal framework from scratch, is currently unrealistic. Therefore we propose to eliminate the structural balance rules and to introduce a new public expenditure rule with debt-correction feedback, embodied in a multi-annual framework, which would also support the central bank's inflation target. A European Fiscal Council could oversee the system.

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1 INTRODUCTION

The European Union's fiscal framework, which consists of fiscal rules, budget procedures and institutions, has been the subject of major controversies since it was put in place in the 1990s[1]. Member state non-compliance with the rules in the early 2000s, and the perceived rigidity of the rules, led to reforms in 2005. The global and European economic and financial crises led to further major changes to the fiscal framework in the form of the so-called Six-Pack (2011), Fiscal Compact (2012) and Two-Pack (2014).

Assessments of the current framework vary widely. Marzinotto and Sapir (2012) and Micossi and Peirce (2014) argue that the current rules represent a sophisticated system of surveillance and *ex-post* control that provides sufficient room for manoeuvre under exceptional circumstances. By contrast, Manesse (2014) and Ódor and P. Kiss (2015) propose to design fundamentally new fiscal frameworks. Several authors from the International Monetary Fund (Andrle *et al*, 2015) suggest various options for simplifying and making the EU fiscal governance framework more effective, of which the most ambitious would profoundly change the current rules.

Revision of the EU's fiscal rules appears to be off the table in the short term. The *Five Presidents' Report* (Juncker *et al*, 2015) did not make any proposal to amend the numerical fiscal rules. This preference for the *status quo* is probably rooted in the political difficulty of starting a new discussion about European fiscal rules so soon after the 2011-14 reforms. But it might also be related to the currently calm government bond market situation.

Meanwhile, the European fiscal framework might not be effective at achieving its two key objectives: (1) to discourage the deficit bias of the government in order to ensure the long-term sustainability of public debt[2] and (2) to leave scope for counter-cyclical fiscal policy. The latter objective has been the main subject of discussion, because many researchers[3] concluded that the fiscal stance has been too restrictive since 2010, taking into account the economic situation in most EU countries and in the euro area as a whole. Pro-cyclical fiscal tightening in a recession implies that long-term public debt sustainability is achieved in an ineffective way, because undue fiscal consolidation in a recession can prolong economic weaknesses and keep the debt ratio higher, triggering further fiscal consolidation. Other key issues are whether the framework is sufficiently implementable, transparent and understandable to the general public, and whether there is strong national ownership of the rules.

This Policy Contribution assesses the suitability of the current European fiscal framework for fulfilling its two key objectives. We argue that because the status quo would preserve an inefficient system, while the first-best solution for a European fiscal framework is politically unrealistic, a change in the Stability and Growth Pact and the Fiscal Compact and the establishment of a European Fiscal Council are needed.

2 THE EU'S CURRENT FISCAL FRAMEWORK

The fiscal framework includes numerical fiscal rules and requirements for budgetary procedures and independent fiscal councils.

Numerical fiscal rules

The basic fiscal rules are relatively simple[4]:

1 The budget deficit must be below 3 percent of GDP;
2 Gross public debt must be below 60 percent of GDP;

1. See for instance Buiter *et al* (1993).

2. Reasons for the deficit bias include informational problems, impatience, electoral competition, common-pool problems and time-inconsistency (see for example Portes and Wren-Lewis, 2014).

3. See for example Blanchard and Leigh (2013), Holland and Portes (2012), Wren-Lewis (2013) and Barbiero and Darvas (2014).

4. The first two rules are from the EU Treaty, while the specification of the 1/20th debt reduction requirement is from the Six-Pack. The third rule originates from the Stability and Growth Pact (SGP) requirement for the budget to be *"close to balance or in surplus"*, while the MTO appeared in the 2005 reform of the SGP, and the minimum numerical requirements for the euro area come from the Fiscal Compact. The fourth rule is from the Six-Pack.

- If it is higher, it must decline annually by at least 1/20th of the gap between the actual debt level and the 60 percent reference value;

3 The structural budget balance (that is, the budget balance which excludes the impact of the economic cycle and one-off fiscal measures) must be higher than the country-specific medium-term objective (MTO), which, in the case of euro-area countries, has to be chosen at or above -0.5 percent of GDP, or -1 percent for countries with a debt-to-GDP ratio below 60 percent.
- If the structural balance is lower than the MTO, is must increase by 0.5 percent of GDP per year as a baseline;

4 An adjusted measure of real government expenditures (nominal expenditures deflated by the GDP deflator forecast)[5] cannot grow faster than the medium-term potential economic growth if the country's structural balance is at its MTO or higher;
- If the structural balance has not yet reached its MTO, expenditure growth must be lower than potential growth, in order to ensure an appropriate adjustment towards the MTO.

When the first two rules are met, the country is in the so-called 'preventive arm' of the Stability and Growth Pact (SGP). If one or both of the first two rules are not met, the country is in the 'corrective arm' of the SGP and an Excessive Deficit Procedure (EDP) is opened. Breaching the rules can lead to financial sanctions in the corrective arm for all countries, and in the preventive arm for euro-area countries.

Flexibility and discretion

The numerical rules are rather simple, at least conceptually. However, there are so many flexibility clauses and exceptions that the whole framework becomes opaque. Certain deviations from the rules are allowed for an unusual event outside the control of the member state concerned and which has a major impact on the financial position of the general government, a severe economic downturn in the member state, a severe economic downturn for the euro area or the EU as a whole, an unexpected adverse economic event, when structural reforms are implemented or planned, when the government contributes to EU-funded investments, when the government implements pension reforms, or when *"relevant factors"* emerge. The 3 percent deficit rule can be disregarded when the deviation from it is small and temporary, while the 1/20th debt reduction rule can be disregarded when the country is assessed as doing enough fiscal consolidation.

The European Commission has wide-ranging discretionary power in the assessment of fiscal performance and plans. Discretion can be a blessing but also a curse. In unusual times it can be helpful to get rid of rigid fiscal rules and calibrate fiscal policy to the specific circumstances. But discretion might also encourage neglect of the rules in other times. It might also lead to unequal treatment of countries. Ódor and P. Kiss (2015) argue that it is difficult to predict the Commission's decisions on flexibility.

Budgetary processes and fiscal councils

The fiscal framework also includes requirements for budgetary processes, such as the establishment of an effective and transparent medium-term budgetary framework, based on high-quality forecasts. Each country is requested to submit a Stability Programme (euro-area members) or a Convergence Programme (non-euro area members) in April and a Draft Budgetary Plan (euro-area members) by October of each year. The Commission assesses the plans for compliance with the fiscal framework. The Six-Pack also introduced a requirement for each country to set up an independent body, such as a fiscal council, that is responsible for monitoring compliance with the fiscal rules.

3 ASSESSMENT OF THE EU FISCAL FRAMEWORK

A fiscal framework has two basic objectives: (1) to discourage the deficit bias of governments in order to ensure fiscal discipline and the long-term sustainability of the public debt, and (2) to support countercyclical fiscal policy in both good and bad times. In theory, both objectives can be achieved with the current European framework if the rules are implemented, but there are so many factors hindering their implementation that the framework is ineffective in practice.

5. *"The expenditure aggregate shall exclude interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. The excess expenditure growth over the medium-term reference shall not be counted as a breach of the benchmark to the extent that it is fully offset by revenue increases mandated by law."* Regulation (EU) no 1175/2011 of the European Parliament and of the Council, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1175&from=EN.

Long-term sustainability

If European fiscal rules are fully adhered to and there are no unexpected shocks, the public debt ratio should generally decline to low levels, because of the debt and structural balance rules. For example, with a nominal GDP growth of 3 percent, respecting an MTO of -1.0 percent of GDP (the minimum MTO for euro-area countries with debt below 60 percent) ensures that public debt converges to 34 percent of GDP.

Given the probability of negative shocks and the current high levels of debt in some euro-area countries, however, the debt-ratio will remain high and the 60 percent target will probably not be reached at the euro-area level for a long time, even if rules are complied with. The recent F*iscal Sustainability Report* (European Commission, 2016) concluded that there is a high medium-term sustainability risk for almost a dozen EU countries, which, in our view, could also increase when the European Central Bank ends its quantitative easing programme.

The conduct of counter-cyclical policy has an impact on public debt sustainability too. An insufficient counter-cyclical policy in good times leads to a higher debt level and the inability to provide sufficient fiscal stabilisation in bad times. An insufficient counter-cyclical policy in bad times amplifies economic and social problems, and can affect negatively potential growth and public finances in the long run, if hysteresis effects are present[6].

Countercyclical policy

The other basic objective of a fiscal framework is to support countercyclical fiscal policy both in good and bad times. Here we focus on options for bad times.

In theory, the 3 percent headline deficit rule and the structural deficit rule, if respected, allow automatic stabilisers to operate even in reasonably deep recessions. For example, a structural balance of -0.5 percent of GDP (which is the minimum MTO for euro-area countries with public debt over 60 percent of GDP) makes it possible for automatic stabilisation of up to 2.5 percent of GDP without breaching the 3 percent deficit rule. If the fiscal stabilisation coefficient (which measures the response of the overall fiscal deficit to changes in the output gap) is 0.7, then a 3.6 percent of GDP negative output gap is compatible with the 3 percent deficit criterion[7]. A negative output gap equal to or larger than 3.6 percent is a relatively rare event: based on the empirical distribution of estimated output gaps between 1965 and 2016, such a negative output gap is expected in every twenty-second year in the 10 core EU15 countries (EU members before 2004 not including five periphery countries) and in every sixth year in the five periphery EU15 countries (Spain, Portugal, Greece, Ireland and Italy)[8], if the historical distribution of output gaps is a good indication of their future distribution. For the 13 countries that joined the EU in 2004 and after, the 1997-2016 period suggests such an output gap can be expected every ninth year.

In addition, countries might decide to perform more cyclical stabilisation than what is allowed by the 3 percent deficit rule and thereby enter an excessive deficit procedure, as highlighted by Micossi and Peirce (2014). Flexibility clauses also allow delayed fiscal consolidation after an increase in the budget deficit. In 2008, the European Commission proposed the European Economic Recovery Plan (European Commission, 2008) and invited EU countries to *"agree to an immediate budgetary impulse amounting to € 200 billion (1.5 percent of GDP), to boost demand in full respect of the Stability and Growth Pact"*. When calling for the stimulus, the Commission noted that countries that would breach the 3 percent deficit limit would be placed under the excessive deficit procedure.

Fiscal policy in the United States from 2008-10 is often portrayed as a good example of effective

'We find it unacceptable that the EU's fiscal framework strongly relies on the change in the structural balance as an indicator, for which the typical one-year revision of the estimate is larger than the required policy action.'

6. As argued by De Long and Summers (2012), downturns can have persistent negative consequences on future economic activity through various channels: *"reduced labour force attachment on the part of the long-term unemployed, scarring effects on young workers who have trouble beginning their careers, reductions in government physical and human capital investments as social insurance expenditures make prior claims on limited public financial resources, reduced investment in both in research and development and in physical capital, reduced experimentation with business models and informational spillovers, and changes in managerial attitudes"*.

7. IMF estimates suggest that the average fiscal stabilisation coefficient is 0.7 for advanced countries (Buti and Gaspar, 2015). For 16 EU countries the estimated coefficient does not exceed 0.7 (for most of them it is well below), while for 5 EU countries it is larger than 0.7.

8. These calculations are based on the European Commission's 2016 winter forecast.

countercyclical policy because it provided a large stimulus in response to the financial crisis. We conclude that such a stimulus would have been in line with the current EU fiscal rules. With the stimulus, the US structural deficit increased to 10 percent of GDP, similar to Greece, Ireland, Romania, Spain and the United Kingdom. In the case of the UK, which had been under an excessive deficit procedure since 8 July 2008, the Council of the EU on 30 November 2009 assessed that the stimulus was *"an appropriate response"*[9].

However some countries were constrained by market pressure and others decided not to stimulate their economies as much. In particular, in the largest EU country, Germany, the structural deficit peaked at a mere 2.2 percent in 2010.

When the economic cycle started to deteriorate again in 2012, fiscal consolidation continued in most EU countries, leading to pro-cyclical fiscal policy even in those countries that had ample fiscal space, as argued by Barbiero and Darvas (2014). Barbiero and Darvas also showed that public investment, the expenditure category with the greatest impact on output growth, suffered the most among the various public expenditure categories throughout the EU.

Germany corrected its excessive deficit in 2011, two years ahead of the deadline set by the Council, and fiscal consolidation continued up to 2014 when the structural balance increased to a surplus of 0.8 percent of GDP, well above the -0.5 percent MTO and also above the requirement set by Germany's own debt-brake rule. The German structural balance increased much more quickly than planned in Germany's Stability Programmes in 2010-13, highlighting the fact that the structural balance is an inadequate fiscal target because the government has only limited control over it. Therefore, we conclude that the post-2012 pro-cyclical fiscal tightening in Germany was not the result of EU fiscal rules, but most likely the result of domestic political preferences and the reliance on an inappropriate fiscal indicator, the structural balance.

To examine how the fiscal rules were interpreted by the Commission and the Council in 2012, we look at the country-specific recommendations made in summer 2012 and their assessments in 2013, for the six largest EU countries.

Among these six countries, the Council requested a fiscal tightening which seemed pro-cyclical at the time for only Poland, because in spring 2012 the Commission forecast a 0.6 percentage point deterioration in the Polish output gap. But for the five other large countries (France, Germany, Italy, Spain and the UK) the Commission forecast some improvements in their output gaps in 2012 and 2013. Therefore, pro-cyclical fiscal tightening resulted more from incorrect Commission forecasts than from a deliberate pro-cyclical fiscal policy.

In 2013, when the Commission revised its output gap estimates to indicate deterioration, seven of the eight countries (France, Malta, Netherlands, Poland, Portugal, Slovenia and Spain) which were missing targets and the deadline under the corrective arm were given a delayed deadline for the correction of the excessive deficit, citing *"unexpected adverse economic developments"*. The eighth country, Belgium, received a 'notice' to step up fiscal consolidation efforts by 0.25 percent of GDP to meet the initially planned structural fiscal effort. Since then, other countries have been granted similar deadline extensions[10]. However, while these countries were given more time to correct their deficits, the Commission and the Council certainly did not call for a stimulus (even in countries that had ample fiscal space) at a time when the cyclical situation deteriorated.

Therefore, concerning counter-cyclical fiscal policy in an economic downturn, we conclude that:

- When all rules are met, sizeable fiscal stabilisation is possible even without entering the excessive deficit procedure;
- In a deep recession, even a 2008-10 US-style stimulus is possible by entering an excessive deficit procedure.

The key problems from the perspective of fiscal stabilisation in a downturn are:

- Estimates and forecasts of the output gap can prove to be incorrect and can therefore mis-

9. We also note that the UK was requested to increase its structural balance by 1.75 percent of GDP annually under the SGP: fiscal consolidation in the US was done at exactly the same pace.

10. For example, according to the estimated structural balance indicator, since 2013 the UK stopped fiscal consolidation, yet non-compliance with the fiscal requirements was not sanctioned. Instead, in June 2015, the Council issued a new recommendation for the UK to reach the 3 percent deficit threshold in two years, which will be supported by the expected improvement in the UK's cyclical situation.

guide fiscal policy and the European Commission's recommendations;

- The structural balance estimates are subject to major revisions and can lead to misguided policy advice;
- When a recession lingers for several years, fiscal rules at best allow the postponement of fiscal consolidation instead of suggesting a necessary repeated stimulus;
- In recent years, most EU countries were far from their MTO and therefore could not avail themselves of the options offered by the fiscal rules to support the economy with counter-cyclical fiscal policy.

Real-time measurement

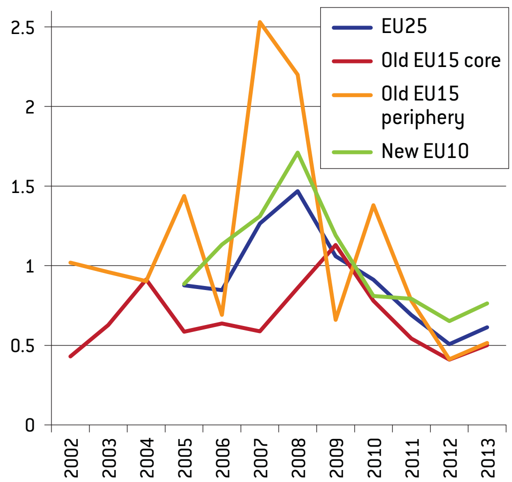
While using cyclically-adjusted targets seems straightforward and sensible in theory, it is not very helpful and can even be harmful in practice. Compliance with at least one of the four numerical rules is very badly measured in real time. The structural balance and potential output are unobservable variables and their real-time estimates are extremely imprecise and subject to major revisions.

The typical yearly revision both in the level and in the change in the structural balance is larger than 0.5 percent of GDP, ie larger than the required baseline annual adjustment (Figure 1)[11]. That is, if the Commission forecasts in spring 2016 that the structural balance will remain unchanged from 2015 to 2016, it is likely that in spring 2017 the 2015-16 change in the structural balance will be estimated as half percent or larger (either an increase or decrease). We find it unacceptable that EU's fiscal framework strongly relies on an indicator (the change in the structural balance) for which the typical one-year revision in the estimate is larger than the required policy action, especially since the revisions are much larger in more uncertain times, as indicated by Figure 1.

The revisions of the real-time estimates of the medium-term average potential growth rate (which is used for the expenditure rule) were smaller than the revisions of the change in the structural balance estimates, though Commission estimates were revised substantially during the crisis, exactly when good guidance was needed (left panel of Figure 2 on the next page). However, the estimates using real-time data from the model of Darvas and Simon (2015) were not subject to such large revisions during the crisis years (right panel of Figure 2). With the exception of the Commission's 2008 estimates, the typical one-year revision for different EU country groups was about 0.1-0.5 percentage points per year[12]. We therefore conclude that the medium-term potential growth rate estimate was a more suitable indicator than the annual change in the structural balance, especially when using a more robust technique than the Commission's current model.

On the other hand, the real-time measurement of the expenditure rule is hindered by its dependence on GDP deflator forecasts (since the rule applies to the real growth of expenditures), the inclusion of EU funding and the non-discretionary unemployment spending[13]. Furthermore, inde-

Figure 1: Average one-year revision in the real-time European Commission estimate of the change in the structural budget balance (% GDP)



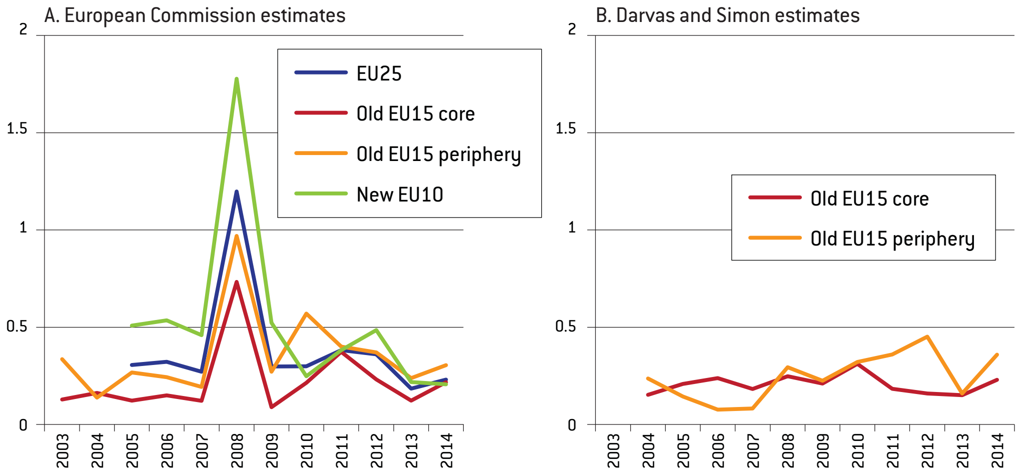
Source: Bruegel. Note: Average absolute revision of the real-time estimate made in spring of the subsequent year. For example, the last observation shows the difference between the May 2015 and May 2014 estimates for the 2013-14 change in the structural balance (absolute values of the differences averaged for the country group indicated in the legend). We could not find real-time structural balance estimates made before 2006, but we found real-time cyclically adjusted budget balance estimates made in 2003, 2004 and 2005. Therefore, for the first three years shown we report the revision in the change to the cyclically adjusted budget balance. EU15 Periphery: Greece, Ireland, Italy, Portugal and Spain; EU15 Core: other 10 countries which were members of the EU before 2004. New EU10: member states joined in 2004. Bulgaria, Croatia and Romania are not included because of data limitations.

11. The average from 2003-14 was 0.71 percent of GDP for core EU15 countries, 1.84 percent for periphery EU15 countries, while in 2006-14 it was 1.24 percent for newer member states. IMF and OECD estimates were characterised by similarly large revisions.

12. For example, a 0.3 percentage point downward revision in medium-term potential growth estimate would imply that if in spring 2016 a country is allowed to increase expenditures by 1.5 percent in 2017, in spring 2017 the allowed growth rate of expenditures is revised downward to 1.2 percent per year. Given that public expenditure amounts to about half of GDP, a 0.3 percent revision in expenditures implies a 0.15 percent of GDP impact on the budget balance, which is much smaller than the average revision in the change in the structural balance.

13. In some cases there were major revisions in the latter two factors. For example, the 2014 French Stability Programme reported that cyclical unemployment expenditures amounted to 0.2 percent of GDP, while the 2015 French Stability Programme revised the estimate to 1.3 percent. EU-funded programmes were indicated at 0.0 percent (after rounding) in the 2014 Austrian Stability Programme, while they was projected at 0.5 percent in the 2013 programme and reported at 0.4 percent in the 2015 programme.

Figure 2: Average one-year revision in the real-time estimate of the medium-term average potential growth rate (%)



Source: Bruegel. Note: Average absolute revision of the real-time estimate made in spring of a year one year later. For example, the last observation on the left panel shows the difference between the May 2015 and May 2014 Commission estimates for the 2009-18 average potential growth rate, while the right panel shows the estimates for the 2009-14 period using spring 2014 and spring 2015 data on the basis of the model of Darvas and Simon (2015) (absolute values of the differences averaged for the country-group indicated in the legend). The Darvas and Simon (2015) estimates are not available for longer-term forecasts.

pendent verification of the relevant expenditure aggregate based on publicly available data is impossible.

Implementation

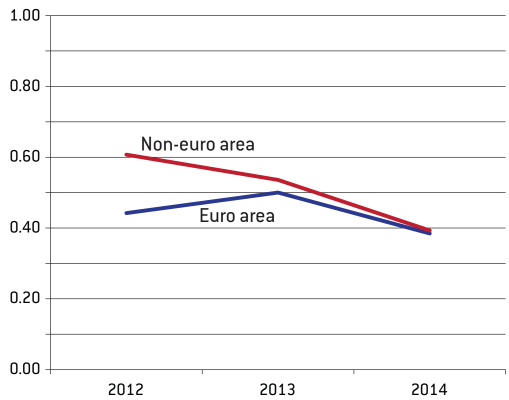
European fiscal rules are barely implemented. The 1/20th debt reduction rule will not be met by Belgium, Croatia, Finland, France, Greece, Italy, Portugal, Slovenia and Spain in the next three years, according to the IMF's October 2015 forecasts[14]. Even the European Commission's own assessment is that only a fraction of the European Semester recommendations related to the Stability and Growth Pact are implemented (Figure 3).

Credibility of sanctions

Finally, we note that the threat of sanctions is not credible. In a time of economic hardship, sanctions would make the economic situation worse (Andrle *et al*, 2015), though when the budget deficit is, for example, about 10 percent of GDP, a 0.2 percent of GDP sanction would be insignificant compared to the scale of fiscal problems.

In our view, the political dimensions of a sanction are more important. Imposition of a financial sanction may lead to backlash against the member states which voted for the sanction and against the EU as a whole, undermining the cohesion of the EU and its peoples. Backlash would be especially harsh if the perception in the sanctioned country is that the Commission's recommenda-

Figure 3: Implementation rates of the Stability and Growth Pact



Source: Bruegel. Note: We consider recommendations related to the SGP made in the context of the European Semester and the European Commission's assessments regarding the progress with the implementation of the recommendations, which is graded on a 5-step scale. We gave a score of 1 to 'full implementation', a score of 0.75 to 'substantial progress', a score of 0.5 to 'some progress', a score of 0.25 to 'limited progress' and a score of zero to 'no progress'; we report an unweighted average of those countries for which data is available for all years. The horizontal axis indicates the date of the European Semester recommendations. See Box 1 of Darvas and Leandro (2015) for further details.

14. The Commission publishes forecasts only one year ahead, which cannot be used to assess the forecast change in the debt ratio of the next three years, as the debt rule requires

tions were misguided, partly because of the forecast and measurement errors described above.

Moreover, game theory also suggests that sanctions are unlikely. The final decision on sanctions lies ultimately with the Council, which makes member states both judges and defendants (Tirole, 2012). Countries might therefore have little incentive to take an adversarial stance towards another member state.

Many countries outside the EU have fiscal rules but do not impose financial sanctions on themselves or on sub-national public entities. In the end, the perception that the rules and the fiscal framework provide economically sound guidance could be a much more important factor than the fear of sanctions to provide an incentive to member states to respect the rules.

4 HOW TO REFORM THE EUROPEAN FISCAL FRAMEWORK

Do we need a fiscal framework at the supranational level?

The deficit bias originates from country-specific problems[15]. Therefore, it would make sense to design and implement the fiscal framework at the national level, which would also increase the domestic ownership of the framework.

However, there are also good reasons for a certain degree of European involvement in the design, monitoring and enforcement of fiscal rules, because of cross-border spillovers of fiscal policies.

1 Some governments might be tempted to free ride by implementing unsustainable fiscal policies and expecting either a bailout from other governments or a monetisation of their debt by the common central bank (Buiter *et al*, 1993). This could have a negative impact on their partners through increased taxation or inflation. In the absence of a bail-out or monetisation, the country that runs an unsustainable fiscal policy might face more adverse economic and financial developments, which would impact partners through trade and financial links. European involvement in the design, monitoring and enforcement of fiscal rules might limit the likelihood that any member state will run unsustainable fiscal policies[16].
2 Inflationary (deflationary) fiscal policy in one euro-area country could impact the average euro-area inflation targeted by the European Central Bank and trigger a monetary tightening (easing) for everyone (Bénassy-Quéré, Ragot and Wolff, 2016).
3 The differences in fiscal policy in different euro-area countries (such as a competitive and low-debt core and an uncompetitive and indebted periphery) provide a major tool to address price/wage divergences in a non-optimal monetary union, in which factor movements and purely market-based relative price adjustments across countries cannot efficiently compensate for price and wage divergences. European involvement in the fiscal framework is justified because fiscal policy has a role both in the build-up and the correction of such divergences (Merler and Pisani-Ferry, 2012).
4 Purely national fiscal policies might lead to a suboptimal area-wide aggregate fiscal stance in the absence of proper fiscal policy coordination, and to a suboptimal macroeconomic policy mix in the absence of coordination between monetary policy and the aggregate fiscal stance (Buiter, 2006).

Most of these arguments are pertinent for the euro-area, but trade and financial linkages tend to be strong between all EU member states and there is also a bail-out option for non-euro countries (the so called balance of payments facility[17]). We therefore prefer an EU-wide approach and conclude that given the current institutional setup of the euro area and the EU, some EU involvement in the design of the fiscal framework is justified.

Should the fiscal framework be changed?

We believe that the 'no change' vision (no change to fiscal rules, appointment of an advisory fiscal board) of the *Five Presidents' Report* (Juncker *et al*, 2015) would be suboptimal. While the framework strongly focuses on long-term sustainability and allows counter-cyclical policy in a downturn when rules are met, several member states persistently and even openly disregard the rules, the large number of flexibility options makes the

15. See footnote 2.

16. The EU Treaty explicitly includes a 'no-bailout' clause and a prohibition of monetary financing by the ECB (respectively in Articles 125 and 123 of the TFEU). However, the authors of the SGP might have believed that these clauses, combined with market discipline, were not enough to prevent the free-riding problem or that they do not represent credible commitments in times of crisis, and therefore a European fiscal framework is needed.

17. See http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm.

whole system opaque and the real-time implementation of the rules is burdened with significant errors related to the estimation and forecasting of the structural budget balance, which can lead to misguided policy recommendations. While some improvements can be made to the current framework, such as better protection of public investment during an economic downturn[18], improved measurement of potential output and thereby cyclically-adjusted fiscal indicators[19], and clearer provisions on flexibility options, it would be better to adopt a framework that is not burdened with such problems.

In our view, the best option would be to re-design the fiscal framework from scratch, which would require a major overhaul of the EU Treaty. One way to do that would be to remove completely the bailout option, establish conditions for market discipline to work effectively, allow a large degree of fiscal independence to member states and design a cyclical stabilisation mechanism at the European level.

However, in our view such an overall of the EU's and the euro area's fiscal system is unrealistic today and therefore we do not develop this scenario in this paper. Instead, we make a proposal to revise fiscal rules so that they are more conducive to long-term debt sustainability and fiscal stabilisation, more transparent, easier to implement and more likely to be respected. We also propose the establishment of a European Fiscal Council to oversee the new framework. Our proposal requires a change to the Stability and Growth Pact and the Fiscal Compact, while the EU Treaty need not be changed[20].

The proposed fiscal rule

We propose to drop the structural balance as an intermediate target of fiscal policy. Instead, we propose an expenditure rule with a debt-feedback mechanism, which would make the 1/20th debt reduction rule redundant.

The intuition behind such a proposal is not new. For example, Pisani-Ferry (2002) proposed that the emphasis of fiscal discipline should be shifted away from the year-by-year monitoring of the deficit to a more medium-term approach that focuses on the long-run sustainability of public finances. Anderson and Minarik (2006) argued that steering on the expenditure side rather than on a cyclically adjusted deficit constraint is more transparent and less susceptible to manipulation. Turrini (2008) found that pro-cyclical bias in good times is an entirely expenditure-driven phenomenon in the euro area and expenditure rules can be helpful to curb the expansionary bias of fiscal policy. Holm-Hadulla, Hauptmeier and Rother (2012) confirmed that expenditure rules reduce pro-cyclical bias. Based on literature surveys, Fabrizio and Mody (2008) and Darvas and Kostyleva (2011) ranked expenditure rules the best among the various fiscal rules when designing fiscal institution quality indices. Ayuso-i-Casals (2012) summarised many positive features of expenditure rules. Model simulations for Germany led Brück and Zwiener (2006) to propose the replacement of the SGP deficit rule with an expenditure rule augmented by medium-term debt targets. More recently, Andrle *et al* (2015) proposed a similar setup, supported by literature review and model simulations.

Our proposed expenditure rule is similar in spirit to rules suggested in some of the above-mentioned works, but has certain specific features that we regard as important. The rule would put a limit on the growth rate of an adjusted measure of government expenditure. Table 1 on the next page compares our proposed new rule to the existing EU expenditure rule.

1 The adjusted expenditure aggregate: nominal expenditure excluding interest expenditure, labour-market related expenditure and one-off expenditure, while public investment expenditure should be smoothed over several years and accounted for in the same way that corporate investment is accounted for.

'The best option, re-designing the fiscal framework from scratch, is unrealistic today and therefore we propose a better fiscal rule and the establishment of a European Fiscal Council to oversee the new framework.'

18. Barbiero and Darvas (2014) proposed an asymmetric golden rule for public investment, while Bénassy-Quéré, Ragot and Wolff (2016) proposed an incremental public investment rule.

19. The potential output method of Darvas and Simon (2015) is conceptually intuitive and led to more reliable real-time estimates than the method of the European Commission.

20. If the Treaty is not changed, the 3 percent deficit rule would continue to exist, but it should not be given much attention in our renewed framework. It would continue to trigger the opening of an excessive deficit procedure (EDP), which should focus on the proper implementation of the expenditure rule.

Motivation:

- The current EU expenditure rule is based on the forecast GDP deflator, which is burdened with forecast uncertainty. Nominal expenditures are under the direct control of the government but the GDP deflator is not.
- The current EU expenditure rule disregards *"non-discretionary changes in unemployment benefit expenditure"*, which is problematic given estimation problems[21]. Excluding all unemployment-related expenditures would not lead to major moral hazard issues, because it is unlikely that a government will adopt measures to increase unemployment just to be able to spend more on unemployment benefits[22].
- Sometimes large one-off expenditure becomes desirable, such as a bank bailout, repair of public infrastructure after a natural disaster or a one-off discretionary fiscal stimulus in a deep recession. The decision on what can be qualified as a one-time expense should be delegated to an appropriate fiscal council – an issue we discuss later.
- The current EU expenditure rule allows public investment expenditure to be averaged over four years, in order to reduce the impact of a possibly large investment in a given year on other expenditure. While this is helpful, our proposal goes further and suggests treating public investment as corporate investment is treated in corporate accounting; that is, the cost of an investment is distributed over future years during the service life of investment. For improved transparency and increased efficiency of public investment, it would be important to separate the investment budget from the current budget and to manage public assets in a transparent holding company.
- The current EU expenditure rule excludes *"expenditure on Union programmes fully matched by Union funds revenue"*, but such special treatment of EU-funded investments is not needed when all public investment is accounted for as we propose.

2 <u>The benchmark for expenditure growth:</u> medium-term potential growth rate plus the central bank's inflation target (2 percent in the euro area and those other EU countries that have this target, and 2.5 or 3 percent in the case of some central European member states[23]). Euro-area countries subject to the Balassa-Samuelson effect may add a higher inflation rate.

Motivation:

- In some non-EU countries expenditure rules define the ratio of expenditure to GDP, but that introduces some pro-cyclicality, because it allows more spending when output is above potential and less spending when it is below. This pro-cyclicality can be avoided by the use of potential output, at the cost of estimation error related to medium-term potential growth. This estimation error, however, is not so large (Figure 2).
- The current EU expenditure rule (nominal expenditure deflated by the forecast GDP defla-

21. We note that Bénassy-Quéré, Ragot and Wolff (2016) suggested to exclude the incremental increase in unemployment payments from the budget deficit, when in a recession the European Commission's advisory Fiscal Board concludes that the situation justifies such an exclusion.

22. It is true that the generosity of unemployment insurance can be increased too (eg before an election to gain popularity among unemployed), yet in our view the possible extra expenditure under such behaviour tends to be small compared to overall unemployment expenditures.

23. The inflation target is 2.5 percent in Poland and Romania and 3 percent in Hungary.

Table 1: Comparison of the current EU expenditure rule with our proposed expenditure rule

	Current EU expenditure rule	Our proposed expenditure rule
Expenditure aggregate	Real (depends on GDP deflator forecast)	Nominal
Items excluded from the expenditure aggregate	Interest, EU funded programmes, non-discretionary changes in unemployment benefit expenditure	Interest, all labour-market related expenditure, one-offs
Treatment of public expenditure	Four-year backward-looking moving average	As in corporate accounting; separate current and investment budgets
Expenditure growth benchmark	Real medium-term potential GDP growth	Real medium-term potential GDP growth + 2% for inflation target
Revenue correction	Yes	Yes
Debt correction	No	Yes
Expenditure-overrun correction	No	Yes

Source: Bruegel.

tor) is subject to measurement and forecast errors and takes expected inflation as given. Instead, we propose to add the central bank inflation target to the growth rate of potential output[24], which also helps the central bank to achieve its inflation target, while providing further cyclical stabilisation: when inflation is high, fiscal policy helps to reduce it, and when inflation is low, fiscal policy supports the economy and the return of inflation to its target.

- The convergence of the price level concurrent with the convergence in productivity (the Balassa-Samuelson effect) is an equilibrium phenomenon, which is relevant for converging countries. Non-euro area countries are able to set their own inflation targets to reflect the importance of this effect, but this is not the case for euro-area countries. We therefore propose the European Fiscal Council (see later) to allow a higher than 2 percent inflation rate for those euro-area countries which are subject to the Balassa-Samuelsson effect. Since these countries are small, their impact on the average euro-area inflation rate is minor.
- The Commission's methodology for estimating medium-term potential output growth was subject to major revisions at the height of the crisis and therefore should be improved by incorporating open-economy considerations, as suggested in Darvas and Simon (2015).

3 Debt correction: the allowed maximum expenditure growth is reduced by 0.02 times the difference between the debt level in the previous year and the 60 percent of GDP debt criterion.

Motivation:

- While gross public debt is not the best indicator of public sector sustainability risks, it is still a useful and widely-used indicator, which can serve as a long-term anchor of fiscal policy.
- The 60 percent of GDP criterion for public debt is included in the Protocol of the EU Treaty. While this number does not have an academic underpinning, the academic literature on the optimal level of debt is inconclusive. There are some advanced countries with debt levels below 60 percent (eg Switzerland, Australia, New Zealand), where fiscal policy seems to operate relatively well. We therefore accept the 60 percent criterion as the political choice of EU leaders.
- The exact value of the parameter of the debt correction term should be open to discussion. However, a back-of-the-envelope calculation suggests that a 0.02 coefficient is reasonable. For example, for a country with a 110 percent of GDP debt ratio, this coefficient implies that expenditure growth should be 1.0 percentage points lower than the sum of potential growth and the inflation target. Since public expenditure typically amounts to about half of GDP, a 1 percentage point slower expenditure growth implies a fiscal tightening of about half percent of GDP, which is similar to the benchmark structural balance adjustment requirement in the current EU framework. We find this magnitude reasonable for a country with a 110 percent debt ratio.
- Debt correction is included in our proposal in a symmetric way: in accordance with the EU Treaty, governments with public debt below 60 percent of GDP should be allowed to increase their debt towards that level. However, the expenditure growth limit resulting from our proposed rule represents a limit and not a target. Any government can opt for lower expenditure growth if it prefers to have a public debt ratio below the 60 percent criterion.

4 Overrun correction: the difference between actual expenditure growth and the expenditure growth limit should be corrected in subsequent years if the gap was positive, while it can be corrected if the gap was negative.

Motivation:

- Even though nominal expenditures (excluding interest and unemployment-related payments) are under the control of the government, overruns are possible, which necessitates a later correction mechanism, while correcting an actually more-restrictive expenditure growth would not endanger public debt sustainability.
- The debt correction mechanism does not make an overrun correction redundant, because debt correction works slowly. For example, a 1 percentage point excess expenditure growth in the last year would imply an approximately half percentage of GDP higher public debt (when

24. Brück and Zwiener (2006) also proposed to consider the ECB's inflation target in the definition of the expenditure limit.

expenditure amounts to half of GDP), which would necessitate only a 0.01 percentage point slower expenditure growth in the next year.

5 Consideration of revenues: a permanent increase in the level of spending is allowed only if appropriate revenue measures are introduced; conversely, a cut in taxes is allowed only if the expenditure level is cut too.

Motivation:

- A government might prefer to spend more, especially when a new government is formed after an election, given the mandate the government received. Yet long-term sustainability requires that a permanent increase in expenditures should be compensated by increased revenues.
- Conversely, we propose to allow tax cuts only if they are matched by an appropriate reduction in expenditure growth.

Thereby, our proposed rule would be conducive to fiscal stabilisation through both expenditures (via the inflation target, unemployment payments and public expenditures) and revenues (revenue-based automatic stabilisers are allowed to work fully)[25]. It would also be conducive to public debt sustainability, because of the incorporation of explicit debt correction and the elimination of the pro-cyclical bias in expenditure during good times, while limiting hysteresis effects in bad times. Implementation of our proposed rule would be much easier than the implementation of the current web of EU fiscal rules with all flexibility clauses, given that nominal expenditure is under the control of the government and the real-time estimation and measurement errors in the expenditure limit is much smaller than in the case of the structural balance indicator. The simplicity and increased transparency of the rule would allow easier surveillance and enforcement and much better communication with the general public.

Given the benefits of medium-term budgeting[26] (such as better allocation of expenditures, avoidance of the negative effects of current expenditure decisions on future expenditure[27], greater predictability and transparency, increased accountability of policymakers and higher effectiveness in stabilisation terms), our rule should also be set in a multiannual budgeting framework.

As an illustration, we simulated the real-time working of our proposed rule for some EU countries in 2004-15. We cannot fully mimic our rule, because we do not have data on discretionary revenue changes and also do not have sufficient information to smooth public investment. We therefore calculated the growth rate of nominal public expenditures excluding interest expenditure, labour-market related expenditure, and one-off expenditure, but make no correction for revenues and public investment. We compare expenditure growth to the real-time estimate of potential output growth using the Darvas and Simon (2015) model. For simplicity, we do not consider the expenditure-overrun correction.

In the pre-crisis period, our proposed expenditure rule would have disciplined Spain, Ireland and the United Kingdom (Figure 4 on the next page), countries that experienced housing booms and rapid pro-cyclical public expenditure increases. It would have disciplined Italy too, where public debt was high. On the contrary, Germany and Sweden could have spent more in 2004-07. After 2009, our rule would have allowed much more countercyclical fiscal policies than those that were actually implemented in many EU countries. The growth rate of public expenditure was inferior to our limit in Germany, Ireland, Spain and the United Kingdom, while the setback in the public expenditure growth rate in Italy in 2010 was justified, given its low medium-term potential growth estimate and the increased level of public debt (for other countries, see the Annex).

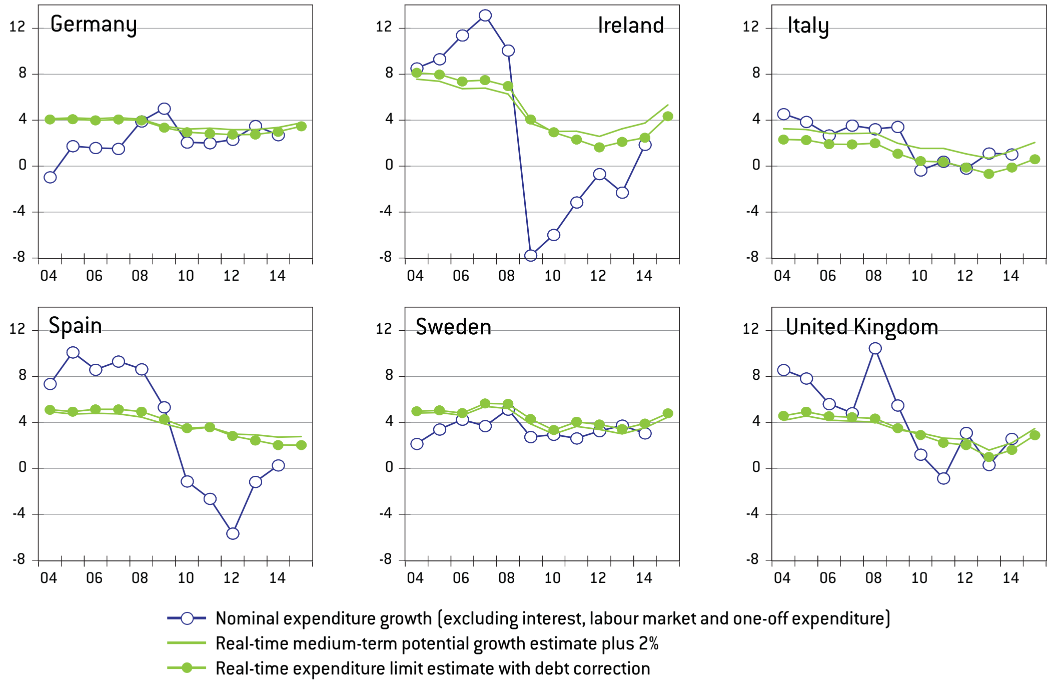
The adoption of our proposed rule would not solve directly the problem of the non-credibility of sanctions that has been present in the European fiscal surveillance framework since the adoption of the Maastricht Treaty. However, we believe that our proposed rule, which is simple, easy to implement in real time and not prone to significant errors, could lead to sound fiscal policy recommendations. Thereby, there would be stronger incentives for countries to abide by the rules. Ultimately, countries should not – and will not – observe the rules because they fear sanctions or because of peer pressure, but

25. We share the opinion of Buti and Gaspar (2015) that budget-neutral automatic stabilisers should play a large role in fiscal stabilisation.

26. See for instance Tarschys (2003).

27. A typical example of this issue is the decision to end a vaccination programme today to meet a fiscal target that will eventually lead to higher expenditure in terms of health care in the future.

Figure 4: Actual expenditure growth and real-time expenditure limit estimate based on our proposed rule, selected countries



Source: Bruegel. Note: Nominal public expenditure excluding interest expenditure, labour-market related expenditure and one-off expenditure, but no correction is made for revenues and public investment. The real-time estimate of potential output growth uses the Darvas and Simon (2015) model. The expenditure limit corrects the real-time potential growth estimate plus 2 percent inflation benchmark with the real-time data on public debt, but for simplicity we do not consider expenditure-overrun correction.

because they all agree that the rule represents the best guidance for their fiscal policies to be both sustainable and countercyclical.

Comparison of the existing structural balance rules with our proposed expenditure rule

There are a number of reasons to conclude that our proposed rule is superior to the existing structural balance rules.

The estimated structural balance depends on the estimates (forecasts) of the budget balance and output gap, on the elasticity of the cyclically adjusted balance to the output gap, and on the quantification of one-off revenue and expenditure measures. For our expenditure rule, estimates (forecasts) of the adjusted expenditure aggregate, estimates of the medium-term potential output growth and quantification of discretionary revenue measures are needed.

Table 2: Comparison of the current EU structural balance rules with our proposed expenditure rule

	Structural balance rule	Our proposed expenditure rule
Operational target	Structural balance (not under government control)	Adjusted nominal expenditure (under government control)
Role of forecasts	GDP and inflation forecasts matter a lot	Forecasts do not matter much
Estimation error	Large (output gap in a given year, elasticity of budget balance to output gap)	Small (multi-year average of potential growth)
Quantification of one-offs	Yes	Yes
Counter-cyclicality	Good in theory, bad in practice	Good in theory, good prospect for practice
Debt sustainability	Good in theory, dubious in practice	Good in theory, good prospect for practice

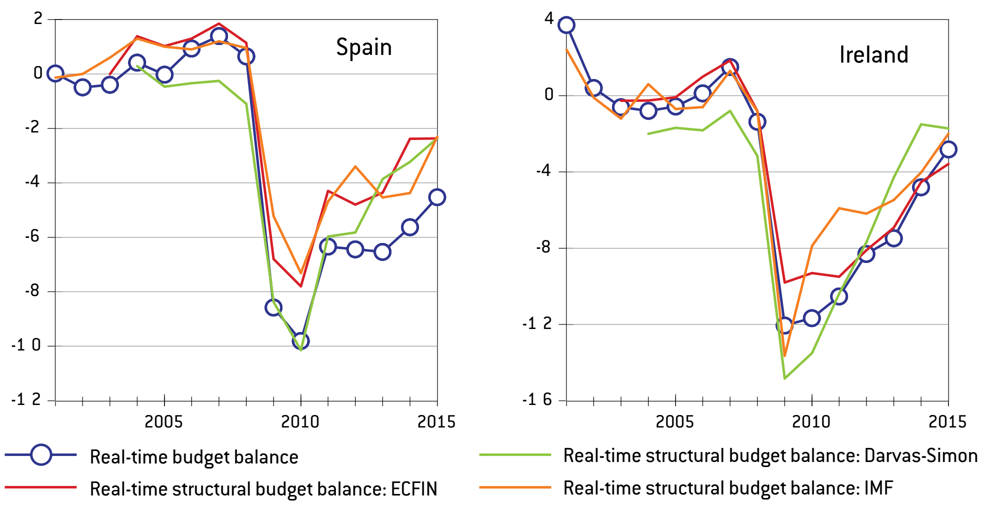
Source: Bruegel.

- For a government it is easier to control the adjusted expenditure aggregate that we proposed than the budget balance, since the latter depends on unemployment expenditure and revenues too (which in turn strongly depend on the state of the economy), and on interest expenditure (which might be subject to changes in market sentiment).
- Fiscal planning under a structural balance rule very much depends on forecasts of output and inflation, while such dependence is not so important for the implementation of the expenditure rule.
- Irrespective of which potential output method is used, the estimation error and the expected revision is greater in the output gap estimate for a given year (which is needed for the structural balance estimate of a given year) than for a medium-term average of potential growth estimates (which is needed to set the limit on expenditure growth). The medium-term average of potential growth is calculated on the basis of several years, eg the past five years and the current year. Even if the current-year estimate might be subject to a sizeable revision, experience shows that the past potential growth estimate is only subject to small revision. Figures 1 and 2 demonstrate the past performance of real-time estimates and underline that the medium-term potential growth estimate is subject to smaller errors.
- Estimating the elasticity of the cyclically adjusted balance to the output gap is needed for the structural balance rule, but not needed for the expenditure rule. Thereby, only the structural balance rule is burdened with this estimation error.
- The quantification of one-off revenue and expenditure measures (structural balance rule) and discretionary revenue measures (expenditure rule) is similarly difficult in our view, and therefore there is no clear ranking between the two rules in this aspect.

In fact, the measurement problems concerning structural budget balances would have made the current smarter rules useless for Spain in the years preceding the crisis: real-time data from the European Commission and IMF suggests that Spain would have been compliant with the structural balance rules (Figure 5).

We also checked a quasi-real-time estimate of the structural balance using the potential output method of Darvas and Simon (2015). To this end, for each year, we calculated the implied elasticity of the difference between the real-time actual and cyclically adjusted budget balance to the output gap as estimated by the European Commission, and applied this elasticity to the real-time output

Figure 5: Spain and Ireland, real-time estimates of the actual budget balance and structural budget balance made in spring each year (% of GDP)



Source: Bruegel. Note: For each year, the real-time estimate for the given year made in the spring of that year is indicated. Eg for 2010, the spring 2010 estimate for 2010 is included, for 2011 the spring 2011 estimate for 2011 is included, etc. Structural balance estimates from the European Commission are available only from 2006 onwards, so for 2003-05, we show the cyclically adjusted balance estimates instead.

gap estimate of Darvas and Simon (2015). We then corrected the resulting cyclically adjusted budget balance with the one-off estimates of the European Commission to obtain a quasi-real-time estimate of the structural balance using the potential output method of Darvas and Simon (2015). The results are also reported in Figure 5, indicating that Spain would have complied with the structural deficit rules even when using the real-time output gap estimates of Darvas and Simon (2015).

The consensus today, as argued for instance by Martin and Philippon (2014), is that Spanish fiscal policy was not countercyclical enough before 2008 and that Spain should have entered the crisis with an even lower debt-to-GDP level than the 35.5 percent ratio in 2007, which would have helped the country dampen the unsustainable boom before the crisis and allowed the government to have more room for manoeuvre when the crisis hit. Figure 4 shows that our expenditure rule would have constrained Spain quite significantly in the pre-crisis period, while we demonstrated above that the current structural balance rule would have not constrained Spain in 2000-08.

The conclusion for Ireland is broadly similar, though the real-time structural balance estimate based on the Darvas and Simon (2015) output gap model suggests that in 2004-06 the real-time structural balance estimate was slightly worse than the Fiscal Compact's -1.0 percent minimum value for euro-area countries with debt below 60 percent of GDP.

Transition

An appropriate transition period will be needed to move from the current system of rules to our proposed new rule. Otherwise, the different starting positions could imply similar expenditure growth limits for countries that have similar debt levels and potential growth rates, but very different budget deficits even though they have similar cyclical situations. We again would recommend a simple transition rule: for countries with budget deficits over a certain threshold (eg 2 percent of GDP), the expenditure growth limit is reduced by 0.5 percentage points per year until the threshold is reached. The threshold should be country-specific and should be calibrated, given country-specific medium-term growth and expected interest rates, so that if public debt was at 60 percent of GDP, it would stay at this level if the expenditure rule is followed. After this transition period is completed, two countries with similar potential growth rates and public debt levels will have significantly different budget balances only if they face markedly different economic situations, such as a rapid boom (leading to a budget surplus) and recession (leading to a deficit), in which case similar recommendations for two such countries would be justified.

Surveillance

To increase ownership of the rule by governments and parliaments, our proposed European rule should be transposed into national law and monitored at the national level by independent national fiscal councils. These councils should be responsible for validating the potential growth estimates used in the rule and for monitoring the consistency of the government policies with the rule during the drafting of the budget, during the budget implementation and also after the fiscal year is closed and the final numbers on the execution of the budget are available.

Still, every possible rule, including our proposed rule, has limitations and we believe that discretionary decisions are needed to face special circumstances. For example, in an exceptionally deep recession, further fiscal stimulus beyond what is allowed by our proposed rule might be justified, or a natural disaster might necessitate unusually large public investment. We propose that such decisions be taken at the European level, because of the potential cross-borders externalities. We see two options for the European-level involvement:

- The current setup involving the European Commission and the Council,
- Creation of a new European Fiscal Council.

Currently, the perception of some stakeholders is that Commission does not always give unbiased recommendations to the Council. Moreover, Mody (2014) argues that the political process always undermines the proper application of any fiscal rule. Such perceptions and political difficulties would likely be reduced if the EU's fiscal framework were to eliminate the current opaque system of exceptions and opt for the simple fiscal rule we propose. However, in order to avoid any possibility of political mismanagement of the discretionary powers at the European level, a new European Fiscal Council (EFC) should be set up, similar to the EMU Stability Council proposal of von Hagen (2007)[28]. The mandate of the EFC should be to safeguard the proper implementation of the fiscal rule with the ultimate objectives of long-term public debt sustainability and countercyclical fiscal policy. In particular, the EFC should be entrusted with taking the discretionary decisions concerning the implementation of the European expenditure rule, such as:

- The occasions when the rule can be suspended either in a particular country or in the EU as a whole;
- Acceptable one-off measures;
- The way investment expenditures should be smoothed over several years;
- Allowing higher inflation in countries characterised by the Balassa-Samuelson effect.

The Commission's 2015 decision[29] about the establishment of an independent advisory European Fiscal Board (EFB) is not sufficient for the task, given that the EFB was created to be an internal advisory body for the Commission: the mission statement specifies an advisory role, the nomination of members depends almost entirely on the Commission, members are not accountable and the transparency regulation requires only one public annual report[30] by the EFB.

Instead, similar to the ECB Governing Council[31], a European Fiscal Council should be established, consisting of an executive board (six members) and the chairs of each EU member state fiscal council. Given the importance of the EFC's decisions, the required qualifications and appointment procedures of the executive board members should be as strict as those for ECB Executive Board members, in order to guarantee professionalism and avoid political appointments and the representation of national preferences[32]. The European Fiscal Council should be accountable to European citizens.

Accountability of unelected officials should be two-dimensional, as explained by Schedler (1999). First, an accountable board should be obliged to inform citizens and its representatives about its decisions and should be able to justify them. This could take the form of press conferences and hearings at the European Parliament on a regular basis, accompanied by the publication of reports justifying its decisions. Second, the European Parliament should be able to impose sanctions on the body in case it fails to fulfil its mandate.

The aggregate fiscal stance of the euro area and the EU

There is a debate on whether the aggregate fiscal stance of the euro area and the EU makes sense and if the fiscal framework should force countries with ample fiscal space to have larger budget deficits when other countries are forced to implement pro-cyclical fiscal tightening. For example, Blanchard *et al* (2014) suggested a fiscal expansion in countries with significant fiscal space might be desirable from a euro-area perspective in case of under-use of productive capacities and too-low inflation, especially in a liquidity trap. But if these countries have a less slack than the euro-area average and they believe that cross-country spillovers from fiscal policy are small, they will most likely provide less stimulus than what would be needed to align the aggregate fiscal stance of the euro area with the aggregate economic situation.

Our proposed framework would ensure that each member state runs responsible fiscal policies in good times and thereby have the fiscal space to provide adequate fiscal stabilisation during bad times. Thereby, the likelihood that some countries will be forced to implement pro-cyclical fiscal tightening during a downturn will be less likely too. For this reason, the aggregate fiscal policy of euro-area and EU member states will more aligned with the aggregate economic situation of the euro area and the EU, even though our new expenditure rule would not try to tackle directly the problem of the aggregate fiscal stance.

We do not propose a rule which can force a country to have a higher budget deficit than what is

28. Our proposal is quite similar to the proposals of von Hagen (2007), with two key differences: we suggest including the chairs of national fiscal councils in the EFC in addition to an executive board, while von Hagen proposed only a professional executive board, and we propose an EU-level council, while von Hagen proposed a euro-area council.

29. See http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015D1937&from=EN.

30. *"Article 6. Transparency. The Board shall publish an annual report of its activities, which shall include summaries of its advice and evaluations rendered to the Commission".*

31. The 'Eurosystem of Fiscal Policy' (EFP) proposal by Sapir and Wolff (2016) was also motivated by the ECB Governing Council. A key difference between their EFP and our EFC proposal is that finance ministers would be the members of the EFP, while the chairs of the national fiscal councils would be the members of the EFC. There are also differences in the proposed mandates of the EFP and EFC.

32. As suggested in Calmfors and Wren-Lewis (2011) fiscal councils could be composed of a mix of academics, public-finance experts, financial-sector analysts and even well-known former politicians, as long as they are not influenced by the prospects of future career opportunities in the government administration.

deemed appropriate domestically. In our view, it is unrealistic to expect that some countries will run larger budget deficits (and consequently tax their citizens more) just because some other countries do not have fiscal space and are forced to implement pro-cyclical fiscal tightening. National policymakers are accountable to their national parliaments and focus on national interests. If the euro-area or EU aggregate fiscal stance is to be managed when some countries face fiscal constraints in a recession, a centralised instrument, such as a European unemployment insurance scheme (ie an automatic mechanism) or a specific investment facility (ie a discretionary mechanism), should be developed.

5 CONCLUDING REMARKS

The EU's current fiscal framework is rather inefficient. In theory, the new fiscal rules, with cyclically adjusted targets, flexibility clauses and the option to enter into an excessive deficit procedure, allow for large fiscal stabilisation during a recession, while they can also support the sustainability of public debt. However, in practice, the implementation of the rules is hindered by badly-measured indicators and incorrect forecasts, which can lead to misleading policy recommendations. The large number of flexibility clauses makes the framework opaque and leads to never-ending bargaining between the countries that do not comply with the rules and the European Commission, which undermines trust in the rules. Compliance with the fiscal rules is low. Several politicians in countries that breach the rules regard the rules as inappropriate, while other politicians in countries that comply with the rules worry that the rules are not enforced on their partners. Preserving this inefficient fiscal framework would be suboptimal.

We recommend changing the EU fiscal framework. The first-best option, in our view, would require redesigning the whole framework from scratch, which is unrealistic. We therefore make a proposal that might be realistic even in the near term, by changing the Stability and Growth Pact and the Fiscal Compact. Our proposal would maintain an EU-wide fiscal rule with supranational surveillance. We propose to drop all rules related to the badly-measured structural balance indicator and adopt an expenditure rule with a debt-correction mechanism, embodied in a multi-annual fiscal framework.

The expenditure rule should set a limit on the growth rate of nominal public expenditure excluding interest, labour-market related and one-off expenditure, while public investment expenditure should be smoothed over several years and accounted for in the same way as corporate investment. The limit should be specified as the (appropriately-measured) medium-term potential growth rate of GDP plus the central bank's inflation target, and should be corrected for deviations of public debt from the 60 percent of GDP Maastricht debt criterion, discretionary revenue measures and possible expenditure-overruns in previous years. This European rule should be transposed into national laws and monitored by national fiscal councils. We also propose to get rid of the opaque web of flexibility clauses in current fiscal rules. Instead, an independent European Fiscal Council should be set up with an appropriate mandate, appointment procedures and accountability, to oversee the system and exercise the necessary discretion in unusual times.

This overhauled framework would be simple, transparent, easy to monitor, easy to explain and would involve a fiscal indicator that is under the direct control of the government. It would be more conducive than the current system to public debt sustainability and fiscal stabilisation, the two key objectives of a fiscal framework. The delegation of the discretionary power to an independent European Fiscal Council would eliminate the perception of a possibly improper or politically-motivated application of the rule.

Enforcement of the rules at the European level should move away from the threat of financial sanctions, which is anyway not credible in the current framework. The political consequences of an eventual financial sanction could be highly negative. The perception that the fiscal framework provides economically-sound guidance would be a much more important factor than the fear of sanctions, to give an incentive to countries to respect the rules.

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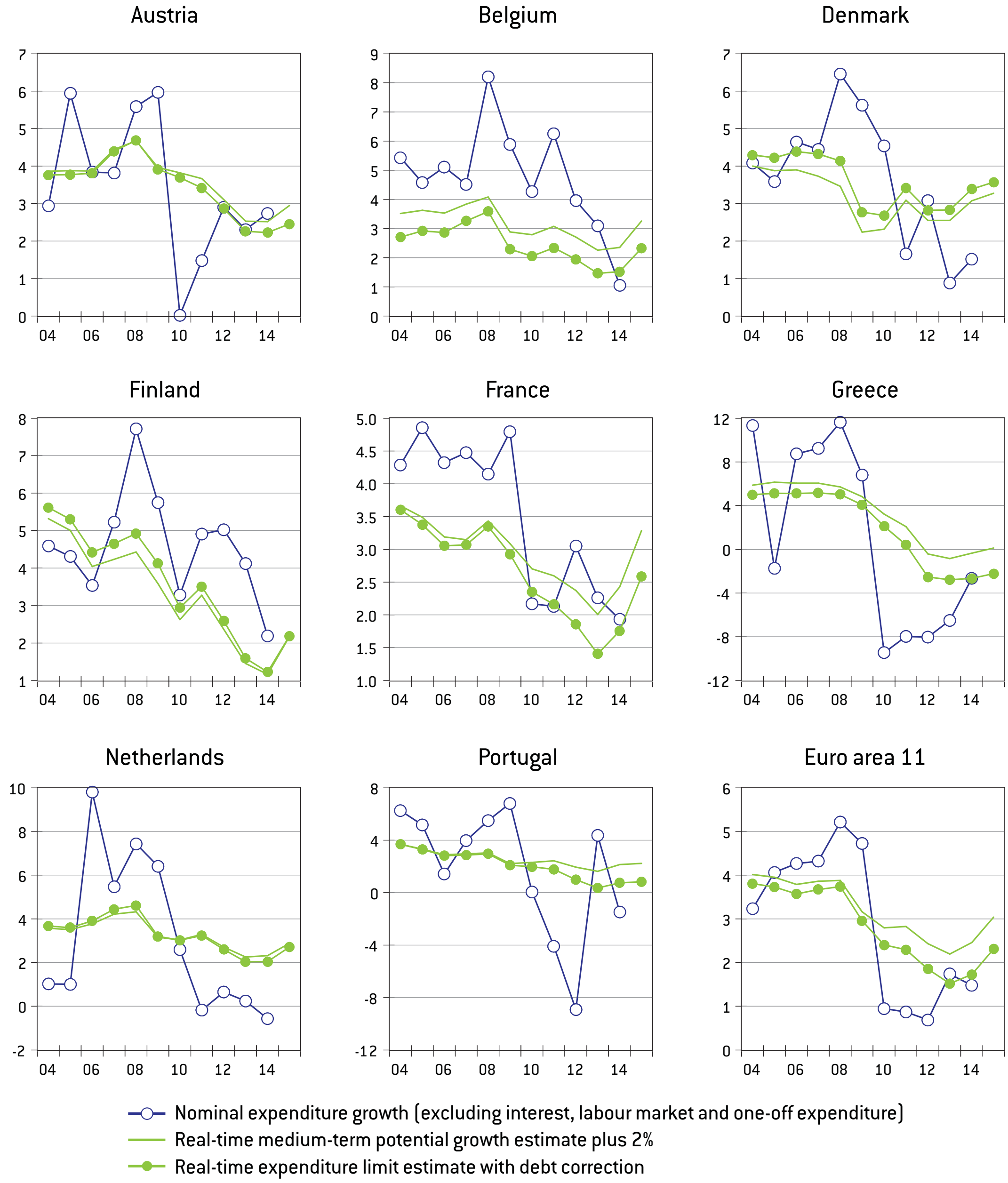
ANNEX

Figure A1: Actual expenditure growth and real-time expenditure limit estimate based on our proposed rule, selected countries



Source: Bruegel. Note: see explanations in the note to Figure 4. Euro area 11 is the aggregate of the first twelve member states of the euro area excluding Luxembourg (because of data limitations).