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Can the Eurozone Develop into a Well-functioning Fiscal Union?

Lars Calmfors*

The sovereign debt crises have demonstrated clearly the inadequacy of the earlier system of economic governance in the euro area. Parallel with the acute crisis management, far-reaching reforms of the rules system have been instituted. These include the new regulations adopted in the so-called ‘Six-pack’ in November 2011 based on earlier proposals from the European Commission and the van Rompuy Task Force.1 The latest addition is the intergovernmental treaty on a fiscal compact agreed in March 2012 (‘Treaty on Stability, Coordination and Governance in the Economic and Monetary Union’).2 This article discusses whether or not these reforms are likely to work.

The earlier rules system

The Treaty on the Functioning of the European Union (TFEU) stipulates that EU institutions and member states’ governments ‘shall not be liable for or assume the commitments’ of other member states’ governments (Article 125, the so-called no-bail-out clause). Article 123 rules out monetary financing of government deficits by both the ECB and the national central banks.

There were always doubts that these provisions would not bind in a full-fledged sovereign debt crisis, as there would then be strong incentives for both governments and the ECB to try to prevent the transmission of financial shocks through bail-outs of member states, as indeed has proved to be the case. These fears were the main motivation for the stipulations in the Treaty on a deficit ceiling of three percent of GDP and that consolidated government gross debt shall not exceed 60 percent of GDP, or if it does, that it shall be ‘sufficiently diminishing’ and approaching the 60 percent level ‘at a satisfactory pace’. These stipulations were backed up by the stability pact, which specified a process for dealing with breaches of the rules (Calmfors Commission 1997; Stark 2001). The original pact also introduced a medium-term fiscal objective (to be interpreted as an objective for the cyclically adjusted fiscal balance) of ‘close to balance or in surplus’.3

The Pact has both a preventive and a corrective arm. In the preventive arm, countries in the euro area are obliged to submit stability programmes explaining whether or not developments are in line with budget targets to the Ecofin Council (The Council of Ministers in its composition of finance or economics ministers), which together with the Commission evaluates the programmes.4 The corrective arm consists of the excessive deficit procedure. If a member state is judged by the Ecofin Council to have an excessive deficit, it can issue a recommendation (and at a later stage a notice) to the state to correct the excessive deficit.5 If both a recommendation and a notice have been given, but not been followed, the TFEU allows for sanctions: first non-interest-bearing deposits and later fines.

Obviously, the governance system in place before 2008/2009 was not sufficient to prevent the fiscal disasters that have occurred in some eurozone countries. Even before the financial crisis struck in 2008 there were already a large number of breaches of the rules: in 45 out of 177 possible cases there were either deficits exceeding three percent of GDP or debt ratios exceeding 60 percent of GDP that were not falling (Calmfors and Wren-Lewis 2011), yet no sanctions were imposed. The most flagrant breaches occurred in

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2 See also European Council (2012).
3 The original stability pact was set out in Council Regulations 1466/1997 and 1467/1997.
4 EU member states that have not adopted the euro instead submit so-called convergence programmes.
5 There must be a formal Council decision that a member state has an excessive deficit for the excessive deficit procedure to be opened. It is not enough for the fiscal deficit to exceed three percent of GDP, as there is an exceptionality clause allowing such deficits “when resulting from an unusual event outside the control of the member state concerned and with a major impact on the financial position of general government, or when resulting from a severe economic downturn” (Regulation 1466/1997).
2002–2005 when the excessive deficit procedures against Germany and France were halted in clear violation of the stipulations in the stability pact. To *ex post* justify these violations, the pact was watered down in 2005. The revision opened up possibilities for the Ecofin Council to extend the deadlines to correct excessive deficits in the case of ‘unexpected adverse economic events with major unfavourable consequences for government finances’ based on considerations of a set of vaguely defined ‘other relevant factors’.*6* Whereas the original pact envisaged sanctions in the form of interest-free deposits after three years of excessive deficits and fines after five years, the maximum time limits for these measures were subsequently widened to six-seven and eight-nine years, respectively (Calmfors 2005).

**The problems with the earlier rules**

One can identify a number of problems with the earlier rules that either precluded their use or rendered them ineffective. A first problem was the *atomic bomb* character of the sanctions once they were to be applied: they would then strike with full force instead of being gradual (Calmfors 2005). For a member state with a deficit of above six percent of GDP the initial deposit (and fine two years later) would be 0.5 percent of GDP (the maximum sanction that could be used). For deficits between three and seven percent of GDP the deposits and fines would even be front-loaded, that is larger in the beginning than later. This is because the deposits (fines) consist both of a variable component (0.1 percent of GDP for each whole percentage point excess of the deficit ratio above three percent of GDP) and a fixed component (0.2 percent of GDP), where the variable component is applicable in all years in which there are deposits (fines), whereas the fixed component is applicable only in the first year with a deposit (fine). This atomic bomb character of the sanctions is likely to have acted as a strong disincentive to use them in much the same way as it

has been found that labour market administrations shun away from using sanctions in the form of loss of unemployment compensation against the unemployed not searching effectively for jobs if the sanctions are too harsh (OECD 2000).

Another problem has to do with the *pecuniary* nature of the sanctions. A fine in the case of an excessive deficit in a member state will exacerbate its deficit problem. This could make policy makers reluctant to apply this sanction. It could also be difficult to explain to the general public the logic of worsening the fiscal situation of a country with a large deficit in this way. Similarly, the stipulation that the proceeds from fines would be distributed among the eurozone countries not suffering from deficit problems may have contributed to problems of legitimacy for these sanctions.

Sanctions could only be applied in the case of violations of the deficit criterion, but not in the case of breaches of the debt criterion. Although it was recognised that an increased emphasis ought to be put on the *debt criterion* when the stability pact was revised in 2005, this was not backed up by any sanction possibilities. The result was insufficient incentives for countries with high debt levels to reduce them.

A further obstacle to a stringent excessive deficit procedure was that each new step (including the use of sanctions) required a discretionary decision in the Ecofin Council with a qualified majority in favour. This was in direct contradiction to the original German proposal on the stability pact, which envisaged automatic sanctions instead (Stark 2001). This might not have been a great problem if violations of the fiscal rules had been confined only to a single country. However, when several countries breached the rules simultaneously, as was the case in 2003–2005 when France, Germany, Italy and Portugal all violated the deficit criterion, these countries could collude and easily form a blocking coalition.

The fact that all decisions in the excessive deficit procedure are *political* ones taken by the ministers in the Ecofin Council is also a problem in itself. Every finance minister will realise that sanction decisions are a repeated game and is therefore likely to act strategically. Since he/she may also end up with an excessive deficit that risks being sanctioned in the future, lenient treatment of current ‘sinners’ can be regarded as an investment in lenient treatment of oneself in a
similar situation. This is bound to cause reluctance to punish one’s peers too harshly.

The earlier rules system did not pay enough attention to developments in ‘good times’. There were no direct incentives for fiscal restraint in booms. The incentives were only indirect in the sense that contractive fiscal policy in booms would lower the risk of violations of the deficit ceiling in a subsequent downturn: hence the reward would come first in the future, and perhaps may not even then be reaped by the current government. Ireland and Spain provide clear examples of how unsustainable booms sowed the seeds of future disaster. Although there were fiscal surpluses in both countries before the financial crisis erupted in 2008, fiscal policy was not contractive enough, with the result that the economies overheated. When the overheating came to an end with asset price declines, bank failures and shrinking tax bases, large fiscal deficits appeared.

The large revisions that have been made of earlier government deficit and debt data for Greece have highlighted significant scope for concealing unfavourable fiscal developments through the falsification of official statistics.

A final deficiency of the earlier EU governance system was the obvious disconnect between the fiscal policy discussion at the European level, and its counterpart at the national level. In many countries, the two discussions seem to have been very far apart. For example, the stability programmes delivered to the EU led a life of their own as ex post accounts, rather than being integrated as an input in the national policy process, which in most countries has been little influenced by the discussion at the EU level (Calmfors 2005).

The reforms of the governance system

One way of evaluating the reforms of the eurozone’s governance system is to examine to what extent they address the problems discussed. The upshot is that they do so to a considerable extent, but that it is still an open question as to whether the changes are sufficient.

A clear improvement is that, in the future, sanctions can be imposed earlier and in a more graduated way. A sanctions option – involving an interest-bearing deposit of up to 0.2 percent of GDP – has now also been introduced into the stability pact’s preventive arm, which seeks to ensure that eurozone countries fulfil their medium-term targets (targets for the cyclically adjusted fiscal balance) of budgets ‘close to balance or in surplus’. This sanctions option can be used when a member state “deviates significantly from its medium-term budgetary objective or the appropriate adjustment path towards that objective and fails to correct the deviation” (Regulation 1173/2011). If such an interest-bearing deposit has been lodged and the Ecofin Council later decides that the country in question has an excessive deficit, the interest-bearing deposit can, at that point of time, be transformed into a non-interest-bearing deposit. Such a deposit can also be decided in connection with an excessive deficit decision in cases of “particularly serious non-compliance with the budgetary policy obligations laid down in the stability pact” (Regulation 1173/2011). In addition, non-compliance with a Council recommendation to correct an excessive deficit can lead to a fine. Both the non-interest-paying deposit and the fine can amount to maximum 0.2 percent of GDP.

The changes have added a continuum of earlier and milder sanctions to the previously existing ones. The more graduated sanctions increase the probability that they will be used. The circumstances motivating extensions of the deadlines in the excessive deficit procedure have also been circumscribed. The interest earned by the Commission on deposits and fines collected should no longer be distributed

7 The formulations regarding ‘other relevant factors’ that should be taken into account in decisions on the extensions of deadlines for correcting an excessive deficit described in footnote 6 have become more demanding. They shall reflect (a) the developments in the medium-term economic position, in particular potential growth, including the various contributions provided by labour, capital accumulation and total factor productivity, cyclical developments, and the private sector net savings position; (b) the developments in the medium-term budgetary positions, including, in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks; and (c) the developments in the medium-term government debt position, its dynamics and sustainability including, in particular risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government (Council Regulation 1177/2011). A comparison with the earlier specification of ‘other relevant factors’ described in footnote 6 shows that a number of factors likely to restrict the scope for deadline extensions have been added. The examples of ‘other factors’, which in the opinion of the member state concerned could be relevant, has been reformulated to ‘financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between member states in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances’. This also seems to limit the scope for deadline extensions.
among the other eurozone countries, but instead be assigned to the eurozone’s rescue funds (at present the European Financial Stability Facility, in the future the European Stability Mechanism). One would expect this use of the proceeds to be regarded as more legitimate by many citizens. This might also increase the willingness of politicians to use the sanctions.

A remaining problem is, however, the pecuniary character of the sanctions. It may still be the case that many citizens as well as politicians object to exacerbating an excessive deficit problem in a country by forcing it to pay fines.

Another change likely to increase budget discipline is that the stipulation that government debt exceeding the reference value of 60 percent of GDP should be ‘sufficiently diminishing and approaching the reference value at a satisfactory pace’ has now been operationalised: the differential with respect to the reference value should have decreased over the previous three years at an average rate of one twentieth per year. Sanctions can be used if this requirement is not met (Council Regulation 1177/2011).

Voting rules in the excessive deficit procedure have also been changed. This has been done in two ways. Firstly, for the additional sanctions at an earlier stage discussed above, and which are not regulated in the TFEU, a reversed qualified majority stipulation has been introduced through a new Regulation (1173/2011). This means that a Commission proposal on these sanctions will be adopted by the Ecofin Council unless there is a qualified majority against them. Secondly, in the new fiscal compact, the eurozone countries have committed themselves to also support the proposals and recommendations of the Commission in all the other steps of the excessive deficit procedure (including the opening of it, as well as the later steps regulated in the TFEU) unless there is a qualified majority against. The implication seems to be that the eurozone signatories of the compact have committed themselves to waive their rights according to the TFEU (which requires a qualified majority in favour of the steps mentioned there) and never to vote against Commission proposals and recommendations in the TFEU-regulated parts of the excessive deficit procedure unless there is a qualified majority against. But legally they are not prevented from doing so if they would choose to violate the compact: it does not allow for any sanctions in this case and the TFEU would supersede the compact. Hence, it remains to be seen how this provision in the compact will work out.

Another problem that remains is that the decisions in the excessive deficit procedure will be political also in the future. It is still the finance ministers in the Ecofin Council who will take them. Although the reversed qualified majority stipulations – if they are followed – make it more difficult to organise blocking coalitions, finance ministers in general may for strategic reasons remain reluctant to punish their peers also in the future. If so, the changed voting rules may not mean that much.

The reforms address the disconnect between the European and national decision levels. The introduction of a European semester for fiscal policy-making serves this purpose (Regulation 1175/2011). It means that the ‘policy cycle’ each year will start with the Commission and the Ecofin Council giving member states ‘strategic guidance’ on policy. This guidance is to be taken into account by member states when formulating their stability programmes. This should be done before key decisions on the national budgets for the succeeding year are taken. This gives the Ecofin Council the possibility to evaluate these programmes with a view to influencing the final national budget decisions.

The fiscal compact goes even further by stipulating that the eurozone countries should introduce into their national laws, preferably constitutions, balanced-budget rules (defined as structural, that is cyclically adjusted, deficits of maximum 0.5 percent of GDP under normal circumstances), as well as automatic correction mechanisms including obligations to implement measures to correct deviations from a balanced budget over a defined period of time. The automatic correction mechanism shall be based on common principles to be proposed by the Commission, and which shall also contain guidelines regarding national institutions for monitoring compliance with the balanced-budget rule. The compact gives the signatories the right to bring failures to introduce such rules to the Court of Justice of the European Union, which can order a country to adjust its national budget rule. If a signatory considers that another signatory has not taken the necessary measures to comply with such a judgement by the Court, it may bring the case before it and request the imposition of a fine of maximum 0.1 percent of the member state’s GDP.

The establishment of national budget balance rules may seem quite a strict provision. However, a fun-
damental problem is that cyclical adjustments of the fiscal balance can be made in an infinite number of ways. Various estimates of the structural fiscal balance tend to differ substantially and there are often large ex post revisions. Since no uniform principles have been established for how the structural balance should be computed – presumably this will be decided by the national governments – there are likely to be large possibilities for manipulating the estimates.

However, it is a clear improvement that common principles regarding the production of the statistics necessary for the EU-level monitoring of actual fiscal balances and government debt have been established. These principles are backed up by the possibility for the Ecofin Council of fining a member state that intentionally or by serious negligence misrepresents deficit and debt data. The fine can amount to 0.2 percent of GDP (Regulation 1173/2011).

The introduction of broader macroeconomic surveillance is also a clear improvement (Regulations 1174/2011 and 1176/2011). The aim is to detect macroeconomic imbalances that can later turn into serious fiscal crises while they are still at an early stage. A number of indicators that could signal macroeconomic imbalances are to be monitored: private as well as public debt developments, financial and asset market developments including housing, credit developments, current account developments, and real exchange rate developments. If the Ecofin Council, on the basis of a recommendation from the Commission, judges that imbalances are excessive, it can initiate an excessive imbalance procedure (in analogy with the excessive deficit procedure) against a member state, which shall then submit a corrective action plan. If the Council finds the corrective actions insufficient, it can decide that the member state does not comply with its recommendations. This could lead to the imposition of sanctions: firstly an interest-bearing deposit and later fines in the case of repeated non-compliance. These decisions are also to be taken by reversed qualified majority. The maximum deposit and fine is 0.1 percent of GDP. It remains to be seen, however, how easy it will be to take such sanction decisions. Since decisions on excessive imbalances will have a much more judgmental character than decisions on excessive deficits, which are more easily defined, one should expect it to be difficult to use sanctions in the excessive imbalance procedure.

Conclusions

Reforms have strengthened the eurozone’s economic governance in several ways. Sanctions can now be imposed much earlier than before. As they have become more graduated, policy makers are likely to be less reluctant to use them, at the same time as the reversed qualified majority stipulation reduces the probability of blocking coalitions in the Ecofin Council. The fact that the proceeds from fines will be assigned to the financial stability mechanisms, instead of being distributed among other EU countries, is likely to increase their legitimacy. The debt criterion in the stability pact has been operationalised and can now trigger sanctions. The connection between EU and national decision levels has been improved through the European semester and the commitment to introduce national budget balance requirements. Common principles, backed up by sanction possibilities, on the production of the statistics required for fiscal monitoring have been established. There will be more emphasis on identifying macroeconomic imbalances that could later create fiscal problems.

At the same time, many of the earlier problems that have undermined the EU rules remain. Sanctions are still pecuniary, which could act as a disincentive to use them, as this will exacerbate deficit problems. Even though the Commission’s role is strengthened, the ultimate decisions still rest with the finance ministers in the Ecofin Council, who are also likely to be reluctant to punish their peers in the future. It is not clear how one will resolve the contradiction between the commitments in the fiscal compact to use reversed qualified majority voting in all parts of the excessive deficit procedure and the TFEU, which stipulates ordinary qualified majority voting regarding the steps regulated there. The fact that the balanced budget stipulations in the fiscal compact refer to the structural (cyclically adjusted) fiscal balance could pave the way for biased computations at the national level. Sanctions are unlikely to be used in the new excessive imbalance procedure.

There should be further reforms if one wants to make sure that economic governance is sufficiently strengthened. These could include also non-pecuniary sanctions, such as partial or complete loss of voting power in the Council. At a minimum, member states with an excessive deficit should lose their voting right in the excessive deficit procedures against other member states, which would make it even more difficult to stop sanctions. The stipulations on reversed qualified
majority would become stronger if they were incorporated in the TFEU, and did not merely have the character of a commitment in the fiscal compact that could be abandoned, as the Treaty legally supersedes the compact.

A more far-reaching change would be to move decisions in the excessive deficit procedure from the political sphere (the Ecofin Council) to the judicial sphere (the Court of Justice), as was suggested by EEAG (2003). The Court of Justice does not currently have the economic expertise to take such decisions, but it could acquire it, for example, by setting up an independent European Fiscal Council with economic experts that could produce background reports for the Court on which it could base its decisions.

It would also be desirable with clearer rewards for eurozone countries that reduce their government debts in good times. There is an attempt that goes in this direction in the fiscal compact, which stipulates that where the ratio of the general government debt to gross domestic product at market prices is significantly below 60 percent, and where risks in terms of long-term sustainability of public finances are low, the maximum structural deficit regarded as consistent with a balanced budget can be raised from 0.5 to 1 percent of GDP. One could go further in this direction by gradually increasing the allowed deficit in a step-wise fashion, the lower is government debt, as proposed by Calmfors and Corsetti (2003). Governments that reduce their debt levels would then receive a stamp of approval more visible to voters.

A problem that should be dealt with is the ambiguity in the fiscal compact resulting from the fact that the balanced budget requirement there concerns the structural balance, which can be measured in different ways and is therefore open to manipulation. One way of lowering these risks would be to let the requirement refer instead to a moving average (over a given number of years) of the actual fiscal balance. Alternatively, the signatories of the compact could be obliged to set up independent national fiscal councils with the task of evaluating the structural balance as one of their remits, perhaps on the basis of common principles established by the Commission.

A key problem is that the reforms in the EU governance system are made at the same time as the acute crisis management sets precedents for the future. The various rescue packages that have been decided and the establishment of a permanent rescue mechanism, the European Stability Mechanism, as well as the ECB’s selective purchases of the eurozone crisis countries’ government bonds and its lowering of collateral requirements are all clear violations of the TFEU’s no-bail out clause (EEAG 2012). This is bound to weaken the credibility of the governance reforms. If the fundamental no-bail-out clause is not respected, why should one expect the new rules to be observed? And why should fines act as a sufficient deterrent, if a country can borrow to pay these fines and then have someone else pay them in the end?

The hope would be that the high degree of conditionality attached to the current rescue programmes is such a strong deterrent that future governments in the eurozone will do their utmost to avoid ending up in similar situations as Greece, Ireland and Portugal. Arguably, this could reduce the moral-hazard risks from the current bail-outs. However, this argument overlooks the importance of incentives for lenders. To the extent that capital losses are avoided for the investors that have lent recklessly to the crisis countries, their incentives to be more cautious in the future are weakened. For this reason, the agreed restructuring of Greece’s government debt is very welcome, as it does impose large losses on private lenders, even if the bail-outs undertaken have gradually reduced their exposure.

From a system point of view, it would be desirable with debt restructurings for Portugal and Ireland as well, since this would make it clear that Greece need not be a unique case. It is unfortunate that European policy makers have argued that Greece is an exception, as it will – to the extent that it is believed – exacerbate the moral-hazard problems. The latter are also likely to be exacerbated by the stipulation that future bail-outs using the new European Stability Mechanism do not necessarily require a consensus among the eurozone countries, as has been the case with the bail-outs from the current European Financial Stability Facility.

How should one judge the chances that the new economic governance system in the EU achieves a reasonable degree of fiscal discipline? It is instructive to

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8 For example, the Statement by the Euro Area Heads of State or Government (2011) says “we clearly reaffirm that the decisions taken on 21 July and 26/27 October concerning Greek debt are unique and exceptional” (European Council 2011).

9 An emergency voting procedure has been agreed, according to which the earlier decided mutual agreement rule is replaced by a qualified majority of 85 percent in case the Commission and the ECB conclude that an urgent decision related to financial assistance is needed when the financial and economic sustainability of the euro area is threatened (European Council 2011).
compare with the case of Sweden. The country suffered a deep sovereign debt crisis in the early 1990s, which triggered first a successful fiscal consolidation and then led to the adoption of a new fiscal framework. In the last decade, Sweden has on average had fiscal surpluses and consolidated gross government debt fell to as low a level as 37 percent of GDP in 2011. However, the Swedish fiscal framework does not build on rules imposed by the EU, the rules are quite flexible (requiring, for example, a fiscal surplus only over a business cycle), and there are no enforcement or automatic correction mechanisms (EEAG 2012). Instead the system seems to build on a political consensus that Sweden should never again end up in a government debt crisis of the type that occurred in the early 1990s, a high degree of fiscal transparency and a qualified economic policy debate involving monitoring of the government budget by several government agencies with a high degree of independence. Such conditions could be much more important than the new formal rules instituted at the EU level. Without it, there is a great risk that the new EU rules will not acquire the legitimacy among voters that is needed for fundamental changes in fiscal behaviour. If so, the ambitious attempts to strengthen economic governance in the eurozone may turn out to be only a house of cards waiting to fall apart.

The upshot is that what will mainly determine future fiscal performance in the eurozone may be whether there can be a shift in fiscal culture, rather than changes in the formal rules. This would seem to require a number of ‘soft’ changes to raise the quality of the economic policy debate. This should involve reliable and objective statistics, the use of unbiased macroeconomic forecasts, qualified sensitivity analysis of fiscal policy under alternative assumptions, multi-annual budget frameworks and the establishment of independent national monitoring. The key to responsible fiscal policy would seem to be that deviations from fiscal targets and the emergence of macroeconomic imbalances trigger a national debate at an early stage, imposing high enough reputation costs on governments. A main risk is that, in the reforms of eurozone economic governance, too little attention will be paid to these ‘softer’ requirements, although they are likely, in the end, to be the decisive ones.

References