

Herzog, Bodo; Choi, Minjae

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Bodo Herzog and Minjae Choi*

Policy Rules in the Economic and Monetary Union

This paper studies whether a monetary union can be managed solely by a rule-based approach. The Five Presidents' Report of the European Union rejects this idea. It suggests a centralisation of powers. We analyse the philosophy of policy rules from the vantage point of the German economic school of thought. There is evidence that a monetary union consisting of sovereign states is well organised by rules, together with the principle of subsidiarity. The root cause of the euro crisis is rather the weak enforcement of rules, compounded by structural problems. Therefore, we suggest a genuine rule-based paradigm for a stable future of the Economic and Monetary Union.

Since the onset of the euro crisis, there has been a lively debate about the challenges facing the European Economic and Monetary Union (EMU). In fact, the outbreak of the financial crisis and the European sovereign debt crisis can be attributed to several factors.¹ The eurozone does not simply face a sovereign debt crisis, as often supposed; rather, it faces a macro-crisis and a crisis of confidence. In 2015 the presidents of the European institutions published a report with the subtitle "Completing Europe's Economic and Monetary Union",² a report that is commonly referred to by its main title, the "Five Presidents' Report". Interestingly, the report is based on a previous paper titled "Towards a Genuine Economic and Monetary Union".³ Both reports attempt to develop a roadmap for the future of the EMU.

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- 1 P.R. Lane: The European Sovereign Debt Crisis, in: *Journal of Economic Perspectives*, Vol. 26, No. 3, 2012, pp. 49-68.
- 2 J.-C. Juncker et al.: The Five Presidents' Report: Completing Europe's Economic and Monetary Union, Brussels 2015, European Commission.
- 3 H. Van Rompuy et al.: Towards A Genuine Economic and Monetary Union, Brussels 2012, European Council.

Bodo Herzog, ESB Business School, Reutlingen University, Germany.

Minjae Choi, University of Exeter, United Kingdom.

The present institutional setup of the EMU is defined by the Maastricht Treaty and European secondary law such as the Stability and Growth Pact (SGP). There is no doubt that the founding fathers of Maastricht designed the EMU based on policy rules rather than political competences at the supranational level. The most important of these rules are: a) the Maastricht criteria, b) the SGP, c) the no-bailout clause in Article 125 of the Treaty on the Functioning of the European Union (TFEU), and d) the prohibition of monetary financing in Article 123 of the TFEU. Consequently, the existing EMU is a truly rule-based approach.⁴

Critics of the rule-based notion argue that the euro crisis demonstrates its flaws. Therefore, so the argument goes, there is a need for a new approach to tackle the future challenges. Nevertheless, research reveals rather weak evidence for this argument.⁵ First of all, there are numerous root causes and vulnerabilities that caused the crisis. It turns out that the major problem is the weak enforcement of existing rules rather than the rule-based approach alone.⁶ Consequently, the existing policy rules cannot be solely responsible for all the difficulties. Con-

- 4 See B. Herzog: Eine Neujustierung der Governance der Europäischen Währungsunion, Konrad-Adenauer-Stiftung, 2016; and B. Herzog: Whither European Economic Governance?, in: *International Journal of Business and Management*, Vol. 9, No. 2, 2013, pp. 7-10.
- 5 See M. Hellwig: Quo vadis, Euroland? European Monetary Union between Crisis and Reform, Working Paper No. 12, Max Planck Institute for Research on Collective Goods, 2011; German Council of Economic Experts: Jahresgutachten 2012/13, November 2012; German Council of Economic Experts: Jahresgutachten 2015/16, November 2015; German Council of Economic Experts: Jahresgutachten 2016/17, November 2016; and H.-W. Sinn: Der schwarze Juni, Freiburg 2016, Herder.
- 6 B. Herzog, K. Hengstermann: Restoring Credible Economic Governance to the Eurozone, in: *Journal of Economic Affairs*, Vol. 33, No. 1, 2013, pp. 2-17.

trary to this evidence, the five presidents boldly suggest the need for centralisation. They claim that the EMU “... cannot be managed through rule-based cooperation alone” and thus requires risk and sovereignty sharing.⁷

We demonstrate that risk and sovereignty sharing does not necessarily tackle the economic problems of the EMU. In addition, a centralised approach in a monetary union with sovereign states has its own flaws due to domestic interests and most importantly different economic traditions. We propose an alternative. In order to stick to the Maastricht philosophy, we propose a redesign of the policy rules and the utilisation of the Europeans’ subsidiarity principle⁸ together with the principle of self-responsible member states⁹. This approach consists of a simple idea: policy rules have to discipline the in-compliant member states and imitate market mechanisms, especially those that are switched off in the monetary union. Furthermore, changes to commonly agreed upon policy rules should be prohibited or strictly bound to unanimity. Otherwise, the rules are time-inconsistent and negotiable, particularly in difficult times. Any adjustment of the rules should be done by either independent expert boards or mechanisms. In fact, neither risk nor sovereignty sharing can be a policy option in the near future due to the member countries’ reluctance to surrender sovereignty.

Below, we provide a philosophical review on the rule of law. We then discuss the economic origin and theory of policy rules. Finally, we describe our rule-based paradigm before concluding.

Philosophy of the rule of law

In philosophy, debates on the rule of law started with Plato (424-348 BC), who developed seminal theories on governance and state. According to Plato, a state and a justice system are mainly based on coherency and reason. He claimed that a state based on reasoning requires consensus. However, it is infeasible to achieve consensus without an organisational hierarchy. Therefore, he proposed the rule of law as a second-best option. A similar philosophy, despite some differences, can be found in Aristotle (BC 384-322), who developed the idea that a state requires a system of justice. A fair relationship can be achieved only with an independent legal system based on the rule of law.

Turning away from Ancient Greece, the next political philosopher of relevance is Thomas Hobbes (1588-1679),

who established liberal ideas that are considered fundamental even today, such as equality of all, the need for an engaged civil society and the idea of representative political power based on the opinion of citizens. In his main work, *Leviathan*, Hobbes sets out a plan for a modern state. He preferred a strong central authority to avoid the evil of disorder or civil war; however, this central authority is an institution based on the rule of law.

John Locke (1632-1704), commonly known as the “father of liberalism”, postulated a social contract model similar to Hobbes. The rule of law (civic laws) is the prerequisite in shaping human actions and behaviour. Contrary to Hobbes, he emphasised the sovereignty of humans. Locke argued that the rule of law has to be enforced by a politically independent authority. This is in line with Jean-Jacques Rousseau (1712-1778), who added that states must be democratically founded. In the tradition of liberalism, both David Hume (1711-1776) and Adam Smith (1723-1790) argued along similar lines of reasoning. However, they proposed a spontaneous order of states by bottom-up market mechanisms.

Certainly the greatest philosopher in this field is Immanuel Kant (1724-1804), whose idea serves as the basis of liberalism to this day. He argues that human life is bound to space and time by senses and reason. The world “as it is” is unknowable. Consequently, our experience of things is always limited to the “phenomenal” world as perceived by our senses. We do not have explicit access to things in an objective “reality”, the so-called “noumenal” world. Thus, experience is purely subjective and cannot be processed by pure reason. However, Kant, arguing in the tradition of Hobbes, believed that a strong centralised authority cannot be the solution. He proposed both fixed rules and values for a society in a state, such as transparency and fairness. Such a state model will eventually be the result of history according to Kant, although it will not be rationally planned.

In conclusion, political philosophy demonstrates the importance of the rule of law over the span of 2,000 years. Interestingly, however, all philosophical theories share the critical assumption of a homogenous society or state. Hence, the foundation of heterogeneous states, such as a monetary union, is not comprehensively considered in philosophy. In fact, under those circumstances, social scientists repeatedly emphasise the benefits of a federal approach.¹⁰

7 J.-C. Juncker et al., op. cit., p. 5.

8 Art. 5 of the Treaty on European Union.

9 Art. 125 of the Treaty on the Functioning of the European Union.

10 W.E. Oates: *Fiscal Federalism*, New York 1972, Harcourt Brace Jovanovich.

The rule-based approach in contemporary economics

The origin of the rule-based approach in economic literature is dated to the Austrian and German economic tradition in the 20th century. Both schools, led by Gustav von Schmoller, Carl Menger, Max Weber and Joseph Alois Schumpeter, argued for rule-based policy. Walter Eucken contributed to this notion and proposed “institutional order policy” (*Ordnungspolitik* in German) in order to restrain economic and political power. Order policy is defined as the rule of law that seeks to achieve efficient economic output. Importantly, order policy must be enforced independently. In general, the theory defines economic policy as a generic term for all state activities, whereas order policy specifically targets the desired economic output. Those rules are designed to produce the best market outcome for a society as a whole. However, the rules should never manipulate the market mechanism. Provided the rules function properly, they should create welfare to the benefit of all citizens.

The underlying elements of policy rules according to the German tradition are a self-regulating mechanism together with personal responsibility if the market fails or output does not yield the intended outcome. If the market has flaws, policymakers are called upon to create a market-based correction mechanism consisting of policy rules. Consequently, institutional order policy does not regulate the nitty-gritty of regulatory policies. On the contrary, policy rules are set up as the rules of the game. In the field of fiscal and monetary policy, policy rules must be more specific in order to restrain the incentive of public authorities to overspend in order to increase the probability of their re-election, i.e. the political budget cycle.¹¹ Another important feature is that rules ought to be designed for the long term. Frequent or sudden changes of rules must be prohibited unless they are for once-in-a-lifetime events.

Ordo-liberalism, referred to as the Freiburg school of economic thought, is a sub-school of Austrian and German liberalism. The intellectual basis of ordo-liberalism was developed by Ludwig von Mises and Max Weber. The new idea of the Freiburg school is the explicit demand for both moral and regulatory limits in free markets, especially in terms of social policies. The main proponents were Walter Eucken, William Röpke, Alfred Müller-Armarck, Franz Böhm and Ludwig Erhard, the first economic minister and later chancellor of Germany. The Freiburg school extensively utilises the concept of institutional order poli-

11 W.D. Nordhaus: The Political Business Cycle, in: Review of Economic Studies, Vol. 42, No. 2, 1975, pp. 169-190.

cy. Rules are of particular relevance in competition policy, monetary policy and public finance due to the political incentives of excessive debt accumulation.

Monetary policy: tradition of policy rules

A seminal idea in the field of monetary economics in line with institutional order policy is the contribution of Nobel laureates Finn Kydland and Edward Prescott. They proposed that the concept of consistent and optimal policy ought to be differentiated with respect to policy rules. An optimal policy is defined as a policy rule that maximises a welfare function from today into the future, but the welfare function (rule) may vary over time. Otherwise, a consistent policy also maximises the welfare function, but the welfare function is invariant over time. They claim that consistent policy – based on invariant rules – is preferable to optimal policy, especially in monetary economics. The reason is the so-called “time-inconsistency problem” due to the feedback loops of expected policy on current decisions. In other words, if an optimal rule constantly adjusts depending on time, today’s decisions are not optimal from a future point of view. This concept was later formalised by John Taylor and is now an acknowledged concept in central banking.¹²

The idea can be explained by the following analogy: a child would like to have candy today or else she will scream. The parent has two policy options: at present, the optimal policy is giving her the candy. But this is certainly not a reasonable policy to teach the child an important lesson for life. The consistent policy is to establish a “rule” from which it is almost impossible to deviate. Suppose the rule is that unless she cleans her room, she will not get the candy. A rational child will modify her behaviour, because no modification will lead to no candy, thereby making the child worse off. In addition, the parent obtains what they want: a clean room and a happy child. Kydland and Prescott argue that policy rules are a form of consistent policy, whereas optimal policy is a form of discretionary policy based on the case at hand.¹³ They state:

The implication of this analysis is that... active stabilization may well be dangerous and it is best that it not be attempted. Reliance on policies such as a constant growth in the money supply and constant tax rates

12 J. Taylor: Discretion versus Policy Rules in Practice, in: Carnegie-Rochester Conference on Public Policy, Vol. 39, No. 1, 1993, pp. 195-214.

13 F. Kydland, E. Prescott: Rules Rather than Discretion: The Inconsistency of Optimal Plans, in: Journal of Political Economy, Vol. 85, No. 3, 1977, pp. 473-492.

constitutes a safer course of action... policy makers should follow rules rather than discretion.¹⁴

This finding explains the benefits of consistently enforced policy rules. Mainstream economists accept this, as indicated by its high relevance in economic theory and policy practice. Why, then, do some economists disagree on the reasoning and benefits of rules, particularly in other economic fields? One explanation is the nature of public policy. In fact, some rules do not create enough incentives or achieve credibility. The art of policy rules, according to institutional order policy, is the search for smart rules with limited flexibility or contingency. The “smart rule” is distinguished from those rules that can be broken in non-once-in-a-lifetime events.

Studies reveal the loopholes and discretion in the EMU’s rule-based approach.¹⁵ The rationale of flawed incentives becomes evident in the unique separation of domestic fiscal and supranational monetary policy. A stand-alone country always has complete control over its own currency. Thus, it can always guarantee the payout for bondholders. This promise does not exist in the EMU. Certainly the currency for all member countries is the euro, and the European Central Bank (ECB) is responsible for price stability according to Article 127 TFEU. However, individual nations cannot pay back their euro-denominated debts by simply printing more money. The ECB will not and cannot act in response to any single member country. Consequently, supranational monetary policy eliminates the market forces in normal times and leads to overreaction during times of turmoil.¹⁶ This creates a unique interplay and moral hazard within the EMU. By contrast, stand-alone countries will face market pressures in the run-up to a crisis but are in control of both policy instruments – fiscal and monetary – in order to tackle these pressures.

A further policy failure can be revealed by studying the discretionary rule enforcement of the European Commission. The Commission is sometimes unwilling to oppose national opinions due to political dependencies. For example, in 2014 the Commission argued in support of the flexibility within the SGP, writing that the EU should make “...the best possible use of the flexibility that is built into the existing rules of the Pact (...).”¹⁷ At the same time, however, in another official report, the Commission stated that “...seven countries [out of 16] run a risk of non-com-

pliance with the SGP”.¹⁸ This demonstrates that the Commission has not been following the rule-based approach as defined in Maastricht. In fact, it has underestimated the importance of consistent policy rules, often adopting rules according to discretionary demands. That is optimal but not consistent policy. As a consequence, the EU institutions have weakened the EMU’s rule-based approach in the short and long term.

Fiscal rules in the EMU

The EMU’s institutional structure was established in the Maastricht Treaty in the early 1990s. In recent years, it has been extended by new rules such as the European Stability Mechanism (ESM), the six-pack and two-pack, the European Semester, and the Fiscal Compact.¹⁹ In the following, we demonstrate that rules are essential in a supranational monetary union.

For centuries there has been a consensus in economic theory that effective fiscal and economic governance is a prerequisite for economic growth. In addition, the history of monetary unions, such as the Scandinavian Monetary Union (1873-1924), the Latin Monetary Union (1866-1927) and the Austro-Hungarian Monetary Union (1867-1918), demonstrate the importance of rules. Without rules, the collapse of currency unions is a matter of time, as confirmed by history. The lag in market forces as well as the heterogeneous economic traditions automatically create moral hazard and eventually lead to a break-up. Economic historians have identified that the major vulnerability is discretionary fiscal policy.²⁰

Another economic challenge in a monetary union is the provision of public goods. Public goods create the renowned problem of free-riding and moral hazard. It is well known that countries have incentives to overspend and delay supply-side reforms due to the electoral cycle.²¹ In addition, there is evidence that free-riding and moral

14 Ibid, p. 476

15 B. Herzog, K. Hengstermann, op. cit.

16 B. Herzog: A Behavioural Model of European Bond Markets, in: Journal of Stock & Forex Trading, Vol. 3, No. 1, 2014, pp. 2-4.

17 J.-C. Juncker: A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, Political Guidelines, European Commission, 15 July 2014.

18 European Commission: Economic governance review, COM(2014) 905 final, 28 November 2014.

19 C. Calliess: Nach der Krise ist vor der Krise: Integrationsstand und Reformperspektiven der Europäischen Union, in: Berlin e-Working Papers on European Law No. 107, 2015, pp. 1-20.

20 M.D. Bordo, H. James: A Long Term Perspective on the Euro, NBER Working Paper No. 13815, 2008; M.D. Bordo: The United States as a Monetary Union and the Euro: A Historical Perspective, in: Cato Journal, Vol. 24, Nos. 1-2, 2004, pp. 163-170; M.D. Bordo, L. Jonung: The Future of EMU: What Does the History of Monetary Unions Tell Us?, NBER Working Paper No. 7365, 1999.

21 A. Alesina, G. Tabellini: Rules and Discretion with Noncoordinated Monetary and Fiscal Policies, in: Economic Inquiry, Vol. 25, No. 4, 1987, pp. 619-630.

hazard are even amplified in a monetary union.²² For this reason, European policymakers established fiscal rules in Maastricht.

From the very beginning, member countries have been obliged to comply with the Maastricht criteria and the SGP. From the outset, most European policymakers were convinced of the need for strong fiscal rules according to the German tradition. This was due to the successful economic and monetary policies of West German institutions over the previous five decades. Therefore, the Maastricht Treaty was set up as a rule-based approach.²³

The SGP legislates a maximum deficit-to-GDP ratio of three per cent and a maximum debt-to-GDP ratio of 60 per cent. It is noteworthy that this rule is even stricter, as it calls for a balanced budget in the medium term. Interestingly, this stricter condition is rarely communicated. This is perhaps due to the failure of nearly every member state to achieve a balanced budget. Consequently, a rigorous interpretation and enforcement of the SGP have never been carried out. However, this is a policy failure, not a failure of policy rules.

Sticking to commonly agreed rules is not in vogue in the eurozone, nor in the European Union as a whole, and especially not in difficult times. For instance, during the reform of the SGP in 2005, policymakers allowed a further degree of flexibility and exceptions. The reformed pact was unable to mitigate excessive debt accumulation. Not surprisingly, countries utilised the flexibility – sometimes quite extensively.

Nonetheless, the theory behind the SGP is solid. It has not failed, as claimed in the Five Presidents' Report.²⁴ However, the “political” enforcement of the pact has failed. Member states have allowed the inclusion of loopholes and policy discretion, and at the same time rejected structural reforms. Most countries are unwilling to imple-

ment painful supply-side reforms and instead prefer easy money and expansionary fiscal policies. This is rational behaviour, because incompliant countries do not pay the bill and will instead benefit in the end. Thus, the majority of euro area member states do not accept the rule-based approach today.

A good example in this respect is the gift of historically low – and even negative – real interest rates for southern member states in the initial years of the EMU. However, these countries were unwilling to use this gift to reform their uncompetitive economies, instead gorging on public and private debt. In the end, this complacent policy further eroded the competitiveness of periphery states and contributed to the current account imbalances. Today's European governance is neither sufficient nor well-designed to tackle these challenges. Therefore, policymakers must come up with a redesign of fiscal and economic governance across sovereign states.²⁵

The future of rules

The rule of law is a crucial element in all states and is especially desirable in a monetary union. The weak enforcement of rules, however, is a major flaw in the EMU. Consequently, tackling the present challenges does not require centralisation or risk and sovereignty sharing. Interestingly, the optimum currency area theory provides further evidence of the superiority of policy rules.²⁶ The theory indicates that rules are of paramount importance in a monetary union and that rule-based policy can be effective. Why, then, do the five presidents reject this evidence, particularly in a heterogeneous monetary union?

They argue that eurozone countries have different economic traditions, and thus can only be managed through one strong centralised power. But would centralisation really solve the problem? Answers can be seen by looking at other large centralised and heterogeneous states. Almost all large states and (historical) monetary unions have certain flaws and inefficiencies of their own, which supports

22 See R.M. Beetsma, A.L. Boverberg: Does Monetary Unification Lead to Excessive Debt Accumulation?, in: *Journal of Public Economics*, Vol. 74, No. 3, 1999, pp. 299-235; R.M. Beetsma, A.L. Boverberg: Designing Fiscal and Monetary Institutions for a Monetary Union, in: *Public Choice*, Vol. 102, Nos. 3-4, 2000, pp. 247-269; R.M. Beetsma, A.L. Boverberg: Strategic Debt Accumulation in a Heterogeneous Monetary Union, in: *European Journal of Political Economy*, Vol. 19, No. 1, 2003, pp. 1-15; R.M. Beetsma, H. Uhlig: An Analysis of the Stability and Growth Pact, in: *Economic Journal*, Vol. 109, No. 458, 1999, pp. 546-571; A. Dixit, L. Lambertini: Symbiosis of Monetary and Fiscal Policies in a Monetary Union, in: *Journal of International Economics*, Vol. 60, No. 2, 2003, pp. 235-247; B. Herzog: Warum verstoßen vorwiegend die großen EWU-Länder gegen den Stabilitäts- und Wachstumspakt?, in: *Quarterly Journal of Economic Research*, Vol. 73, No. 3, 2004, pp. 405-417.

23 J. Jonas: Euro Adoption and Maastricht Criteria: Rules or Discretion?, in: *Economic Systems*, Vol. 30, No. 4, 2006, pp. 326-345.

24 J.-C. Juncker et al., op. cit.

25 Furthermore, financial markets heightened the vulnerability in the euro area. After the onset of the crisis, bond spreads significantly widened. Remarkably, the surge in spreads was considerably larger than the change in the fundamentals. Thus, the existing rules have not provided sufficient incentives upfront. The abrupt market reversal pushed several countries to the brink of default. But this is not the fault of markets or the rule-based approach. It is rather the fault of flawed pre-emptive policy rules and interventions. See P. De Grauwe, Y. Ji: Self-fulfilling crises in the Eurozone: An empirical test, in: *Journal of International Money and Finance*, Vol. 34, 2013, pp. 15-36.

26 R. Mundell: A Theory of Optimum Currency Areas, in: *American Economic Review*, Vol. 51, No. 4, 1961, pp. 657-665; R. Mundell: A Plan for A European Currency, in: H. Johnson, A. Swoboda (eds.): *The Economics of Common Currencies*, Cambridge 1973, Harvard University Press.

our argument that the rule-based approach needs to be strengthened rather than weakened in a monetary union consisting of sovereign states.

In this regard, the recommendation of the Five Presidents' Report is flawed. Renouncing the rule-based approach in favour of centralisation is a risky strategy. Moreover, the public goods problem cannot be solved by a political union, as argued by centralists.²⁷ In fact, in a union of sovereign states, a transfer mechanism is merely a displacement mechanism. It does not solve the underlying problem but instead amplifies free-riding as well as moral hazard issues. Similar problems appear in federal states with fiscal equalisation schemes such as Canada, the US, Switzerland and Germany. In these cases, economically weak federal states receive fiscal transfers from economically strong ones. However, this often does not result in sustained changes to public policy or an adjustment of macroeconomic imbalances in the weak states. In fact, in Germany, the weak federal states such as Bremen or Berlin still have increasing debt levels even after receiving financial support from the fiscal equalisation scheme.²⁸ This empirical evidence is ignored by the European centralists.

In addition, all existing fiscal equalisation schemes surrender full sovereignty for the highly indebted states through insolvency procedures or stability councils. In Germany, such a council has to approve all of the agreed consolidation steps (in scope and volume). Moreover, compliance with the budget consolidation of the previous years is the prerequisite of further financial support in the following year. The enforcement of this mechanism is not easy in a homogeneous state, and thus it has never been utilised in Germany. But the design and enforcement of such a scheme across heterogeneous sovereign states such as the eurozone is almost impossible.

Moreover, fiscal schemes do not eradicate the root cause, and they create moral hazard issues. In order to propose a transfer mechanism, one must plan how to surrender the sovereignty of EMU member states. Otherwise, such a proposal is infeasible and becomes a mere displacement of domestic problems to the centralised level. Eco-

27 H. Enderlin: Welche Economic Governance für Europa? Die Vorschläge zur wirtschaftspolitischen Steuerung im Euroraum, in: W. Weidenfeld, W. Wessels (eds.): Jahrbuch der Europäischen Integration, Baden-Baden 2012, Nomos; H. Enderlin et al.: Repair and Prepare: Der Euro und Wachstum nach dem Brexit, Bertelsmann Stiftung, 2016.

28 C. Fuest et al.: Fiscal Union in Europe? Redistributive and Stabilising Effects of a European Tax-Benefit System and Fiscal Equalisation Mechanism, in: *Economic Policy*, Vol. 28, No. 75, 2013, pp. 375-422; K. Konrad: Haushaltsdisziplin in Deutschland unter der Perspektive des Bremen-Syndroms, in: D. Gesmann-Nuissl, R. Hartz, M. Dittrich (eds.): *Perspektiven der Wirtschaftswissenschaften*, Wiesbaden 2014, Gabler Verlag, pp. 109-122.

nomie policy, particularly institutional order policy, must attempt to solve the root cause at the lowest state levels, in line with the EU commitment to subsidiarity and the self-responsibility of sovereign states. In this regard, a fiscal union with risk and sovereignty sharing is not consistent with the Maastricht philosophy. A fiscal union without a European government causes instability due to overlapping responsibilities and a failure of the principle of liability and control.²⁹ Therefore, the founding fathers designed the EMU as a rule-based framework. They anticipated that it would be difficult to manage fiscal policies in the euro area. Similarly, they also anticipated that it would be even more difficult to create and manage a fiscal or political union. Hence, the redesign of the existing policy rules is a genuine policy option in a monetary union consisting of sovereign states.

Conclusion

This paper studies the origins and relevance of policy rules in the European Economic and Monetary Union. While the Five Presidents' Report asserts that the rule-based approach alone is not appropriate for the eurozone,³⁰ we demonstrate the flaws of the centralists' arguments and argue that the centralisation of fiscal policies will not solve the root causes of the eurozone's problems.

As a matter of fact, the Maastricht philosophy is not sufficiently enforced today. There is still political complacency across eurozone institutions and member states with respect to these rules. A combination of rules and centralised mechanisms is a risky strategy, because responsibility and control would end up in separate hands. Provided that member states are reluctant to surrender sovereignty, the rule-based approach reveals advantages. A rule-based framework mitigates the differences of economic traditions and strengthens the responsibility of sovereigns. It also keeps responsibility and control in the same hands.

Countries that contravene the rules must experience immediate consequences, while countries in compliance ought to benefit. Political discretion needs to be repressed. In this regard, a new rule-based paradigm should strengthen automatic mechanisms and imitate the switched-off market forces, such as the exchange rate mechanism. Indeed, while rules temporarily limit sovereignty, a centralised approach implies a full loss of sovereignty. Consequently, it is time for a redesign of policy rules in the euro area.

29 German Ministry of Finance: *Fiskalpolitische Institutionen in der Eurozone*, Gutachten des Wissenschaftlichen Beirats beim Bundesministerium der Finanzen, 2012; German Council of Economic Experts: *Zeit für Reformen, Jahresgutachten 2016/17*, 2016.

30 J.-C. Juncker et al., op. cit.