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**Research Report**

## European fiscal rules require a major overhaul

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# European fiscal rules require a major overhaul

Zsolt Darvas, Philippe Martin and Xavier Ragot

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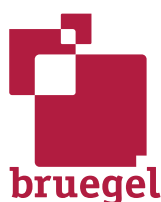
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## Executive summary

**THE RECONSIDERATION OF** the complex set of European fiscal rules should be a priority in terms of euro-area reform. The rules contributed to excessive fiscal austerity during the crisis, thus helping to aggravate and prolong its economic, social and political consequences. Moreover, either because countries did not abide by the rules or because the rules were not sufficiently strictly applied during good years, there was insufficient debt reduction in many countries in the 2000s, which reduced their fiscal capacity during bad years. In addition, the rules suffered from large measurement problems. They are based on a valid theoretical concept – the structural budget balance – but this is not observable and its estimation is subject to massive errors.

**THE POST-2010 PRO-CYCLICAL** fiscal tightening caused by the fiscal rules also led to the European Central Bank becoming overburdened as the main remaining stabilisation instrument. The fiscal framework has also put the European Commission in the difficult position of enforcing a highly complex, non-transparent and error-prone system, exposing the Commission to criticism from countries with both stronger and weaker fiscal fundamentals. The rules are used as a scapegoat by anti-European populists because they are seen as a manifestation of centralised micro-management which infringes on national sovereignty.

**HOWEVER, FISCAL RULES** to ensure debt sustainability in the euro area are a necessity because the no-bail-out clause in case of fiscal crises is not credible in a monetary union. The fiscal rules need a major overhaul. They are not a silver bullet and cannot be substituted for the national democratic debate on fiscal choices and debt sustainability, but should help frame this debate. They should be as transparent and simple as possible, should set targets under the direct control of the government, should allow countercyclical fiscal policy and should incentivise the reduction of excessive public debt.

**THIS POLICY CONTRIBUTION** assesses the current framework and proposes a major simplification. We recommend substituting the numerous and complex rules with a simple new rule: nominal expenditures should not grow faster than long-term nominal income, and they should grow at a slower pace in countries with excessive debt levels. Our simulations suggest that this rule would help reconcile fiscal prudence and macroeconomic stabilisation of the economy. We set out a national and European institutional framework that could implement such a rule. We advocate the credible enforcement of fiscal rules, mixing several instruments pertaining to surveillance, positive incentives, market discipline and increased political cost of non-compliance.

**FINALLY, ONE EXAMPLE** of a country in which the national fiscal framework could be improved is France: we recommend the better integration of the French independent fiscal council (Haut-Conseil des finances publiques) into the national budget process by broadening its mandate to include endorsement of fiscal forecasts and debt sustainability analysis, by increasing its capacity to independently produce fiscal and macroeconomic forecasts.

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# 1 The rationale for fiscal rules

## What are fiscal rules for?

A fiscal rule can be defined as a constraint on a government's fiscal policy that imposes numerical limits on public finance aggregates (expenditures, revenues, budget balance and/or public debt). Its two main objectives are the long-term sustainability of public finances and the short-term stabilisation of economic activity.

Between 1990 and 2015, the number of countries with national and/or supranational fiscal rules surged from five to 96. What is the rationale for such rules?

First, most fiscal rules take the form of ceilings on aggregates, such as deficit, public debt or public spending, but do not set out the details of components of the budget. One difficulty is that fiscal rules constrain government policies but should not limit democratic choices. They should help to correct identified deficit biases and coordination failures in the complex decision-making process, but should not appear as a bureaucratic constraint on democracy. We recognise that this arbitrage between rules and discretion is not easy, especially in the European context in which cultural and political histories have created different views of the balance between the two.

The general rationale for such rules is to avoid political cycles in public finance which might distort short-term incentives to opt for high deficits today followed by future austerity. Economists have focused on political biases that favour deficits. This is certainly valid in many countries. However, current political debates in some European countries, such as Germany, suggest that a bias towards surpluses might be at work. Fiscal rules are not a magic answer to these biases, but if they are well-designed and implemented can go a long way to limit their impact. However, if not well-designed and implemented, they can also be a source of instability, in particular if they generate pro-cyclical fiscal policy.

## The specific need for fiscal rules in the euro area

In a monetary union such as the euro area, there are additional arguments to justify the adoption of fiscal rules and the adoption of a common framework. The issue here is that governments do not internalise the long-term impacts of their fiscal policy decisions on other Economic and Monetary Union (EMU) members. Too expansive (or too restrictive) fiscal policies and debt accumulation by one country have potential impacts on the others.

Inflationary or 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 or easing for all (Bénassy-Quéré *et al*, 2016). European involvement in the fiscal rule is also justified because fiscal policy has a role in both the build-up and correction of wage/price divergences, especially in a non-optimal monetary union in which factor movements and purely market-based relative price adjustments in different countries cannot efficiently compensate dis-equilibrating developments.

There could be also a channel via interest rates: an increase in the deficit and debt of one country would lead to higher interest rates in other euro-area countries. However, this channel has not so far been empirically relevant and in fact during the euro-area crisis the opposite might have happened as investors fled countries with high debt and bought the public debt of 'safe-haven' euro-area countries. This new effect might be an independent justification for fiscal rules to prevent such destabilising movements in crisis periods.

The distinctive feature of EMU comprised of sovereign countries is that debt restructuring or debt monetisation, which might be the consequences of excessive debt accumulation by one country, heavily affect the other member countries. There is a risk that the ECB could be pressured to use monetary policy to prevent a default in fiscally weak countries via debt monetisation. This monetisation, ie the implicit transfer to the country whose public debt is purchased by the ECB, might generate an inflation tax on all EMU countries or reduce transfers from central banks to governments. Such transfers are not voted on by parliaments and might eventually lead to a backlash against the monetary union, as the amounts at stake

are potentially very large. This was well understood at the time of the creation of the euro; Article 123 of the Treaty on the Functioning of the European Union (TFEU) expressly prohibits the ECB from purchasing member countries' public debt directly from public authorities. In addition, Article 125 of the TFEU prevents any form of EU liability for member states' debt obligations (no bailout clause). However, in a situation when there is a risk of a messy default and of a potential exit from the currency union, triggering contagion and collateral damage for all members, the cost of a bailout through financial assistance loans might be lower than the cost of default and exit<sup>1</sup>. Therefore, the pressure for monetisation and/or bailout through financial assistance loans is very strong, reducing the credibility of the no-monetisation/no-bailout rules (Gourinchas *et al*, 2018).

At various points during the euro-area sovereign debt crisis, Greece, Ireland, Portugal, Spain and Cyprus had to ask for the support of other member states in order to avoid defaults or collapses of their domestic banking sectors and, potentially, exit from the monetary union.

In addition, the expectation of bailouts might also have reduced market discipline in the sense that the cost of borrowing for some countries might have been too low in the period before the crisis. This might also have reduced the incentive for fiscal prudence, such as in Greece in the 2000s. Note therefore that debt sustainability, not the public deficit per se, should be the core objective in the EMU. Note also that macroprudential rules that limit the vulnerability of financial institutions are a necessary complement to fiscal rules because, as seen for example in Ireland and Spain, bank debts can rapidly be transformed into public debts (Martin and Philippon, 2017).

Finally, because countries in a monetary union no longer have the monetary instrument to stabilise their economies against asymmetric shocks, the fiscal instrument is a key countercyclical policy tool. Hence, fiscal rules in the EMU, more than in countries with independent monetary policy, must play a countercyclical role.

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## 2 The deficiencies of the current European fiscal framework

European fiscal rules originate from the Maastricht Treaty (1993), which specified the criteria for joining EMU, including budget deficit and public debt criteria. The Stability and Growth Pact (SGP), put in place in 1997, clarified and complemented the fiscal criteria. The SGP was reformed in 2005, in 2011 (by the so-called 'six-pack')<sup>2</sup>, in 2012 (by the so-called 'Fiscal compact')<sup>3</sup> and in 2013 (by the so-called 'two-pack')<sup>4</sup>. Beyond these legislative acts, the European Commission also regularly updates and extends a detailed Code of Conduct<sup>5</sup> and a detailed Vade Mecum on the Stability and Growth Pact<sup>6</sup>, which specify various aspects of the implementation of the fiscal rules.

The current fiscal framework includes four numerical fiscal rules:

- The budget deficit must be below 3 percent of GDP;
- Gross public debt must be below 60 percent of GDP. 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;

1 Note that a financial assistance loan from some EU member states or EU institutions to other EU member states does not violate Article 125 of the TFEU.

2 See [http://europa.eu/rapid/press-release\\_MEMO-11-898\\_en.htm](http://europa.eu/rapid/press-release_MEMO-11-898_en.htm).

3 See [https://ec.europa.eu/info/publications/fiscal-compact-taking-stock\\_en](https://ec.europa.eu/info/publications/fiscal-compact-taking-stock_en).

4 See [http://europa.eu/rapid/press-release\\_MEMO-13-457\\_en.htm](http://europa.eu/rapid/press-release_MEMO-13-457_en.htm).

5 See <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>.

6 See [https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2018-edition\\_en](https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2018-edition_en).

- 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 EMU 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, it must increase by 0.5 percent of GDP per year as a baseline;
- The adjusted measure of real government expenditures (deflated by the GDP deflator forecast) 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.

A fiscal framework has two basic objectives: to ensure the long-term fiscal sustainability of the public debt, and to support countercyclical fiscal policy in both good and bad times.

Conceptually, with the exception of the 3 percent deficit rule, which is ad hoc and not conducive to either of the two basic objectives, the other numerical rules have good theoretical justification. If European fiscal rules are fully adhered to, the public debt-to-GDP ratio would generally decline to low levels (well below 60 percent if we make reasonable growth/interest rate assumptions). While there is no consensus view on the optimal or sustainable level of public debt, one could argue that a debt level well below 60 percent of GDP is both sustainable with a high probability and large enough to provide a useful amount of safe assets in the economy. As regards the countercyclical policy objective, if the structural balance indicator is properly measured and the structural balance rule is properly implemented then this rule restrains expenditure bias in good times and allows automatic stabilisers in bad times. Moreover, a government might decide to implement a discretionary fiscal stimulus in a recession at the cost of entering the EU's excessive deficit procedure.

However, European fiscal rules suffer from several conceptual and practical weaknesses. When a recession lingers for several years, economic good sense might call for a repeated fiscal stimulus if the recession deepens. However, current EU fiscal rules at best allow the slow-down or some postponement of fiscal consolidation. They are thus not well designed for the type of persistent recession the EU experienced after 2008. Complexity is another major problem. As noted by Wieser (2018), every presumed breaking of the fiscal rules has resulted in further refinement of the rules, reflected in the length of the Vade Mecum, which has grown to 220 pages. Wieser (2018) concludes that *"the present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors"*. This complexity makes the fiscal framework non-transparent and difficult for policymakers to internalise, which in turn has contributed to non-compliance. This has become the norm, while fiscal policy both in member states and at EU level became increasingly pro-cyclical.

*Observation 1: European fiscal rules have become overly complex, which hinders their internalisation by policymakers and their acceptance by the wider public.*

Furthermore, the rules suffer from substantial measurement problems. While the structural budget balance is a nice theoretical concept, it is not observable and its estimation is subject to massive errors. Structural balance measurement depends on output gap (the difference between actual output and potential output) estimates, which are themselves very uncertain<sup>7</sup>. For example, in their seminal work, Orphanides and van Norden (2002) concluded that ex-post revisions of the estimated gap are of the same order of magnitude as the

<sup>7</sup> Output gap estimate uncertainty relates to certain features of the methodology, changes in the methodology, use of forecasts in the estimation of current output gaps and data revisions. See for example Darvas (2015).

estimated gap itself. By focusing on the euro area, Marcellino and Musso (2011) found that both the magnitude and the sign of the real-time estimates of the euro-area output gap are very uncertain. Ince and Papell (2013) confirmed the findings of Orphanides and van Norden (2002) for ten OECD countries. Similar conclusions were drawn by Bundesbank (2014), arguing that the estimates of the output gap are associated with a high degree of uncertainty and later revisions to first estimates were often as large as the previously identified gap itself. Darvas and Simon (2015) concluded that the yearly revision of the output gap estimates of the European Commission, IMF and OECD were broadly similar in the range of 0.5-1.0 percent of GDP for advanced countries, which are rather large. A further source of measurement difficulty is the estimates of the elasticity of the budget balance to the output gap.

The uncertainty of the structural balance estimate can be illustrated by revisions of the change in the structural balance estimate after one year. For instance, in May 2017, the European Commission estimated that the German structural balance had declined by 0.25 percentage points between 2016 and 2017 (Table 1). A year later, in May 2018, revisions to the 2016 and 2017 structural balance estimates implied an increase of 0.35 percentage points between 2016 and 2017. Therefore, the change in the structural balance was revised by 0.60 percentage points of potential output. This is a very large revision considering that the baseline fiscal adjustment required by the EU fiscal rule is 0.50 percentage points, that Germany is a relatively stable economy and there were no big shocks in 2017.

**Table 1: European Commission estimates of the German structural budget balance, % of potential GDP**

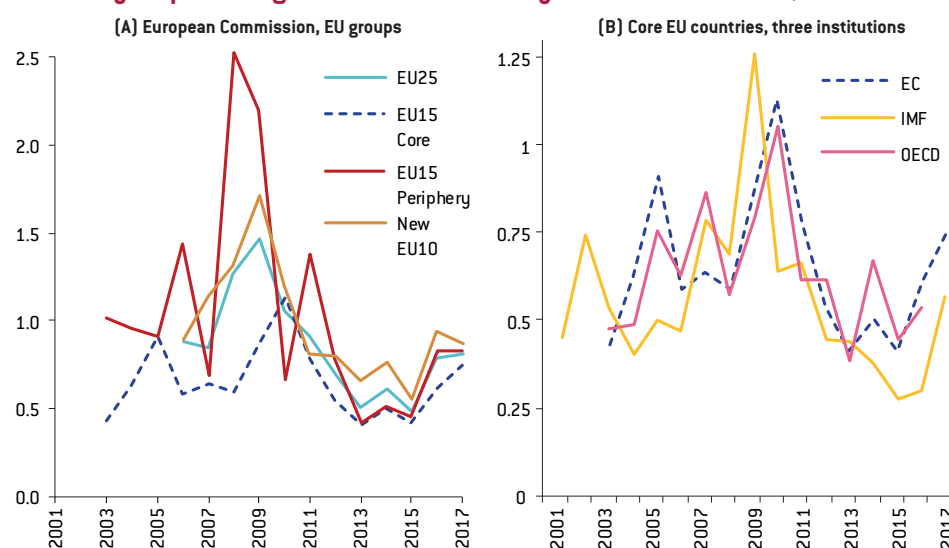
	Structural balance in 2016	Structural balance in 2017	Change from 2016 to 2017
May 2017 estimate	0.83	0.58	-0.25
May 2018 estimate	1.12	1.47	0.35
Revision	0.29	0.89	0.60

Source: European Commission (2017 and 2018): AMECO Dataset, May.

For ‘core EU’ countries – the first 15 EU members excluding Greece, Ireland, Italy, Portugal and Spain – the typical revision in the change of the structural balance estimate after one year (ie corresponding to the 0.60 value in Table 1) is between a half and one percent of GDP (Figure 1). For periphery countries and for the newer EU members that joined in 2004 the revision is typically somewhat higher. Moreover, there has been no decline in the size of revisions over the years: for 2015-17 revisions even increased, although there were no big shocks in these years and the EU economic situation improved. It must be noted that large revisions do not exclusively characterise European Commission estimates; International Monetary Fund and OECD estimates are subject to similar revisions (Darvas, 2015).

A deeper issue arises in the presence of persistent shocks (such as the Great Recession), which might lead to overly pessimistic estimates of potential output because potential output is affected by cyclical condition (hysteresis effect). Fatás and Summers (2018) and Fatás (2018) argue that in EMU, a vicious circle might have been at work: low GDP growth was seen as structural so that potential output estimates were revised and this pushed policymakers to believe that further fiscal policy adjustments were needed. The successive rounds of fiscal contractions might then have caused further reductions in potential output that validated the initial pessimistic estimates. Coibion et al (2017) also show that potential output estimates actually respond to demand shocks that should have only transitory effects on output. Given these uncertainties in measuring structural balances, we do not believe that fiscal rules can be implemented simply using mathematical formula and without proper economic analysis. At minimum, we recommend that the European Commission should publish confidence intervals on output-gap, potential-growth and structural-deficit estimates.

**Figure 1: Average absolute revision of the change in structural budget balance from the year preceding the estimation to the year of the estimation, % GDP**



Source: Bruegel based on European Commission forecasts published in May of each year. Note: for example, the last value for 2017 shows the difference between the May 2018 and May 2017 estimates for the change in the structural balance from 2016 to 2017. EU25: EU members in 2004; EU15 Core: pre-2004 EU members excluding Greece, Ireland, Italy, Portugal and Spain; EU15 Periphery: Greece, Ireland, Italy, Portugal and Spain; New EU10: ten countries that joined in 2004. Bulgaria, Croatia and Romania are excluded because of the shorter available time period.

***Observation 2: Potential output, the output gap and the structural balance are badly estimated, undermining real-time fiscal policy decision-making.***

Because of these problems, it is not surprising that the EU fiscal rules were exposed as not fit for purpose. They led to pro-cyclical fiscal policies before the 2008 global financial crisis (over-expansive fiscal policy in many EU countries), and, with the sole exception of 2009, they also contributed to pro-cyclical fiscal tightening starting in 2010, which likely played a role in prolonging the recession and increased unemployment in the EU. Eyraud *et al* (2017) presented comprehensive analyses of the European fiscal framework and concluded that fiscal policy was acyclic in its preparation phase (meaning an unchanged structural balance over the economic cycle), but became pro-cyclical in its execution phase, which corresponds to frequent divergence between commitments and budget execution<sup>8</sup>.

The excessive pro-cyclicality of fiscal rules thus undermines the stabilising effects of fiscal policies. In the expansion phase, deficits and debt levels are not reduced as much as they should be (although fiscal multipliers are likely to be lower and fiscal consolidation policies would be appropriate). Conversely, in the recession phase, fiscal consolidation plans cannot achieve their objectives, given the higher fiscal multipliers and the public debt increases, despite the fiscal effort made.

Moreover, compliance with the rules has been weak: in more than three-quarters of cases, euro-area countries exceeded the 3 percent deficit threshold between 1998 and 2015, and 16 of the 19 member countries had an average deficit above their medium-term target (Eyraud *et al*, 2017). European fiscal rules have not been sufficient either to ensure the sustainability of public finances in the medium term or to protect the quality of their composition (to prevent public investment from being penalised).

Furthermore, EU fiscal rules also lack a proper enforcement mechanism. Though 24 EU countries were made subject to an excessive deficit procedure after 2008, the complex web of

<sup>8</sup> Eyraud *et al* (2017) also find that large countries tend to deviate more from their commitments, while small countries tend to stay longer under the excessive deficit procedure.

flexibility has been used to the extreme to avoid sanctions. Flexibility was also used to avoid opening an excessive deficit procedure (EDP) for high-public debt countries not complying with the 1/20<sup>th</sup> debt reduction rule. This rule should be met three years after closure of a previous EDP. Though Italy left its EDP in 2013 and Belgium its in 2014, , these two countries did not meet the debt-reduction criteria when the three-year period after these dates elapsed. Even the May 2018 conclusion of the Commission concludes that the two countries continue to miss the debt reduction benchmark in 2018 and 2019 according to both the fiscal plans of the respective governments and the forecasts of the Commission<sup>9</sup>, yet the Commission did not propose applying the EDP to them. The unfavourable properties of the European fiscal rules also lead to ‘Brussels-bashing’, whereby national governments argue with the Commission about the ‘stupidity’ and incorrect application of the rules.

*Observation 3: European fiscal policy suffers from pro-cyclicality, while non-compliance with the rules has become the norm. EU fiscal rules lack proper enforcement mechanisms and credibility.*

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## 3 Reforming the European fiscal framework

While there is no universal and perfect fiscal policy rule, the economic literature identifies some broad criteria for judging the relevance of a fiscal rule. It should be well-defined, transparent, simple, flexible (in order to respond effectively to an exogenous shock outside the scope of public policy control), adequate relative to the final goal, enforceable, consistent and supported by sound policies, including structural reforms if needed (Kopits and Symansky, 1998).

### 3.1 Proposal for a new public expenditure rule

Recent contributions advocate the introduction of a fiscal rule based on the growth rate of public expenditure (Claeys *et al*, 2016; Benassy-Quéré *et al*, 2018; Feld *et al*, 2018). One advantage of such a rule would be that its basic principle is easy to describe: nominal expenditures should not grow faster than long-term nominal income, and they should grow at a slower pace in countries with excessive debt levels. Unlike the cyclically adjusted deficit, public expenditures are observable in real time and are directly controlled by the government. Furthermore, expenditure rules embed countercyclical stabilisation because cyclical revenue increases have no effect on the expenditure ceiling – inducing stronger fiscal discipline in good times compared to the current rules – and because they do not require cyclical revenue shortfalls to be offset by lower expenditure. We analyse this characteristic in section 3.2.

This translates into a two-pillar approach, consisting of a long-term target debt level, such as 60 percent of GDP, and an expenditure-based operational rule to achieve the anchor. This would work in practice as follows:

<sup>9</sup> For Belgium see [https://ec.europa.eu/info/sites/info/files/economy-finance/com\\_2018\\_429\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/com_2018_429_en.pdf), which says “The notified data show that Belgium did not comply with the debt reduction benchmark in 2017 ... Belgium is forecast not to comply with the debt reduction benchmark in 2018 and 2019”. The report states: “Overall, Belgium’s insufficient progress towards compliance with the debt reduction benchmark in 2016 provides evidence of a *prima facie* existence of an excessive deficit for the purposes of the Stability and Growth Pact before, however, considering all factors as set out below”. For Italy, see [https://ec.europa.eu/info/sites/info/files/economy-finance/italy\\_1263\\_may2018.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/italy_1263_may2018.pdf), which says “Based on notified data and the Commission 2018 spring forecast, Italy did not comply with the debt reduction benchmark in either 2016 (gap of 5.9% of GDP) or 2017 (gap of 5.1% of GDP). ... Moreover, based on the Commission 2018 spring forecast, Italy’s debt-to-GDP ratio is projected to be above the debt reduction benchmark in both 2018 and 2019 (gap of 5.1% of GDP each year)”. The report also states: “Overall, Italy’s lack of compliance with the debt reduction benchmark in 2016 and 2017 provides evidence of a *prima facie* existence of an excessive deficit within the meaning of the SGP before, however, considering all factors as set out below ....”



Each year, the government would propose a rolling medium-term (eg five-year-ahead) target of reduction of the debt-to-GDP ratio. This could be part of the existing Stability Programme provided each year by EU countries to the European Commission. The national independent fiscal council and the euro-area fiscal watchdog would be consulted and would provide public assessments of the target's feasibility and ambition. A discussion with the European Commission would follow, based on an economic analysis in which the main parameters would be the distance between the actual debt-to-GDP ratio and the long-term target of 60 percent (the greater the gap, the more ambitious the adjustment), a broader analysis of fiscal sustainability (in particular, to give credit to countries that undertake solvency-improving entitlement reforms, or major reforms expected to raise potential growth), and an economic analysis of the economic situation and the relevant path of debt reduction. As a result, the medium-term debt reduction pace should not be determined by a formula. The Commission would then present its conclusion on each country's debt reduction target to the Council of the EU, which would be able to vote against them (separately in the case of each country) by a reverse qualified majority.

Each national fiscal council would prepare a medium-term nominal GDP growth projection based on expected potential output growth, expected inflation and a possible cyclical correction, in case initial conditions depart markedly from the long-run equilibrium. Given the medium-term debt reduction targets, national fiscal councils would provide consistent medium-term nominal public expenditure paths, which would be used to set nominal expenditure ceilings for the coming year, for use in the preparation of the corresponding budget.

Nominal expenditures would be calculated net of interest payments, of unemployment spending (except when these are a result of discretionary changes to unemployment benefits), and of the estimated impact of any new discretionary revenue measures (changes in tax rates and tax bases). Public investment should also be properly taken into account. The first two adjustments would allow for greater counter-cyclicality, while excluding the effect of expenditure-increasing structural measures. The revenue adjustment is meant to preclude the manipulation of tax rules (for example, tax cuts ahead of an election) that are not compensated for by offsetting expenditure measures. But it would also allow elected governments to make fiscal policy choices (implying different but consistent long-term levels of expenditures and taxes) that reflect political preferences. For instance, a government that decides on a permanent increase of 2 percentage points of GDP of income tax revenues would be allowed by the rule to increase permanently the level of spending by the same amount. This would temporarily increase the growth rate of spending allowed by the rule.

It would also be important to properly account for public investment, which tends to vary substantially from year to year. For example, when a big infrastructure project starts, public investment can be huge in that year and small in subsequent years. The best way to treat such public investment is the way private companies treat private investment: the cost of the investment is distributed across years during the service life of the capital good purchased.

Limited deviations between actual and budgeted spending could be absorbed by an 'adjustment account' that would be credited if expenditures net of discretionary tax cuts run below the expenditure rule, and debited if they exceed it. These types of accounts exist in Germany and Switzerland. If a country passes a budget with no excessive spending but realised spending is above the target, the overrun could be financed without a breach of the rule, provided that the deficit in the adjustment account does not exceed a pre-determined threshold (eg 1 percent of GDP). If the threshold has been breached, the country violates the fiscal rule.

Simulations conducted for this paper by CEPREMAP and the French Economic Observatory – *Observatoire français des conjonctures économiques* (OFCE) – suggest that during a major crisis, the fiscal rule might be too stringent. This would justify an escape clause that would allow countries to deviate from the rule in exceptional circumstances. The activation of such a clause would have to be agreed by the Eurogroup, after consultation with the euro-area fiscal watchdog.

We have noted that structural budget balance estimates are subject to large revisions, partly because of uncertain output-gap estimates. Based on that finding, one might argue that medium-term potential growth estimates, which are the basis of our proposed expenditure rule, could be also subject to large revisions – but this is not the case. With the exception of 2008, even European Commission estimates were subject to rather small revisions<sup>10</sup>. For example, for the EU15 Core countries, the typical revision is about 0.15 percentage points per year. A 0.15 percentage point downward revision in a medium-term potential growth estimate would imply that if in spring 2018 a country is allowed to increase expenditures by 3.0 percent, in spring 2019 the allowed growth rate of expenditures is revised downward to 2.85 percent per year. Given that public expenditures amount to about half of GDP, a 0.15 percent revision in expenditures implies a 0.075 percent of GDP impact on the budget balance, which is rather small and well below the impact of revisions to the structural balance<sup>11</sup>.

*Recommendation 1: Adopt a new fiscal rule targeting the growth rate of nominal public expenditure. The growth rate should be constrained by the potential GDP growth rate, the expected inflation rate and a debt-reduction objective that would be specific to each country. The public spending trajectory must be consistent with the rolling medium-term (eg five-year-ahead) reduction target for the debt-to-GDP ratio, which European countries agree upon.*

### 3.2 Simulations of an expenditure rule

In order to assess the consequences of the application of an expenditure rule, we set out several quantitative simulations done by the OFCE. The structural model providing these simulations is based on the iAGS project (Feigl *et al*, 2018), in which AK Wien, ECLM, IMK and OFCE participate. The following form of expenditure rule is simulated: the growth rate of nominal public spending (net of interest payments and of unemployment spending) for country *i* in year *t* is the sum of real potential growth, expected inflation<sup>12</sup> minus a debt brake term which takes into account the difference between the observed debt-to-GDP ratio and the long term target which we take to be 60 percent. The parameter associated with the debt brake is important because it drives the speed at which the country converges on its long-term debt target. It should be computed to be consistent with the debt reduction objective at a five-year horizon and should therefore be different for different countries<sup>13</sup>.

A public spending rule with a constant and homogenous debt brake parameter to reach the 60 percent target does not generate realistic fiscal policy recommendations for certain

10 We note that the revisions of the real-time medium-term potential output growth estimates of Darvas and Simon (2015) did not increase in 2008 (but remained at around 0.2 percent), underlining that the commonly agreed potential output methodology run by the Commission could be significantly improved.

11 Even the largest revision in 2008 would have led to a much smaller error in real-time policymaking than the current rule based on structural balances. In 2008, the average downward revision of the six-year average potential growth rate for core EU countries was 0.53 percentage points, which implies a 0.265 percentage points of GDP impact on the budget balance with the expenditure rule. In contrast, the largest revision in the change in the structural balance for core EU countries was 1.13 percent of GDP in 2009, which has the same impact on the actual balance. Therefore, the peak error of the structural balance-based real-time fiscal policymaking for core EU countries during the recent crisis was more than four-times greater than the peak error of the rule based on expenditure ceilings.

12 Since inflation forecast may in certain countries be systematically incorrect, Claeys *et al* (2016) suggested instead using the ECB's 2 percent inflation threshold (and possibly higher rates for converging economies like Slovakia). This would involve an additional element of cyclical stabilisation: more real fiscal spending when inflation is below 2 percent, less spending when inflation is above 2 percent. However, this would bias public spending if the long-run average inflation rate is not 2 percent. Further research should assess which of these two issues is more damaging for both stabilisation and debt sustainability: short-run inflation forecast errors or long-run deviations from the 2 percent inflation target.

13 Another reason is to avoid long-term oscillations of the debt-to-GDP ratio.

European countries. In countries with debt levels significantly above 60 percent of GDP, the necessary initial budgetary effort is unrealistically high if, for example, the debt brake parameter is chosen to fit France or Germany. This is the reason we recommend an expenditure rule based on a five-year country specific debt reduction target.

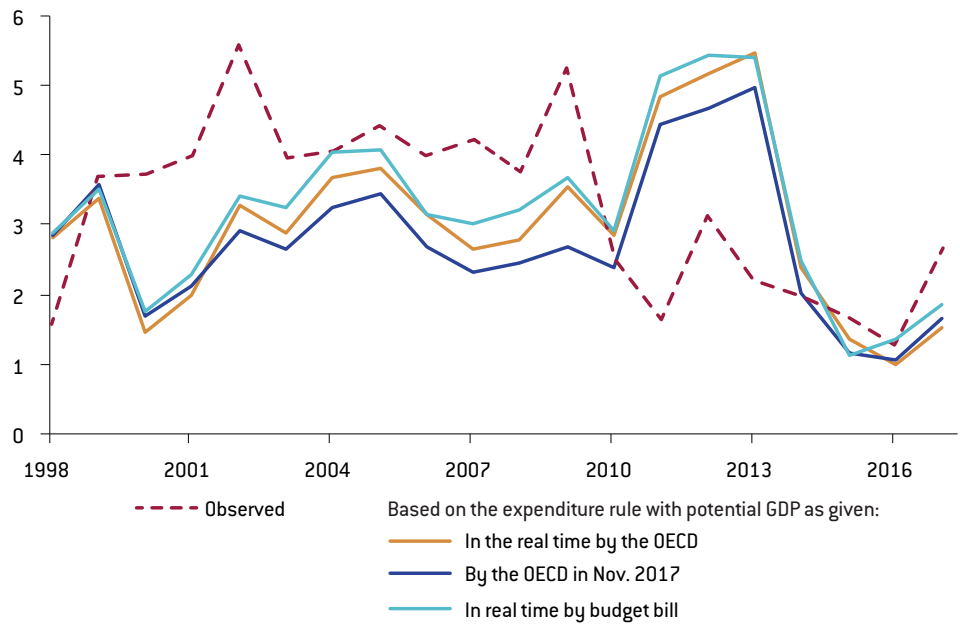
This is what OFCE simulated: a sequence of budgetary efforts is computed each year in order to reach a debt reduction objective over a five-year period. The sequence is revised every year based on the new debt level. Debt reduction objectives vary for different countries depending on their debt levels. In this way, the necessary effort is concentrated in the early years and tends to move to zero over time. Examples of the OFCE simulations for France's debt dynamics and real public expenditure growth rates for three objectives (-2 percent; -4 percent and -6 percent reductions in debt over GDP over five years), suggest that depending on the degree of ambition of the five-year debt reduction target, an expenditure rule can generate debt reduction dynamics that are similar or less stringent than the MTO rule. In all cases of the proposed expenditure, the real growth rate of expenditure for France would converge to a bit less than 1 percent (therefore less than the potential growth rate assumed to be 1.1 percent) but with more front-loading of the adjustment in the early years. CEPREMAP simulations also show that in order to obtain, over a five-year period, a five percentage-points reduction of the public debt-to-GDP ratio, an inflection point is necessary early on that itself requires a front loading of fiscal adjustment with a negative impact on growth (Brand and Langot, 2018).

Next, we analyse the cyclical properties of the rule. This analysis is based on a rule calibrated for France. The rule has good countercyclical properties for unexpected demand shocks. First, the nominal growth rate of expenditure is not affected by the shock and automatic stabilisation is at work because of lower revenues and higher deficits. Second, a negative demand shock generates inflation below expectations. As the growth rate of nominal public spending is based on expected inflation, such a shock induces a higher real growth rate of public expenditure and therefore a positive fiscal impulse<sup>14</sup>. Concerning supply shocks, such as oil price shocks generating a fall in output and an increase in inflation, the expenditure rule is still stabilising because it induces a budget deficit but the higher unexpected inflation slightly reduces its stabilising properties (relative to the current rule). Overall, if, as is mostly believed, demand shocks are predominant in the euro area, we conclude that the expenditure rule has better cyclical properties than the current rule.

To illustrate the better countercyclical properties of the expenditure rule, Figures 2 and 3 show the observed primary public spending growth rate in France and the fiscal impulse and a counterfactual simulation performed by OFCE of these two series, as generated by an expenditure rule. The figures suggest that the rule would be more countercyclical than what was observed in France. During good years the public expenditure growth rate and the fiscal impulse would have been lower. Vice versa, in the period 2011-13, French fiscal policy would have been less restrictive. Note that the variance in the expenditure growth rate as generated by the rule appears high in these simulations. One reason is that the expenditure rule is net of discretionary changes in fiscal revenues: for example in 2011-13, tax rates and revenues were increased so that the rule allows for a large increase in spending. Our counter-factual simulations take as given the tax changes. This is rather hypothetical. Had our rule been in place and followed, no such tax rate increase would have been necessary and thereby the year-to-year expenditure growth rate limit would have not been as erratic as in the simulation. In any case, our rule requires a careful consideration of revenue-side measures. Note however that in 2009, the rule would have implied less fiscal stimulus and this is the reason we advocate an escape clause in case of exceptional circumstances.

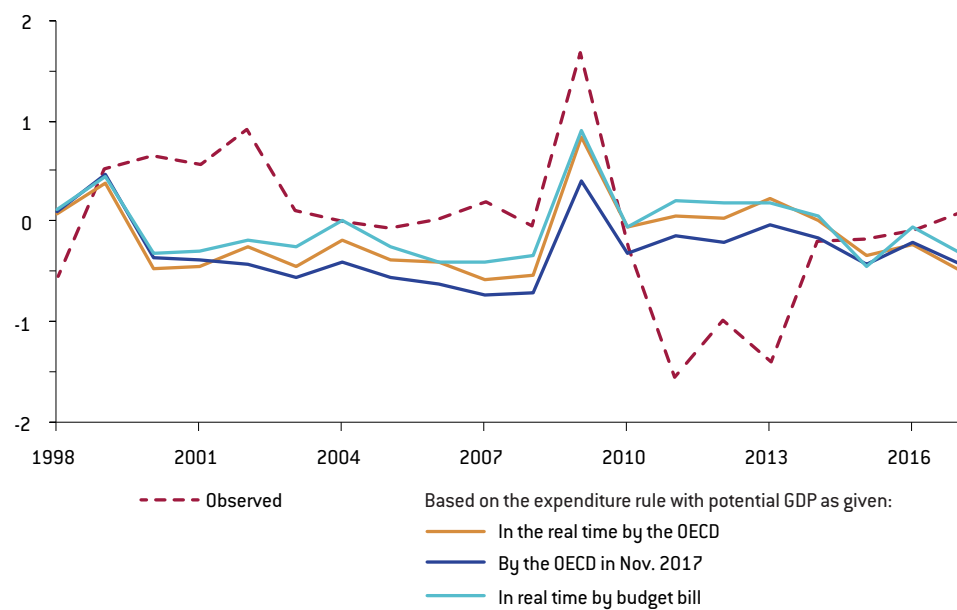
<sup>14</sup> Fiscal impulses are defined as a yearly (negative or positive) change in the structural budget balance.

**Figure 2: Nominal growth rate of primary public spending in France, 1998-2017 in %, current euro**



Sources: INSEE, OECD, Budget Bill, OFCE's calculations. Note: The simulation considers actual tax measures as given, such as the tax cut in 1999 and the tax increase in 2011-2013.

**Figure 3: Fiscal impulse in France, 1998-2017 in % of potential GDP**



Sources: INSEE, OECD, Budget Bill, OFCE's calculations. Note: The simulation considers actual tax measures as given, such as the tax cut in 1999 and the tax increase in 2011-2013. Fiscal impulses are defined as a yearly (negative or positive) change in the structural budget balance.

To summarise, based on our simulations, the advantage we see in the expenditure rule are:

- A country-specific public-expenditure rule delivers a realistic path for debt reduction, within explicit debt reduction targets;
- The policy prescriptions are simpler to implement because the final recommendations concern nominal public expenditures directly controlled by the government;
- The cyclical properties are generally better than the current rule, in particular in respect of demand shocks.

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## 4 Institutional and legal issues

### Creating the right institutions

A recent literature on fiscal discipline emphasises the complementary role of fiscal rules and the establishment of national independent fiscal institutions (IFIs) or fiscal councils (Alesina and Tabellini, 2007; Beetsma and Debrun, 2018). Building such institutions is not enough to improve trust in public governance but it is a necessary ingredient.

The ability of a fiscal council to identify biases in governments' fiscal and economic forecasts and to provide competent macroeconomic analysis is essential to its effectiveness. Fiscal councils can provide macroeconomic forecasts in relation to budget preparation that do not suffer from the optimistic biases often found in official government forecasts. This is even more important because euro-area countries appear to have responded to the 3 percent limit imposed by the Stability and Growth Pact by offering over-optimistic forecasts when they are most in danger of breaching the limit (Frankel and Schreger, 2013). This is the reason we believe independent growth forecasts are key, especially in the presence of fiscal rules.

The OECD identifies six conditions for such councils to be effectively independent:

- Proper inclusion in the national fiscal framework (including integration into the national budget process with evaluation of the medium-term sustainability of public finances, realisation of budget estimates on behalf of the government, counter-expertise and analysis of the government's economic and fiscal scenarios and providing information to parliament);
- Adequate human and financial resources;
- Access to relevant information at all times (this means establishing formal information-exchange systems with national administrations and the national government);
- Credible communication in real time;
- An impartial stance and accountability of the Independent Fiscal Institutions (IFI) based on past records;
- Strong links with parliament (regular hearings of the National Budget Board Executive Board in Parliament and technical sessions with the parliamentary budget committee).

### The role of independent fiscal institutions

The fiscal framework we propose must be complemented by strong national and European institutions: economic analysis and monitoring should occur to a significant extent at the national level – by independent fiscal institutions – under the oversight of a euro-area fiscal institution. The fiscal debates should be partly renationalised in order to prevent the use by national governments of micromanagement by Brussels as a scapegoat and the continuous conflicts that pit governments against each other. National fiscal councils should help in that objective, notably by expressing an opinion each year on a rolling medium-term debt reduction target proposed by the government. This means the IFIs need to be independent and empowered to be able to make assessments of medium-term potential growth, inflation and the impact of tax changes on government revenues, and also to run long-term fiscal sustainability analyses.

In fact, the 'six-pack' reform in 2011 broadened the role and formalised the tasks of national independent fiscal institutions. Virtually all IFIs contribute to monitoring compliance with national fiscal rules and/or to macroeconomic forecasting for fiscal planning purposes. Nevertheless there are significant differences between IFIs in different member states in terms of mandates, resources and visibility in public debates. Depending on the country, they perform a broad spectrum of tasks including macroeconomic and budgetary forecasting, assessment of compliance with fiscal rules, policy costing, analysis of long-term sustainability, promotion of transparency and making recommendations on fiscal policy. In our view not all IFIs have a sufficiently broad mandate and or sufficient resources to honour a broader mandate.

*Recommendation 2: Expand the mandates of all independent fiscal institutions so they can make assessments of medium-term potential growth, inflation and the impact of tax changes on government revenues, and also run long-term fiscal sustainability analysis.*

### **The French independent fiscal institution**

One example of a country in which the national fiscal framework could be improved is France. French government forecasts of growth one year ahead were characterised by optimistic biases in relation to budget balances and growth from 1996 to 2013 (Frankel and Schreger, 2013). On average the forecast error for the budget balance was 0.36 percentage points of GDP, compared to 0.29 – and 0.09 excluding Greece – on average for 20 OECD countries. Only seven of these 20 countries have more optimistic biases than France in relation to the balance forecast. As for the growth forecast, the average error pre-2013 was 0.57 percentage points, compared to a 0.27 percentage points average forecast error for the 20 OECD countries. However, since 2013 and the creation of the French High Council of Public Finance – Haut-Conseil des finances publiques (HCFP) – these biases have been drastically reduced: the budget balance bias forecast is 0.06 percentage points of GDP and the GDP growth bias forecast is very small at –0.05 points of GDP. Although it is still too soon to fully assess the impact of the French IFI on forecast biases, this suggests that the mere existence of the HCFP reduced government pressure on the Treasury forecast unit to ‘massage’ data in order to provide growth forecasts.

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#### **BOX 1: Organisation and mandate of the HCFP\***

The HCFP of France is an independent body, backed by the French Court of Auditors (Cour des Comptes), created by the organic law of 17 December 2012 on the programming and governance of public finances. The HCFP is responsible for delivering opinions on the macroeconomic assumptions – particularly growth forecasts – used by the French government to prepare the main public finance legislation, before it is submitted to the Parliament. If the Government is led to modify its forecasts during the parliamentary debates, it informs the HCFP of this modification, on which the HCFP must also issue an opinion.

With regard to public finance, the mandate of the HCFP is limited: it delivers an opinion on the consistency of the return trajectory to structural balanced public finances (general government: state, local authorities, social security) defined by the public finance programming bill with France’s European commitments, and on the consistency of all financial bills with this trajectory.

In case of ‘significant deviations’, the HCFP assesses the corrective measures taken by the government and, if necessary, the deviation from the structural balance trajectory.

The HCFP college is composed of ten members plus its chair\*\*. The members of the college are appointed for five-year terms by the First President of the Court of Auditors, the parliamentary authorities and the President of the Economic, Social and Environmental Council (EESC), with no possibility of dismissal. The members are trained public finance magistrates and economists.

The HCFP has an autonomous budget of approximately €500,000 (2017) within the Court of Auditors’ budget, but has no staff to perform independent forecasts.

\* Source: High Council of Public Finance (2018), [www.hcfp.fr](http://www.hcfp.fr)

\*\* The College, chaired by the First President of the Court of Auditors, is composed of four judges of the Court, five qualified persons and the Director General of the national statistical institute INSEE. The members of the HCFP are unpaid.

The scope of the HCFP (see Box 1) is limited in comparison to similar bodies in other EU countries. The HCFP does not produce macroeconomic forecasts: it simply publishes an opinion on the government's macroeconomic scenario but does not provide a formal endorsement (unlike, for example, in Spain or Italy). Nor does the HCFP generate fiscal forecasts and its 'endorsement' role derives from an extensive interpretation of its mandate while IFIs in many other countries are mandated to focus also on the analysis of the actual balance in relation to the 3 percent rule, on compliance with the MTO and on structural adjustment. The capacity to provide a sound assessment of fiscal forecasts depends critically on the quality of the information provided and the time the institution is given to process and analyse this information. The HCFP is only given about one week to provide such an opinion, which is much shorter than the time other IFIs have to perform similar work, and clearly does not allow for a deep analysis. Lastly, the comply-or-explain principle, according to which budgetary authorities should react publicly to IFIs' opinions, is not clearly set out in French legislation.

The HCFP's mandate should therefore be broadened to improve its effectiveness. It should be responsible not only for giving opinion on the government's macroeconomic forecasts but also for providing its own macroeconomic forecasts, potential growth estimates and fiscal forecasts for each budgetary bill and stability programme, and it should continue to ensure compliance with the correction mechanism.

Producing (or even assessing) macroeconomic forecasts is time-consuming, involving skilled staff and extensive use of modelling. In addition, several iterations are needed between economic and fiscal forecasts to converge on a consistent framework. The HCFP is not in the position today to provide such forecasts and to provide a model-based analysis of the government's forecasts. In six EU countries (Austria, Belgium, Luxemburg, the Netherlands, Slovenia and the United Kingdom) the government's macroeconomic forecasts are actually produced by independent forecasters, such as the Office for Budget Responsibility (OBR) in the UK.

To avoid duplication of resources, and drawing from the UK's experience, we recommend organising a forecast process inside the HCFP with the cooperation of the Treasury and other relevant administrative units in charge of fiscal forecasts on the spending and revenue sides.

There are two possible practical ways to do this:

- Create a small economic team in charge of economic forecasts in the HCFP which would have the right interplay with Treasury staff and other administrations or independent institutions in charge of public finance forecasts. In such a set-up, the HCFP would be better integrated within the national budget process and would be in a better position to provide counter-expertise and analysis of the government budget estimates;
- Move the growth forecasting unit of the Treasury to the HCFP. This resembles the British OBR model. It would still (as it does today) produce regular confidential forecasts for the Minister and Treasury. However, the Minister would no longer have authority over the forecasting unit. The HCFP would also continue to discuss and cooperate with the Treasury units in charge of forecasts on the fiscal spending and revenue sides, to ensure consistency of the forecasts (macroeconomic and fiscal).

*Recommendation 3: Broaden and better integrate the mandate of the HCFP into the national budget process by including in it the endorsement of fiscal forecasts and debt sustainability analysis, and by increasing its capacity to independently produce fiscal and macroeconomic forecasts.*

This recommendation is all the more important if the recommended expenditure rule is put into place. The reformed HCFP would need to produce independent forecasts of potential growth, expected inflation and the permanent fiscal impact of changes in the tax system.

Forecast errors should be better acknowledged and the HCFP should present its central forecasts while also showing the probability of different outcomes.

### How to enforce the rules?

Introducing a new expenditure-based fiscal rule is a necessary but insufficient step for an effective fiscal framework. The actual enforcement of the rule is crucial. The traditional view is that this should be done by increasing the cost, both economic and political, of non-compliance. This is certainly part of the solution but there is no silver bullet in particular because political sensibilities, history, culture and beliefs shape views on the optimal trade-off between rules versus discretion. Experience suggests that enforcing compliance through penalties imposed by what is seen in many countries as Brussels bureaucracy or Berlin political might has its own shortcomings. European fiscal rules were sometimes used as a scapegoat by national governments, which preferred to blame them for a necessary fiscal adjustment rather than past profligacy.

Under the current fiscal framework, non-compliance is theoretically subject to fines, amounting to up to 0.5 percent of a member state's GDP. Large fines are not credible, as they do not pursue an economic purpose apart from penalty, and might exacerbate an already fragile fiscal stance. This creates a time consistency problem: *ex ante* everyone agrees that credible sanctions are important to enforce the SGP, but once the SGP is violated, imposing a sanction might do more political and economic harm than good. In addition, the recent literature emphasises the political economy deadlock of such a compliance mechanism in the EU. As the European Council votes by majority on fines, coalitions might emerge for bad reasons: one minister might prove reluctant to vote in favour of sanctions against another member state, in order not to be voted against should a similar situation arise for him. We should not rely on finance ministers to impose discipline on each other. The introduction of reversed qualified majority following the euro-area crisis did not change the status quo. An alternative to monetary fines paid to the EU by member states would be making EU budget payments to member states conditional on respecting fiscal rules: such a system would face exactly the same problems as the problems of current fines we have described. Moreover, EU budget payments serve EU goals and therefore suspending them would harm EU goals.

We believe that the European fiscal framework is stuck in a corner, with all the weight of compliance placed on rules and fines and not enough on domestic institutions and market discipline. In our view, a mix of rules, domestic institutions and market discipline can help, though each has their own costs and advantages. On top of the institutional surveillance described above, reform should focus on two main aspects: rewards and sanctions.

**Rewards:** One possibility would be to relate the enforcement of fiscal rules to the creation of fiscal capacity for the euro area. In a sense, this also shifts the mechanism from using sticks to offering carrots. For example, participation in a fiscal stabilisation scheme that offers one-off transfers in case of large downturns could be made conditional on compliance with fiscal rules. The same condition can apply to the right to benefit from low-cost European Stability Mechanism (ESM) lending for prequalified countries (lending even when countries have not lost market access and when there is no imminent financial stability risk to the euro area as a whole). The access to this 'flexible' ESM facility could be made conditional on compliance with fiscal rules, as proposed by Benassy-Quéré *et al* (2018) and the June 2018 Council declaration.

**Sanctions:** Market discipline should also be part of the package even if it has not worked well in the past. In the 2000s, markets did not discipline countries that were running imprudent fiscal policies – or imprudent financial policies that generated excessive private leverage – and during the euro crisis, market discipline over-reacted with mechanisms of self-fulfilling expectations whereby the fear of default and exit pushed the cost of financing for several countries to levels that were driving them towards default. Steps have already been taken to guide market discipline. For example, the introduction of collective action clauses for government bonds will likely help prevent a repeat of the pre-2007 market complacency. This has to



be accompanied by instruments that reduce the danger that default risk transforms itself into redenomination risk. This is one objective of the European Central Bank's Outright Monetary Transactions (OMT) instrument and it is important to keep this instrument in the toolbox to help to contain self-fulfilling expectations. Market discipline that prices default risk should not be eliminated. Redenomination risk is different in nature and should not be allowed to destabilise the euro area.

One can go a step further to guide market discipline towards providing the right incentives for fiscal prudence. One possibility would be forcing countries that violate the fiscal rule to issue junior bonds to finance expenditure in excess of the fiscal rule (Benassy-Quéré *et al*, 2018). The advantage of this idea is that it applies not to the stock of existing debt but to a portion of the flow of the new debt necessary to finance excessive expenditure. Hence, discipline is applied where it is most useful in terms of incentives, ie at the margin, to increase the marginal cost of financing excessive expenditure flows. Governments that decide to spend in excess of the spending rule would have to explain their economic and political reasons for doing so, and the marginal cost of such spending would depend on the motives and credibility of the government plans.

In case of repeated deviations from the rule, the issuance of junior bonds can also protect existing bondholders by creating a buffer of junior sovereign debt that will be restructured first. This is akin to debt covenants protecting the interests of creditors in privately issued debt, and could in fact lower the average cost of debt issuance. The proposal has been criticised in particular because there is no experience of countries issuing such junior debt and because it would create a precedent that acknowledges the possibility that euro-area countries might default on some of their debt. However, only countries that repeatedly violate the fiscal rule would accumulate a large amount of junior debt. Also, the cost of issuing junior sovereign bonds may depend on market conditions largely outside the control of the government such as monetary conditions or general risk appetite. This is however a characteristic of governments financing that also applies to senior sovereign debt. In addition, the issuance of junior bonds would not be automatic but imposed after some analysis showing that this issuance is not destabilising. This path towards enhanced market discipline requires further analysis.

*Recommendation 4: Transfer surveillance to well-equipped national fiscal councils, coordinated and overseen by a European Fiscal Council. Make the access to a 'flexible' ESM/European Monetary Fund credit line and the participation in euro-area-wide fiscal stabilisation instrument conditional on compliance with the fiscal rule.*

A further 'stick' would be to increase the political cost of deviating from the fiscal rule, in line with objective of renationalising fiscal debates. For example, whenever the national fiscal council concludes that the rule is not respected, it should hold a press conference and the finance minister should testify in front of the national parliament. When the European Fiscal Council concludes that the deviation from the rule is major, the finance minister should also appear before the European Parliament.

*Recommendation 5: In case of non-compliance with fiscal rules, as concluded by the national fiscal council, introduce national comply-or-explain procedures for the finance minister in front of the parliament and the press in member states, and in front of the European Parliament in case of a major deviation, as identified by the European Fiscal Council.*

## Legislative changes needed to introduce our proposal

The EU fiscal framework is based on the TFEU, the SGP and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), an intergovernmental treaty signed by 26 countries<sup>15</sup>, which is frequently called the Fiscal Compact.

We presume that the EU Treaty will not be changed in the near future, because that would require complicated negotiations and a difficult ratification process. The six-pack and two-pack regulations (SGP) could be changed by co-decision of the Council and the European Parliament, which should be feasible. A change to the Fiscal Compact is probably much easier than changing the EU Treaty, yet that would also necessitate national ratification, which in some countries requires a referendum.

Article 126 of TFEU says that “*Member States shall avoid excessive government deficits*” and includes two indicators to assess such a situation: the budget deficit should not exceed 3 percent of GDP (unless the excess is small and temporary), and the public debt should be below 60 percent of GDP, or if larger “*the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*” (the 3 percent and 60 percent reference values are defined in the annex of the TFEU).

Our proposed expenditure rule is fully in line with the public debt criterion of the Treaty, since a major aim of our proposed rule is to reduce public debt. However, our proposed rule does not necessarily comply with the 3 percent deficit threshold which, if it were breached, would not necessitate an immediate fiscal adjustment to reduce the deficit below 3 percent. Yet such a situation would not violate the Treaty, because Article 126 of TFEU gives the right to the Council to decide about the period during which the excessive deficit will have to be addressed. The Council could thus consider the opinion of the European Fiscal Council about the timing and the measures, a process which respects the requirements of the proposed expenditure rule.

There could also be cases in which both the 3 percent deficit and our proposed expenditure rule are violated, and it is also possible that the expenditure rule could be violated while the deficit does not breach the 3 percent of GDP reference value. Therefore, there are three possible cases of violations: the 3 percent deficit rule is violated but the expenditure rule is obeyed; both the 3 percent deficit rule and the expenditure rule are violated; or the 3 percent deficit rule is obeyed but the expenditure rule is violated. Such situations require different interventions. In the first, we recommend a ‘light’ EDP, whereby the Commission carefully considers the opinion of the European Fiscal Council. When our proposed expenditure rule is violated (cases 2 and 3), the ‘normal’ level of the EDP should be applied and we should consider the positive and negative incentives discussed previously.

Finally, the Fiscal Compact is mostly in line with the new rule we propose. The two most relevant rules of the Fiscal Compact are the minimum requirement for the medium-term objective of the structural balance for euro-area countries (-0.5 percent or -1.0 percent) and the 1/20th debt reduction rule from the six-pack.

The concrete MTO values are not in contradiction with our proposed rule, because that would lead to a close to balanced budget in the long term. Therefore, keeping these numerical requirements as long-run requirements (if no specific annual changes in the structural balance are required) would not conflict with our proposed rule. But the 1/20th debt reduction rule does conflict with our proposed rule, since we argued for a moving five-year debt-reduction target, which might be lighter (but also tighter) than the 1/20th rule. Therefore, the Fiscal Compact should be revised along with the SGP (six-pack regulations).

15 All EU countries apart from the Czech Republic and UK have signed the TSCG.

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