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Searching under the lamp-post: the evolution of fiscal surveillance

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Searching under the lamp-post: the evolution of fiscal surveillance

Deborah Mabbett & Waltraud Schelkle

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Searching under the lamp-post: the evolution of fiscal surveillance

Deborah Mabbett* & Waltraud Schelkle**

Abstract

Fiscal surveillance was developed as a supranational regulatory process to counteract short-termism and deficit biases in government decision-making. With effective monetary policy to stabilize the economy, restraint on the fiscal discretion of national governments was seen as the key to macroeconomic stability. The financial crisis and its aftermath challenge this paradigm. Private debt caused the crisis and monetary policy is so weak that pro-cyclical fiscal retrenchment could worsen fiscal outturns. We argue, contrary to the ‘disciplinarian’ interpretation of the Stability and Growth Pact, that the regulatory process of fiscal surveillance is strongly affected by the potential perversities of fiscal restraint and is therefore resistant to the prescription of austerity. This claim is developed by tracing the technical difficulties encountered by fiscal surveillance since the financial crisis. The crisis has so destabilized expectations of the performance of the economy and the proper scope of government that the statistical and economic norms of surveillance have been undermined. We conclude that the problem with fiscal surveillance is not that the EU inflicts undue fiscal discipline on member states, but rather that the EU institutions are unable to protect member states against bond market panic, and therefore cannot coordinate stabilizing fiscal policies.

Keywords: economic governance, financial crisis, Stability and Growth Pact

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Searching under the lamp-post: the evolution of fiscal surveillance

1. Regulating budgets in hard times

Since the earliest days of monetary union, the Commission and the Council have looked for the key to macroeconomic stability under the lamp-post of fiscal surveillance. The initial Stability and Growth Pact (SGP) was designed on the assumption that monetary union changed government incentives in incurring debt and running deficits. The prescription of discipline and control fitted well with the fashion of the time for a 'hands-tying' approach: fiscal authorities were meant to stay out of macroeconomic stabilization and let independent central banks take care of it (Forder 2001; Schelkle and Hassel 2012).

The original disciplinarian SGP could not be implemented and was reformed in 2005. The orientation of the process shifted from sanctioning excessive deficits to ensuring the long-term sustainability of public finances. Schelkle (2009) argued that the system became more regulatory, with an emphasis on establishing common budgetary standards and procedures among national bureaucracies. Rather than operating as an external constraint on national governments as the disciplinarian approach implies, the regulatory interpretation sees commitment to fiscal rules and acceptance of external monitoring as part of the structure of checks and balances that can be found in any sovereign state. As a 'fourth branch of government', regulators exercise

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authority by consent, and rely on an expert consensus within the member states (Majone 1993).

Both the disciplinarian and the regulatory thrust of fiscal surveillance shared the assumption that governments were the central cause of macroeconomic instability. But the crisis has made it evident that the fiscal surveillance lamp-post does not illuminate all the necessary conditions for macroeconomic stability in the Euro area. The SGP did not detect the origins of the crisis: in all cases but Greece, it was private debt that fed the imbalances, not profligate fiscal policy. Indeed, Commission officials had noticed this in a report in 2006, before the crisis broke, and drew attention to current account imbalances arising from asset price bubbles and private credit expansion (CEC 2006). While the lamp-post was directed to the supposed risk of moral hazard among governments, the moral hazard of banks had proved to be a much greater problem. Nor would adherence to the prescription of fiscal rectitude provide a way out for the euro area countries: monetary policy remains strikingly ineffective at stabilizing, let alone stimulating, the economy, and macroeconomic stability is therefore underprovided. In paying heightened attention to fiscal indicators following a banking crisis, the EU resembles the drunk who looks for his lost keys under the lamp-post, not because he can be sure that they are there but because 'that's where the light is'.

We argue in this paper that the financial crisis has profoundly unsettled the process of fiscal surveillance. The SGP has proved unenforceable in the face of disagreement and genuine uncertainty about the best settings for fiscal policy. Governments may indeed have short-termist reasons to run deficits, but they also have every reason vigorously to resist policies that they fear will create or worsen recessions. As we show below, they have particularly strong reasons

when monetary policy is ineffective, or when the emphasis on fiscal 'soundness' leads to maintaining zombie banks. To continue to search under the fiscal lamp-post in these conditions strains the regulatory capacities of the Commission.

This argument runs directly against the disciplinarian interpretation of the Pact. On this interpretation, the original Stability and Growth Pact (SGP) suffered from a problem of 'sinners voting on sinners'. Member states in the Council were reluctant to impose discipline upon each other. But, since the financial crisis, member states can be expected to be more inclined to penalize delinquents. Countries which see themselves as likely creditors in bailout arrangements clearly have incentives to limit their exposures. Even the weaker states may look more critically at each other, given the evidence of how contagion can spread in European bond markets. On this account, the Pact has become more enforceable because member states' incentives have changed (Yiangou et al 2013: 233).

This analysis invites the criticism that the euro area is gripped by an 'austerity delusion' (Blyth 2013). Blyth's own account is ideational rather than institutional: he pays no attention to the fiscal surveillance process and identifies Germany as the leading actor in the austerity drama, with the ECB as the sorcerer's apprentice. Others hold the Commission at least partly responsible: Krugman (2013) writes of a 'Rehn of terror', perversely flattering the Commissioner for Economic and Financial Affairs and the Euro for his role in the excessive enforcement of budgetary retrenchment. Taken at face value, without regard for the discretion which the Commission can exercise, the reforms to fiscal surveillance adopted since the financial crisis have tightened the fiscal constraints on member states (Barnes et al 2012).

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Our regulatory interpretation emphasizes that it is technical expertise that gives the Commission the authority to make national democracies conform to norms of 'good governance'. If the Commission cannot confidently maintain the technical soundness of the SGP, its role must be marginalized. We show below that the financial crisis has so destabilized expectations of the performance of the economy and the proper scope of government that the statistical and economic norms of surveillance have been undermined. We also show that it is to the credit of the Commission at the operational level that it has understood this and refrains from pressing for fiscal austerity in its assessments. Yet publicly the Commission must also play to the gallery of major guarantor countries, such as Germany and the Netherlands, which require tough talk from Brussels for domestic consumption.

Our discussion falls into four sections. In the next section, we provide a brief account of the reforms to fiscal governance that have taken place and show that, while the new rules under the Six Pack, the Two Pack and the Fiscal Compact delegate more authority to the Commission, this does not mean that the Commission necessarily advocates austere policies. In practice, austerity has been imposed by the Troika of the IMF, the ECB and the Commission in the course of arranging financial support for countries requiring bailout programs; program countries are exempt from the normal fiscal surveillance process. Section 3 turns to the statistical process of accounting for the crisis, with a particular focus on the impact of financial sector instability. Eurostat strives to apply technical standards consistently, but we show that these standards have differential effects on strong and weak economies. Furthermore, our research identifies some deviations from consistent practice in accounting for bank recapitalizations. In section 4, we examine how the changed economic environment poses a challenge to the process of fiscal

surveillance and to the Commission as the main stakeholder of the process. We show how technical and political disagreements have emerged around the issue of cyclical adjustment. Section explores the interaction between fiscal rules and rescue programs. Given Germany's reluctance to create new supranational institutions, it is ironic that the fiscal rules militated against the use of bilateral lending programs and contributed to the creation of a new common institution. The wider point is that the indicators are manipulated by all parties, not just delinquent member states.

We conclude by summarizing how these findings fit into our interpretation of the contested politics of regulating budgets (Mabbett and Schelkle 2009). We agree with critics of austerity like Blyth and Krugman that the fiscal surveillance lamp-post shines on the wrong part of the pavement. But far from being an encompassing delusion or obsession, we find that the Commission is navigating a fine line being satisfying the political pressures facing national governments on the one hand, and avoiding causing economic damage on the other. Moreover, fiscal surveillance has become marginalized as a policy process. Meanwhile, Euro area member states are left exposed to the vagaries of the bond markets, with the Troika, as the conduit of pro-cyclical market pressures, imposing austerity.

2. Searching under the lamp-post in the financial crisis

2.1 The evolution of fiscal surveillance

When the financial crisis broke, it seemed at first that the fiscal surveillance process would be allowed to generate assessments that were tolerant and forgiving of the straits in which member states found themselves. The immediate effect of the financial crisis was to create a short-lived Keynesian turn in fiscal policy in Europe. Member states undertook stimulus programs which were endorsed and given a European label in the form of the European Economic Recovery Plan (EERP). These programs, combined with sharp falls in GDP, took almost all member states across the threshold for deficits. The members states in the Council decided to start Excessive Deficit Procedures (EDPs) against each one of them, even though an escape clause in the Pact could have been invoked that said that, in the case of a deep recession, an EDP could be suspended. The opening of an EDP forces a government to inform its peers in the Council in detail about its budgetary plans. In other words, given the number of 'delinquents', the EDP process created a venue for policy coordination.

Instead of invoking the escape clause, the Council agreed in October 2009 on a general extension of the time for correction, whereby consolidation should begin in 2011 in most member states. Two examples can illustrate the tenor of assessments at this time. Reviewing the situation in France in November 2009, the Council was informed that the deficit target of 5.6% of GDP was likely to be missed because of a greater than expected decline in GDP. The deficit was likely to reach 8.3% of GDP. Furthermore, the 'minimum average structural

effort' (leaving out the effects of the GDP outturn) fell short of requirements, but this had 'to be seen in the context of the still somewhat fragile economy'. Overall, the Commission recommended and the Council agreed that 'taking into account the particular circumstances of the economic crisis and the EERP, the French authorities can be considered to have taken effective action' (CEU 2009a). Similarly, Italy's huge deficit in 2009 was determined to 'have resulted from an appropriate response to the EERP and the free play of automatic stabilisers' (CEU 2009b).

This phase, whereby counter-cyclical policy was endorsed in the surveillance process, was brought to an end by the emerging sovereign debt crisis in Greece, and its contagious effects. The no-bailout clause could not be exercised because the relevant decision-makers feared the possible consequence of yet another 'Lehman moment'. The ECB was in effect drawn into monetary financing of government deficits, through its operations in bond markets. These developments created pressure for a revitalization of fiscal surveillance. Both Germany, as the principal guarantor of bailout funds, and the ECB, with a hawkish reputation to defend, pressed for stronger arrangements for fiscal control.

Importantly, stronger controls did not have to come through the established surveillance process. Instead, there were opportunities to impose austerity in the loan agreements made with member states that had to call on the IMF and the EU for assistance. Loan agreements were not bound by the norms of symmetry and common agreement that were foundational for the fiscal surveillance process. Under IMF rules, the key criterion for a loan agreement was that the borrowing country should adopt a program that would enable it to repay. This program could prescribe a country-specific adjustment path

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and could impose requirements which lenders themselves did not comply with.

There can be no question about the effectiveness of these programs in promoting austerity. Countries operating under loan agreements, generically termed Macroeconomic Adjustment Programmes (MAPs), have been required to cut expenditure, take steps to raise revenue, and reduce debt through privatization. Austerity programs were also adopted by Ireland (before being pushed into accepting a MAP) and by Spain out of the desire to avoid a loan and the MAP that came with it. This meant that they responded to bond market pressures, which were strongly pro-cyclical. In other words, countries whose ability to service their debt was called into question by bond investors were all forced into austerity, but not by the fiscal surveillance process.

Both Germany and the ECB sought to embed austerity in revitalized surveillance policies. German initiatives show an ambivalent attitude towards the Commission-led process. On the one hand, promoting collective self-restraint through the Council might veil the exercise of power by creditors and mitigate anti-German sentiment (a forlorn hope, as it turned out). On the other hand, Union institutions could provide venues for challenging austerity and manoeuvring Germany into larger contributions to collective resources. This at least is the plausible interpretation that can be put on Chancellor Merkel's resistance to creating a new permanent competence for the Commission in the form of a bailout fund (Barber 2010).

2.2 Reforms to fiscal surveillance

Germany's sudden disaffection with the rigor of enforcement of fiscal surveillance by the Commission and Council was reflected in the initiative to create an intergovernmental Fiscal Compact (Chang 2013: 264). This intergovernmental treaty, outside the EU's legal framework, is modeled on legal changes, among them a 'debt brake' (Schuldenbremse) in the German constitution, passed in 2009 under the Grand Coalition. The emphasis of the Compact is on the incorporation of fiscal restraints into domestic law. National parliaments are required to legislate on balanced budget rules and debt limits; failure to do so can be challenged before the European Court of Justice. Moreover, a member state who does not sign the Compact is not eligible for assistance from the permanent bailout fund, the European Stability Mechanism (ESM). Twenty-five of the then 27 member states signed the Compact, only the Czech Republic and the UK stayed out.

Table 1a: Major reforms to fiscal surveillance – 'Fiscal Compact'

Applicability	Major provisions	Major innovation
Contracting parties (25 as of 22 July 2013)	Balanced Budget Rule analogous to the MTO; Automatic correction mechanism for debt significantly moving away from the 60% debt ratio	Fiscal rules written into domestic law; access to ESM is conditional on signing up

At the same time, the task force of Council President Van Rompuy, made up largely of the finance ministers of the Euro area members, was at work preparing proposals to strengthen the Commission-led process. The 'Six Pack' of five Regulations and one Directive was passed in 2011. The Six Pack

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introduced four substantive innovations that helped to establish the impression that fiscal surveillance was being tightened. First, sanctions now attach to excessive debt as well as deficits. Penalties can be levied on a debt-GDP ratio above 60% (even if the deficit is not excessive) if it is not reduced by at least 0.5% over three years. Second, there is an intensified emphasis on the 'medium term objective' (MTO) of achieving a fiscal position 'close to balance or in surplus'; non-compliance can lead to a fine. The MTO is fulfilled if the structural deficit does not exceed 1% (or 0.5% for those above the debt threshold). Third, more checks on data validity have been introduced. Eurostat has obtained extended rights to visit member states and inspect primary source data; if fraud is detected, the government can be fined. Furthermore, the assumptions underlying GDP forecasts must be verified and assessed by national fiscal councils, and agreed with the Commission. Table 1b gives an overview.

Table 1b: Major reforms to fiscal surveillance – ‘Six Pack’

Applicability	Major provisions	Major innovation
All MS of the EU but sanctions only for EA countries	<i>SGP preventative arm:</i> -definition of country-specific MTOs in terms of structural balances -annual evaluation of MTO, expenditure rule and debt -evaluation of adjustment to MTO with possibility of financial sanction	Precise MTOs; Expenditure rule; financial sanction in the form of an interest-bearing deposit
All MS of the EU but sanctions only for EA countries	<i>SGP corrective arm:</i> -surveillance of deficit (3%) and debt (60%) ratios to GDP -financial sanctions (non-interest bearing deposit or fine) - quasi-automaticity thanks to reverse majority principle	Excessive Deficit Procedure includes ‘excessive’ debt above 60%; decision rule of reverse majority
All MS	<i>National fiscal frameworks:</i> Mandatory minimum requirements re numerical fiscal rules, medium-term fiscal frameworks, independent fiscal councils etc	GDP forecasts to be confirmed by independent national councils and agreed with the Commission
All MS	<i>Statistical governance:</i> Minimum standards for independent authorities; independent auditing of data by Eurostat; financial sanctions for statistical fraud	Underpinning by sanctions

Sources: Regulations (EU) 1173-1177/2011, Directive 2011/85/EU, available at URL:
http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

Heightened attention to debt levels has been interpreted as a toughening of fiscal surveillance, because it means that many countries will remain subject to requirements to exercise fiscal restraint for long periods, instead of coming

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under scrutiny only intermittently for breaching the deficit limit. But it is possible to read the shift of emphasis from ‘correction’ to ‘prevention’ differently. The Commission retains considerable discretion to push deadlines for corrective action into the future.

Commission officials drew the lesson from the standoff with member states in 2003, and again from the sovereign debt crisis of 2010, that the preventative arm of the Pact needed to be strengthened, in order to create more fiscal space for countercyclical policy. Larch et al (2010: 4), writing as Commission insiders (but of course in personal capacity), argue that the shift to a medium-term orientation is desirable because countries failed to restrain spending in the pre-crisis years and their fiscal positions were therefore too vulnerable to a downturn. This should please those who deplore the austerity delusion and the Rehn of terror, because it goes against the imposition of austerity measures when economies are weak, but retains a role for fiscal surveillance in cautioning and reining in governments in good times.

The Six Pack regulations extended the Commission’s discretion in evaluating a member state’s fiscal position and adjustment effort. The regulations insist that the Commission should take into account ‘the whole range of relevant factors’ in judging whether an excessive deficit exists or how non-compliance with the numerical criterion for debt reduction should be judged. Included among the factors which can be ‘mitigating’ or ‘aggravating’ are so-called ‘stock-flow adjustments’. These can be mitigating when caused by bank bailouts and aggravating when deemed ‘fiscal gimmickry’.¹ Special consideration should also be given to ‘debt related to financial stabilisation

¹ This is discussed further in section 5 below.

operations during major financial disturbances'.² 'Exceptional' circumstances can also be taken into account, defined as outside of the control of a member state or if resulting from a severe economic downturn (Reg 1177/2011, Article 1(2)(a)).

The Commission has the sole right of initiative in proposing an EDP or sanctions in an on-going procedure. This was clarified in the 2004 ruling of the European Court of Justice (C-27/04) arising from the refusal of Germany, France and Portugal to accept the initiation of an excessive deficit procedure. The Court held that the Council could reject a Commission recommendation, but could not initiate its own course of action. For disciplinarians, the right of initiative of the Commission is an important counter to the problem of 'sinners voting on sinners' in the Council. The introduction of reverse qualified majority voting in the Six Pack is important from this perspective, as it makes it harder for the Council to reject Commission recommendations. But this assumes that the principal obstacle to fiscal restraint is the Council, and that the Commission will be inclined to make hard-line recommendations for compliance with fiscal rules. As the following sections show, it is by no means clear that the Commission is inclined to stick to the letter of the fiscal rules, and it has discretion to make lenient evaluations and recommendations.

The 'Two Pack' of regulations codifies the ad hoc arrangements adopted in loan agreements. It thus continues the mirroring of intergovernmental measures in supranational legislation which we saw with the Fiscal Compact and the Six Pack. Loan agreements have been country-specific; the Two Pack establishes generic procedures. It confirms that countries in financial difficulties or receiving support from the ESM will be subject to inspection of

² We demonstrate below the significance of this factor. See Article 1(2)(c) of Regulation 1177/2011, amending Article 2 of Reg 1467/97.

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their budget plans and regular mission visits to the country. It spells out the general parameters of loan conditions in MAPs, and provides that these replace regular fiscal surveillance processes as long as they are in force. Table 1c summarizes the provisions of the Two Pack.

Table 1c: Major reforms to fiscal surveillance – ‘Two Pack’

Applicability	Major provisions	Major innovation
EA-MS without/ with excessive deficits or debt	Gradually closer monitoring of draft budget plans with 3yr horizon; ‘economic partnership programmes’ for structural reforms for those with excessive deficits	Not only the balance but the composition of budgets under surveillance
EA-MS experiencing fiscal difficulties	Bi-annual Macroeconomic Adjustment Programmes with close monitoring of draft budget plans; Explicitly excluded for ESM assistance directly to banks	As above; ECB and Financial Supervisory Authorities involved

Sources: [Regulation \(EU\) No 473/2013](#), [Regulation \(EU\) No 472/2013](#)

The measures secure the role of the Commission in preparing assessments and making recommendations. However, as the following sections show, it is far from clear that the Commission will always use these powers to recommend fiscal consolidation measures. Our interpretation is that the Two-Pack confirms that the operation of fiscal surveillance for non-program countries is distinct from the imposition of austerity in program countries. In non-program countries, the emphasis is on avoiding pro-cyclical

retrenchment, while the programs enforced by the Troika on countries requiring official lending yield to the pro-cyclical tendencies of bond markets.

3. Accounting for the financial crisis

The fiscal surveillance process starts with ascertaining the data on deficits and debt. It has become clear in the aftermath of the crisis that some of these rules are inconvenient and others are unsuited to current conditions. In this section, we show, first, that the consistent application of technical standards does not preclude inconsistent outcomes for member states and so there is legitimate disagreement about some of the classifications. Second, we show how the rules have been varied, if not bent, to accommodate the needs of monetary policy.

3.1 Statistical principles versus economic outcomes

Eurostat's accounting for the debt and deficit of general government is dependent on the judgments of statisticians, who are guided by well-established, internationally-agreed norms (Savage 2005: 62-65). For our purposes, the two most relevant are the norms of comprehensiveness and adherence to market valuations. Comprehensiveness has been an important feature of statistical practice in the Euro area since the Maastricht Treaty requirements were laid down. Member states varied widely in the coverage of their budgetary processes, and many were forced to pay unwelcome attention to the financial position of entities that had previously operated off-budget, such as loss-making public trading entities. Comprehensiveness is considered

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good practice in the international fiscal policy community, as it ensures that priorities for the use of fiscal resources can be properly established and implemented. In particular, the leakage of resources to loss-making entities can create a situation in which health, education and welfare become the primary targets for retrenchment, while 'economic' activities of the government may have a greater negative impact on the fiscal position but are not subject to the same control.

As governments have taken on losses arising from the financial crisis, the norm of comprehensiveness has been tested and restated. One of the measures in the Six Pack (Directive 2011/85/EU, Chapter VI) requires member states to ensure 'the comprehensive scope of budgetary frameworks', including the identification of 'all general government bodies and funds which do not form part of the regular budgets'. Among the targets for this edict are banks taken into public ownership, particularly 'bad banks' created to achieve the orderly resolution of impaired assets while encouraging normal banking activity to resume. Statisticians have to decide whether state-owned banks are viable trading entities, in which case they are part of the 'public sector' but not 'general government' and so do not count towards the deficit under fiscal surveillance. They also have to determine whether financial support given by governments to banks has been matched by the acquisition of assets of equal value, in which case it is a 'financial transaction' which does not raise the fiscal deficit. If financial support is unlikely to be recovered, it is a 'capital transfer' which counts as government spending.

In making these judgments, statisticians turn to a second norm: reliance on market judgments. This norm reflects a widespread shift in accounting practice away from historic cost accounting towards 'marking to market',

where the market is seen as providing objective valuations. For example, when a government purchases shares on an active market, ‘any excess of the price paid by the government over the prevailing market price is recorded as a capital transfer’ (Eurostat 2012b: 1). Alternatively, the expected rate of return can be compared with ‘a sufficient’ rate of return – if the expected return on the now publicly owned assets is lower than the sufficient return for a commercial investor, the difference is deemed to be a capital transfer. The presence of private co-investors is taken to indicate an adequate return, ‘since it is assumed that the private investors are seeking a return’ (Eurostat 2012b: 2). This approach has some affinities with the methodology used by DG Competition to calculate the ‘state aid’ element in government intervention: specifically with the so-called ‘private market investor principle’ (Hancher et al 2012). But it is applied there in a microeconomic setting where the intervention can be scrutinized in isolation.

Applying the method in an unstable macroeconomic situation introduces systematic biases towards deficit-increasing classifications in weak economies, however. Market valuations are affected by negative ‘animal spirits’, driving down expected rates of return, and high risk premia, driving up the rate of return that private co-investors would consider sufficient (Goodhart 2010). The effect is to reduce the market valuation of assets and increase the share of state support which counts as a transfer. We can find examples of this tendency in decisions about whether to classify bank bailouts as capital transfers or financial transactions, and in classification of entities inside or outside the Maastricht definition of ‘general government’.

Much of the Irish government’s bailout expenditure has been classified as capital transfer, reflecting the poor recovery prospects of several of the large

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institutions. The effect was to increase the Irish deficit by 20.2% of GDP in 2010 and about 26% cumulatively (Eurostat 2012a: 4, 8). By contrast, much of the financial support to banks provided by Germany and the Netherlands has been classified as 'financial transactions'. In the Netherlands, bailouts cost some 14.6% of GDP but, by end-2012, 10% had been recovered, validating the statistical classification. Not so for Germany however: while only 1.4% of the German bailout expenditure of 12.8% of GDP was classified as capital transfer, recovery through asset sales in Germany has been low so far, at only 2.0% of GDP (IMF 2013: 14, Table 5).

Such differential treatment can create the impression of political bias, in this case in favor of Germany. But statisticians adhere to norms and operate in an environment which apparently precludes direct political intervention. We suggest that the classification reflects the judgment of 'the markets' in an environment in which Germany's economic performance is much stronger than that of Ireland. The classification is not necessarily wrong in its implicit prediction about whether bailout expenditure will be recovered. But it works to the detriment of weaker economies and reinforces pro-cyclical market pressures.

A similar process, namely of letting market valuations rule a policy process, is at work in determining how entities brought into public ownership should be classified. The central issue for the statisticians that the Maastricht indicators refer to is the deficit and gross debt of 'general government', not the 'public sector'. Trading entities owned by the government are part of the 'public sector' but not part of 'general government'. This raises the question of what constitutes sufficient autonomy and viability to make an operation a trading entity. Trading at a loss temporarily does not jeopardize trading entity status,

but at some point a loss-making entity crosses the border to becoming a mere conduit for government funding, such that it should be reclassified into 'general government'.

Surveillance operations in several countries have produced some striking reclassifications. Eurostat reclassified several Greek public enterprises which led to an explosion of government debt by 7.8% of GDP in 2009 (Irwin 2012: 11; Eurostat 2010: 6-7). Eurostat argued that the magnitude of their losses meant that they should be accounted for as non-market producers and hence as part of general government. Portugal also experienced a considerable rise in gross public debt because of the reclassification of public enterprises. The adverse economic environment made the statisticians decide that these enterprises will make losses for the foreseeable future and hence must be counted as debt-increasing parts of general government. While justifiable in each case on narrow statistical grounds, these decisions create the impression that the governments had been hiding debt figures before. However, all that happened was that their economies worsened.

3.2 Separating fiscal from monetary policy

Since the financial crisis, the norm that the definition of general government should be as comprehensive as possible has repeatedly raised issues over the classification of financial intermediaries inside or outside it. An entity that is classified as a financial intermediary cannot be part of general government: the definitions are mutually exclusive. The general principles are that the classification should depend on the extent of autonomy of decision and the assignment of risk. Financial intermediaries 'place themselves at risk by acquiring financial assets and incurring liabilities on their own

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account.’(Eurostat 2013: 31). The financial crisis revealed that banks generally do not place themselves at risk: rather, they place public finances at risk. Hence, it is necessary to decide when the risk to public finances is remote enough to maintain the distinct status of a financial intermediary, and when the risk has crystallized sufficiently to bring the liabilities onto the government account with the bank losing its status as a financial institution. If it loses this status, it has no longer access to liquidity provided by the ECB.

Eurostat has taken the view that ‘defeasance structures’ or ‘bad banks’ are part of general government. It issued guidance in 2009 to the effect that ‘Government-owned special purpose entities, which have as their purpose to conduct specific government policies (for example with regard to defeasance or recapitalisation) with no autonomy of decision, are to be classified in the general government sector’ (Eurostat 2009: 5). This meant that their debt would become part of general government debt, and any ongoing deficits of those entities would add to the deficit.

An implication of this decision is that governments which lack fiscal room for manoeuvre must avoid creating defeasance structures, and instead leave impaired assets inside the originating banks to be gradually worked out. But this is widely thought to be a counterproductive strategy that leads to a ‘Japan scenario’: it hides problems and postpones a return to normal operations in the banking system. One ‘solution’ is to have bad banks in majority private ownership. Yet, statisticians pursue a norm of ‘substance over form’ in deciding how to classify entities, and private ownership is not normally sufficient, although it is necessary, for an entity to be excluded from the public sector and hence from general government (Eurostat 2013: 12).

But recently Eurostat has adopted a ‘formal’ approach, allowing defeasance structures in several countries, including France, Ireland and Spain, to be kept out of the government sector. As an interlocutor at Eurostat told us, classifying defeasance structures a private meant that these countries were able to reduce their public debt ‘artificially’. One possible explanation of this decision was that it impinged on the conduct of monetary policy. The ECB is likely to have preferred to see these banks remain outside general government. As elsewhere in the world, the ECB has pushed on the monetary policy string with unusual vigor in the crisis, adopting its own version of quantitative easing with long-term refinancing operations, giving banks ready access to cash. At the same time, ECB lending direct to Euro area governments remains prohibited. This means that a financial intermediary classified within general government would lose its borrowing rights because of the prohibition on monetary finance of governments.

The ECB maintains a list of Monetary Financial Institutions (MFIs) which are eligible to borrow from it.³ It might be imagined that an entity which is, for example, granted a banking licence by the national regulator and meets the financial soundness requirements laid down by the central bank should self-evidently be a market entity and not part of general government. But this was not how the statisticians saw it. In April 2012, Eurostat produced an analysis in which it found that the debt of some MFIs was effectively general government debt: in other words, the government was bearing the risks. However, it could not reclassify these entities as part of general government because the ECB insisted that they were MFIs (Eurostat 2012c: Table 1). The implication is that the ECB and the other central banks in the Euro system have an interest in a less comprehensive definition of general government

³ Available at URL: <http://www.ecb.europa.eu/stats/money/mfi/html/index.en.html> (accessed November 15th, 2013).

than the technical process of fiscal surveillance would call for. Concerns for financial stability thus trump the statistical norm of comprehensive accounting for fiscal risks.

4. Fiscal surveillance in a depression

In this section, we show how the Commission navigates between the political pressures from major guarantor countries to ensure fiscal discipline and an economic situation where there is a heightened risk that collective fiscal restraint may trigger a downward spiral of the Euro area economy. The technical method for avoiding pro-cyclical austerity is cyclical adjustment. While the original Pact specified that '3% is 3%', the Commission and the Council moved to monitoring a 'structural' measure of the deficit in the early 2000s. The adoption of cyclical adjustment was seen as necessary because it was not possible to maintain compliance with rules when the regulatory target was not fully under the control of the regulatee. Plans for expenditure cuts could be implemented and the target nonetheless missed because tax receipts fell short of expectations and the denominator for the deficit-to-GDP ratio shrank.

Commentators in the 2000s paid some, but not much, attention to the problem that fiscal tightening could worsen a recession, and therefore potentially be counterproductive for meeting fiscal targets. The reason was that the prevailing economic policy paradigm assumed that monetary policy could ensure that the economy of the Euro area would, in aggregate, track a stable GDP path (Schelkle and Hassel 2012). Fiscal policy was only necessary to

address idiosyncratic shocks in individual member states. The Commission's economists always had doubts about governments' political capacities to implement stabilizing fiscal policies, and promoted an analysis in which countercyclical fiscal policy would rely on 'automatic stabilizers' rather than discretionary measures (Buti et al 2003; cf Mabbett and Schelkle 2007). Their analysis claimed that the 3% deficit criterion, once cyclically adjusted, provided a sufficient margin for the automatic stabilizers to operate.

The obvious difficulty presented by the financial crisis is that monetary policy is not effective at stabilizing or stimulating GDP. Furthermore, in this situation of a 'liquidity trap', fiscal policy may be very effective through a Keynesian multiplier mechanism. Recent IMF research has found a strong negative response of economies to fiscal consolidation in times of deep recession (Blanchard and Leigh 2013). This research, showing that in times of economic depression fiscal policy can be powerful while monetary policy amounts to 'pushing on a string', generated a heated controversy about the wisdom of adhering to fiscal rules in Europe.

The 'Commissioner for the Euro' Olli Rehn presented himself as a vocal adherent to austerity, warning that plans for Eurobonds and ECB interventions were no substitute for a 'stability culture'. Faced with discussion among finance ministers of the possibility that fiscal multipliers were so large that austerity could worsen deficits, Rehn sent an open letter in an attempt to close off 'a debate that has not been helpful.' (Rehn 2013a) The Commissioner argued that 'the confidence that we have painstakingly built up in numerous late-night meetings' was eroded by airing the possibility of fiscal stimulus. He claimed that different multipliers attach to temporary and permanent fiscal 'consolidation', and that '[c]onsolidation that is announced as permanent and

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perceived as credible' has a smaller multiplier. Specifically in the case of Greece, 'persistent uncertainty and problems with implementation' meant that Greece 'could not benefit from confidence effects'.

Rehn's argument was drawn straight from the theory of 'growth friendly fiscal consolidation' or 'Non-Keynesian effects of fiscal contraction' (Giavazzi and Pagano 1996; cf Blyth 2013: 57-58, 131-2). He might have believed this theory, but it is also evident that he simply insisted on the inadmissibility of the discussion of fiscal multipliers, as this would undermine the political case for fiscal restraint and control. However, his officials appear to have paid more attention to their peers among economists, or perhaps they were more concerned with due diligence in their empirical work. They have to assess member states' forecasts of GDP and evaluate their consistency with fiscal plans. It cannot be ruled out that fiscal policy affects GDP; if this is ignored, then forecasts will be incorrect.

The 'Codes of Conduct' – the guides to preparing surveillance reports--prepared by Rehn's officials suggest that they are not convinced that fiscal multiplier effects can be discounted. The guide for all member states (in and out of the euro area) simply states that assumptions on real GDP growth should be underpinned by an indication of the expected demand contributions to growth (CEC 2012: 14). The code for euro area states, revised in 2013, is more explicit. It asks reporting countries to specify the assumptions on which their GDP estimates are based, including 'the estimated impact on economic growth of the aggregated budgetary measures envisaged in the DBP' (draft budget plan) (CEC 2013: 3). This estimate is also itemised in the report's first table on macroeconomic prospects. In practice, the surveillance

process thus acknowledges that the fiscal multiplier can be uncomfortably effective in some member state economies.

The possible endogeneity of GDP with respect to fiscal policy provides a good reason for officials to keep their eyes firmly on the medium term, as allowed by the Six Pack reform. It also suggests that policy recommendations to adopt structural reforms to promote growth are less likely to have perverse effects than recommendations to raise taxes or cut expenditure. And this is exactly what we find in the Commission's assessments. Member states are repeatedly urged to adopt 'growth friendly structural measures' drawn from a limited and familiar menu: pension reform, improvements to public administration, changes to wage-setting institutions, and measures to liberalize the services sector and network industries.

The Commission itself is under surveillance for the accuracy of its assessments, and its approach to structural adjustment has been subject to some criticism.⁴ In a deep and prolonged depression, there are inevitably doubts about whether economies will return to their previous levels of productive capacity. The Commission has been criticized for its estimates in the current downturn. It uses a production function methodology to estimate potential GDP and output gaps (D'Auria et al 2010). This requires it to determine the available productive inputs, converted by the production function into an estimate of potential output. Controversially, the Commission's estimates of potential employment track actual (rather than potential) employment rather closely for some countries. Spain, Portugal and

⁴ See the review in a blog by the Bruegel Institute: <http://www.bruegel.org/nc/blog/detail/article/1176-blogs-review-the-structural-balance-controversy/> as well as the campaign for different measurement of structural balances by Zsolt Darvas from Bruegel: <http://www.bruegel.org/nc/blog/detail/article/1170-mind-the-gap-and-the-way-structural-budget-balances-are-calculated/>

Ireland are all estimated as having experienced strong and sharp increases in the level of structural unemployment in recent years.⁵ This has the effect of raising the Commission's estimates of the structural deficit and the adjustment effort required to restore fiscal balance. This controversy also highlights that fiscal austerity may not be the best way to reach structural targets: measures to enhance gainful employment⁶ or deregulate the service sector could be adopted instead, and the Commission's recommendations have taken on precisely this tenor.

5. Images and mirages under the fiscal surveillance lamp-post

The fiscal surveillance lamp-post shines on two indicators: the structural balance and gross debt. It is well-known that the choice of just a few focal points can be distortive: what is gained in focus is lost in context. Again, one can easily highlight particular difficulties of interpretation created by the financial crisis. But more strikingly and profoundly, we also find that policies adopted to manage the crisis – specifically, the creation of European bailout funds – affect the interpretation of fiscal indicators, as do the moves taken towards a banking union.

⁵ See

http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp_455_en.pdf in Graph 1.

⁶ This is not to say that we consider the labour market reforms endorsed by the EU to be particularly helpful; they have arguably contributed to the dualisation of labour markets and the creation of poverty traps for working adults that even the OECD now admits.

The SGP could be criticized from its inception for referring to the structural balance including interest payments, rather than the primary balance, since fiscal authorities cannot control the interest they have to pay (Blanchard 1990). The cyclically-adjusted primary balance would be a better indicator of their discretionary fiscal position. Most of the countries attacked in the bond markets now have primary surpluses, but their interest burdens produce substantial overall deficits. These were magnified in the first rescue programs by the insistence of the lenders on setting a 'prohibitive price tag' so that official lending would only be used as a last resort (Schäuble, quoted in Gocaj and Meunier 2013: 242). As it became clear that this policy was counterproductive, interest burdens have been reduced. Greece, in particular, has benefitted from several revisions to the terms of its loans. Each reduction in the interest rate charged by the lenders brings compliance with the deficit target closer, even though it has nothing to do with the borrower's behavior.

The gross debt indicator is also problematic. As discussed in the section on Eurostat's fiscal accounting, when distressed financial institutions are rescued by governments, they may be reclassified as part of 'general government'. This will often produce a sharp one-off increase in the level of government debt, but without a corresponding deficit. Debt and deficits are related: normally, the deficit is equal to the increase in the debt. The deficit is a flow that adds to the debt stock. If the arithmetic does not add up, a 'stock-flow adjustment' (SFA) has to be made to reconcile debt and deficit outturns. The effect is that there has been a veritable explosion of SFAs since the financial crisis. Before the crisis, these SFAs were taken as indicators of 'fiscal gimmickry', ie governments gaming the deficit criterion under the SGP.

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Moreover, financial transactions that see the government taking over financial institutions raise gross debt more than net debt since the banking assets acquired are not counted against the cost to the government. For example, the gross general government debt of the Netherlands stood at 66.2% of GDP in 2011, but the net debt at just 31.8% (IMF 2012: 18). The conclusion the IMF draws is that both gross and net debt should be monitored (IMF 2012: 23), and it has the discretionary power to do this. But the EU is stuck with its gross measure.

This had striking consequences when a bailout mechanism came to be designed. One possibility for lending to Greece was to avoid the use of an EU mechanism, with individual member states lending to Greece bilaterally. But this was unattractive to the lenders, because the borrowing they undertook to on-lend to Greece would raise their gross debt, and the corresponding asset (the Greek loan) could not be set against this. In the jargon of the time, bilateral loans were ‘too heavy in terms of balance sheets’ (Renaud-Basso, quoted in Gocaj and Meunier 2013: 242). At the same time Germany, in particular, did not want to create a fund under EU authority (Barber 2010). The solution was to establish the EFSF as a special purpose vehicle of which the guarantors were partners. Yet, it turned out not to be a solution at all in accounting terms. Eurostat soon decided that the guarantees provided by non-program countries should count as part of their gross debt (Eurostat 2012d: 1). Balance sheets duly swelled.

The creation of the ESM as a permanent EU institution with its own legal personality addressed the balance sheet problem for the guarantors. Because the ESM has its own legal personality and a higher buffer of loss-absorbing capital, the credit it gives to program countries does not count as debt of non-

program countries guaranteeing ESM bond issues (Eurostat 2012d: 2-3). We can see in this instance how an institutional arrangement was adopted to produce a more favorable accounting outcome for the guarantors, without any change in the substance of their contingent liability.

Furthermore, the Council's agreement that the ESM could intervene in primary bond markets, ie buy bond issues from governments directly⁷, could give member states a breathing space and take pressure from the ECB. Last but not least, a Commission staff paper alluded to the possibility of direct recapitalization of banks by the ESM once a banking union with a Single Supervisory Mechanism was in place. While not provided for in the ESM Treaty, Article 19 gives the Board of Directors a mandate to review the instruments of the ESM. In this way, loans might be kept off the books of the borrowing countries. Spain was at the centre of this development: it pressed, in the context of proposals for a banking union, that the ESM should undertake a lending program to Spanish banks that did not go via the accounts of the Spanish government. This last idea was a step too far for Germany. Chancellor Merkel's spokesman immediately went on air and reiterated that the German government was against direct recapitalization of banks. The Commission had to retract its comments a day later, and the staff paper in question disappeared, although references to it in the reports of credible sources (BBC, Bloomberg) remain online.⁸

Many commentators have pointed out the benefits of breaking the close connection between sovereigns and banks in the Euro area (De Grauwe 2011). This should have made the Commission's proposal very attractive, not least

⁷ Treaty Establishing the European Stability Mechanism, Article 17.

⁸ Cf. URL: <http://www.bbc.co.uk/news/business-18261969> and URL: <http://www.bloomberg.com/news/2012-05-30/eu-weighs-direct-aid-for-banks-common-bonds-as-crisis-antidote.html> on 30 May 2012 (accessed November 15th, 2013).

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for the ECB. Member states' desire to avoid applying for financial assistance could delay bank recapitalizations, putting strain on bond markets and forcing the ECB to act as a permanent lender of last resort to its banks. Delay is detrimental to the effectiveness of monetary policy. The alternative to recapitalization is that banks would rebuild their balance sheets by taking cheap loans from the ECB and earning a margin from on-lending. This was the rationale of the Long-Term Refinancing Operation in 2011-12 (Schelkle 2012). But the more banks rely on this process, the larger the gap between the ECB's policy rate and bank lending rates has to be, the longer this gap will have to persist, leaving the monetary transmission of interest rates to the real economy impaired.

Yet the ECB resisted the Commission's plan, on the grounds that direct recapitalization would avoid the imposition of fiscal conditionality through a MAP. The ECB's preferred solution was that the Council should have enhanced powers to compel a member state to receive assistance (ECB 2012: observation 3). Having been compelled to take out a loan, a state would be required to prepare a MAP because of 'the close relationship between fiscal sustainability and financial sector instability' (ECB 2012: obs 6). There is indeed a close relationship, but the direction of causation runs both ways: financial sector instability has threatened fiscal sustainability.

The ECB's insistence on conditionality is puzzling, given its institutional interest in financial stability for which progress on bank recapitalization is essential. One explanation for the apparent inconsistency of the ECB's position is that central bankers are inclined to see budget balances as a matter of political willpower while they are rather fatalistic about financial market failure. Another explanation is that the ECB had failed in its own attempt to

enforce conditionality on one of the countries (Italy) benefitting from its intervention in the market for their bonds.⁹ It was therefore particularly concerned to maintain a formal institutional arrangement for extracting conditionality in return for supportive intervention.

The ECB's hard line on bank recapitalization did not prevail. The Two Pack does not require the full conditionality of a MAP for an ESM loan to recapitalize banks (Reg 472/2013, Article 7(12)). Furthermore, the Commission has moved to reduce deterrents to government-financed support for banking systems, by making it explicit that bank recapitalizations will not produce adverse verdicts under existing surveillance processes. In a letter to finance ministers in October 2013, Olli Rehn spelled out how capital injections would affect Member States' standing in relation to the debt and deficit criteria in the Pact. There is no way to exclude these interventions from the statistical measures of debt and deficits, but they can be 'taken into account as a relevant factor' in the Commission's assessment of compliance. The aim of the letter was establish, or at least to assert, 'that the EU fiscal rules provide no disincentive' to publicly financed bank recapitalizations (Rehn 2013b). We can see here that the Commissioner for the Euro is capable of sensible discretion in situations where there are no established procedures on which some member states can insist.

⁹ The ECB was bruised by its attempt to get assurance from then Prime Minister Berlusconi to cut expenditure and engage in structural reforms in return for the ECB's buying of Italian government bonds in secondary markets. On August 5th 2011, ECB President Trichet and the Italian Central Bank Governor Draghi wrote a [letter](#) (in English) with specific instructions and deadlines to the Prime Minister. Berlusconi complied, but as soon as Italian bond yields fell, he stopped pursuing the reform agenda. The ECB retaliated by reducing its bond purchases which drove yields up again, and under intense pressure from other members, the Commission and the IMF, Berlusconi had to resign in November 2011 (Bastasin 2012: 336-339).

6. Conclusion

In this chapter, we examined the evolution of fiscal surveillance under the stress of a drawn-out financial crisis. It has been claimed that Europe suffers from an ‘austerity delusion’ (Blyth 2013). The political leadership of the Commission arguably tried to keep in line with the preferences of Germany and the ECB, both insisting on the importance of fiscal consolidation at a time when private demand is depressed. It is easy to see where this impression comes from: the Six Pack and Two Pack were portrayed as bringing about more and tougher regulation of budgets. At the technical level, Eurostat follows norms that push financial sector rescues under the fiscal lamp-post.

But we have also shown that this ostentatious fiscal rectitude is tempered by recognition that the strategy of austerity can have perverse results. Several technical aspects of the fiscal surveillance structure are at odds with enhancing financial stability, including the expansive definition of general government and the accounting treatment of capital transfers to revive distressed banks. Other examples include multiplier effects on GDP when monetary policy is ineffective and resistance to meeting the fiscal costs of reviving monetary institutions if it counts towards the fiscal indicators. Fundamentally, governments could not be accused of delinquency when the deterioration of fiscal positions was clearly the result of financial collapse.

If we track through the mountains of guidance and reports produced by the Commission, we find that fiscal surveillance casts a soft and wide light. Commission officials can fairly claim to have recognized early that adherence to the fiscal rules was an insufficient basis for stability in the Euro area (CEC

2008). The reforms in the Six Pack are often presented as a ‘toughening’ of the regime, but this has not been reflected in recommendations and decisions. Instead, we find the deadlines for adjustment being pushed further into the distance with reference to ‘relevant factors’ and ‘exceptional economic circumstances’, while verdicts on current outturns continue to reflect fragile economic conditions. The strengthening of the ‘preventative arm’ of the Pact and the shifting of focus towards debt rather than deficits have served to lengthen the time horizon of surveillance rather than making enforcement more rigorous. The Commission strives to operate surveillance in a counter-cyclical way, meaning that assessments are lenient now but may become more critical in the future. Under the arrangements now in place, Commission assessments will link fiscal reporting with the Macroeconomic Imbalance Procedure, thereby expanding the range of the lamp-post if not moving away from it entirely.

Evidence for our interpretation that the Commission tried to avoid pro-cyclical fiscal restraint for non-program countries comes from the guarantor countries themselves. Finland and Germany publicly criticized the Commission’s leniency in its assessments of countries with excessive deficits that are not subject to conditionality under a loan agreement, notably France, Spain and Italy (Spiegel and Carnegie 2014). The demand for ‘discipline’ here is obviously politically motivated, allaying fears of taxpayers at home. Fiscal hawks do not concern themselves with the technical difficulty of fiscal surveillance, the ambiguity of statistical measures and the interdependence of fiscal and monetary policy. The nature of this crisis has shown the limits of the regulatory polity in fiscal surveillance (Schelkle 2009). The economic justification of fiscal rules remains ambiguous and contentious, which is why they have to be bent in practice. The tension between the requirements of

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control and the economic justification of fiscal rules has tended to be tilted in favor of good economics, at least as long as a member state is not in need of financial support.

The real problem in the conduct of euro area fiscal policy lies in the policies towards states that have needed loans. The EU institutions have proved hapless in protecting member states against market panic. Access to the common resource of low-interest public finance was left to be determined by the temperament of the bond markets. The hastily-constructed support mechanisms have indeed changed member states' incentives for enforcing fiscal compliance. To celebrate this as bringing about more market discipline, as Yiangou et al (2013) do, is perverse. Financial markets first ignored breaches of the Pact and then over-reacted to them (De Grauwe and Ji 2013). The weakness of collective institutions to counter pro-cyclical bond market pressures remains the euro area's greatest failure.

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