IN-DEPTH ANALYSIS

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How could the Stability and Growth Pact be simplified?

Euro Area Scrutiny

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How could the Stability and Growth Pact be simplified?

Abstract

An assessment of the present SGP fiscal rules reveals a significant deterioration in simplicity, undermining their effectiveness. In fact, in both design and process, they have become the most complex worldwide. Three options for future reform are offered to correct this deficiency. Under the first, the structural balance and the debt convergence targets are replaced with a debt-stabilizing or -reducing primary surplus target, while retaining the expenditure benchmark. The second consolidates all current rules into a single operational debt rule by setting a limit on the discretionary budget deficit, derived from the debt reduction target. The third option consists of a market-based approach, inspired by the oldest and most successful subnational fiscal frameworks.

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EXECUTIVE SUMMARY

Uneven implementation of the SGP fiscal rules, characterized by frequent violations of reference values and by failure in enforcement by EU institutions, including apparent disregard of the no-bailout clause mandated under the TFEU, contributed to the debt crisis experienced in some member countries. The reforms introduced in 2011-13, in response to the crisis, were intended to clarify the design and implementation of the rules, and in particular, to ensure public debt sustainability. However, an assessment of the reformed rules, applying well-known criteria of good practice, suggests that the reforms have failed to strengthen the Pact.

When compared to the original design and process, the present Pact reveals a marked deterioration in terms of complexity. In essence, the reformed version consists of four fiscal rules that are meant to clear up ambiguities in the initial version: besides the deficit reference value, the structural budget balance or surplus specified as a medium-term objective, the path of convergence to the debt reference value, and the expenditure benchmark. However, the revised rules seem excessively fine-tuned and overidentified, far beyond requirements of objectivity and automaticity. In the quest for greater flexibility, a number of exemptions, wide open to interpretation by the European Commission, now qualify the rules. Thus the initial division of roles between the Commission as the technical arm, charged with analysis and monitoring compliance, and the European Council as the political decision-maker, responsible for exercising moral suasion and levying sanctions for non-compliance, has been blurred. Yet violations of the rules without penalty continue unabated. All told, greater complexity has led to diminished transparency and weaker enforcement.

Three options for simplification are presented, with a view to strengthening transparency and enforceability of the rules. The options range from relatively marginal modifications to a more radical approach. Under all options, the initial distinction of responsibilities between the Commission and the Council should be restored; in addition, financial sanctions for non-compliance should be abolished.

The first option replaces the structural balance and debt convergence targets with a debt-stabilizing or -reducing primary surplus target, while retaining the expenditure benchmark. Exemptions are to be well-specified and significantly streamlined, subject to less discretionary judgment by the Commission. Under this and the next option, instead of financial sanctions for non-compliance, Member States could be obliged to issue junior sovereign bonds to finance any shortfall in the primary surplus requirement or any excess above the expenditure ceiling.

The second option consolidates all current rules into a single operational debt rule by setting a limit on the discretionary budget deficit, derived from a debt reduction target—all expressed in nominal amounts—announced three years in advance. Such a rule provides major benefits, besides simplicity. It obviates estimation of the structural balance, and the underlying output gap and fiscal elasticities. It provides direct, real-time control and accountability by the authorities over the operational target, and it is inherently flexible in that allows the operation of automatic stabilizers. Also, it serves as an early indicator on the need to regain fiscal space for discretionary action through periodic expenditure reviews, and if necessary, through structural reforms in taxation and mandatory spending programs.

The third option consists of a market-based approach, whereby Member States may either adopt home-grown fiscal rules or engage in discretionary fiscal policymaking. Such an approach, essentially an autonomous regime of rules, in contrast to coordinated or centralized regimes, essentially replicates the oldest and most successful subnational fiscal frameworks. Two steps taken recently by most Member States, namely, the enshrinement of SGP-compatible rules in higher-level legislation and the creation of independent fiscal institutions, should be helpful for adopting this option. However, most critical for its success is the unequivocal application of the no-bailout provision.

1. INTRODUCTION

The Stability and Growth Pact, appended as an enabling statute to the Treaty of Maastricht—consolidated under the Treaty on the Functioning of the European Union (TFEU)—, is regarded as the anchor of macro-fiscal policymaking in the European Union. In essence, as an instrument of coordinated fiscal discipline, the Pact was conceived to prevent free-rider behaviour by a Member State, with potentially adverse spillovers to the rest of the membership. Over the years, widespread complacency and fitful implementation by EU institutions and by some member governments, leading up to the financial crisis, have prompted a number of modifications with a view to strengthening it. Increasingly, however, it appears that, on the contrary, the present design and procedures may in fact undermine the effectiveness of the Pact. Hence, the basic question addressed in this paper is both highly relevant and timely.

In an attempt to answer the above question (assuming its validity), any formulation of a proposed solution requires an examination of the background of current regulations and implementation, followed by an evaluation from the perspective of good practices and a review of lessons from international experience. To this end, the paper is structured as follows. The second section summarizes the evolution of the Pact and the underlying drivers since its inception. The third provides an overall evidence-based assessment of the policy rules contained in the Pact, which provides the context for examining its alleged complexity and possible corrective measures in the fourth section. The fifth section is devoted to a survey of the nature of fiscal policy rules at the subnational level in comparable federal or quasi-federal systems, with the purpose of deriving possibly relevant lessons for the EU. The sixth section outlines options for simplifying the Pact.

2. EVOLUTION OF THE PACT

The SGP evolved over two decades from a rather straightforward set of fiscal rules, albeit subject to ambiguous interpretation, onto an elaborated collection of policy rules and procedural rules. This evolution took place mainly in response to two drivers. The first driver was a noncompliance episode by two major member governments. The second was the onset of euro debt crisis. More generally, the fiscal misbehaviour of some member governments, especially within the euro area, put in question the adequacy of certain features of the preventive and corrective arms of the Pact.

In its original version, codifying the Treaty, the Pact's preventive arm consisted of reference values for the maximum levels for the general government deficit and gross liabilities, of 3 percent and 60 percent of GDP, respectively. In addition, member governments were expected to maintain budgetary position "close to balance or in surplus" over the medium term—thereby allowing automatic stabilizers to operate, with some room for a discretionary countercyclical stance depending mainly on the underlying tax progressivity. Member governments in excess of the debt reference value were expected to converge toward the reference value over an unspecified time period. To facilitate monitoring compliance with the rules and for early identification of possible slippages, euro member governments were required to submit annual medium-term stability programs and non-euro member governments to submit medium-term convergence programs. The European Council was made responsible for rendering an opinion on each national program, on the basis of a recommendation by the European Commission.

Under the corrective arm of the Pact, failure by a member government to stay within the deficit reference value would trigger an excess deficit procedure (EDP), which in the case of non-complying euro area members eventually would call for a significant financial penalty (in the form of a fine or a non-interest bearing deposit) and a possible temporary suspension of European Structural and

Investment Funds (under EU Regulation 1303/2013) unless waived because of exceptional and temporary circumstances, such as a severe downturn in economic activity.

The Commission was responsible for determining whether the government complies with the EDP and report to the Council, which in turn was the arbiter for levying penalties in the case of persistent and unjustified excess deficits. Beyond the Pact, however, the ultimate incentive for fiscal probity was the no-bailout clause, enshrined in the Treaty, which prohibited budgetary transfers to a Member State facing a sovereign default risk on its obligations.[1]

From the early years of implementation, in several Member States, the Pact suffered an erosion of credibility on several fronts: insufficient political ownership; continued pro-cyclical stance financed in part with windfall gains from the vanishing currency risk premium; non-observance of stability or convergence programs; and questionable enforcement of the no-bailout clause.[2] The trend was exacerbated with violation of the EDP by France and Germany in 2003, as the Council failed to act on the recommendation of the Commission to impose sanctions.[3] Needless to say, this had a deleterious demonstration effect on the reputation of the Pact for the rest of the membership. Moreover, it undermined the effectiveness of the peer review process, which since then has been viewed as peer protection especially vis-à-vis large member states. As an *ex post* justification—at least in the case of Germany—of the Council's decision, in 2005, the Pact was revised to allow for excess deficits if they reflected the impact of underlying structural reforms, thus opening application of the EDP to further interpretation by the Council.

The trend in the weakening of the Pact's credibility and noncompliance continued well into the financial crisis, as the latter metastasized into the euro debt crisis. In response, there were several attempts to reform the rules toward greater precision and automaticity, while ensuring flexibility incorporating country-specific developments in the interpretation of the rules by the Commission and the Council. In 2011, the so-called Six-Pack amendments specified three policy rules: numerically calibrated convergence to the medium-term objective (MTO) of structural balance, convergence toward the debt reference value for countries in excess of that value, and an expenditure benchmark. In addition, it provides for temporary deviations and extensions in case of severe economic downturn and for early and gradual activation of sanctions for repeated violations of the EDP. Further revisions were incorporated in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the so-called Two-Pack, signed in 2012 and 2013, respectively. They include steps for strengthening Commission surveillance of national budget bills and compliance with the MTO, for adopting key features of the SGP in national legislation, for preparing independent macroeconomic projections, and for establishing independent fiscal institutions.

3. AN ASSESSMENT OF THE PACT

In order to provide context to our inquiry, it is necessary to evaluate the Pact. For this purpose, a widely accepted template of good practice for assessing the design and implementation of fiscal policy rules is used. Specifically, the rules are evaluated against such a template consisting of eight criteria:

[1] Contrary to the journalistic misuse of the term—encompassing any form of financial rescue operation—a bailout consists only of unconditional budgetary assistance.

[2] See the analysis of the crisis and of its roots in Kopits (2017a).

[3] It was hoped that the strict interpretation of the sanctions by European Court of Justice would compensate for the damage inflicted by the Council's decision; see Kopits (2004).

definition, transparency, simplicity, flexibility, adequacy, enforceability, consistency, and efficiency.[4] These criteria are to be interpreted as guidelines of good practice, rather best practice, insofar as there are unavoidable trade-offs among them. It is not always easy to improve the design of a rule under a particular criterion without sacrificing another criterion. For example, it is far simpler to prescribe and communicate a yearly budget balance rule in terms of the headline balance to be met yearly, but at a significant loss in flexibility. Although the focus of the paper is simplicity, the latter must be weighed against the other criteria of good practice.

It would be difficult, if not impossible, to assign numerical scores to the extent the fiscal rules meet the criteria. Instead, following the broad rating used by the Commission staff to evaluate the initial version of the Pact, each criterion is rated as "very good" if it is deemed to be fully met, "good" if mostly met, "fair" if partially met, or not rated at all if it does not seem to be met even minimally. [5] Although such an approach may be seen as somewhat subjective, it provides a ballpark rating of key attributes from the viewpoint of good practice.

3.1 Definition

Are the performance indicators, time-frame, and institutional coverage of the rules sufficiently well specified? A fiscal rule should stipulate clear and unambiguous conditions of compliance; sanctions for noncompliance should be explicitly stated. Performance indicators must be subject to an explicit time horizon and the spectrum of institutions covered should be broad and well defined (including, for example, quasi-fiscal activities of state enterprises). Exceptions and changes over time should be kept to a minimum.

In statutory terms, the fiscal rules and conditions under the preventive and corrective arms are well defined on all counts: performance indicators, time horizon, institutional coverage, and sanctions for violation for the rules. In fact, both the time horizon and the coverage has become more precise with the revisions. The medium-term "close to balance or surplus" is now defined in terms of the structural budget balance, with allowance for numerical country-specific deviations depending mainly on the excess over the public debt-GDP ratio over the reference value. As well, the required decline in indebtedness to the reference value is now quantified. In addition, coverage of the reference values has been expanded to include losses of many state-owned enterprises (SOEs) on an accrual basis, as they arise.[6]

3.2 Transparency

Is there scope for creative accounting and forecasting, and can compliance with the rules be monitored in real time? Generally speaking, application of the rule should follow transparent norms of accounting and forecasting, and on the basis of clear regulatory responsibilities. Rules should be applied on the basis of timely, comprehensive, accrual-based public accounts, unbiased medium-term macro-fiscal forecasts, and supported by clear financial relations within the public sector.

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[4] Formulated by Kopits and Symansky (1998), the criteria were discussed and endorsed by the IMF Executive Board. The template has been applied to evaluate fiscal policy rules in Europe (Germany, Hungary, Russia, United Kingdom, Western Balkans, and the EU as a whole) and elsewhere.

[5] Buti and Giudice (2002) applied such scoring to the fiscal rules under the Maastricht Treaty and the Stability and Growth Pact.

[6] Until recently, losses incurred by SOEs that sell more than one half of their turnover on the market are excluded from the general government debt until recognized by the government and offset with a capital injection. This loophole led to understatement of government liabilities by some Member States, such as Hungary and Portugal, where SOEs that provide public transportation services have been operating at a loss.

The revised Pact exhibits a high degree of transparency in accounting, as indicated above, extending accrual-based to SOEs as well. In addition, an effort has been made to introduce unbiased macroeconomic assumptions underlying medium-term fiscal forecasts. Some procedures have also become more transparent, particularly, as regards the mandate vested in Eurostat to verify the primary sources of data on national and fiscal accounts in member states—following years of misreporting by the Greek government, prior to the crisis, when Eurostat was not authorized to do so. Despite these steps, overall transparency seems to have deteriorated because of the significant rise in complexity of the revised Pact, and on the other, but perhaps more important, because of the increased discretion granted to the Commission in interpreting the conditions for exemptions and extensions for compliance with the rules (see below).

3.3 Simplicity

Are the rules easy to understand by politicians, economic agents, and the public at large, so as to gain widespread support for the rules? The rationale, design and implementation of the rules must be communicated easily and understood without difficulty by policymakers and stakeholders endowed with a sufficient level of financial and economic literacy. Communication and explanation of a relatively complex set of rules requires a major outreach effort. Failure to provide an adequate explanation in the case of noncompliance with a rule undermines its credibility in the eyes of financial markets and the public at large.

In an effort to cover all possible cases of deviation from the basic rules, whether justified or not, the Pact has become so complex in both statutes and process that the Commission has been compelled to issue annually a 200-page technical manual for policymakers and analysts. [7] Yet even the manual does not seem sufficient help for the news media or the public to follow the dynamics of the application and interpretation by national authorities and by EU institutions. In sum, there is increasing consensus that simplicity has deteriorated significantly as a result of the revisions and has become the most serious deficiency of the Pact, with collateral damage on its effectiveness.[8]

3.4 Flexibility

Can the rules help offset the impact of economic cycles and various exogenous shocks, or do they aggravate their macroeconomic impact? The rules should at least permit the operation of automatic stabilizers, neutralizing the impact of unforeseen deviations from the initial underlying macroeconomic projection. The rules should ensure at least a neutral, or possibly a countercyclical, fiscal stance. In addition, well-defined escape clauses should permit suspension of a rule in case of national emergency (natural disasters, severe financial crises, etc.) and accommodate structural reforms that will facilitate future compliance. The more rigid the rule (e.g., an annual headline budget balance), the greater the need to support its operation with a stabilization fund (so-called rainy-day fund).

From the very outset, the Pact explicitly has been designed to provide latitude for responding to the effects of unforeseen macroeconomic volatility, whether due to cycles or shocks. In addition, since 2005, as a further step toward flexibility, excess deficits are allowed to accommodate the short-run adverse effect of structural reform measures since they are likely to strengthen public debt sustainability over time, either by reducing future deficits and/or by improving growth prospects. The recent reforms have added further flexibility by empowering the Commission to interpret more liberally the granting of exemptions and prolonged deadlines for compliance with the rules.

[7] See the most recent edition of European Commission (2018).

[8] See the critical assessments by Andrle and others (2015), Koester and others (2012), Odor and Kiss (2017), and Wyplosz (2017).

3.5 Adequacy

Are the rules likely to achieve their objective? In particular, a debt rule should be operationally well-specified to significantly improve medium- and long-term fiscal sustainability by containing the rise in the public debt burden relative to economic activity. A set of rules intended to stamp out or minimize free-rider behaviour by lower-level governments should be supported by an effective no-bailout provision. Rules are deemed adequate if they are calibrated to reach their declared objective, and if the objective itself is adequate to correct for fiscal deficiencies, such as deficit bias, debt sustainability problem, optimistic forecast bias, composition bias, and procyclical bias.

Prior to the revisions, the EU fiscal rules displayed partial adequacy in that they were binding only with regard the deficit reference value; in reality, the debt reference value served merely as an indicative rule. The 2011 reforms obliged member governments with an excess debt position to abide by a numerically specified asymptotic convergence path to the debt reference value.[9] In addition, these countries are not allowed to incur a pre-set marginal deviation from the structural balance target. However, the three major rules seem to be running on separate tracks, as a direct linkage between an operational target (say, a limit on the discretionary budget deficit) and the policy target (the debt ratio) is missing.

3.6 Enforceability

Are the rules enforceable? Rules should be designed to provide the government direct control over the operational target, with the support of procedural rules such as the pay-go principle. Breaching a rule should trigger corrective action and possibly sanctions. Yet typically, the most effective sanction is the reputational cost of noncompliance, reflected in a highrisk premium on sovereign bonds. Therefore, especially absent a credible no-bailout provision, it may be necessary to impose legal or financial sanctions for noncompliance. Enforcement is effective if supported by procedural rules under effective public financial management with strong top-down budgetary control, if noncompliance is met with appropriate corrective action or sanctions, and if assisted by an independent monitoring institution.

Initially, it was assumed that through effective peer pressure, the rules would be observed by the national authorities, and monitored and enforced by the EU institutions.[10] Often, however, Commission recommendations went unheeded by the national authorities, including through exhortations in the context of the European Semester.[11] More worrisome is that, as the ultimate enforcer of the rules, the Council has never imposed the prescribed financial sanctions for violations of the rules, [12] apparently acting as a vehicle of peer protection rather than peer pressure.[13] The absence of effective enforcement failed to support steps taken since the crisis, which may strengthen enforcement at the national level, namely, enhanced monitoring by a newly-created independent fiscal institution and increased local

[9] Insofar as the 1/20th annual reduction is defined with respect to the excess above the 60 percent debt ratio threshold over the past 3-year moving average rather than with respect to the initial excess, the convergence path is asymptotic rather than linear.

[10] According Buti and Giudice (2002), "… a collegiate culture of stability through personal contact between policymakers and national and EU institutions" facilitates "peer pressure between national authorities and enhanced the role and authority of the European institutions."

[11] See the assessment of the European Semester by Darvas and Leandro (2015).

[12] In a recent documentation of the track record under the Pact, Hans-Werner Sinn observed that, through 2016, there were altogether 170 transgressions of the deficit reference value, of which about 50 were allowed because of a recession, while nearly 120 violations went unpunished.

[13] Allegedly, Otmar Issing described this game-theoretic behaviour as a situation where potential sinners reject passing judgment on actual sinners.

ownership through the incorporation of fiscal rules in the constitution or an organic law. Notably, however, the complexity of the revised Pact seems to have undermined compliance and enforcement.

3.7 Consistency

Is there consistency among fiscal policy rules on the one hand, and between the rules and other economic policy instruments on the other? For instance, a primary budget balance rule derived from the debt target ensures internal consistency. At the same time, compliance with the rules should help reduce or avoid fiscal dominance, and thus expand the room for the conduct of monetary policy and support macroeconomic stability.

Originally, the rules were designed to be internally consistent. Consistency between the reference values for the government deficit and debt holds under the assumption of a 5 percent nominal growth rate.[14] Since the underlying real growth and inflation assumptions did not materialize over time and across Member States, each with different starting deficit and positions, the reformed Pact called for multiple rules to be met over country-specific convergence paths. At times, however, the rules may be in conflict with each other,[15] requiring a judgment call by the Commission as to how to prioritize them. At the macroeconomic level, the fiscal rules are broadly consistent with the inflation targeting regime adopted by the ECB for the euro area and by most central banks in the rest of the membership[16]—in essence, approximating a desirable case of monetary dominance.

3.8 Efficiency

Does compliance with the rules cause distortions in resource allocation? Over time, if rules become binding, the government may be compelled to resort increasingly to distortionary improvised one-off measures to abide by the rules. In order to pre-empt improvisation, it is useful to protect a squeeze in critical discretionary outlays, especially in public investment, from expanding social entitlements or from loss in tax revenue. Proactively, for efficient compliance with debt and deficit limits, it may be necessary to embark on structural reforms in the tax system and/or in mandatory spending programs, as anticipated with medium-term budgetary forecasting and planning. Efficiency obtains when fiscal rules are observed with the implementation of lasting non-distortionary policy measures, anticipated with medium-term fiscal planning.

Generally, it is difficult to build efficiency into the application of fiscal rules; EU rules are no exception. It behoves the national authorities to apply the rules in a manner that is sustainable over an extended time horizon. For this purpose, it is necessary to undertake budgetary reforms and eschew reliance on short-term stop-gap measures. In principle, under the reformed Pact, both the preventive and corrective arms are increasingly focused on structural effort. Explicit exclusion of one-off measures under the MTO, as well as enhanced monitoring in the revised Pact, should help make application of the rules more efficient. By the same token, allowance for transitory excesses over the deficit ceiling to accommodate the effect of structural reforms should be equally helpful in this regard. Finally, elevating the importance of the debt reference value to the same level as the deficit reference value should contribute to greater efficiency as well.

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[14] Conceptually, under an assumed potential growth rate of over 2 percent and a target 2 percent rate inflation rate, a deficit ceiling of 3 percent of GDP stabilizes public debt at 60 percent of GDP.

[15] For example, although adherence to the expenditure benchmark is in principle consistent with the structural balance rule, in practice they may be in conflict with each other because of the difference in the underlying calculation of potential or trend output.

[16] In practice, however, each small- and medium-size Member State within the euro area operates under a fixed exchange-rate regime.

3.9 Overall assessment

Given the nature of fiscal policy rules, an evaluation of their quality, let alone their performance and effectiveness, does not lend itself to generalization or quantification. Although every effort is made to conduct an evidence-based assessment, there is an inevitable subjective judgment in interpreting the design and actual practices. It must be reiterated that the rating by criteria of good practice does not pretend to provide more than a broad evaluation of the SGP rules. Subject to this caveat, Table 1 summarizes the assessment of the revised Pact under each criterion, compared with an evaluation of the original version. [17]

On balance, the revised Pact seems to meet most international standards of good practice for fiscal rules. Whereas in terms of definition and flexibility the rules are rated very good, enforceability is merely fair. More troubling, however, is that the complexity tends to weaken transparency and enforceability, thereby undermining the effectiveness of the rules. Hence, it is logical to focus on the nature of this deficiency, before exploring possible corrective steps toward simplifying and strengthening the Pact.

Table 1: The SGP Rated by Criteria of Good Practice

Table 1: The SGP Rated by Criteria of Good Practice

Criterion	Original version	Present version
Well defined	+++	+++
Transparent	+++	++
Simple	++	
Flexible	++	+++
Adequate	++	++
Enforceable	++	+
Consistent	++	++
Efficient	++	++

Key: +++ very good; ++ good; + fair.

Sources: Buti and Giudice (2002) and author's update.

[17] The rating of the original Pact may be interpreted as reflecting an apparent optimistic bias by the Commission staff with regard to certain criteria. Nonetheless, an *ex ante* assessment, focused on design—in the absence of sufficient track record in application—justified a more favourable rating of the rules. In particular, the rating of the enforceability criterion as "good" seemed appropriate prior to the demonstrated failure of peer review by the Council in the 2004 case.

4. MAIN WEAKNESS: COMPLEXITY[18]

From the perspective of simplicity, the 2011-13 revisions of the Stability and Growth Pact seem to be counterproductive. Indeed, as it stands, it ranks as the most complex rules-based fiscal framework worldwide. The complexity encompasses both design and process, undermining transparency and enforcement and potentially damaging the goals of fiscal discipline and sustainability in Member States. This section seeks to identify the nature of the problem and sets the ground for arguing that the rules can in fact be simplified, with likely gains in overall effectiveness.

4.1 Design

The design of the four basic rules in the present version of the Pact attempts to improve in a number ways of the original design through increased objectivity and automaticity, while taking into account country-specificity and flexibility. These goals are to be accomplished by quantitative fine-tuning: maintenance of, or convergence to, "close to balance or surplus" in terms of structural balance in the MTO; reduction in the debt ratio toward the debt reference value; an expenditure benchmark in support of the other rules; and retention of the deficit reference value, to be observed when all else fails. But well-known measurement issues bedevil the calculations underlying these rules in real time, especially as regards the structural balance,[19] its conceptual superiority as a fiscal rule notwithstanding.[20]

While in general terms the design of each rule has its rationale, their interaction seems questionable, resulting in likely overidentification and inconsistencies. An added complication is the proliferation of exemptions—to accommodate structural reforms, pensions, investment, and expenditure related to refugees and earthquakes or other unusual events—and country-specific circumstances that need to be resolved in implementation. Under the preventive arm, the combination of these flexibility clauses with a matrix specifying numerically the required adjustment at various points in the cycle result in scope and incentive for serial and cumulative deviations from the adjustment path toward the MTO; furthermore, such deviations are not subject to *ex post* verification or compensation.[21]

Disregarding the flexibility clauses, a stylized country-by-country simulation suggests that, in most Member States, the structural balance rule is legally the most binding for achieving and abiding continuously by the reference values.[22] In all, however, the greater precision of the rules is achieved at a significant cost in terms of complexity.

[18] Complexity of the rules is a deficiency in terms of both blueprint and application, as distinct from failure in enforcement that is only manifest in the application of an appropriate design.

[19] Besides the controversy about estimating the potential growth rate, output gap, and fiscal elasticities, it is also necessary to capture the effect the asset price bubbles, as demonstrated by the failure of doing so in Ireland in the run-up to the recent financial crisis; see Kanda (2010).

[20] Given the political will, along with cautious application with a margin, the 2 percent of GDP structural surplus rule has served well Chile and Sweden in reducing the debt ratio and maintaining a high growth rate over an extended period.

[21] See European Fiscal Board (2017).

[22] See Barnes and others (2012).

4.2 Process

Ironically, the potential rigidity of excessively fine-tuned rules in the revised Pact has been diluted by the increased latitude of the Commission to interpret the rules in evaluating compliance. In the quest for greater flexibility, a number of exemptions and extension of deadlines for compliance, wide open to interpretation by the Commission, in fact qualify the rules. Accordingly, the Commission has been granting longer deadlines than envisaged under the revised Pact for complying with the MTO or the EDP.[23] Such forbearance was in line with Jean-Claude Juncker's declared goal of a "more political" Commission when he assumed the presidency in late 2014, blurring the distinction of responsibilities between the Commission and the Council. This is a departure from past practice, when the Commission was the technical body charged with analysis and monitoring compliance, while the Council assumed the political decision-making role in exercising moral suasion and levying sanctions for non-compliance, respectively, under the preventive and corrective arms of the SGP.

In the latest step, taken in 2017, toward further flexibility in interpreting the SGP, the Commission formally announced a "margin of appreciation" or "margin of discretion" to be invoked in cases where the impact of a large fiscal adjustment on growth and employment is deemed to be significant.[24] In the opinion of the European Fiscal Board (2017), "While flexibility is desirable, the growing number of flexibility provisions under the SGP is increasingly perceived as lacking transparency and, at times, to be determined in an ad hoc manner, including in response to political considerations." As an upshot, violations of the deficit reference value continue unabated since the reforms. All told, greater complexity has led to increased opacity and weaker enforcement.

5. LESSONS FROM INTERNATIONAL EXPERIENCE

In order to explore ways to simplify and strengthen the SGP, it is useful to survey the international experience of subnational government finances, with a view to drawing possible lessons that may have some relevance for the EU insofar as the latter is, *mutatis mutandis*, a collection of governments under a supranational authority. Fiscal systems vary worldwide over a wide range between unitary and federal regimes. Under the unitary regime, subnational governments are administered centrally with a fully consolidated budget and taxation throughout the country—as for example in France. In a federal regime, subnational governments operate more or less independently from the central government, following to a greater or lesser degree the subsidiarity principle in the allocation of expenditure responsibilities and in the assignment of tax bases and revenue at different levels of government. From the perspective of the EU, given a high degree of fiscal decentralization, unitary systems bear no relevance for the SGP.

Broadly speaking, federal systems in the context of a monetary union can be classified in two basic types. The more prevalent type, closer to a unitary system, follows a coordinated "top down" approach whereby subnational governments are legally bound to follow a mutually agreed set of uniform fiscal rules under a national government. As a corollary, subnational governments operate under an explicit

[23] Specific cases of prolonged deadlines include Spain and Slovenia, and on repeated occasions France and Italy.

[24] In the first application of the margin, the Commission's (2017) country-specific recommendations for Italy, explicitly state that "… the assessment of the Draft Budgetary Plan and subsequent assessment of the 2018 budget outcomes will need to take due account of the goal to achieve a fiscal stance contributes to both strengthening the ongoing recovery and ensuring the sustainability of Italy's public finances. In that context, the Commission intends to make use of the applicable margin of appreciation in the light of the cyclical situation of Italy."

or implicit guarantee—by either statute or precedent—of financial assistance by the central government in case of insolvency. For example, in Germany, in cases of insolvency, the constitutional court has ordered a bailout of lower level governments by the federal government. For the most part, in such circumstances, financial assistance is provided without substantive conditions.[25] In these countries, risk premia of national and subnational government bonds tend move in tandem, with no significant yield spreads.

The second type of federal regime, prevalent in Canada, Switzerland and United States, is characterized by an autonomous "bottom-up" approach that allows each subnational government to conduct a discretion-based fiscal policy or to adopt a rules-based framework. Over time, most subnational governments in these countries chose to adopt a "golden rule" whereby they are committed to maintain balance between current revenue and current outlays, limiting borrowing for capital expenditure only. While fiscally independent from the central government,[26] subnational governments in these countries are subject to an informal but effective no-bailout principle, tested and strengthened over a long time, including at the lowest levels of government.[27] Furthermore, in these countries, the monetary authority does not hold subnational government paper in its balance sheet—even under a quantitative easing program—and payments among subnational jurisdictions are normally settled by the end of each year.

A major lesson from the experience with the autonomous approach is that pressures from well-functioning financial markets prevent free-rider behavior by subnational governments. Absence of an explicit or implicit guaranteed bailout prompts the markets to assign risk premia and credit ratings on subnational government bonds that reflect concerns about the debt sustainability of the issuing government. Subnational governments, in turn, tend to respond to these concerns by introducing corrective measures in their finances. In Switzerland, half a dozen cantons ran into financial difficulties in the 1990s due to losses incurred by cantonal banks; consequently, they were forced to consolidate their public finances on their own, without any federal transfers. In the United States, the recent fiscal adjustment undertaken in the state of California is equally a case in point. Given a protracted deterioration in budgetary performance, reflected in the accumulation of payment arrears (covered partly by the issuance of promissory notes to state employees and to suppliers), coupled with local legislative reluctance to raise taxes or cut social entitlements, the state government suffered a marked loss of confidence and downgrading in financial markets.[28] As a result, the state had no choice but to undertake a major fiscal adjustment, lacking any financial support from the federal government.

This lesson has some relevance for national governments joined under a supranational government, within a currency union, such as the Economic and Monetary Union. Admittedly, there are a number of differences in the fiscal framework between the euro area and comparable federations, including a

[25] In some countries (including Argentina, Brazil and India), conditions for assistance are specified in bilateral memoranda of understanding between the national and subnational governments, which in fact are rarely followed by the latter.

[26] Fiscal independence of state governments is enshrined in the 11th amendment to the U.S. Constitution.

[27] Following a long trail of subnational government bailouts (McGrane, 1935), since the 1840s, the U.S. Congress has declined to rescue state governments in financial distress. Lower-level governments facing bankruptcy, as illustrated by the well-known cases of Orange County, New York City and Detroit, had to undergo painful budgetary adjustments. Similarly, in the Swiss canton of Valais, the no-bailout principle was upheld in court in the recent bankruptcy of the city of Leukerbad.

[28] In early 2010, the CDS spread on 10-year government bonds in both the state of California and Greece (following the revelation of gross misreporting of national and public accounts) had reached about 300 basis points.

relatively large central budget in the latter.[29] However, from an economic standpoint, the only significant difference is the legacy debt of several Member States that far exceeds the magnitude of outstanding liabilities of subnational governments in federations under an autonomous regime.[30] Other apparent differences are far less critical.[31]

Interestingly, the fiscal regime embodied in the TFEU can be regarded as a mongrel, combining the coordination and autonomous approaches, through the SGP rules and the no-bailout clause, respectively. However, instead of these two pillars reinforcing each other, as initially envisaged, the upshot has been a failure to bring about fiscal discipline and prevent crises in some Member States, owing to erosion of credibility of the rules and of the clause. Arguably, voluntary adoption of national fiscal rules—preferably under the tutelage of national independent fiscal institutions—following the autonomous model, without the Pact, might have been more effective in preventing the euro debt crisis.[32] An additional, albeit related, lesson to be drawn from the historical experience of Swiss and US subnational governments is the probable causality between the no-bailout principle and subnational fiscal rules. The enforcement of the principle, merely by precedent and not by statutory obligation, has contributed to the adoption of balanced-budget rules by most subnational governments, in the face of market pressure.

6. OPTIONS FOR SIMPLIFICATION

The following three options intend to simplify the design of the rules under the Pact, while serving the overarching goals of fiscal discipline and public debt sustainability in member countries. Besides attempting to correct the major weakness of complexity, each option should be helpful in fostering transparency and compliance, currently undermined by intricate regulations and formula, which are difficult to communicate to policymakers, analysts, and the public at large. The options range between least to most radical solutions. The first option consists of a blend of key rules, with marginal modifications. The second is a bolder variant that replaces the current rules with a single rule that confers direct control over implementation to national budgetary authorities. The third offers a more radical market-based alternative inspired by subnational rules successfully applied elsewhere. A common denominator for all three options is to streamline the current set of rules, with very few

[29] See for example Hagelstam and others (2017) for a comparison of fiscal frameworks in the EU and the US.

[30] Whereas the public debt ratio of several euro area members stands at 100 percent or more, none of the US states has a debt ratio in excess of 25 percent of GDP. Among the latter, however, a number of states have accumulated sizable contingent liabilities (defined pension and health-care benefits for their employees), circumventing the golden rule, which may not be sustainable over time without a major adjustment effort at the state level in the future.

[31] The argument that, upon sovereign default, a US state would always remain within the union, while a euro area member may be forced to quit the EU—albeit permitted under Article 50 of TFEU—has been invalidated by the case of Greece. Equally, the argument that the federal unemployment insurance is a critical factor in support of the US fiscal framework is questionable; US unemployment benefits are financed from earmarked federal and state payroll taxes paid by employers and employees at rates that vary widely across states. In general, however, in any federal system, the greater are the expenditure responsibilities assigned to the central government, the lower tends to be the budgetary burden on lower levels of government.

[32] A necessary condition for such an outcome would have been for the ECB and commercial banks to adjust the value of government bonds for risk, rather than treating them as riskless collateral. In fact, failure of the ECB and banks to differentiate sovereign bonds by risk prior to the crisis was interpreted by financial markets as a signal that the no-bailout clause would not be enforced—as reflected by minimal, if any, spreads in interest rates and in CDS on government paper; see Kopits (2017a).

exceptions and maximum automaticity in application, thereby eliminating a number of regulations and reducing intervention by EU institutions.

Under all options, the emphasis of the rules is placed on policy decisions and political will, instead of the present focus on actual outcome in terms of fiscal performance. In addition, in conformity with the current design, the ultimate goal is to maintain or regain fiscal sustainability through an effective limit or decline in public indebtedness. The options require minimal amendments of the TFEU. To be sure, interpretation of the no-bailout provision under Article 125 would be strengthened with the requirement that any financial support from the ESM[33] of an adjustment program by a Member State be provided under strict conditionality, prioritizing the introduction of macro-critical structural reform measures. Observance of the reference values on government deficit and debt would remain in effect, as stipulated in Article 126 of the Treaty, possibly except under the third option.

A major innovation under any option should be the repeal of financial sanctions because of their procyclicality if levied during an economic downturn, and more important, because of the Council's demonstrated failure to impose them on noncomplying Member States. A far more effective penalty, under the first and second reform options, would be an obligation for a Member State to issue junior sovereign bonds (so-called "accountability bonds") to finance excess deficits incurred under the EDP.[34] Conversely, a Member State would deposit excess surpluses in its own special-purpose stabilization fund—much like under the "debt brake" rule effective in Germany and Switzerland—which would be tapped to finance excess deficits prior to issuing such bonds.

Monitoring compliance with fiscal rules, and more broadly, maintenance or progress toward public debt sustainability, remains a critical feature under the first and second options. Given its technical expertise, the Commission should recover this role and eschew any political decision-making or messaging role toward member governments, to be left to the Council. The process for undertaking these roles would also benefit from some simplification. In particular, fiscal policy surveillance conducted under the European Semester could be streamlined, perhaps emulating in some respects the approach of other international financial institutions with respect to member countries, while complementing their assessments rather than duplicating them.[35]

The establishment of independent fiscal institutions in Member States, pursuant EP Regulation 473/2013, is a welcome development as, in most countries, they are charged with close-up monitoring of the government's annual budget bill and medium-term budgetary programs, underpinned by its own unbiased macrofiscal no-policy-change forecasts. The institution's surveillance responsibility is specified in national legislation, which typically embodies the country's own fiscal rules as well. By implication, the oversight responsibility extends to the national rules, rather than to the SGP rules. Therefore, even the appearance that such institutions are operating as agents of the Commission or the Council could damage their reputation of independence. In Europe, apart from a few well-

[33] This should include financing through various indirect channels, such as the Target 2 settlement system.

[34] Fuest and Heinemann (2017) discuss the rationale and mechanics of the proposed "accountability bonds." These bonds are intended to deter the issuing government from violating the fiscal rules because of the increasing risk premium to be paid to bondholders, including to banks that would have to finance such bond purchases with equity. Basic assumptions underlying the proposal are that these bonds would not affect the value of regular bonds and that there is a sizable market for comparable junk bonds.

[35] Annual Article IV consultations and country reviews conducted respectively by the IMF and the OECD have a long history.

established institutions (Netherlands, Sweden), the majority of independent fiscal institutions are of recent vintage and still rather fragile; hence, their effectiveness in most cases is yet to be ascertained.[36]

Lastly, any of the three options, and particularly the third one, would benefit from a closer fiscal and banking union, including the establishment of a central EU budgetary authority, which would be endowed *inter alia* with a common EU-wide stabilization function—in line with the subsidiarity principle. A review or evaluation of various proposals for further fiscal integration, however, lies beyond the scope of this paper.[37]

6.1 Partial consolidation

The rules under the Pact have proliferated in the pursuit of three objectives: adherence or convergence to structural budget balance, through country-specific MTOs, while subject to the deficit reference value; containment of government spending to a cyclically neutral path through the expenditure benchmark; and stabilization or convergence of public indebtedness relative to economic activity, to the debt reference value.[38] The present reform option is meant to streamline the design of the rules in line with these objectives.

This option consists of a rule that links the budget balance and debt sustainability objectives through a single policy reaction function. The latter is derived from the well-known debt-stabilizing primary balance condition, which rests on the equivalence between the primary surplus and the interest rate-growth rate differential qualified by the existing debt-ratio. The reaction function is augmented by the yearly target decline in the debt-GDP ratio.

In algebraic terms, given a target debt ratio d^* for year n that is lower than actual d in year t,

$$d_n^* < d_t \quad ,$$

the required primary budget surplus rule can be stated as:

$$s_t^* \geq \left(\frac{r-g}{1+g}\right) d_{t-1} + \Delta d_t^*$$

where for each year t, s^* is the required primary surplus, r the interest rate, g the growth rate, and Δd^* the target annual debt reduction to reach d^* in year n. The higher is the interest rate, or lower the growth rate, or higher the debt ratio, or higher the target yearly reduction in the debt ratio, the higher is the minimum primary surplus required under the rule.[39]

[36] Kopits (2018) discusses some misconceptions about independent fiscal institutions and clarifies the assessment of the institutions' effectiveness. In fact, their influence is rather subtle in that it is mostly exercised in a pre-emptive fashion in that the preparation of new tax or spending proposals by the government tend to be conditioned by the anticipated reaction and quantitative analysis by the independent fiscal institution.

[37] See, for example, the recent proposals by Kopits (2017b) and Benassy-Quere and others (2018).

[38] As indicated in footnote 15, some of these rules are potentially in conflict with each other because of measurement issues.

[39] Goldfajn and Guardia (2004) describe a similar fiscal rule adopted in Brazil, effective 2001, requiring a linear reduction in the net general government debt from about 55 to 40 percent of GDP over a 15-year period, which successive governments failed to implement.

A practical issue is the quantification of *s*, *r*, and *g*. In order to avoid procyclicality, these variables should be expressed as medium- to long-run steady-state values, subject to revision periodically as warranted. For simplicity, *r* can be estimated from the average interest rate on government debt outstanding and *g*, the trend or potential growth rate can be calculated as the growth rate underlying the expenditure benchmark. The primary surplus could be defined in structural terms, with all the attendant shortcomings inherent in the calculation of the MTO. In addition, the present primary expenditure benchmark would be maintained to complement the primary surplus rule.

Thus, the new rule would integrate and replace the formula for both the MTO and the debt convergence criterion, pruning most current exceptions and various adjustments such as the stock-flow adjustment. These would become redundant since the compliance with the new rule is predicated on observance of the required primary surplus instead of the actual achievement of the annual target reduction in the debt ratio. All other elements of the present design would be retained, namely, the reference values for the budget deficit and debt, as well as the asymptotic convergence to the debt reference value. Member countries that have a debt ratio lower than, or equal to, d^* would target the debt-stabilizing surplus and be bound by the deficit reference value only.

Alternatively, these rules could be specified abstracting from estimates of potential output, the output gap and the structural balance, in a manner that resembles Sweden's highly successful rules. The latter simply mandate a budget surplus over the cycle (allowing for automatic stabilizers and discretionary countercyclical measures) and a primary expenditure ceiling expressed in nominal terms.[40] (Sweden can dispense with a debt reduction rule given that by now its actual debt ratio lies well within the reference value.) The Swedish Fiscal Council has monitored closely compliance with these rules, without ever incurring an excess deficit procedure status, consistent with the Pact.

6.2 Operational debt rule

Ideally, the simplest approach should integrate all present rules into a single fiscal rule that aims at public debt sustainability, the ultimate goal of the Pact, and yet is under the operational control of the policymaker in real time. Derived from the target debt level, the operational target is an annual ceiling on the discretionary budget deficit,[41] amenable to continuous monitoring and control. In the course of the budget execution, the decision-maker is bound only by this ceiling and can be held fully accountable for compliance.

The rule under this option, linking the policy target to the operational target, all expressed in nominal amounts, can be summarized as follows. Each year *t*, the government sets the target reduction in debt ΔD^* (which can be zero if $d \leq d^*$) to be realized in the future, say, three years later, in year *t*+3. This allows the government to calculate the target primary surplus S^* for t+3 required to cover the forecast interest bill plus the target debt reduction that year

$$S^*_{t+3} = r^f_{t+3} D^f_{t+2} + \Delta D^*_{t+3}$$

[40] The expenditure ceiling applies to 27 categories of nominal expenditure, which can be tracked relatively easily, without having to rely on GDP estimates (to calculate expenditure ratios), not observable in real time. See the analysis by Lindh and Ljungman (2007).

[41] The discretionary balance in the budget is given by the difference between nontax revenue and non-mandatory expenditures, as distinct from (or complement to) the mandatory balance calculated from tax revenue less interest payments, transfers under entitlement programs, and other expenditures mandated by law.

In year t+1, the government derives the discretionary budget deficit limit B* for t+3 from the difference between the target primary surplus and the forecast of mandatory components M of the budget

$$B^*_{t+3} \geq S^*_{t+3} - M^f_{t+3} \quad \text{where} \quad S^*_{t+3} < M^f_{t+3}\,.$$

In year t+2, the government incorporates the target discretionary deficit limit and the mandatory forecast into the budget bill for execution in t+3. This recursive process is then repeated every consecutive year. Key ingredients in the design of the rule include medium-term forecast of the rates of interest and inflation, but more important, the forecast of major mandatory components of the budget.

Hungary introduced a full version of the operational debt rule, complemented with a procedural pay-go rule,[42] with the purpose of containing the rise in public indebtedness, driven by a persistent deficit bias and time inconsistency.[43] Besides simplicity, the rule has a number of practical advantages over the present SGP rules and over the first option for reform, in terms of transparency, accountability, and as an early warning indicator of the need for an expenditure review plus structural reform, without sacrificing flexibility.

On simplicity, the operational debt rule is superior in design, replacing the three SGP rules, obviating real-time estimates of potential GDP and of the output gap, as well as of tax and expenditure elasticities, to calculate the structural budget balance. Greater transparency obtains not only by eliminating the uncertainty surrounding such estimates, but also by preannouncing targets well before budget legislation and execution: targets for debt reduction and for primary surplus three years in advance, and limit on discretionary budget deficit two years in advance.

Accountability is enhanced by holding the decision-maker responsible for compliance since he or she has direct control of the discretionary expenditures during the budget execution. It is understood that the actual level of tax revenue, mandatory outlays and macroeconomic developments are beyond his or her control. Thus, the authorities focus on meeting an operational target (discretionary deficit) stated in nominal terms, rather than an elusive policy target (debt stock) expressed as a ratio of GDP, which is tends to be more open to manipulation.

Forecasts of mandatory components against the primary surplus target help anticipate the space available for discretionary action. This creates an incentive for the government to conduct periodic expenditure reviews in order to reduce the discretionary deficit to stay within the targeted limit. If such reviews have exhausted the scope for pruning discretionary expenditures, then the rule serves to alert policymakers about the possible need for structural reform to generate additional fiscal space. Accordingly, as the scope for discretionary expenditures becomes increasingly narrower, the government may find it necessary to consider raising taxes and/or cutting social entitlement programs, in order to meet the debt reduction target.

[42] The original pay-go rule requires that any proposed mandatory expenditure increase or any tax cut be accompanied by a cut in mandatory outlays or a tax increase with an equivalent budgetary impact over the medium term.

[43] Hungary incorporated the rule in the Fiscal Responsibility Act of 2008, while experiencing the threat of a sudden stop in capital inflows from abroad following the collapse of Lehman Brothers. As the threat subsided, in 2011, the new government abolished both the rule and the independent fiscal council charged with monitoring compliance. For a detailed discussion of the rule and the council, see Kopits and Romhanyi (2013). In the United States, the Budget Enforcement Act of 1990 provided a successful tool of budgetary discipline, with the combination of discretionary spending caps and the pay-go rule, as discussed by Reischauer (1993).

The rule is flexible in that it allows for the operation of automatic stabilizers, insofar any deviations in the mandatory components from the forecast, due to unexpected variations, are treated as "bygones are bygones." The latter need not be assessed through estimates of the structural balance or compensated with offsetting measures. By design, the rule is inherently neutral with respect to an economic cycle or shock, regardless of magnitude and duration. An unanticipated shock in tax revenue between year t+1, when the forecast of mandatory items (including tax revenue) for year t+3 is prepared, and year t+3, when the mandatory items are realized, has no bearing on the operational discretionary deficit target. Obviously, the effect of the shock, if persistent, would need to be incorporated in forecasts for subsequent years.

6.3 Market-based approach

Among these reform options, the most radical and simplest is a market-based approach. In essence, this implies a fiscal framework in which each member government decides to choose (or not to choose at all) its own set of rules, as it faces financial markets for holding its sovereign bonds.[44] As mentioned, two important post-crisis developments facilitate such an approach. Enactment of rules in the national constitution or a law, broadly compatible with the SGP framework, strengthens local ownership of the rules. Concomitantly, establishment of a well-functioning independent fiscal institution ensures local oversight over compliance with the rules.[45]

This autonomous "bottom up" approach essentially would replicate *mutatis mutandis* the decentralized fiscal system that prevails in Switzerland or in the United States. Both countries have had a lengthy and successful experience—unlike countries where subnational governments are subject to a coordinated "top down" approach—with minimal moral hazard and free-rider behaviour by subnational governments. Although the rules are implemented with different degree of stringency across subnational governments, the regime has achieved a high degree of fiscal discipline at the subnational level. In both countries, the unequivocal enforcement of the no-bailout principle, albeit without a statutory basis, has proven indispensable for the success of the approach. As noted, enforcement of the principle led to the adoption and observance of fiscal rules by subnational governments in these countries.

In the EU context, under this option, the no-bailout principle must be reaffirmed repeatedly, closing any backdoor channels—including through the Target settlement mechanism—that may serve as a less-than-transparent violation of the principle. In calculating capital adequacy ratios, banks and other financial institutions should account for member government bonds adjusted for risk. Likewise, the ECB should adjust for risk the value of sovereign bonds presented as collateral. Finally, in the event of a crisis, the European Stability Mechanism (or a prospective European Monetary Fund) would only provide financing to a crisis-hit member state under strict conditionality—as foreseen in Article 136.3 of TFEU.

[44] This approach envisages the delegation of the design of, and accountability for, fiscal rules to Member States, but does not preclude effective euro area macroprudential and banking regulation and supervision, along with a common deposit insurance scheme at the supranational level. Thus, it overrides the two-dimensional grid presented by Hagelstam and Margerit (2017) regarding the evolution of EMU.

[45] The track record of Member States that have adopted their own national rules and independent fiscal institutions in recent years so far has been mixed, depending largely by each State's post-crisis learning curve. To be sure, the States that have followed internationally accepted good practices—outlined above for fiscal rules and the OECD Principles for independent fiscal institutions—for a longer period have been the most successful, as demonstrated for example by the Netherlands and Sweden, and more recently, the United Kingdom.

A major question involves the functions and authority of EU institutions under a market-based approach. To be sure, the technical monitoring role of the Commission and Eurostat would prevail. Although perhaps subject to a broader interpretation, deficit and debt reference values would remain in place as guidelines. The Commission would publicly flag to the Council persistent failure of a member government to adhere to the deficit reference value or to converge toward the debt reference value. The Council, in turn, may impose a legal penalty (for instance, loss of voting rights in the Council) on a Member State upon determining a gross and continuous violation of the reference values. Yet there would be no need to levy a financial sanction, since the government would suffer from a downgrade in terms of a penalty interest rate on its bonds. Anyway, the threat of financial penalties, as discussed, has lost all credibility over the years.

In any event, a common currency area is to be usefully complemented with a banking union, as well as a central budget responsible for financing well-defined supranational tasks, in line with the subsidiarity principle. Accordingly, this rationale for establishing a central budget responsible for financing EU-wide stabilization is particularly strong under the third option, as suggested above.

More important, the feasibility of the market-based approach depends on an orderly drawdown of a significant portion of legacy debts—though precluding transfers among Member States—[46] that may be inevitable in the euro area under the existing SPG or under any selected option for further reform. In any event, a viable solution of the debt legacy problem must be accompanied by a meaningful structural reform effort by highly indebted Member States on several fronts (taxation, public pensions, health care, and other mandatory spending). Indeed, structural reforms can go a long way toward a reduction in the public debt ratio, sustained through a virtuous circle by stimulating growth, as illustrated for instance by the case of Ireland since the late 1980s and of Sweden since the mid-1990s.

7. CONCLUSION

An examination of the design and operation of the SGP, in the light of an international template of good practice, confirms that the post-crisis reforms have rendered the EU fiscal rules increasingly unmanageable in complexity. As a collateral damage, the Pact has become more opaque and less enforceable, outweighing any benefits in terms of flexibility. The excessive statutory fine-tuning of the rules are found to be undermined by the wide latitude for discretion assumed by the European Commission in interpreting and evaluating compliance, which in turn is compounded by the *de facto* absence of imposition of any sanctions by the Council as prescribed *de jure* for noncompliance.

In order to correct the significant decline in simplicity of the Pact and to strengthen its effectiveness, three options for further reform—rooted in rules-based frameworks that have been adopted elsewhere—are outlined for consideration. All three options are compatible with virtually any proposal for further EU-wide integration of fiscal policymaking. But a review or evaluation of such proposals, however, lies beyond the scope of this paper.

The first option replaces the structural balance and debt convergence targets with a debt-stabilizing or -reducing primary surplus target, while retaining the expenditure benchmark. Exemptions are to be well-specified and streamlined, subject to less discretionary judgment by the Commission. Under this and the next option, instead of requiring the Council to impose financial sanctions for noncompliance, an alternative could be the obligation for noncomplying Member States to issue junior sovereign bonds to finance any shortfall in the primary surplus or any excess above the expenditure ceiling.

[46] Cioffi and others (2018) propose a redemption fund for the euro area that pools together excessive sovereign debt of Member States and redeems it gradually over time, without significant cross-country redistribution.

The second option consolidates all current rules into a single operational debt rule by setting a limit on the discretionary budget deficit, derived from a debt reduction target—all expressed in nominal amounts—announced three years in advance. Such a rule provides major benefits, besides simplicity. It obviates estimation of the structural balance and the underlying output gap and fiscal elasticities. It provides direct, real-time control and accountability by the authorities over the operational target; it is inherently flexible in that allows the operation of automatic stabilizers. Also, it serves as an early indicator on the need to regain fiscal space for discretionary action through periodic expenditure reviews, and if necessary, through structural reforms in taxation and mandatory spending programs.

The third option consists of a market-based approach, whereby Member States may either adopt home-grown fiscal rules or engage in discretionary fiscal policymaking. Such an approach, essentially an autonomous regime of rules, in contrast to coordinated or centralized regimes, essentially replicates the oldest and most successful subnational fiscal frameworks. Two steps taken recently by most Member States, namely, the enshrinement of SGP-compatible rules in higher-level legislation and the creation of independent fiscal institutions should be most helpful for adopting this option. However, most critical for its success is the unequivocal application of the no-bailout provision. In addition, the feasibility of this option depends on the satisfactory treatment of a significant portion of legacy debts, which seems necessary anyway regardless of the existing or the envisaged fiscal framework, to be accompanied by meaningful structural reforms by highly indebted Member States.

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This document was provided by the Economic Governance Support Unit at the request of the ECON Committee. This study suggests a possible simplification of the Stability and Growth pact, whose design and process have become the most complex worldwide. Three options for future reform are offered to correct this deficiency.

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