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Framework in the Euro Area?**

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By

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Abstract:

The rules stipulated by the Stability and Growth Pact have proved impossible to enforce. However, to avoid unsustainable fiscal policies reappearing, and to prevent monetary policy from being undermined by self-interested governments, there is still a need for a fiscal framework within the Euro Area. To achieve co-ordination between monetary and fiscal policies, this paper suggests an intertemporal assignment, where fiscal policy focuses on long-term objectives (e.g., social security, public provision of education and research) and monetary policies focus on short run objectives (macroeconomic stabilisation). Specifically, we suggest public debt targets as a practical way to achieve such a set up without compromising the independence of monetary policy. An excessive debt protocol is proposed to give concrete form to this targeting arrangement, and as a mechanism to identify the stable region within which the debt target must operate. Making these factors explicit would both improve the credibility of the Euro Area's fiscal policies and reduce the risk premia in borrowing costs. However stabilising the stock of debt by fiscal means alone is not always possible. We therefore examine the role of "internal devaluations" as a means of circumventing those barriers. This framework provides the analytic support to underpin many of the innovations currently under discussion in Brussels.

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1. Introduction

Prior to the outburst of the financial crisis in September 2008, public finances in the European Union (EU), including the countries in the euro area (EA), were in reasonable shape. In fact, the average deficit-to-GDP ratio was close to 3%, and the average debt-to-GDP ratio was around 60% (EU Commission, 2010). In other words, for the EU taken as a whole, fiscal policy had been conducted more or less in line with the Stability and Growth Pact (SGP).

However, over the last couple of years, the stance of fiscal policy has deteriorated massively. Public finances across the globe are now in a worse shape than ever before in peace time, and fiscal policy is on an unsustainable path in nearly all countries. The budgetary crisis in Europe has received most attention, not least due to the desperate situation in Greece, but it is noteworthy that public finances in Europe *overall* are stronger than in the UK, USA and Japan.

Behind the average figures in the EA - a public debt ratio of more than 80% and a deficit ratio of nearly 7% - lurk significant differences between the member states. For example, Finland and Sweden have strong public finances, whereas the so-called PIIGS (Portugal, Italy, Ireland, Greece and Spain) have very high debt and deficit ratios. And in between are Germany and the Netherlands, although with public finances not yet strong enough to satisfy the Maastricht criteria.

There are several reasons for this dramatic worsening of public finances. One is the direct increase in public expenditures associated with the rescue packages for banks and other financial institutions after the financial crisis. Another is the automatic rise in expenditures and fall in revenues in the economic downturn due to the operation of built-in stabilisers. Moreover, public revenues have fallen as a result of the slimming of the housing and financial sectors, and the loss of output and employment that followed over the last two years.

This fiscal misery may have serious economic consequences. First, it is well-known that high deficit and debt ratios can lead to dramatically increasing risk premia on interest rates, reflecting risk of sovereign default, which in turn may not only reinforce the fiscal troubles but also be harmful to private investment etc. Second, there is growing evidence that debt ratios above 90% may adversely affect economic growth (Reinhart and Rogoff, 2009; Checherita and Rother, 2010). In fact, the US and UK debt-to-GDP ratios are expected to exceed 90% already by 2011 (Buiter, 2010).

Against this background, concerns about explosive debt developments seem well founded. While simple in principle, it appears to be difficult for EA members to implement the fiscal pain needed to bring their public finances in order. In any case, governments hesitate to raise taxes and/or cut expenditures. This reflects more a populist attitude of “won’t pay” rather than “can’t pay” which might, in a longer term perspective, pose a threat to the survival of the euro. So, there seems to be a need for a policy framework which (a) allows for short-term stabilisation policies to be carried out, (b) allows policymakers to choose a size of the public sector as they want, and (c) constrains the behaviour of fiscal authorities so as to avoid unsustainable fiscal deficits.

This paper is primarily concerned with the setting of fiscal and monetary policies in the EA, but we also review the difficulties caused by how those policies interact with policies of structural reform. We treat the policy making framework as a whole, rather than the detail of how different policies might best be constructed in specific circumstances. We use that framework to show how different policy institutions may be allowed to retain different priorities, and hence individual policies that fit together in a consistent manner, while maintaining a degree of flexibility that allows them to deal with problems as they arise. At the same time, policymakers need to remain independent of external influences (and political pressures in particular) so that their policies will remain consistent in the pursuit of the goals that they or society have set for them.

The paper proceeds as follows. In the next section we review the current state of the SGP. Then, in Section 3, we outline the principles of a new macroeconomic framework in the EA, and Section 4 continues by explaining how a regime of public debt targeting may be put into practice. Section 5 addresses the link between fiscal policy and structural reform, including how a so-called “internal devaluation” may be achieved. Finally, Section 6 concludes by summarising our propositions.

2. The SGP: where do we stand?

The SGP was introduced in 1997 to restrain the impact of excessive public deficits and debt on economic performance. It imposes constraints on fiscal policy: the deficit-to-GDP ratio should not exceed 3% in the medium term, and the debt-to-GDP ratio should not exceed 60%. While the debt criterion is unenforced, the Pact operates a so-called excessive deficit procedure, with sanctions for violators and other enforcement procedures.

According to one line of criticism, the SGP is too restrictive: the automatic stabilisers are not strong enough to stabilise the national economies when subject to common monetary policies, whatever they may have achieved when countries had their own monetary policies and exchange rates. As a result, social and other expenditures have been cut back to meet the Pact. The Commission then responded by loosening the effective limits by granting a number of expenditure exemptions, and trying to make governments feel more responsible (i.e., political ownership) for common limits on the use of fiscal policy.

The fact of the matter is, however, that the SGP has been widely ignored in practice. In the first six years of the EMU, that is, *before* the financial crisis, 6 out of 12 EA members breached the deficit limit, and a larger number exceeded the debt limit. And, as already pointed out, *after* the financial crisis, hardly any EA member meets either of the fiscal criteria. So, the SGP has now been effectively set aside.

At least three reasons can be given for that:

First, the SGP has proved to be unenforcable. This is so because the Amsterdam treaty which governs the working of the SGP defines a country to have an excessive fiscal deficit if *both* that country's deficit exceeds 3% of its gross national product *and* if the Council of Ministers judges it to have done so. This leaves open the possibility that the Council of Ministers will judge the deficit not to be beyond 3% on the grounds that the excess is either excusable or only temporary. That is what happened when the case of France and Germany, who by 2005 had exceeded the 3% limit for two years without accepting the Treaty's sanctions, was referred to the European Court of Justice. The court found in favour of Germany and France precisely because the Council of Ministers had not declared them to be in excess of the 3% limit.

Second, a necessary condition for its enforcement – that the Council of Ministers needs to declare a country to be in violation of the excessive deficit procedure – involves “sinners sitting in judgement of sinners” since the Council necessarily includes representatives of the violating government and unanimity is required in matters of taxation and fiscal policy. Even if unanimity is taken away (as it is in the case of the final vote on excessive deficits), there is little incentive for countries to vote to support sanctions on others: whether they have an excessive deficit or not, those countries have an incentive to provide a veto on the argument that “it will be our turn next; a veto now will bring a veto in our favour next time”. More worrying, perhaps, are the possibilities that countries will form

coalitions to vote against such decisions in support of one another; or that they will do so in their own perceived short term self-interest -- on the argument that some countries are too big to fail. It could be that that it would be too dangerous to the rest of the community in terms of deflationary spillovers (and to the voting country in particular) if the accused were forced to cut its deficits back sharply. It therefore seems unlikely that the SGP would ever produce a judgement that a country was in violation of the excessive deficit rule.

Third, if there was little incentive for governments to keep to the bounds of the SGP in its original form, then there is no obvious reason, and even less incentive, for them to keep to the SGP after it was eased in 2005. It is clear that they would find it easier to do so. But that is not the same thing as saying that they would want to do so. This point would be even stronger if further steps were taken to “soften” the fiscal criteria, such as setting requirements to balance the budget for non-investment expenditures only (golden rule) or using cyclically adjusted budget deficits instead of conventional deficits.

The bottom line is that there is no coherent macroeconomic policy framework within the EA today. Yet, with monetary policy being set by independent central bank, fiscal policies need to be co-ordinated both among themselves to avoid threats of instability or imposing adverse spillovers onto others; *and* with monetary policy to ensure consistency and commitment to Europe’s inflation goals and financial discipline. Against that, several questions can be raised:

- Should fiscal policies be directed towards a common fiscal policy, i.e. harmonization?
- Should fiscal policies, taken as a group, be better co-ordinated with monetary policies (inter-institutional co-ordination) within the EA?
- Should fiscal policies be restricted in order to prevent spillovers on others, or to prevent them undermining the ECB’s inflation policies, or to prevent public debt becoming unsustainable when there is no national monetary policy to bail governments out?
- Or should fiscal policies become more flexible to cope with the asymmetric impacts of a common monetary policy on economies with differing structures or economies that are out of cycle with each other?

Evidently, the logic of a currency union suggests that strict harmonization is *not* appropriate, unless it is to be done for political reasons or to restrict the use of fiscal policies for any of the reasons just mentioned. The need for extra flexibility at a national level could be supplied by greater wage and

price flexibility of course, in which case fiscal flexibility becomes less important. That implies a policy of structural reform: Europe's markets are notoriously short on flexibility, especially in the labour markets. Consequently, there is a need for inter-policy co-ordination between the two arenas, similar to that between fiscal and monetary policies.

If this is not possible, or if political considerations are important, then a regime of fiscal federalism may be able to produce a similar effect. That suggests a common fiscal policy would be useful at the union level with sufficient flexibility to reduce the European cycle (so national stabilisation is not so pressing), plus regional fiscal deviations that sum to zero to deal with the country specific asymmetries.¹

In what follows we outline a less far-reaching and less complex reform in the conduct of fiscal policy, briefly referred to as "fiscal leadership with debt targets".

3. Elements of a New Framework for Fiscal Policy

Fiscal policy lends itself naturally to long term objectives. This provides an element of leadership (going first) which can be combined with independent monetary policies directed at short run or demand management objectives. That would in itself create a basis for *rule-based* co-ordination between policymakers without the need for explicit negotiations: each policy would then be operating according to comparative advantage.² The leadership role derives from the fact that fiscal policies typically have longer run targets, and are not easily reversible (public services, social equality etc.), and are not easily used for stabilisation if consistency across time and different types of policy is to be maintained.

Moreover, any policy, independent or not, must be conditioned on the state of the economy and other policies. Improved co-ordination follows from the fact that policies can be adjusted to reduce the constraints (externality costs) imposed by one set of policies on another. If the constraints imposed on one policy are eased, that policy can then be relaxed which in turn allows the first policy to be scaled back and not cause the externality in the first place. Less conflict and more favourable operating conditions would lead to better policies and better outcomes. Thus the key to a

¹ This is a regime of inter-country plus inter-policy co-ordination that has not been investigated. This seems to be an important issue to take up in future work.

²The early co-ordination literature identified comparative advantage in the use of policy instruments as the principle source of co-ordination gains (Hughes Hallett, 1986, Currie et al, 1989).

more effective use of policy is that each policy be used to achieve the target for which it has comparative advantage: fiscal policies directed at the longer run goals of public finance, and an independent monetary policy being used to underwrite the commitment to credible stabilisation.

However, there are *automatic* stabilisers in any fiscal policy framework, implying that monetary policy must condition itself on the fiscal stance at each point. This necessarily puts monetary policy in a follower's role. It would allow the economy to retain the benefits of an independent monetary policy; and also secure a certain degree of flexibility and co-ordination between policy makers. Better co-ordination arises because an agreed leadership role reduces the externalities which independent, but purely self-interested agents would otherwise impose on one another. The result is Pareto improvements over the usual non-cooperative solution, without reducing the central bank's ability to act independently on its shorter run objectives.³

Debt targets, fiscal pre-commitment and fiscal leadership

Debt targets have the advantage of being a stock, not a flow. That implies a degree of persistence - especially in those countries with high levels of public debt. Debt targets can therefore be used to pre-commit fiscal policies, all the more so in countries where fiscal policies have tended to be lax in the past, to a path which is consistent with the expected stance of the independent monetary policy - and hence to achieve the twin goals of sustainable public finances and limited spillovers on others.⁴

We suppose that *soft* targets would probably work better for the following reasons. Policy making is less likely to be disabled by arguments over the precise definition and measurement of the target, or the arbitrary nature of a numerical limit. In addition, soft targets introduce flexibility into policy making - so that the pro-cyclicality of hard targets is reduced, along with the tendency of rigid targets to block reforms whenever the latter have short run costs. Soft targets can also accommodate the positive effects of a deficit, and the desire to allow differences in national priorities, although simplicity and fairness suggest uniform limits should be imposed in the long run.

All these points are applicable to both debt and deficit targets of course. Nonetheless debt limits or debt targets may be helpful in themselves because they focus on avoiding the ultimate risk: unsustainable public finances. Moreover, a soft target version allows policymakers to trade off good

³ See, for example, Dixit and Lambertini (2003), Hughes Hallett and Weymark (2007) and Hughes Hallett (2008a).

⁴ In Denmark, for example, a policy of public debt targeting is widely regarded to have been very successful for a decade or so (Andersen, Jensen and Pedersen, 2008).

years against bad (in effect, because the target is a stock not a flow, this produces a cyclically adjusted fiscal rule without the extra difficulty of having to actually calculate the cyclically adjusted deficit accurately⁵). Finally, and again because the target is a stock and therefore more persistent, a debt rule gives policymakers a greater incentive to obey the rules: first, to preserve freedom of manoeuvre in the future; second, to save for a rainy day at the top of the cycle and therefore remain “within target” in the future; and third because the persistence in such a target makes it possible to create credibility and co-ordination for the future. From there we can get the fiscal pre-commitment we need, but only if monetary policy follows (with a shorter horizon) to provide the threat of punishment to any deviant fiscal policy making (Hughes Hallett 2008b).

A natural way to pre-commit fiscal policy in a way that can be combined with an independent monetary policy, but without any explicit negotiations that might bind or compromise the monetary independence, is to make fiscal policy lead – in the sense of going first with a longer period of commitment (rather than dominating as such). It is easy to operationalise this suggestion by giving the fiscal authorities an explicit debt target so that we achieve a pre-commitment technology with a long-term objective and a slow moving target variable. With debt being a stock rather than a flow, it has a high degree of persistence and a lot of “carry-over” in the higher debt economies. This particular mechanism would therefore provide a convenient solution, since the fiscal authorities will be obliged to make their longer term plans first.

Moreover, the goal of ensuring the long term sustainability of the public finances would also be catered for. Co-ordination will then also follow because, once the monetary authority knows what the (now credible) long run path of fiscal policy is going to be, it is free to choose a monetary policy that fits best in terms of achieving the Bank’s objectives. Moreover, should the fiscal policies deviate from their chosen path, the monetary policies can immediately adapt to counteract and cut out any unwanted effects. That punishment threat, in the context of a strategic game, should be enough to persuade fiscal policymakers to stick with their announced path. Once again, fiscal pre-commitment and credibility are achieved.

Fiscal leadership therefore carries the scope for greater co-ordination between institutions, and to a lesser extent between countries. It also allows a degree of flexibility in the short term fiscal policies but without at the same time limiting the credibility of a common but independent monetary policy

⁵ For the significance of this point in practice, see Hughes Hallett, Lewis and Kattai (2010).

focused on inflation control. Furthermore, it is easily implemented in practice using debt targets. Thus, it is an alternative way of putting limits on the use of fiscal policy, without at the same time destroying the co-ordination between monetary and fiscal policies or restricting the flexibility in the latter.

4. Making Debt Targeting into a Practical Proposition

There remains the question of how to set specific debt targets. This might be done using the empirical results of Reinhart and Rogoff (2009) or Checherita and Rother (2010) on the links between debt and growth rates. However, that kind of analysis is entirely empirical in its definition of the level of debt that could maximise growth rates. A theoretical explanation of *why* this happens has not yet been attempted. A more sophisticated approach is given by Aschauer (2000) where the optimal level of public debt is expressed in terms of the public-to-private capital ratio. This would allow us to determine and calculate the best level of public debt for any specific economy or sample period. Such a rule does of course imply some kind of golden rule in the long run (i.e., across the cycle, current government spending has to be financed by current revenues rather than borrowing) and that the target debt-to-GDP ratio must remain constant – results which were later confirmed by Aizenman et al. (2007).⁶ If maintained, such a rule would imply sufficient capital cover in the economy as a whole for the public borrowing, which is just a matter of good banking practice.

The problem with any fiscal control rule of this type is always enforcement, as the experience of the SGP shows. We therefore propose the following enforcement mechanism:

- a) The EU Commission and national governments jointly operate an EA-wide monetary fund (a “mini-IMF”) as part of their joint governance framework;
- b) The debt targeting system should be set up for each government as a debt target value and an upper boundary or ceiling;
- c) The space between the target and upper boundary should be divided into three equal ranges.
- d) The debt target value itself might be specific to each country, at least in the transition from today’s high debt ratios to more reasonable values for a long term framework; but they are more

⁶ By contrast, Kisanova et al. (2006) argue that the optimal debt rule is a random walk; i.e. each period you aim to keep the debt ratio where it currently is, rather than return it to some fixed level. However a random walk implies an infinite variance, which means a country operating such a rule would become insolvent at some point with probability one. It is hard to know what is optimal about going bankrupt with certainty. The source of this difference lies in the myopic optimisation techniques used.

likely to reach and follow a common value for that long term (permanent) framework. The space between target and upper boundary should be common to all member economies.

- e) It is important to draw a clear distinction between a declining debt target for use in transition from a severe recession, or in recovering from an excessive debt episode; vs. a constant debt target for use in normal times. But the debt targeting mechanism itself would work in the same way in either case.

By way of example, if the debt target was set as a 45% debt-to-GDP ratio, and the ceiling at 60% in normal times, the excessive debt protocol range would be divided into three: from 45% to 50%; from 50% to 55%; and from 55% to 60%.

The first range would be the range of normal fluctuation and would require no immediate action or comment (bear in mind that the debt ratio, being a structural indicator, is less volatile and slower moving than a deficit).

If the level of debt entered the second range, national fiscal authorities would be placed on the watch list and be subject to comments or advice from what we call the Fiscal Policy Commission below (FPC). Any financial assistance from the FPC or other governments, any liquidity provision to domestic firms or banks by the ECB, or indeed comfort statements from the FPC to reassure the markets, would immediately become conditional on policy improvements being undertaken and be subject to joint oversight to avoid that assistance being diverted.

If that country's level of debt entered the third debt range, this would trigger public warnings and specific policy recommendations, delivered through the FPC and to remain in place until the 55% ratio or less is regained. At this point, any assistance, loans, or bail-out guarantees would become strictly conditional on those recommendations being implemented and carried out to the FPC's satisfaction.

Finally, if the national debt-to-GDP ratio rose above 60%, all bail-out guarantees would be lifted and any further debt issued would be priced according to market forces with an explicit *no bail-out* provision attached. Moreover, any further European or IMF support would only be offered if the national government accepted the "assistance" of European Commission officials in running government spending and taxation until the 60% limit or better was regained; i.e. the national fiscal authorities would be placed in administration.

Any loans or other assistance invoked under the excessive debt protocol would be channelled through the European Commission. To pay for that, the Commission could use its own funds (from the budget contributed by the EA governments) plus a levy imposed of 0.25% of GDP say for each percentage point that any *deficit* (symmetrically for any participant) had exceeded the 3% limit in the period in which public debt was in one of the upper two excessive debt ranges. This levy would be lifted only in quarters in which growth was recorded as negative. These conditions would all be agreed and made public to all before the regime started, and the government's progress in relation to them would be assessed and discussed in public by the FPC.

Apart from a mild fiscal penalty designed to slow down the expansion of excessive deficits in the debt conditionality ranges, the real sanction here is that the possibility of any loan, bail-out or other help is strictly conditional and known to be so. Once debt goes beyond the 60% barrier, any further assistance becomes unavailable or is withdrawn and the national government will be abandoned to the markets. Since this fact will be known in advance, and that any breaches come with two zones of warning, it should act as a break on imprudent debt expansions (except in severe recessions) and should guard against the dilemma of moral hazard. In fact, given the warnings and the threat of outside control, any government that nonetheless transgressed the 60% debt-to-GDP limit would be subject to a severe political backlash and likely to incur rapidly escalating borrowing costs. Note that all the penalties in this protocol are designed to withhold what a government would like to have (fiscal freedom, a subsidy), not to remove something which they already have (eg a fine).

The EA needs an effective monitoring agency to overcome two defects in existing EU monitoring arrangements; first that they are automatic and partial, and second they are backward looking. They do not imply any pressure to modify fiscal plans in the light of predictable future problems. To get round that, we need an independent FPC to have responsibility for (a) reviewing the fiscal outlook for the EA governments, (b) reviewing the revenues likely to be available, (c) estimating the current *structural* positions and (d) estimating the likely consequences of current spending plans, including those implied by changing demography and pension costs. A more detailed specification of how the fiscal policy commission might be constructed and work is given in Appendix.

The Most Recent Proposals from Brussels

Since this paper was first drafted, a variety of rather similar proposals have been made within the European Commission. In brief, these proposals would have a debt target of 60%; that the growth in

public spending should not exceed the growth in GDP; that countries with debt ratios exceeding 60% should show adequate progress to reaching that target (defined in one proposal as eliminating 1/20th of the excess over 60% each year); and that each economy with a persistently excess debt ratio on this criterion should pay a fine of 0.2% of GDP each year. In addition, there are proposals that countries that do not improve their competitiveness or correct other macroeconomic imbalances will be fined 0.1% of GDP each year (Financial Times, 24 September 2010).

The definitions of what constitutes “persistent”, or what criteria should define “competitiveness” or “other imbalances”, is not yet clear. But these suggestions are clearly in line with the debt targeting proposals above, and follow earlier studies done for the Commission that advocated a debt targeting mechanism be applied in this context (Hughes Hallett, 2008a). However, they differ in that no excessive debt protocol is included; and in that what is viewed as adequate progress back to target seems to be very slow (it would take 20 years to get near to 60%, and being a geometric progression might never get there). Moreover, the enforcement mechanism (fines) is likely to be less effective because it violates the principle that punishments should remove something that national governments would like to have but do not currently control; rather than take away something they do control and may refuse to give up. To impose discipline on those who refuse to cooperate is likely to be less successful than abandoning such governments to market discipline without guarantees or any support, and then finally placing their policymakers “under administration”.

That said, the extension to include sanctions on those who do not take action to improve their competitiveness, assuming a suitable definition can be found, is an important innovation for the reasons we outline next.

5. Labour market policies and structural reform

The Lisbon Agenda has made it clear that flexible labour markets, and labour market policies which influence employment and development of wages or non-wage costs, are an important element of policy design in a currency union where shocks, transmissions and economic structures differ across countries. Since market flexibility is not a feature of the European labour (or product) markets, structural reforms are needed to ensure that sufficient price and wage flexibility can be brought to bear. If they cannot, it is inevitable that part (if not all) of the load of rebalancing each economy will be borne by expanding the national fiscal deficits. There is a natural political imperative to try to regenerate employment and growth this way. But even in the absence of any political interventions,

the automatic stabiliser effects of unemployment benefits, of social support, retraining and tax revenues that are lower than otherwise, will make it happen anyway. Since a nominal devaluation to reduce relative labour costs and prices is not possible, nor is a monetary expansion, the only option is to undertake reforms to reduce domestic production costs and prices directly. A real devaluation through relative prices in other words.

The difficulty with structural reforms is that, once in a currency union, no country has an incentive to carry them out. Such reforms inevitably carry short run costs. They will increase unemployment in the short run while they are being carried out; and they may well require fiscal subsidies or extra transfer payments while that is happening, also development grants, tax relief or retraining to induce the investment in the new plant, equipment and skills needed for the reforms to take place. And that is before the policy makers face the special interest groups that will be damaged by the change in market regulation, employment protection or social support arrangements. As a result, it is very likely that the short run costs will loom large, and make the policymakers/population reluctant to engage in any reform whatever the long run benefits (especially if those benefits appear uncertain).

Indeed, fiscal restrictions, occasioned by excessive deficits or the need to reduce an excessive debt burden, could prevent the necessary reforms being undertaken. Any programme of structural reform is likely to entail additional public expenditures, and possibly lower revenues, while the reforms were being undertaken. There will therefore be added unemployment and other social benefits to be paid in the interim, plus extra retraining to get people back to work. At the same time, there may be new infrastructure projects or support for new technologies. In each case, public spending will rise.

With unemployment temporarily higher and output lower, tax revenues will fall. Consequently, the fiscal deficit will become larger, and the debt ratio larger, than the trend level of either. Figure 1 illustrates the point, by showing how the fiscal deficit ratio will vary with different sizes of output gap. The bold line AA' shows the position before structural reforms are undertaken. The European Commission (2002) estimates the slope of this line to be approximately -0.5 for the EA as a whole, a bit steeper for countries with extensive social welfare but less steep elsewhere. Point D is the structural deficit for this economy; the deficit being positive even though the output gap is zero.

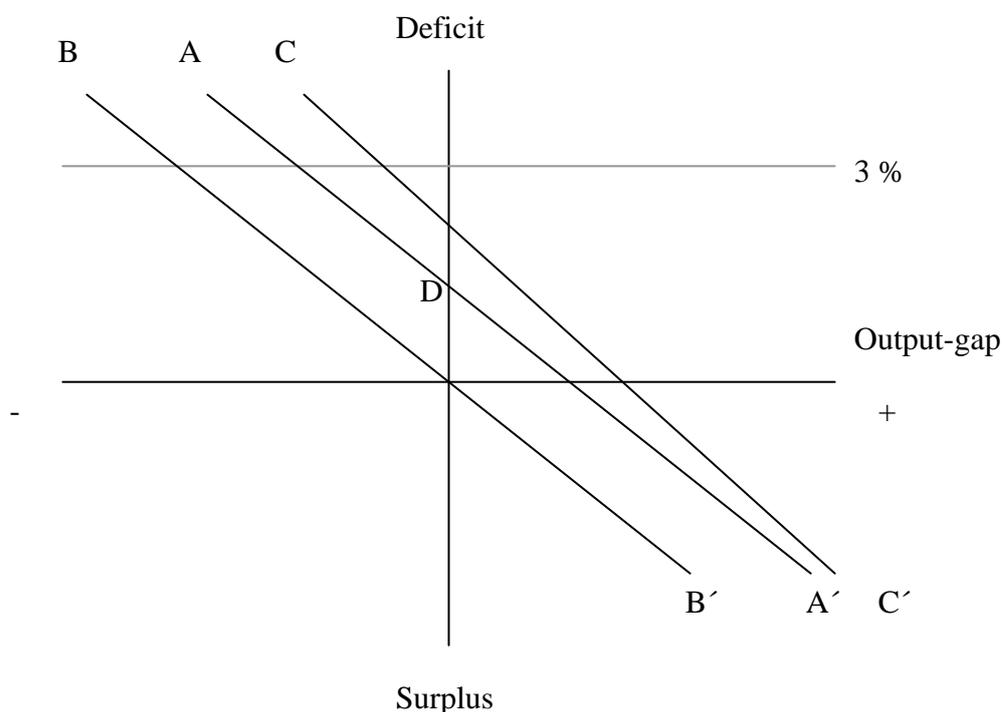


Figure 1: Link between Fiscal Policy and Structural Reform

A reform programme would, presumably, be designed to eliminate that structural deficit. This would get us to line BB'. But the argument above shows that we would have to reach that position *via* the line CC' which represents a short term adjustment phase. In practice, it is not exactly clear where CC' should lie, other than it must be above AA' with a slope no less than AA'. Consequently, it could involve a simple rightward shift from AA'; or a rightward shift with steeper slope; or be kinked with a rightward shift for negative output gaps only. Experience suggests that it is probably one of the latter two, since structural reforms made during boom periods are easier and cheaper to finance; meaning any unemployment/retraining costs will be lower per unit output gap. In that case, the CC' line will be as we show it.

Now suppose we impose fiscal constraints to see the consequences. In Figure 1 this is represented by the SGP's 3% limit on the deficit ratio. It is immediately obvious that any such restriction would interfere with the process of structural reform. Although the probability of exceeding that limit (or, more accurately, of getting an output gap that forces us to do so) is lower after the reforms are completed, the probability of exceeding such a limit in the interim will have increased significantly. That would be a considerable barrier to ever undertaking such reforms. It would make them much

more expensive: either in fines, risk premia, or in financing costs or other expenditures forgone. In that case, a rational government would likely postpone the reforms or abandon them every time they approached the 3% limit.

In addition, it will always be more attractive to persuade your neighbours undertake any such reforms so that you can free ride on the rise in average flexibility that they will introduce. If they do reform, you can benefit from the adjustments in their markets (to which you have unlimited access) without actually having to bear the fiscal burden or financial/political cost of carrying out the reforms yourself. Consequently, no country has an incentive to carry out reforms or become more flexible, unless others are sure to reform at the same time. This is a “Groucho Marx theorem”:⁷ no country will want to be in a union that is less flexible than itself, and no country will want the others to be as inflexible as it is.

Moreover, if this move to greater market flexibility is not to damage the welfare state, much of the costs of social security, which in many European countries are paid for by payroll taxes and other contributions by employers, needs to be transferred to regular tax payers. If the burden of contributions is on employers, then their costs will increase and any downward flexibility in unit labour costs will be lost. Thus, the key to generating employment and output growth in fiscally constrained economies will not be policies that expand aggregate demand or the supply of labour in that economy; but policies that expand the demand for labour within the existing configuration of policies. But those policies are exactly the policies which will help reduce a fiscal deficit, or excessive debt burden, at the same time – as we show next.

Meeting and stabilising the economy at a given debt target:

The identity describing the evolution of an economy’s public debt burden is given by:

$$\dot{d} = pdef + (r - g)d - \dot{m} \tag{1}$$

where d represents the public debt-to-GDP ratio, \dot{d} denotes the change in that ratio per unit of time, $pdef$ is the primary deficit (defined such that $pdef > 0$ implies a deficit), r is the average real rate of interest charged on debt, g is the rate of growth of output in real terms, and \dot{m} is the change in the ratio of the money stock to GDP per unit of time (de Grauwe, 2009).

⁷ Hughes Hallett and Jensen (2004) and Hughes Hallett, Jensen and Richter (2005).

If debt reduction programmes are not to result in inflation, the ECB must rule out undue expansions of the money supply, as indeed it has done in the current recession and recovery. Thus, money may not grow faster than national output, i.e. $\dot{m} = 0$. If that is the case, the debt ratio will stabilise if $\dot{d} = 0$. In view of the debt dynamics in (1), that will happen when

$$pb = (r - g)d \tag{2}$$

where pb is the budget's primary *surplus* defined as $pdef = (G - T)/Y = -pb$ (where G is government spending net of interest payments, and T are total government revenues). Thus if $r > g$, the government must run a primary surplus to stop the debt burden rising and an even larger one to reduce the debt burden.⁸ And that primary surplus will need to be bigger, the greater is $r > g$ and the greater is the initial value of d . Otherwise, the debt burden will rise. But if $r < g$, the government may run a primary deficit as long as it is not larger than the term on the right of (2).

The implication of these observations is that it will be much easier to reduce a debt burden, or at least to prevent any further increases, if r is reduced and, more importantly, if g can be increased – the more so, the larger is the existing debt burden d . In most economies and in the EA in particular, reducing r is problematic because monetary policy does not lie within the control of the national governments, and is anyway subject to outside influences. However, in difficult cases, such as the UK in 2010, quite a lot of progress can be made by adopting an aggressive and very public approach to reducing the budget deficit. If credible, these announcements lead the financial markets to suppose that financing requirements will be reduced along with the debt burden, and that risk premia, currently imposed on new borrowing/refinancing, need not be imposed on future borrowing or refinancing. The cost of borrowing and the right hand side of (2) will come down.

So, the first lesson is that good communication, and a plausible, consistent and credible debt reduction plan is crucial. Otherwise, reducing r will become dependent on co-ordination with the ECB and (where necessary) quantitative easing to get interest rates in the markets for longer dated securities down to low levels. But this will be slow and a low impact process because r refers to the *average* rate of interest paid on all existing debt, whereas the reduced interest rates apply only to that part which is new debt or refinanced debt – not the whole stock. There is no magic bullet here; it will take time for this option to take effect.

⁸ Values of $pb > (r - g)d$ will ensure falling debt burdens, $\dot{d} < 0$.

The alternative, raising g , seems more attractive because it would typically have a more immediate and substantive effect. Unfortunately, the growth rate of GDP is not a policy instrument, at least not directly. Indirectly, however, the government may have some influence on g . The usual approach here is to take steps to reduce the public sector wage bill via both wage and employment level reductions; reduce the non-wage costs imposed on employers (shifting them onto employees as in Denmark and Ireland for example, or via reforms to pensions or other benefit schemes to lighten the contributions load on employers elsewhere). Or to use tax reforms to shift the burden from income, profits and employment taxes to consumption taxes or user costs; and to introduce measures to encourage the private sector to do the same with respect to wage settlements and productivity (R&D) increases.⁹

If combined with strong controls on inflation and increased competition in the markets (e.g., by further opening up the economy to competition from world markets), these reductions in unit labour costs will reduce home prices relative to competing economies: that is, a real (internal) devaluation even for an economy in a fixed exchange rate regime or a currency union. The result is to raise growth rates and lower debt through increased external demand, and to increase investment rates and ultimately *real* incomes as a consequence.¹⁰ As a policy strategy, this has the advantage that it largely resolves the short run (fiscal) conflict vs. long run gains, in which deficits get worse before they get better, as illustrated in Figure 1 – without resorting to any monetary financing of deficits.

This kind of “internal devaluation” strategy has been used to great effect in Germany since the introduction of the Euro in 1999. Table 1 shows the extent of Germany’s real devaluations against other EA members. In size they are substantial and must be responsible in large part for Germany’s revived growth and lower deficits in 2009/10, and also since 2000 after the years in the economic doldrums following German unification. The same arguments, of course, apply to competitiveness with respect to outsiders (China, the US, Japan), which may explain why the rise of the Euro has had a much smaller impact on Germany than on her Euro partners.

⁹ In a formal analysis of the possible reforms, Bokan and Hughes Hallett (2008) show that if employment growth is the objective, labour market deregulation is the most effective instrument if the product markets are relatively competitive, but market liberalization otherwise.

¹⁰ This is not a new idea. Several authors noted (references in Hughes Hallett, Lewis, von Hagen (2004)) that reductions in wage costs, not Ricardian or non-Keynesian effects, were responsible for the successful deficit/debt consolidations in the 1980s and 1990s.

Table 1: Germany's Real Devaluation Relative to Euro Partners (1995-2009)¹¹

Austria	7%	Ireland	35%
Finland	8%	Cyprus	38%
France	12%	Spain	43%
Belgium	13%	Greece	55%
Netherlands	24%	Slovakia	67%
Luxembourg	30%	Slovenia	99%
Italy	31%	Malta	na.
Portugal	35%	EA, trade weighted	17%

Source: Sinn (2010), table 11 based on Eurostat data and the German Federal Statistical Office.

Germany is not the only country to apply this strategy in the recent recession of course, but the countries that have done so are a small minority. Latvia, in a fixed exchange rate regime with the Euro, is a second example. Sweden has also used the opportunity to apply a nominal depreciation coupled with a formal wage agreement to restrain costs and consequent inflation spiral; a strategy that was adopted by Ireland after 1986 to generate her remarkable growth performance before and after entering the Euro.

Nothing in this analysis of how co-ordination between fiscal policy and labour market or structural reforms can deliver new fiscal arrangements for Europe, or what an exit from excess debt or deficits should say about what debt level will or should be reached at the end of the correction process. To do that, we need to specify the primary surplus reaction function that governments would choose to follow - or perhaps should be made to follow. As things stand, the debt burden will shrink without limit so long as the primary surplus is always set larger than the right hand side of (2). But it will rise, again without limit, if that inequality is reversed.

Neither scenario is particularly plausible in a dynamic setting. However, we can get a better grip on how to solve that problem if we use the analysis of "fiscal space" set out in Ostry et al. (2010). On

¹¹ For the newcomers, a real devaluation by Germany does not mean that they are now less competitive than Germany, if their initial price level was sufficiently below Germany's. But it does mean a loss in competitive advantage, as we might have expected anyway from the Belassa-Samuelson effect.

the basis of data from 23 advanced economies, Ostry et al. hypothesise and find a statistically significant cubic relationship for the setting of primary surpluses as a function of debt levels.¹² This gives rise to an S-shaped reaction function, as shown in Figure 2, which describes how these economies actually set primary surpluses as their debt burdens rose: the left hand side of (2). The right hand side of (2) also rises with debt: it is the straight line in the diagram (when $r > g$).

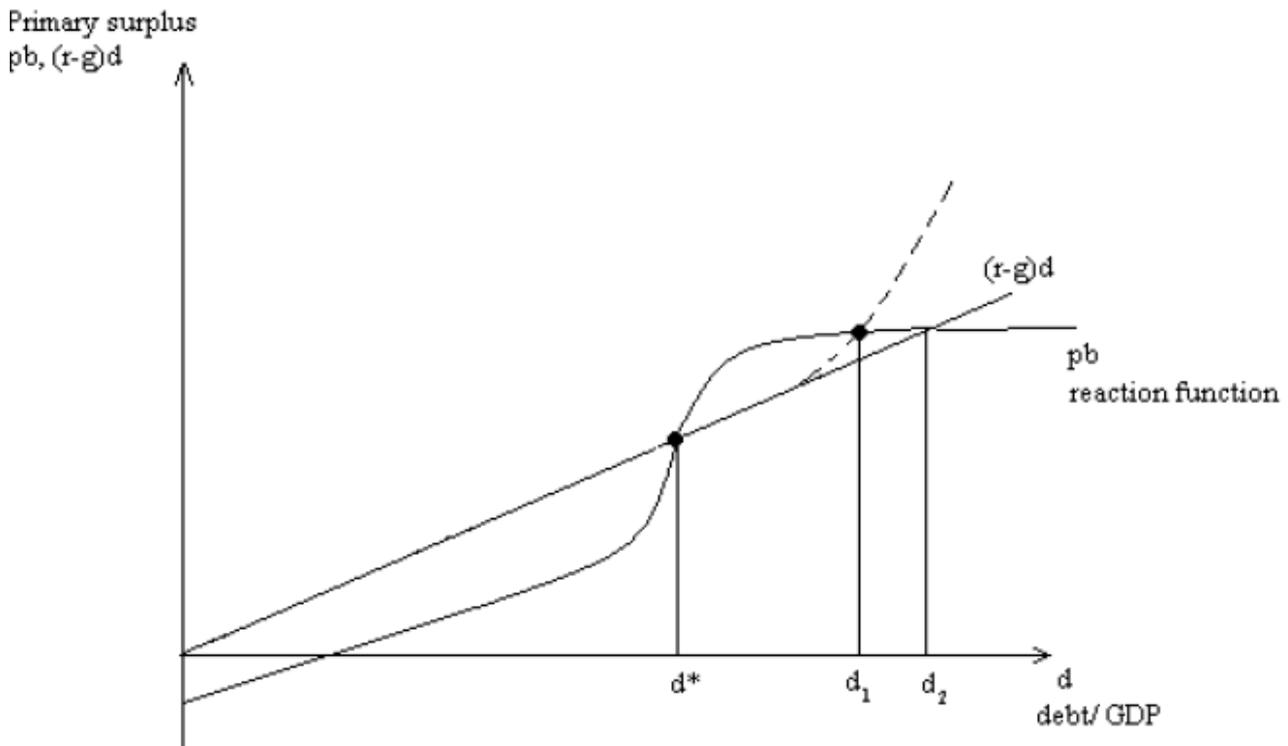


Figure 2: Determination of the Equilibrium Debt Target

As drawn, there are two intersection points; one at d^* , and one at d_2 . The first, d^* , represents the equilibrium value where the debt ratio will ultimately settle so long as we are still operating below the level of d_2 . This is because, for $d < d^*$, the primary surplus, pb , is less than $(r-g)d$ so $\dot{d} > 0$. But for $d^* < d < d_2$, we have $pb > (r-g)d$ so $\dot{d} < 0$. However at d_2 and beyond, the debt burden increases without limit since $pb \leq (r-g)d$. Hence there is a stable equilibrium at d^* , and an unstable one at d_2 . Thus, if we have a serious idea of the optimal debt target (using the references given in section 3 say), or if a common debt target is to be set for all the EA at say 60%, the last part of the problem is

¹² This relationship simply says that policymakers make little effort to raise a primary surplus at very low levels of debt, and find they are unable to do so (or that the political consequences of attempting to do so are too severe) at very high levels of debt.

to set the debt ratio, by choice of pb , to adjust according to (2) until d^* is reached - and then to estimate d_2 in order to be able to stay well away from it.

Of course, Figure 2 is not the only possibility. It is easy to see that having a positive intercept in the S-curve at very low debt levels will give an additional unstable low debt equilibrium. But our analysis would remain exactly the same. Similarly, we might have $r < g$ in which case the straight line is downward sloping and only the stable equilibrium d^* may exist. No explosive debt. Finally, both r and g may actually vary with the debt level; in fact that is likely, with r increasing with d as risk premia are set and as increasing fiscal contractions are imposed that reduce g . In that case, the upward sloping line becomes the upward sloping dashed curve, reducing d_2 to d_1 . But, as can be seen from Figure 2, none of these extensions change our story in any way beyond complicating it.

6. Concluding remarks

The received position in the EA policy framework is that the ECB should be independent of outside forces, and of exposure to political pressures in particular. Moreover, national fiscal policies should be left free to account for and address the particular circumstances of each member economy. The difficulty with this is that an independent monetary authority necessarily also means an independent fiscal authority. Since a fiscal authority is subject to political and electoral pressures, rational voters will drive governments to push harder for what they elect those governments to do, even if it conflicts with the policies pursued by the ECB (Demertzis et al., 2004).

That means fiscal policy will increasingly cater for the preferences of local populations since monetary policies, being common to all, cannot. Fiscal policies will also be increasingly called to reflect the population's legitimate interest in seeing that public money is spent on the goals that they wish. Again, the electoral mechanism will be the force behind this. But, as a result, fiscal and monetary policies are likely to, if not conflict, at least be used to blunt the impact of the other on their own favoured targets. That will lead to poor and possibly unstable outcomes. Indeed, that appears to be the story of the SGP: it was first put in to rule out such un-coordinated and undisciplined behaviour. But under popular pressure, it was violated widely, as this argument suggests it would.

Something therefore has to happen in the general policy framework in Europe. The answer seems obvious at a theoretical level. We need to reduce the excessive self-interest in the implied one-to-

one (policy to target) assignments in the current policy framework when there is no corresponding one-to-one separation of their effects within the economy itself. That suggests we need to find a way to create greater co-ordination (or consistency) between the fiscal and monetary policymakers, without introducing the need for direct negotiations over the precise measures to be taken in any particular case since that would compromise the independence of the policymakers to take whatever actions they regard as necessary.

To do that, we argue, it will be necessary to provide a less than exclusive *intertemporal* assignment of policy goals to policymakers. This stands in contrast to the one-to-one assignments (separation) within each period. The reason is that *within* period assignments mean that policies must compete to satisfy their own priorities at that time, increasing the degree of conflict between them. Inevitably each will end up offsetting the effects of the decisions of the other, in a vain attempt to reach their own goals since they know they have no other opportunity to do so without further conflict with their rival.

With an intertemporal assignment, however, where fiscal policies prioritise long term expenditure goals and monetary policy concentrates on cyclical stabilisation and inflation control, there would be less conflict and each policymaker can start to take into account the existing or predicted stance of the other. There is also the threat that an undisciplined (or inappropriately selfish) move by one player will be punished, and will be anticipated to be punished, according to the preferences of the other through the subsequent actions by the other player. Yet each player gets their chance to implement their own preferred policies without direct opposition of the other. This implied process of action and counteraction, or “negotiation over time”, leads policies to an equilibrium in which the policies are better co-ordinated than when the resolution is achieved by the outcome of a simple conflict.¹³

We find that a convenient way to set this implicit negotiation process up is to impose a debt target on fiscal policy making. Being a stock variable, and not a flow, a debt target implies a significant persistence from period to period and therefore forces a longer term view in the fiscal planning of governments which is not evident in monetary policy making. But there is no compromise in the independence of the central bank to make monetary policy as it sees fit. Similarly, there are no

¹³ Based on the theory of asynchronous games: see Libich and Stehlik (2008)

physical restrictions on fiscal policymakers to interfere with the legitimate priorities of the societies that elected them.

Fiscal-monetary interactions like these are just one example of where interactions between the impact of policies can change the outcomes you would expect from the analysis of the individual policies one by one – and hence change how you would use them from what may have appeared best when you analysed them as if they were separate. We touched on other examples here: for example, the interaction between fiscal policy and the ability to carry out structural reforms.

This is an old theme, but we are giving it new European clothes as a suggestion for improving fiscal policy making in Europe. In the tradition of Tinbergen, Cooper and others who helped develop the theory of economic policy, the difficulties that arise when policies cannot be co-ordinated properly are well known. The result will be greater instability and a worse economic performance as each policymaker tries to cope with the (to him) unanticipated spill-over from the decisions of others while also trying to get the best for his own targets in the current period. That means larger deviations from target, more time spent away from target, and a slower return. Our framework allows for better co-ordination without any loss of independence for the individual policymakers.

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Appendix: A Fiscal Policy Commission for Europe.

The Fiscal Policy Commission's task would be to provide an informed and independent assessment of the fiscal position and general prospects for the Euro area, covering the outlook for public finances, financial conditions more generally, and the main targets of policy in the participating economies. This would bring fiscal policy framework back to the spirit of a system of rules that safeguard solvency and efficiency, without impairing the ability to apply discretion and judgement. More importantly it would be forward looking. And by entrusting the analysis and judgement of sustainability to an independent commission, it would solve the basic credibility problem of any fiscal regime; namely that governments are left to judge the quality of their own policies, especially those with financing implications that last long after the next election or elections. In this respect, the proper balance between a long-run interest in sustainability and short-run obligations and opportunities offered by fiscal policy can be maintained by making the body making the assessments independent from short-term political pressures.¹⁴

The Fiscal Policy Commission would be created by and report to the European Parliament, which would also provide its resources. Its members should be experts on public finance and public finance management of high professional standing. Membership in the Commission¹⁵ need not be a full-time activity for the executive board; although the chairperson and the operating personnel should have full-time professional appointments. The Commission should have a small staff/secretariat and have guaranteed access to all relevant information at the national and Euro levels.

The idea of creating yet another institution may seem unattractive. Europe already has a network of advisory groups with overlapping responsibilities. That suggests fewer rather than more institutions would be helpful. But in the case of fiscal policy, currently based on a network of de facto interacting national decisions, there is an obvious lack of transparency which makes fiscal policy utterly opaque to the public. Others may find the idea of delegating any authority over public finances – historically the core of parliamentary rights – to an independent commission to be incompatible with modern democracy. These criticisms must be taken seriously. It is important to distinguish between the oversight, monitoring and advisory role, from an executive or operational role. In this proposal, the Commission would have *none* of the latter. On the other hand, in a world where regulatory capture and self-interested politics are all too possible, a Fiscal Policy Commission would make it necessary for a government that wishes to deviate beyond the limits of what an independent authority regards as sound to defend its plans in public. In that, a Fiscal Policy Commission

¹⁴ This discussion draws heavily on earlier work: Fatas et al (2003), von Hagen and Harden (1994), Eichengreen et al (1999), Wyplosz (2002). More general discussions can be found in Wyplosz (2005), Debrun et al (2007), Leeper (2009). Many countries now have such a commission: inter alia, Belgium, Canada, Chile, Germany, Hungary, and Sweden.

¹⁵For this Annex, "Commission" means the fiscal policy commission, not the European Commission

would improve both transparency and the functioning of democracy. Hence, delimiting of the Commission's authority and remit is the key issue.

A clear mandate: safeguarding sustainability

The Fiscal Policy Commission would have the sole task of overseeing the sustainability of public finances. Since the Commission would have no responsibility for monetary affairs, inflation or financial stability, and since the Commission would have no *executive* role in fiscal policy (such as setting taxes or public expenditures), the Commission would have no need of secondary objectives such as supporting the general economic policies of any government. The Commission's function would be to make explicit the implications of each government's inter-temporal budget constraint and the likely outcomes of that government's policies on its own economy and for the Euro-zone. To fulfil this task, the Commission would have to assess the financial position of the government in all relevant aspects, to produce forecasts of future financial developments and, on this basis, to evaluate the risk of future fiscal crises.

The sustainability of public finances, like that of price stability, varies with circumstances over time and across countries. There is no unique definition of sustainability for all circumstances. An important part of the Commission's task would, therefore, be to develop a framework for the assessment of public finances and for making forecasts and judgements. But the Commission would probably not settle on a unique test for sustainability. And there is no call to do so.

The fact that the Commission would not have the authority to set fiscal policy instruments is key for the legitimacy of the arrangement. The right to determine the level and distribution of taxes and spending lies at the heart of parliamentary democracy. In this context, the Commission's mandate is to make the limits to fiscal policy choices known. This is a legitimate interest for all in the EU; and it may be assumed that national parliaments, by agreeing to remain in the Union, agree to accept those limits. Thus, the creation of a Fiscal Policy Commission does not take sovereignty away from a national government beyond what is already implied by being in the EU.

Note also in this regard, that the Commission would be concerned with the sustainability of public finances, not their size or effect. That is, it would be concerned with the *differences* between revenues and spending; *not* with their levels, or the proper size and structure of the public sector.

Method of operation:

A Fiscal Policy Commission might be considered a referee in the budgeting process. A national government would have to submit its annual and medium-term fiscal plans to the Commission in the early phase of their

budgeting process, perhaps in the year proceeding the budget under consideration. The Commission would judge the compatibility of the change in government debt implied by these plans, with the sustainability of the country's public finances. Its assessment would take into account past and current economic performance and the medium-term outlook of the economy, as well as the financial position of its public sector. The Commission would issue a veto warning if it came to the conclusion that a government's fiscal plans were not sustainable in the longer term. In this case, it would demand adjustments and would make recommendations for such adjustments. The Commission would deliver its warnings *in public* within two months after submission of the national fiscal plans to ensure that the government could adjust its budget in time. The Commission could also make a public assessment of the adjustments proposed by the government.

During the course of each fiscal year, the Fiscal Policy Commission would also monitor the development of public debt to see whether the government had complied with their plans and whether any slippage had arisen which might have damaging consequences for sustainability. The Commission would comment on such situations in public and admonish the government for deviating from their original plan, especially if the sustainability of public finances were at risk. We suggest that this should lead to two smaller reports: one reviewing aims and guidelines for fiscal policy in the early stages of the fiscal year, and another mid-year assessing the nation's fiscal health, general prospects and likely future fiscal position given current policies.

There is an issue of the definition of government debt, the main focus of the Commission's assessment. To do that, the Commission would define deficits on an accruals basis, implying that items such as privatisations, receipts from special purpose vehicles, operating deficits of statutory bodies, capital transactions, explicit guarantees to the financial sector or other governments, or changes in the value of foreign-currency denominated debt, which are often taken to be "off budget", are included. The Commission should also take a long run view in its assessment of sustainability, including, for example, pension liabilities or hidden guarantees.

To fulfil its task, the Commission would need to produce an annual report on the sustainability of public finances. Obviously, this could be very short if the Commission foresaw no problems. Without prejudice to its independence, the Commission could and should allow the government (especially with respect to guidelines for its aims and objectives) and other institutions to review its assessment by holding hearings with experts and representatives of the relevant bodies.

To involve the public in the process as far as possible, and to avoid giving the impression that the national government and country were being judged by an institution far removed from the electorate, the Commission would deliver its report and especially its veto warning on the government's fiscal plans in a

public forum. Bringing the Commission's activities and assessment to different locations around the member states would enhance the political ownership and public support of the process.

Credible enforcement

The question remains how a commitment to live within agreed policies could be enforced in practice. The current framework has two mechanisms in discussion: peer pressure and the possibility of withholding elements of European funds if a government were to run excessive deficits. And we have added our excessive debt protocol.

Being untried, the effectiveness of these mechanisms is not clear. However it is clear that the Commission cannot impose penalties itself as it has no legitimacy as a supra-government agency. Nor could it impose judgements by legal means. Judgements in a "sustainability court" would always come much after the fact, and the judicial process would not be able to impose timely corrections to policies deemed non-sustainable. The Commission, in contrast, would work in a much more forward-looking way, signalling risks of fiscal crises before crisis hits and demanding policy adjustments that prevent crises. Thus, and in contrast to a court that judges what governments have done, the Fiscal Policy Commission would also judge what a government intends to do. Furthermore, since the concept of sustainability is not uniquely defined, the same policies may or may not be sustainable at different times. The judgements will always be for specific circumstances.

In view of this, the only mechanism the Commission could rely on to enforce its judgements and prescriptions would be its ability to generate political pressures through public opinion and by shaping market reactions. To facilitate this, the Commission should have the right to make its judgements and recommendations fully public in a timely manner. It should have the right to make differentiated judgements on the fiscal situation depending on circumstances, pointing to risks and problems as it sees fit. It should also have the right to educate public opinion through public statements about the importance, interpretation and implementation of policies that are sustainable. And it should be allowed to talk to the European and national Parliaments.

Enforcement in this way can only work if the public regards the Commission as an authority in these matters. The need to rely on public opinion creates an incentive for the Commission to exert the best possible judgement, make its decisions transparent and use its public role most carefully. A Council making unreasonable proposals or posing unreasonable demands would soon lose credibility in the public eye, as would a Council that based its judgements on shaky analysis and questionable assumptions. Thus, the limitation of the enforcement power would at the same time be the best guarantee for a high-quality performance from the Commission.

An important criticism of this approach is that public announcements, by shaping expectations in financial markets, can precipitate a fiscal crisis in situations where a crisis might have been avoided. Multiple equilibria can arise in debt markets when debtors will hold the debt of a government if they remain convinced that future policy adjustments will restore solvency, but sell that debt when they expect that such adjustments will not take place. A public announcement that the sustainability of the country's debt is in doubt could shift market expectations from the first to the second, and result in massive sales. In view of this possibility, one might think that the Commission should not be allowed to make public announcements which refer to the possibility of fiscal crises in order to avoid such self-fulfilling expectations.

In fact the best way to avoid that danger is to give the government a clear debt target, plus a zone where deviations can be tolerated up to a critical boundary. After that, zero tolerance. Debt ratios, being a stock not a flow, are a reasonably slow moving variable. It would be easy to build conditionality into the Commission's judgements and recommendations. Favourable judgements and mild policy changes can be recommended, with the offer of extra financing help and no cuts in European funds, if the government is seen to be taking steps to reduce the debt burden towards target well before the upper boundary is reached. But once the boundary is breached major adjustments will be demanded and abandonment warnings issued. At the same time, the government should have an opportunity to prepare a response in reasonable time and not be taken by surprise by the Commission's announcements. This could be achieved by requiring the Commission to forward its assessment of a potential crisis to the government before it is made public.

Independence, accountability and transparency

To fulfil its role properly and make unbiased judgements, the Commission would have to enjoy full political independence of national governments and European institutions. Like independence at the ECB, the Commission's independence should be determined by five statutory rules:-

First, that the Commission does not and may not take directives from any national or regional government, or from any institutions controlled by those governments.

Second, that the Commission has the right to develop its own framework of analysis and its own operating definition of sustainability.

Third, the resources made available to the Commission should fix the Commission's budget for a medium-term horizon of, say, five years, and should be amendable only by a majority of votes in the European Parliament. Such a rule would shield the Commission from any attempt by politicians to make it ineffective by draining its resources. The remuneration of Commission's members should be determined by the

Commission's statutes and linked to the salaries of comparable public sector officials. National governments should be required to give the Commission full and timely access to all information requested.

Fourth, members of the Commission should be personally independent from political pressures. Personal independence could be assured by giving members fixed-term, non-renewable appointments. Their appointments should be long enough to allow them to acquire the necessary expertise and standing in the public debate. Appointments should be staggered to ensure the Commission's membership does not change entirely at the end of a given year, thus assuring continuity in its views and judgements. It should be impossible to dismiss Commission member except in cases of unethical or unprofessional behaviour. This will ensure that they cannot be threatened or removed if they make decisions which are unpopular with any government. Members leaving the Commission after the expiration of their term should be restricted from political office for four years to ensure that they have no incentive to grant favours that might improve their post-Commission career prospects.

Fifth, the Commission's freedom from political pressure should be balanced by an appropriate accountability mechanism to ensure effectiveness and democratic legitimacy. For this purpose, the European Parliament should have the right to call the chairperson in for public hearings, and it should have the right to dismiss the Commission *in toto*. This last provision, however, should be limited by two specifications. First, that the Commission may be dismissed only by sufficient majority of the Parliament, and, second, that the last assessment would not be put out of effect if the Commission is dismissed. In this way, Parliament would be kept from abusing its power for the sake of short-sighted political gains, and would dismiss the Commission only in cases where a broad majority felt that it had not performed properly.

The independence of the Commission also demands a high degree of transparency in its operations. This calls for the publication of all materials relevant to the Council's judgements and decisions, including a clear exposition of the criteria used for the assessment, as well as the minutes of Commission meetings. There is no need to publish these materials immediately after a meeting or decision. Such a requirement might affect the Commission's ability to obtain and process all relevant information. Instead, the Commission could choose a publication lag of several months.

The Commission: an agenda setter?

Instead of being a referee of budgetary plans, some suggest the Commission could become an agenda setter, spelling out annual limits for the increase in a state's public spending or debt at the beginning of the budget process. National governments would then be obliged to observe these limits, though of course, they would be free to choose an increase in government debt smaller than the limit set by the Commission.

The role of an agenda setter would increase the public visibility of the Commission, but also the intensity of its involvement in national decision making. The Commission would also have to evaluate each government's priorities and goals every year, as well as each country's economic and fiscal situation and prospects. This could become a very large task, duplicating existing government departments, demanding substantial resources and a lot of time for hearings and consultations. More importantly, it would almost certainly bring the Commission into conflict with national Parliaments where elected governments have democratic legitimacy, but the Commission does not.

Making the Commission an agenda setter in the national budget processes would also shift the burden of proof of sustainability from the government to the Commission. If the Commission is to set annual limits for the change in government spending, the public will assume that the economy will meet its sustainability requirements as long as they observe the annual limits set by the Commission. The government itself would not have to worry about sustainability, and would simply rely on the judgement of the Commission instead. The Commission would then find it hard to demand fiscal adjustments from the government, if that government had observed the limits set by the Commission even if the Commission had had to change its view of the situation. Thus the Commission would end up assuming responsibility for sustainability and a good part of fiscal policy in the eyes of the public – raising questions of legitimacy and the function of parliament.

The Commission: a veto player?

By contrast, the responsibility for ensuring sustainability, and the choice of fiscal policies, would remain firmly with the government if the Commission were cast as a veto player. The burden of proof would remain with the government who would have to convince the Commission that their fiscal plans were sustainable given the current economic situation and the outlook for the future. This would force the government to argue openly about sustainability and signal that sustainability is their responsibility. Since the government retains full control over all fiscal policy instruments and, therefore, control over the adjustments to be made when sustainability is at risk, it is clear that being a veto player is a more appropriate role for the Commission.