Proposals to reform the Eurozone are on the agenda again. The evolution of the complex set of European fiscal rules should be on high on this agenda. The rules generated excessive fiscal austerity during the crisis therefore aggravating and prolonging its economic, social and political consequences. Moreover, either because countries did not abide by the rules or because the rules were not sufficiently stringent during good years, there was insufficient debt reduction in many countries in the 2000s and this reduced fiscal capacity during bad years. In addition, these rules suffered from large problems of measurement. They are indeed based on a valid theoretical concept, the structural budget balance, but which is not observable and whose estimation is subject to massive errors.

The policy mistakes generated by the fiscal rules also led to overburdening the ECB as the main remaining stabilization instrument. The fiscal framework has also put the European Commission in the difficult position of enforcing a highly complex, non-transparent and error-prone system, exposing it to criticism from countries with both stronger and weaker fiscal fundamentals. The rules are used as a scapegoat by anti-European populists because they are seen as a centralised micro-management which infringes on national sovereignty.

However, fiscal rules to insure debt sustainability in the Eurozone are a necessity because the no bail-out clause in case of fiscal crisis is not credible in a monetary union. They need a major overhaul. Fiscal rules are not a silver bullet and cannot be substituted to the national democratic debate on fiscal choices and debt sustainability but should help framing this debate. Fiscal rules should be as transparent and simple as possible, should set targets under the direct control of the government, should allow countercyclical fiscal policy and should generate incentives to reduce excessive public debt.

The purpose of this Note is to assess the current framework and to propose a major simplification. This Note recommends substituting to the numerous and complex present rules a new simple rule: nominal expenditures should not grow faster than long term nominal income, and they should grow at a slower pace in countries with excessive levels of debt. The simulations performed for this Note suggest that this rule would help reconciling fiscal prudence and macroeconomic stabilization of the economy. The Note specifies a national and European institutional framework that could implement such a rule. We recommend to broaden and better integrate the mandate of the French independent fiscal council (Haut-Conseil des finances publiques) into the national budget process by including fiscal forecasts endorsement and debt sustainability analysis in its mandate and by increasing its capacity to independently produce fiscal and macroeconomic forecasts. Finally, we advocate for a credible enforcement of fiscal rules, mixing several instruments pertaining to surveillance, positive incentives, market discipline and increased political cost of non-compliance.
The rationale for fiscal rules

Fiscal rules, what for?

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

Between 1990 and 2015, the number of countries with national and/or supranational fiscal rules surged from 5 to 96. What is the rationale for such rules?

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

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

The specific need of fiscal rules in the Eurozone

In a monetary union like the euro area, additional arguments exist to justify the adoption of fiscal rules and the adoption of a common framework. The issue here is that governments do not internalize the long-term impact of their fiscal policy decisions on other European Monetary Union (EMU) members. The externalities go through the potential impact of too expansive (or too restrictive) fiscal policies and debt accumulation by one country on the others.

Inflationary (deflationary) fiscal policy in one euro-area country could impact the average euro-area inflation targeted by the ECB and trigger a monetary tightening (easing) for everyone. European involvement in the fiscal rule is also justified because fiscal policy has a role both in the build-up and the correction of wage/price divergences, especially in a non-optimal monetary union in which factor movements and purely market-based relative price adjustments across countries cannot efficiently compensate dis-equilibrating developments.

There could be also a channel through interest rates: an increase in the deficit and debt of one country would lead to higher interest rates in other countries of the euro area. However, this channel has not been empirically relevant and in fact during the Eurozone crisis it may have gone in the opposite direction as investors fled countries with high debt and bought public debt of “safe haven” countries of EMU. This new effect may be an independent justification for fiscal rules to prevent such destabilizing movements in crisis period.

The distinctive feature of the EMU comprised of sovereign countries is that debt restructuring or debt monetization may be the consequence of excessive debt accumulation by one country heavily affects the other member countries. There is a risk that ECB may be pressured to use monetary policy to prevent a default in fiscally weak countries via debt monetization. This monetization, i.e. the implicit transfer to the country which public debt is purchased by the ECB, might generate an inflation tax on all EMU countries or lower transfers from central banks to governments. Such transfers are not voted by parliaments and may eventually backlash on the monetary union, as the amounts at stake are potentially very large. This was well understood at the time of the creation of the euro and Article 123 of the Treaty on the Functioning of the European Union (TFEU) expressly prohibits the ECB’s purchase of member countries’ public debt directly from public authorities. In addition, Article 125 of the TFEU prevents any form of liability of the EU for Member States debt obligations (no bailout clause). However, in a situation where there is a risk of a messy default and of a potential exit from the currency union, triggering contagion and collateral damage for all members, the cost of a bailout through financial assistance loans may eventually be lower than the cost of default and exit. Therefore, the pressure for monetization and/or bailout through financial assistance loans is very strong, reducing the credibility of the no monetization/no bailout rules.
At various points during the Eurozone sovereign debt crisis, Greece, Ireland, Portugal, Spain and Cyprus had to ask for the support of the other member states in order to avoid a default or a collapse of their domestic banking sector and potentially an exit from the monetary union.

In addition, expected bailouts may also have reduced market discipline in the sense that the cost of borrowing for some countries may have been too low in the period before the crisis. This may also have reduced the incentive for fiscal prudence such as in Greece in the 2000s. Note therefore that debt sustainability not public deficit per se should be the core objective in the EMU. Note also that macroprudential rules that limit vulnerability of financial institutions are a necessary complement to fiscal rules as we have seen (for example in Ireland and Spain) that bank debts can rapidly be transformed into public debts.6

Finally, because countries in a monetary union loose the monetary instrument to stabilize the economy against asymmetric shocks, the fiscal instrument is a key countercyclical policy tool. Hence, fiscal rules in the EMU, more than in countries with independent monetary policy, must play a countercyclical role.

**Deficiencies of the current European fiscal framework**

European fiscal rules originate from the Maastricht treaty (1993). It specified the criteria for joining the EMU, including budget deficit and public deficit criteria. The Stability and Growth Pact (SGP) put in place in 1997 clarified and complemented the fiscal criteria, which in turn was reformed in 2005, in 2011 (by the so-called “Six-pack”), in 2012 (by the so-called “Fiscal compact”) and in 2013 (by the so-called “Two-pack”). Beyond these legislative acts, the European Commission regularly updates and extends a detailed Code of Conduct and a detailed Vade Mecum, which specify various aspects of the implementation of the fiscal rules.

The current fiscal framework includes four numerical fiscal rules:

- The budget deficit must be below 3 percent of GDP;
- Gross public debt must be below 60 percent of GDP. If it is higher, it must decline annually by at least 1/20th of the gap between the actual debt level and the 60 percent reference value;
- The structural budget balance (that is, the budget balance which excludes the impact of the economic cycle and one-off fiscal measures) must be higher than the country-specific medium-term objective (MTO), which, in the case of EMU countries, has to be chosen at or above −0.5 percent of GDP, or −1 percent for countries with a debt-to-GDP ratio below 60 percent. If the structural balance is lower than the MTO, it must increase by 0.5 percent of GDP per year as a baseline;
- The adjusted measure of real government expenditures (deflated by the GDP deflator forecast) cannot grow faster than the medium-term potential economic growth if the country’s structural balance is at its MTO or higher. If the structural balance has not yet reached its MTO, expenditure growth must be lower than potential growth, in order to ensure an appropriate adjustment towards the MTO.

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

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

However, European fiscal rules suffer from several conceptual and practical weaknesses. When a recession lingers for several years, economic rationale might call for a repeated fiscal stimulus if the recession deepens. However, current EU fiscal rules at best allow the slow-down or some postponement of fiscal consolidation. They are thus not well designed for the type of persistent recession we experienced after 2008. Complexity is another major problem. As noted by Wieser (2018), every presumed breaking of the fiscal rule book has resulted in further refinement of the rules, which is reflected in the length of the Vade Mecum, which has grown to 244 pages. He concludes that “The present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors”.5 This complexity makes the fiscal framework non-transparent and difficult for policy makers to internalize, which in turn has contributed to non-compliance. This became the norm, while fiscal policy both in member states and at the EU level became increasingly pro-cyclical.

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European Fiscal Rules Require a Major Overhaul

Observation 1. European fiscal rules have become overly complex, which hinders their internalization by policy makers and their acceptance by the wider public.

Furthermore, current rules suffer from large measurement problems. While the structural budget balance is a nice theoretical concept, it is not observable and its estimation is subject to massive errors. Structural balance measurement depends on output gap (the difference between actual output and potential output) estimates, which are themselves very uncertain. Several works conclude that output gaps were mostly underestimated by the European Commission and these estimation errors were pro-cyclical. A further source of measurement issue is the estimates of the elasticity of the budget balance to the output gap.

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

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

For “core EU” countries, i.e. the first 15 EU members excluding Greece, Ireland, Italy, Portugal and Spain, the typical revision in the change of the structural balance estimate one year later (i.e. corresponding to the 0.60 value in Table) is between half and one percent of GDP (Figure 1). For periphery countries and for the newer EU members that joined in 2004 the revision is even somewhat higher. Moreover, there is no decline in the size of revisions over the years: for 2015-17 revisions have even increased, although there were no big shocks these years and the economic situation of the EU improved. It must be noted that large revisions do not exclusively characterize European Commission estimates as IMF an OECD estimates are also subject to similar revisions.

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1 Output gap estimate uncertainty relates to certain features of the methodology, changes in the methodology, the use of forecasts in the estimation of current output gaps and data revisions. See for example Darvas Z. (2015): Mind the Gap (and its Revision), Bruegel Blog Post, May.
Observation 2. Potential output, the output gap and the structural balance are badly estimated, misleading real time fiscal policy decision-making.

Due to these problems, it is not surprising that EU fiscal rules performed very poorly. They led to pro-cyclical fiscal policies before the 2008 global financial crises (too expansive fiscal policy in many EU countries), and with the sole exception of 2009, they also contributed to pro-cyclical fiscal tightening starting in 2010, which likely played a role in the prolonged recession and increased unemployment of the EU. A recent study present comprehensive analyses of the European fiscal framework and conclude that fiscal policy was acyclic in its preparation phase (meaning unchanged structural balance over the economic cycle), but became pro-cyclical in its execution phase, which corresponds to frequent divergence between commitments and budget execution.11

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

Moreover, compliance with the rules has been weak: in more than three-quarters of the cases, the countries in the Eurozone exceeded the 3% deficit threshold between 1998 and 2015 and 16 of the 19 member countries had an average deficit above their medium-term target.12 European fiscal rules have not been sufficient either to ensure the sustainability of public finances in the medium term or to protect the quality of their composition (to prevent public investment from being penalized). Furthermore, EU fiscal rules also lack proper enforcement mechanism. While 24 EU countries were placed in an excessive deficit procedure after 2008, the complex web of flexibility has been used to the extreme to avoid sanctions. More recently, while for example Belgium and Italy did not meet the debt reduction criteria, the Commission did not propose to place these countries under the Excessive Deficit Procedure (EDP). The unfavorable properties of the European fiscal rules also lead to “Brussels-bashing”, whereby national governments argue with the Commission about the “stupidity” and incorrect application of the rules.

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

Reforming the European fiscal framework

While there is no universal and perfect fiscal policy rule, the economic literature identifies some broad criteria for judging the relevance of a fiscal rule. It should be well-defined, transparent, simple, flexible (in order to respond effectively to an exogenous shock outside the scope of public policy control), adequate relative to the final goal, enforceable, consistent, and supported by sound policies, including structural reforms if needed.13

Proposal for a new public expenditure rule

Recent contributions advocate the introduction of a fiscal rule based on the growth rate of public expenditure.14 One advantage of such a rule is that its basic principle is easy to describe: nominal expenditures should not grow faster than long term nominal income, and they should grow at a slower pace in countries with excessive levels of debt. Unlike the cyclically adjusted deficit, public expenditures are observable in real time and are directly controlled by the government. Furthermore, expenditure rules embed countercyclical stabilisation both because cyclical revenue increases have no effect on the expenditure ceiling – inducing stronger fiscal discipline in good times compared to the current rules – and because they do not require cyclical revenue shortfalls to be offset by lower expenditure. This characteristic will be analysed in the next section reporting simulations of such a rule.

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

Each year, the government proposes a rolling medium-term (e.g. five-year-ahead) target of reduction on the debt to GDP ratio. This could be part of the existing Stability Program provided each year by member states to the European Commission. Both the national independent fiscal council and the euro area fiscal watchdog are consulted and provide a public assessment

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11 See Eyraud L., V. Gaspar and T. Poghosyan (2017): “Fiscal Policy in the Euro Area”, IMF Working Paper, no 17/18, January. The authors also find that large countries tend to deviate more from their commitments, while small countries tend to stay longer under the excessive deficit procedure.

12 See Eyraud et al. (2017) op. cit.


of the target in terms of both feasibility and ambition. A discussion follows with the European Commission. The discussion should be based on an economic analysis where the important parameters would be the distance between the actual debt-to-GDP ratio and the long-term target of 60% (the higher the gap, the more ambitious the adjustment); a broader analysis of fiscal sustainability (in particular, to give credit to countries that undertake solvency-improving entitlement reforms, or major reforms expected to raise potential growth); and an economic analysis of the economic situation and the relevant path of debt reduction. As a result, the medium-term debt reduction pace should not be determined by a formula. The Commission then presents its conclusion for the debt reduction targets for each country to the Council that can vote against it by a reverse qualified majority.

The national fiscal council would prepare a medium-term nominal GDP growth projection based on expected potential output growth; expected inflation; and a possible cyclical correction, in case initial conditions depart markedly from long-run equilibrium. Given the medium-term target on debt reduction, the national fiscal council provides a consistent medium-term nominal public expenditure path and uses it to set a nominal expenditure ceiling for the coming year, for use in the preparation of the corresponding budget.

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

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

The simulations conducted for this Note by CEPREMAP and the French Economic Observatory – *Observatoire français des conjonctures économiques* (OFCE) – suggest that during a very large crisis, the fiscal rule may be too stringent. Hence, this militates, as is the case presently, in favour of an escape clause that would allow countries to deviate from the rule in case of ‘exceptional circumstances’. The activation of such a clause would have to be agreed by the Eurogroup, after consultation with the euro area fiscal watchdog.

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

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

**Simulations of an expenditure rule**

In order to assess the consequences of an application of an expenditure rule, several quantitative simulations done by the...
Next, we analyze the cyclical properties of the rule. This analysis is based on a rule calibrated for France. The rule has good countercyclical properties for unexpected demand shocks. First, the nominal growth rate of expenditures is not affected by the shock and automatic stabilization is at work due to lower revenues and higher deficits. Second, a negative demand shock generates inflation below expectations. As the growth rate of nominal public spending is based on expected inflation, such a shock induces a higher real growth rate of public expenditure and therefore a positive fiscal impulse. Concerning supply shocks, such as oil price shocks generating a fall in output and an increase in inflation, the expenditure rule is still stabilizing because it induces a budget deficit but the higher unexpected inflation slightly reduces its stabilizing properties (relative to the current rule). Overall, if, as is mostly believed, demand shocks are predominant in the Eurozone, we conclude that the expenditure rule has a better cyclical properties than the current rule.

To illustrate how better are the countercyclical properties of the expenditure rule, the graphs below show the observed growth rate of primary public spending in France and of the fiscal impulse and a counterfactual simulation performed by OFCE of these two series as generated by an expenditure rule. Both graphs below suggest that the rule would be more countercyclical than what was observed in France. During good years the growth rate of public expenditure as well as the fiscal impulse would have been lower. Vice versa, in the period 2011-2013 French fiscal policy would have been less restrictive. Note that the variance in the growth rate of expenditures as generated by the rule appears high in these simulations. One reason is that the expenditure rule is net of discretionary changes in fiscal revenues: for example in 2011-2013, tax rates and revenues were increased so that the rule would have allowed for a large increase in spending. Our counter-factual simulations take as given tax changes. This is rather hypothetical. Had our rule been in place and followed, no such tax rate increase would have been necessary and thereby the year-to-year expenditure growth rate limit would have not been as erratic as in the simulation. In any case, our rule requires a careful consideration of revenue-side measures. Note however that in 2009, the rule would have implied less fiscal stimulus and this is the reason we advocate to keep an escape clause in case of exceptional circumstances.

17 See the iAGS (2018): "Repair the Roof When the Sun is Shining, Report available on www.iags-project.org

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

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


22 Fiscal impulses are defined as a yearly (negative or positive) change in the structural budget balance.
European Fiscal Rules Require a Major Overhaul


Institutional and legal issues

Creating the right institutions

A recent literature on fiscal discipline emphasizes the complementary role of fiscal rules and the establishment of national independent fiscal institutions (IFIs) or fiscal councils. Building such institutions is not enough to improve trust in public governance but it is a necessary ingredient.

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

The OECD identifies six conditions to effective independence of such councils:

- Appropriation in the national fiscal framework (integration into the national budget process with evaluation of the medium-term sustainability of public finances, realization of budget estimates on behalf of the government, counter-expertise and analysis economic and fiscal scenarios of the government, information of parliamentary debate...);
- Adequacy of the human and financial resources with the mandate;
- Access to relevant information at all times (this means establishing formal information exchange systems with national administrations and the national government);
- Credible communication in real time;
- Impartial stance and accountability of the Independent Fiscal Institutions (IFI) based on past records;
- Strong links with Parliament (set up regular hearings of the National Budget Board Executive Board in Parliament, as well as technical sessions with parliamentary budget committee).

The role of independent fiscal institution

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

In fact, the 6-Pack reform in 2011 has broadened the role and formalised the tasks of national independent fiscal institutions. Virtually all IFIs contribute to monitoring compliance with national fiscal rules and/or to macroeconomic forecasting for fiscal planning purposes. Yet there are significant differences between IFIs across the Member States in terms of mandates, resources and visibility in public debates. Depending on the country, they could perform a broad spectrum of tasks including macroeconomic and budgetary forecasting, assessment of compliance with fiscal rules, policy costing, analysis of long-term sustainability, promotion of transparency, and recommendations on fiscal policy. In our view not all IFIs have a sufficiently broad mandate and dispose of sufficient resources to honour a broader mandate.

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

The French independent fiscal institution

French government forecasts on growth one year ahead have been characterized by an optimistic biases on budget balances and growth over the period 1996-2013. On average the forecast error on the budget balance was 0.36 point of GDP (against 0.29 –and 0.09 excluding Greece– on average for 20 OECD). Only 7 of these 20 countries have a more optimistic bias on the balance forecast than France. As for the growth forecast, the average error pre-2013 is 0.57 (against 0.27 average forecast error for the 20 OECD countries). However, since 2013 and the creation of the French High Council of Public Finance –Haut-Conseil des finances publiques (HCFP)– these biases have been drastically reduced: the budget balance bias forecast is 0.06 point of GDP and the GDP growth bias forecast is very small at – 0.05 point of GDP. Although it is still too soon to fully assess the role of the French IFI on forecast bias, this suggests that the mere presence of HCFP reduced pressure by the government on the forecast unit of the Treasury to "massage" data so as to provide growth forecasts.

The scope of HCFP (see Box) is limited in comparison to other member countries. It does not produce macroeconomic forecasts: it simply publishes an opinion on the government macroeconomic scenario but does not provide a formal endorsement (unlike for example Spain or Italy). Regarding fiscal forecasts, the HCFP is not a producer as well and its “endorsement” role derives from an extensive interpretation of its mandate while the other IFIs are mandated to focus also on the analysis of the actual balance in relation to the 3% rule, on the compliance with the MTO and on the structural adjustment. The capacity to provide a sound assessment on fiscal forecasts depends critically on the quality of the information provided as well as the time the institution is given to process and analyze this information. The HCFP is only given around one week to provide such an opinion which is much less time than what other IFIs have to perform similar work and clearly does not allow a deep analysis. Lastly, the comply-or-explain principle according to which budgetary authorities should react publicly to IFIs’ opinions is not clearly set in the French legislation.

The mandate of the HCFP should thus be broadened to improve its effectiveness. It should be responsible not only to give an opinion on the government macroeconomic forecasts but for providing itself macroeconomic forecasts, potential growth estimates and fiscal forecasts made for every budgetary bill and stability programme and should keep ensuring compliance with the correction mechanism.

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

To avoid heavy duplication of resources, and drawing from the UK experience, we recommend organizing a forecast process inside the HCFP with the cooperation of the Treasury and other relevant administrative units in charge of fiscal forecast on the spending and revenue side. There are two possible practical ways to do this:

- Creating a small economic team in charge of economic forecasts in the HCFP which would have the right interplay with the Treasury staff, and other administrations or independent institutions, in charge of public finance forecasts. In such an organization, the HCFP would be better integrated within the national budget process.

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See Frankel and Schreger (2013) op. cit.
European Fiscal Rules Require a Major Overhaul

Organization and mandate of the HCFP *(Haut-Conseil des finances publiques)*

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

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

In case of “significant deviations”, the HCFP carries out an assessment of the corrective measures taken by Government and, if necessary, on the deviation from the structural balance trajectory.

Its college is composed of ten members in addition to its chair. The members of the college are appointed for a five-year term by the First President of the Court of Auditors, the parliamentary authorities, and the President of the Economic, Social and Environmental Council (EESC), with no possibility of dismissal. The members are trained public finance magistrates and economists.

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

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

This recommendation is all the more important if the recommended expenditure rule is put into place. The reformed HCFP would need to produce independent forecasts of potential growth, expected inflation, and permanent fiscal impact of changes in the tax system. Forecast errors should be better acknowledged and HCFP should present its central forecasts together with a fan showing the probability of different outcomes.

How to enforce the rules?

Introducing a new expenditure based fiscal rule is a necessary yet not sufficient step for an effective fiscal framework. The actual enforcement of the rule is crucial. The traditional view is that this should be done by increasing the cost, both economic and political, of non-compliance. This is certainly part of the solution but there is no silver bullet here in particular because political sensibilities, history, culture and beliefs shapes the views on the optimal trade-off between rules versus discretion. Experience suggests that enforcing compliance through penalties imposed by what is seen in many countries as Brussels bureaucracy or Berlin political might has its own deficiencies. European fiscal rules were sometimes used as a scapegoat by national governments, which preferred to blame them for a necessary fiscal adjustment rather than past profligacy.

Under the current fiscal framework, non-compliance is theoretically subject to fines, amounting to up to 0.5% of a member state’s GDP. Large fines are not credible, as they do not pursue an economic purpose apart from penalty, and might exacerbate an already fragile fiscal stance. This creates a time consistency problem: everyone agrees that credible sanctions are important to enforce the SGP, but once the SGP is violated, imposing that sanction may do more political and economic harm than good. In addition, the recent literature emphasises the political economy deadlock of such a compliance mechanism in the EU. As fines are voted at the majority of the Council, a bad coalition may arise: one Minister might prove reluctant to vote in favour of sanctions against another member state, in order not to be voted against should a similar situation arise for him: we should not rely on Finance Ministers to impose discipline on each other. The introduction of reversed qualified majority following the Eurozone crisis did not break the status quo. An alternative to monetary fines paid by member states to the EU would be conditioning EU budget payments to member states on respecting fiscal rules: such a system would face exactly the

and would be in better position to provide counter-expertise and analysis of the government budget estimates;

- Moving the growth forecasting unit of the Treasury to the HCFP. This resembles the British OBR model. It would still (as it does today) produce regular confidential forecasts for the Minister and Treasury. However, the Minister would not have anymore authority on the forecasting unit. It would also continue to discuss and cooperate with the Treasury units in charge of forecast on the fiscal spending and revenue side so as to make sure the forecasts (macroeconomic and fiscal) are consistent with each other.
same problems as the problems of current fines described above. Moreover, EU budget payments serve EU goals and therefore suspending them would harm EU goals.

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

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

**Sanctions.** Market discipline should also be part of the package even if it has not worked well in the past. In the 2000s, markets did not discipline countries that were running imprudent fiscal policies – or imprudent financial policies that generated excessive private leverage - and during the euro crisis market discipline over-reacted with mechanisms of self-fulfilling expectations where the fear of default and exit were pushing the cost of financing of several countries to levels that were driving them towards default. Steps have already been taken to guide market discipline. For example, the introduction of collective action clauses to government bonds will likely help to avoid the pre-2007 market complacency. This has to be accompanied by instruments that reduce the danger that default risk transforms itself into redenomination risk. This is one objective the Outright Monetary Transactions (OMT) instrument by the ECB and it is important to keep this instrument in the toolbox to help to contain self-fulfilling expectations. Market discipline that prices default risk should not be eliminated. Redenomination risk is different in nature and should not be allowed to destabilize the Eurozone.

One can go one step further to guide market discipline towards giving the right incentive for fiscal prudence. One possibility is the proposal to force countries that violate the fiscal rule to issue junior bonds to finance expenditures in excess of the fiscal rule. The advantage of this proposal is that it applies not on the stock of existing debt but on a portion of the flow of the new debt necessary to finance excessive expenditures. Hence, discipline is applied where it is most useful in terms of incentives, i.e. at the margin to increase the marginal cost of financing excessive expenditure flows. Governments that decide to spend in excess of the spending rule would have to explain their economic and political rational to do so and the marginal cost of such spending would depend on the motives and credibility of the government plans.

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

**Recommendation 4.** Transfer surveillance to well-equipped national fiscal councils, coordinated and overseen by a European fiscal council. Subject the access to a “flexible” ESM credit line and the participation in euro area-wide fiscal stabilisation instrument to compliance with the fiscal rule.

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

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26 See Benassy-Quéré et al. (2018) op. cit.
27 For more details see Benassy-Quéré et al. (2018) op. cit.
Recommendation 5. In case of non-compliance with fiscal rules, as concluded by the national fiscal council introduce national “comply or explain” procedures for the Minister of Finance in front of the parliament and the press in member states, and in front of the European Parliament in the case of a major deviation as concluded by the European fiscal council.

Legislative changes needed to introduce our proposal

The EU fiscal framework is based on three types of laws: the TFEU, the SGP and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), an intergovernmental treaty signed by 26 countries, which is frequently called Fiscal Compact.

We presume that the EU Treaty will not be changed soon, because that would require complicated negotiations and a difficult ratification process. The 6-Pack and 2-Pack regulations (SGP) could be changed by the co-decision of the Council and the European Parliament, which should be feasible. A change in TSCG is probably much easier than changing the EU Treaty, yet that would also necessitate national ratification, which in some countries requires a referendum.

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

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

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

Finally, The Fiscal Compact is mostly in line with the new rule we propose. The two most relevant regulations of the Fiscal Compact are the minimum requirement for the medium term objective of the structural balance for Eurozone countries (~ 0.5 or – 1.0%) and the 1/20th debt reduction rule from the 6-Pack.

The concrete MTO values are not in contradiction with our proposed rule, because that would lead to a close to balance budget in the long term. Therefore, keeping these numerical requirements as long run requirements (if no specific annual changes in the structural balance is required) would not be in contradiction with our proposed rule. But the 1/20th debt reduction rule is in contradiction with our proposed rule, since we argued for a moving 5-year debt reduction target, which might be lighter (but also tighter) than the 1/20th rule. Therefore, the Fiscal Compact should be revised along with the SGP (6-Pack regulations).

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28 All EU member states but the Czech Republic and UK have signed the TSGC.