Is There a Need for a New Fiscal Framework in the Euro Area?*

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. This paper suggests an inter-temporal assignment, where fiscal policy focuses on long-term objectives (e.g., social security, education, infrastructure and research) and monetary policies focus on short run objectives (macroeconomic stabilisation). Specifically, we argue for 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 enforceable form to this targeting arrangement, and also provide a mechanism to identify the stable region within which the targeted debt must operate. Making these factors explicit would both improve the credibility of the Euro Area’s fiscal policies and reduce the risk premia on borrowing costs. However stabilising the stock of debt by fiscal controls alone is not always possible. We therefore examine the “competitiveness pact” (internal devaluations) as a means of circumventing those barriers. This framework provides analytic support to underpin many of the innovations 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 three 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 many 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 unsustainably high debt and deficit ratios. And in between are Germany, Belgium and the Netherlands, with public finances no longer 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 out 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 not only reinforces these fiscal difficulties but will also prove harmful to private investment and recovery in the long term. Second, there is growing evidence that debt ratios above 90% adversely affect economic growth (Reinhart and Rogoff, 2009; Checherita and Rother, 2010). In fact, US and UK debt-to-GDP ratios (among others) are expected to exceed 90% as soon as 2011 (Buiter, 2010).
Against this background, concerns about explosive debt developments seem well founded. While simple in principle, in practice it appears to be difficult for EA members to implement the fiscal pain necessary to bring their public finances in order. Governments hesitate to raise taxes and/or cut expenditures. This reflects 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 the size of public sector as they want, and (c) constrains the fiscal authorities to avoid unsustainable fiscal deficits in the future.

This paper is primarily concerned with how fiscal and monetary policies are set in the EA, but we also review how those policies interact with policies of structural reform. We treat the policymaking framework as a whole, rather than the detail of how different policies might best be constructed to fit 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 (political pressures in particular) so that their policies 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 briefly review the SGP’s track record and its design/enforcement problems. In Section 3 we outline the principles of a debt targeting framework for the EA, and Section 4 continues by explaining how a regime of enforceable 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 (or competitiveness pact) may be achieved. Finally, Section 6 contains our core proposal: how to run fiscal balances that stabilise public sector debt around its long term optimal value. Section 7 then concludes by summarising our propositions.

2. Experiences with the Stability and Growth Pact

The SGP was introduced in 1997 to restrain the impact of excessive public deficits and debt on the economy. It imposes constraints on fiscal policy: the deficit-to-GDP ratio should not exceed 3% across the cycle, and the debt-to-GDP ratio should not exceed 60%. While the debt criterion remains unenforced, the Pact operates an excessive deficit procedure, with sanctions for violators and other enforcement procedures.
The fact of the matter, however, is 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 after the financial crisis, hardly any EA member meets either fiscal criterion. 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 unenforceable in practice. 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.

Second, a necessary condition for 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.

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.

The bottom line is that there is no coherent fiscal 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; and with monetary policy to ensure consistency and commitment to Europe’s inflation goals and financial discipline (since an independent monetary policy makes fiscal policies independent of that monetary policy). Against that, several questions can be raised:

- Should fiscal policies be directed towards a common fiscal policy, i.e. harmonization?
- Should fiscal policies, taken together, be better co-ordinated with monetary policy?
- Should fiscal policies be formally restricted to prevent spillovers on others, 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 where economic structures differ and economies are out of cycle?

3. Why Debt Targets?
Fiscal policy lends itself naturally to longer term objectives. This provides an element of leadership, in the sense of going first, which can be combined with independent monetary policies directed at short run and 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 could then operate according to its comparative advantage.\(^1\) The leadership role derives from the fact that fiscal policies typically have longer run targets (public services, social support, education, infrastructure, sustainable public finances), and are therefore not easily reversible or easily used for stabilisation if consistency across time and policy types is to be maintained.

The result of such a framework is Pareto improvements over the usual competitive policies, without reducing the central bank’s ability to act independently on its shorter run objectives.\(^2\) Debt targets in this context have the advantage of being a stock – not a flow. That implies a degree of persistence, especially in countries with higher levels of public debt. Debt targets can therefore be used to pre-commit fiscal policies, 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.\(^3\)

We suppose that soft targets (a band, or a debt ceiling) would work better for the following reasons. Decision making is less likely to become 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 allow different national priorities, although simplicity and fairness suggest uniform limits should be imposed in the long run.

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\(^1\)The 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).

\(^2\) See, for example, Dixit and Lambertini (2003), Hughes Hallett and Weymark (2007) and Hughes Hallett (2008a).

\(^3\) 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).
All these points are applicable to either 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 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 accurately\(^4\)). 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 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 commitments for the future. From here 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).

Thus, 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. It is easy to operationalise this suggestion by giving the fiscal authorities an explicit debt target; that is, to provide a pre-commitment technology with a long-term objective and a slow moving target variable. Debt, being a stock rather than a flow, has a high degree of persistence and a lot of “carry-over” in the higher debt economies. It remains to provide an enforcement mechanism to rule out the possibility of opportunistic behaviour by the fiscal authorities.

Fiscal-monetary coordination can now 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 fiscal policies then deviate from their chosen path, monetary policies can quickly counteract to cut out any unwanted consequences. This punishment threat, in the context of a strategic policy game, should normally be enough to persuade fiscal policymakers to stick with their announced path. In fact a formal analysis shows exactly that.\(^5\) In a world of asynchronous games, where policy makers have different periods of commitment to their regime and underlying policy paths which those regimes generate, monetary discipline will constrain fiscal policies except in extreme cases (the central bank is too impatient, or

\(^4\) For the significance of this point in practice, see Hughes Hallett, Lewis and Kattai (2011).
\(^5\) The results quoted in this paragraph are demonstrated formally in Libich, Hughes Hallett and Stehlik (2010).
its commitment relative to fiscal policy is insufficient). However, this result weakens in a monetary union depending on the number, size and capacity of the smaller economies to free ride on the discipline of others. For that reason, we superimpose a self-stabilising mechanism, with an explicit enforcement of debt targets to deal with extreme cases, below. Once again, fiscal pre-commitment and credibility are achieved.

4. Making Debt Targeting 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 or “debt brake” in the long run (across the cycle, current government spending has to be financed by current revenues rather than borrowing; see Schnellenbach 2010) since, in steady state, the target debt-to-GDP ratio will become constant – results which were later confirmed in the empirical work of Aizenman et al. (2007). 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 enforcement, as the experience of the SGP process 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 to cope with sudden shocks;

b) The debt targeting system should be set up for each government as a debt target value and an upper boundary or ceiling (both expressed as a percentage of GDP);

c) The space between the target and upper boundary should be divided into three equal ranges.

6 By contrast, Kirsanova 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.
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 likely to reach and follow a common value for the long term framework thereafter. 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 could 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 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. The principle threat to domestic policymakers is that this step will be known in advance. 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 (IMF style) 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 before the regime started, and each 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 in this protocol is that the possibility of any loan, bailout or other help is strictly conditional and known to be so. Once debt goes beyond the 60% barrier, any further assistance 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 likely be subject to a severe political backlash and incur escalating borrowing costs. Note that all the penalties in this scheme are designed to withhold what a government would like to have (fiscal freedom, guarantees, loans), not to remove something which they already have (resources for a fine).\(^7\)

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.

\(^7\) Some may object that this plan is “all stick, and no carrot”. It would be possible to reinforce it by offering rebates from a country’s EU budget contributions in proportion to the extent the debt ratio is below target.
The Most Recent Proposals from Brussels:

Since this paper was first drafted, a number of similar proposals have been made by the European Commission and by the French and German governments. 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 counties with debt ratios exceeding 60% should show adequate progress to reaching that target (defined in one proposal as eliminating 1/20\(^{th}\) of the excess over 60% each year); and that each economy with a persistent excess debt ratio on this criterion should pay a fine of 0.2% of GDP each year (Financial Times, 24 September 2010). The French-German proposal adds a “debt brake” (that current spending must be balanced across the cycle), although the sanction or penalty to be imposed on those who fail to meet this condition, what definitions of current spending and cycle should be used, and how compliance with such a condition can be measured in real time, are all problems that need to be resolved – before they become “constitutionally embedded”.

In addition, there are proposals that countries that do not improve their competitiveness or correct other macroeconomic imbalances (a “competitiveness pact”) will be fined 0.1% of GDP each year. As before, what constitutes “persistent”, or what criteria should define “competitiveness” and “other imbalances”, are matters that remain to be agreed. 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, the real weakness is the enforcement procedure is the same as in the Stability Pact and unlikely to be any more effective because it violates the principle that punishments should remove something that the national governments would like to have but do not control; rather than demand 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 support, and then placing their policymakers “under administration”. In addition there are clearly technical problems in monitoring what amounts to a structural deficit in real time; and with the fact that a debt brake is (as we shall see next) neither necessary, nor sufficient for eliminating growth in the debt ratios.

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 reasons that we outline next.
5. Labour markets and structural reform

The Lisbon Agenda has made it clear that flexible labour markets, and labour market policies which influence employment and reduce the setting 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 support the fiscal corrections. 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 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 then 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. In addition to the opportunity to free ride on the reforms of others, 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 changes in market regulation, employment protection or social support. 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 to be 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'. 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 that any unemployment/retraining costs will be lower per unit of 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, 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, or in risk premia, or in financing costs or other expenditures forgone. In that case, a rational government would likely postpone the reforms or abandon them each 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 would 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 political cost of carrying out the reforms yourself. Consequently, no country has an incentive to carry out reforms or become more flexible, unless others reform at the same time. This is a “Groucho Marx theorem”: 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 or social 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, at the same time – as we show next.

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6. Debt dynamics: stabilising the economy at a given debt target

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

\[
\dot{d} = pdef + (r - g)d - \dot{m}
\]

(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 the debt burden, \(g\) 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 (Bohn 1998; de Grauwe, 2009).

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 (1), that will happen when

\[
pb = (r - g)d
\]

(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.\(^9\) 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).

In other words, a simple rule like the debt brake is neither necessary nor sufficient to stop debt burdens growing; the fiscal position needed will depend on the average interest rate paid on existing debt relative to the growth rate, and the existing debt burden, at each planning period.

**Approach I: financial corrections.** The implication of these observations is that it is 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.

\(^9\) Values of \(pb > (r - g)d\) will ensure falling debt burdens, \(\dot{d} < 0\).
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 (to anchor expectations about financing costs). 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.

**Approach II: improving competitiveness.** 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). 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.\(^{10}\)

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.

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\(^{10}\) 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.
and ultimately real incomes as a consequence.\textsuperscript{11} As a policy strategy, this has the advantage that it largely resolves the short run (fiscal) conflict vs. long run gains issue, in which deficits get worse before they get better (as illustrated in Figure 1) – without resorting to any monetary financing of interim deficits. But it may be a slow process.

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 since 2004 after several 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.

<table>
<thead>
<tr>
<th>Country</th>
<th>% Real Devaluation</th>
<th>Country</th>
<th>% Real Devaluation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>7%</td>
<td>Ireland</td>
<td>35%</td>
</tr>
<tr>
<td>Finland</td>
<td>8%</td>
<td>Cyprus</td>
<td>38%</td>
</tr>
<tr>
<td>France</td>
<td>12%</td>
<td>Spain</td>
<td>43%</td>
</tr>
<tr>
<td>Belgium</td>
<td>13%</td>
<td>Greece</td>
<td>55%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>24%</td>
<td>Slovakia</td>
<td>67%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>30%</td>
<td>Slovenia</td>
<td>99%</td>
</tr>
<tr>
<td>Italy</td>
<td>31%</td>
<td>Malta</td>
<td>na.</td>
</tr>
<tr>
<td>Portugal</td>
<td>35%</td>
<td>EA, trade weighted</td>
<td>17%</td>
</tr>
</tbody>
</table>

\textbf{Table 1: Germany’s Real Devaluation Relative to Euro Partners (1995-2009)}\textsuperscript{12}


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

\textsuperscript{11}This is not a new idea. Several authors (Alesina and Perotti 1997a,b; Lane and Perotti 1998 for example) have noted that reductions in wage and non-wage costs, not Ricardian or non-Keynesian effects, were responsible for the successful deficit/debt consolidations of the 1980s and 1990s.

\textsuperscript{12}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.
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 also adopted by Ireland after 1986 to generate her remarkable growth performance before and after entering the Euro.

**Approach III: debt controls.** Nothing in this analysis of how co-ordination between fiscal policy and structural reforms can deliver new fiscal arrangements for Europe, or what the exit from excess debt or deficits should look like, says what debt level 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, more importantly, 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. 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) and Ghosh et al (2011). On 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. 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 $r > g$).

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 $d > 0$. But for $d^* < d < d_2$, we have $pb > (r-g)d$ so $d < 0$. 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, or if a common debt target is to be set for all the EA countries at say 60%, the last part of the problem is to allow the debt ratio, by choice of a suitable reaction function imposed on $pb$, to adjust according to the inequalities implied by (2) until $d^*$ is reached - and then to estimate $d_2$ in order to be able to stay well away from it.

---

13 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 – a situation often referred to as “fiscal fatigue” or the fiscal limit.
Figure 2: Determination of the Equilibrium Debt Target

Optimal levels of debt: Two points now follow. First, how can we choose a value for the optimal debt ratio to which we can aim to converge? Adapting Aschauer’s (2000) model, the optimal public sector debt ratio to maximise the rate of economic growth can be obtained as follows. Start with a standard production function augmented with public capital, where \( L = \) labour, \( K = \) private capital, and \( K_{g} = \) public sector capital (actually the accumulated stock of public spending). Borrowing is permitted to fund that public capital. Thus:

\[
Y = [L^\beta K^{1-\beta}]^{1-\alpha} K_{g}^\alpha \tag{3}
\]

Constant returns to scale are not strictly necessary, but the model is easier explained in such terms. This model can be rewritten as:

\[
Y = L K^{1-\gamma} (K_{g} / K)^\gamma \tag{4}
\]

where \( \gamma = \beta(1 - \alpha) \), and \( K_{g} / K \) is the public to private capital ratio that defines the level of public sector borrowing. Think of it as the public sector, infrastructure, human capital technology input; or,
put more formally, the total factor productivity derived from public capital. That said, we need to estimate (4) because, given estimates of $\gamma$ and $\alpha$, the optimal level of debt is then given by

$$d^* = \frac{K_g}{K} = \frac{\alpha}{(1 - \alpha)^2}$$

Thus, $\alpha = 0.2$ would imply an optimal debt level of 30%; and $\alpha = 0.3$ an optimal debt level of 60% of GDP. Notice that less productive public spending (that is, less productive forms of $K_g$) will lead to lower values of $\alpha$ and hence to lower levels of optimal debt.

The second point is that we are not much interested in estimating the S-shaped reaction function itself in Figure 2 given past behaviour in different countries, even if it were possible to do so\textsuperscript{14}, because it would only tell us what certain governments did in the past. Instead we need to construct rules that can be used to define how fiscal authorities should behave in the future. Since it is natural that little corrective action (by raising $p_b$) will be taken at low levels of debt, and inevitable that a fiscal limit (or fiscal fatigue) will set in at high levels, an S-shaped curve of some form will inevitably emerge as the primary budget reaction function in any economy we need to investigate. The only question is how to find ways to ensure that this reaction function rises at moderate debt levels, and also rises fast enough to cut the $(r - g)d$ line from below to define a stable point $d^*$.

Hence the key research issue remaining is how to design simple fiscal rules, driven by the level of debt, that produce a (sufficiently large) upward sloping reaction function as shown. A second task is to calibrate these rules so $d^*$ is set at the optimal debt level for average $r$ and $g$ values in a given economy – and then, if possible, to maximize the distance from $d^*$ to $d_2$. A third issue is to find ways to constrain the variance of the random shocks to debt in the conditional distribution, $f(d|d^*)$, so that the probability of experiencing $d > d^*$, and hence $d > d_2$, is suitably small.

**Expanding available fiscal space:** In a recent paper, Ghosh et al (2011) provide a more rigorous foundation for the reaction function in Figure 2. They first assume a function of the form $\mu + f(d)$, where $\mu$ is the intercept term and $f(d)$ is a continuous differentiable function of the given shape. This is not controversial. As just explained, it is almost inevitable that behaviour and reaction function of this shape should emerge. But it is controversial to imply that primary surplus should necessarily

\textsuperscript{14} It appears that empirical estimates of those reaction functions at a country level can be very fragile and variable in practice (see Ghosh et al 2011), making them an unreliable guide to how fiscal authorities have behaved in the past — and hence a weak basis to rely on for constructing fiscal control rules to be applied into the future.
rise in the central section, and by enough to cut the \((r-g)d\) line from below. That cannot simply be assumed, although it might be imposed by convention or suitable policy rules as we propose here.

They then demonstrate that, accounting for the probabilities that unfavourable shocks may hit debt, there is an upper unstable point, \(d_2\), even in the absence of risk premia; a lower unstable point, \(d_1\), when markets demand risk premia as compensation for the risk that unanticipated shocks may yet push debt into the unstable region; and a last “safe” point, \(d_0\), at which the risk premia start to be demanded. Beyond \(d_2\) and \(d_1\) default becomes inevitable (or inevitable because of extra borrowing costs); and beyond \(d_0\) it becomes a risk because we are within the range of shocks that could push us over \(d_1\) or \(d_2\). However, it is easy to see that if the risk free rate of interest (or risk premia) were to fall, or growth to rise, then the \((r-g)d\) line (or its dashed portion) would rotate down. That implies \(d_2\), \(d_1\) and \(d_0\) will all rise. But \(d^*\) would fall, albeit by only a small amount given the necessary differences in slope in the reaction function at \(d^*\) vs. at \(d_2\) or \(d_1\). These changes are easily seen from Figure 2; but can be shown formally because, as Ghosh et al demonstrate, the \(d_2\), \(d_1\) and \(d_0\) values are determined by solving the equations

\[ \mu + f(d) = (r-g)d \]

where \(r\) stands for the risk free interest rate, or that rate plus a risk premium, as appropriate. Since, by construction, \((r-g)d\) is positive here, taking that term to the left of (6) means the solution values for \(d\) must necessarily increase if \((r-g)\) itself becomes smaller. Three conclusions now follow:

a) Downward rotations of \((r-g)d\), given a reaction function, lowers \(d^*\) relative to any optimal level of debt – and therefore allows a relaxation of the primary surplus reaction function;

b) Downward rotations of \((r-g)d\) expands the available “fiscal space” \((d_2-d^*)\), and the available “safe zone” \((d_0-d^*)\);

c) Given the slope of the reaction function \(f(d)\), steep at \(d^*\) but shallow at \(d_2\), \(d_1\) or \(d_0\), rotations of the \((r-g)d\) line have a larger impact in terms of stretching fiscal space or the safe zone at the \(d_2\), \(d_1\) or \(d_0\) end of things, than at \(d^*\).

All three of these effects are larger, and hence more useful, for high debt countries and those subject to risk premia. In addition, since downward rotations of \((r-g)d\) are driven by approaches I and II above, a natural pattern of comparative advantage emerges. We should use financial corrections and structural reform/competitiveness policies to expand the available fiscal space, but debt controls to ensure stability and favourable levels of debt.
**Extensions and Variations:** Notice that our approach recognises that fiscal limits are unavoidable in practice; but that we can deal with the enforcement issue which derailed the Stability Pact in its various forms (and threatens to do the same with today’s debt reduction plans) by placing the optimal debt target at the stability point \(d^*\) so that enforcement procedures are not needed. Sanctions are needed instead for not following agreed adjustment rules at all levels of debt – while enforcement at \(d_2\) effectively passes to the European Financial Stability Fund, where the sanctions are financial collapse and new fiscal provisions which place the domestic government in “de facto administration”. This aspect of our debt targeting approach is important because, in practice, enforcement has proved to be a bigger problem than the design of the mechanism itself. An optimal mechanism is of little help if it is impossible to enforce.

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. In this case there are no worries and 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 which 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, none of these extensions change our story in any way beyond complicating it. There is one difficult case however. If the S-curve lies under \((r-g)d\) for all \(d\), there is no zone of stability. In such a situation, we would have to rely on aggressive debt reduction plans to reduce \(r\), and on structural reforms (competitiveness measures) to raise \(g\) in support of the fiscal restructuring. That is where a competitiveness pact (“pact for the Euro”) would have to be brought in.

7. Concluding remarks

This paper makes three contributions. First it shows how to use the fiscal space idea to provide a zone of stability for public finances, and an optimal level of debt to aim for and stabilise around. Second, it shows how to expand the available fiscal space and safe zone of operation in the face of significant uncertainties. This is done using financial restructuring and structural reforms to extend the fiscal space/safe zone, but debt control to establish stability and to maximise growth. Third, it
shows how to integrate a competitiveness pact into a workable fiscal framework for Europe – and perhaps for many other places.

The principle advantages of such a framework are two. First, that enforcement and monitoring of a precise debt or deficit level (as in Europe’s unsuccessful Stability Pact) are no longer necessary. The stability of the system ensures that it is self-enforcing. Circuit breakers, to prevent the economy getting into the unsafe zone where default becomes a real possibility, are however necessary and an explicit debt protocol has been designed to provide the necessary circuit breaks. Consequently, the only monitoring or enforcement needed is a mechanism to provide general rules to raise primary fiscal surpluses sufficiently in response to increasing debt burdens at all levels of debt (i.e. before we arrive at the end of the available fiscal space). The precise form those rules might take remains a subject for further research, but their role is now clear.

The second advantage is that it preserves the principle of independent monetary policies, while providing a proper degree of coordination between monetary and fiscal policymakers. The standard position in Europe is that the ECB should be independent of outside forces, and of exposure to political pressure. However fiscal policies should be left free to account for and address the specific circumstances of each member economy. The difficulty with this is that an independent monetary authority automatically implies an independent fiscal authority. Since a fiscal authority is always 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 must 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 interest in seeing that public money is spent on the goals that they wish. Again, the electoral mechanism will be behind this. 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 unstable outcomes.

Something therefore has to happen in the policy framework. The answer seems obvious in theory. We need to reduce the self-interest in the one-to-one policy to target assignments implied by the current framework since there is no one-to-one separation of their effects within the economy itself. To do that, we argue, it is necessary to provide an intertemporal assignment of policy goals to policymakers. This stands in contrast to the one-to-one assignments/separation within each period.
With an intertemporal assignment, where fiscal policies prioritise long term expenditure goals and manageable debt levels while monetary policy concentrates on cyclical stabilisation and inflation control, there will be less direct conflict and each policymaker can take into account the existing or predicted stance of the other. There is also the threat that undisciplined or inappropriately selfish moves by one player will be punished, and be anticipated to be punished, according to the policy preferences of the other. Yet each player gets their chance to implement their own preferred policies without immediate 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.15

A convenient way to create this implicit negotiation process is to impose a debt target on fiscal policy. Being a stock 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 physical restrictions on fiscal policymakers to interfere with the legitimate priorities of the societies that elected them.

This is an old approach, in new European clothes. 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 are well known. The result is greater instability and a worse economic performance as each policymaker tries to cope with the unwelcome spillovers 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 shows how to achieve better co-ordination without any loss of independence for the individual policymakers.

References


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


**Appendix: A Fiscal Policy Commission for Europe.**

*For information; not necessarily for publication*

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.¹⁶

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 Commission¹⁷ 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

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¹⁷ For this Annex, “Commission” means the fiscal policy commission, not the European Commission
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 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 preceding 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.