IN-DEPTH ANALYSIS

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How could the Stability and Growth Pact be simplified?

Euro Area Scrutiny

External author:

Friedrich HEINEMANN

Economic Governance Support Unit

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How could the Stability and Growth Pact be simplified?

Abstract

Past reforms of the Stability and Growth Pact (SGP) have improved its economic rationale, but this progress has come at the expense of simplicity, transparency and, possibly, enforceability. This study surveys and evaluates reform models that could reduce complexity without compromising the SGP's indispensable flexibility. From a holistic perspective, the greatest potential for simplification will result from a shift of discretionary power to an independent fiscal institution. Independence is a substitute for complexity. With a narrower focus on the potential streamlining of the SGP and a reduction of excess complexity, first, the preventive and corrective arms could be integrated into one procedure. Second, this integrated procedure should be centred on a net expenditure rule that is combined with a debt feedback mechanism and a memory for expenditure overruns. Third, further fiscal indicators that are currently treated as parallel targets (headline deficit rule and structural balance) could be downgraded to non-binding reference values. And fourth, the planned transposition of the Fiscal Compact into European law should follow SGP reforms in order to promote consistency between European and national fiscal rules.

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AUTHOR
Friedrich HEINEMANN
Centre for European Economic Research (ZEW) Mannheim and University of Heidelberg

RESPONSIBLE ADMINISTRATOR
Jost ANGERER

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To contact the Economic Governance Support Unit, please send an email to:

E-mail: egov@ep.europa.eu

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EXECUTIVE SUMMARY

The Stability and Growth Pact (SGP) looks back at a history of three major reforms since its establishment in 1997. Doubtless these reforms have made the Pact 'smarter' and addressed much of the criticism from the early days. However, the rules have attained a degree of complexity that seriously undermines the Pact's transparency and enforceability. Against this backdrop, this study proposes a reform agenda for a simplified SGP.

The first step (section 2) is to classify the underlying – very diverse – sources of complexity. A fundamental driver for highly detailed rules is the underlying lack of trust with respect to the European Commission and the Council. To the extent that these institutions do not enjoy a reputation as impartial guardians of the Pact, there is a need for a highly detailed contract. Complexity may furthermore disguise underlying dissent on the 'true' economic model or be the result of a path-dependent evolution of the rules.

Based on the SGP reform literature the study then searches for 'excess complexity' (section 3). Excess complexity results from redundancies or inconsistencies between different fiscal targets or procedures. An assessment of SGP rules shows a variety of parallel fiscal targets that is difficult to defend, so any simplification strategy should downgrade the importance of inferior targets. A two-step argument is developed. First, the nominal deficit target (the 3% rule) is clearly inferior to the structural balance or an expenditure benchmark. Second, a whole list of arguments point to the superiority of a net expenditure rule over the structural balance. Two of the key arguments here are that expenditure rules have a less severe real-time measurement problem than a structural balance rule as the latter requires an estimate of the output gap which tends to be particularly unreliable and biased; and expenditure rules adequately address the notorious problem of pro-cyclical fiscal policies by forcing governments to build up fiscal buffers in good times but safeguard a substantial level of spending in cyclical downturns.

Section 4 systematically surveys important SGP simplification models from the literature and provides a synoptic view of their elements. This survey includes reflections from the European Fiscal Board and more elaborated reform templates from IMF and Bruegel authors. The latter two clearly favour reform towards a set of rules centred on expenditure rules but differ with respect to various details.

The recommendations (section 5) start with a holistic perspective which includes the potential for more effective market discipline and a truly independent fiscal institution for SGP simplification. Therefore, the European Fiscal Board (EFB) should be strengthened and re-established as an independent institution outside the Commission. It would then be the natural institution to assume responsibility for important SGP discretionary measures, such as decisions on escape clauses. In addition, the section points to possible problems of net expenditure rules that relate to difficult quantifications of discretionary revenue measures. The study argues that a stronger role for cross-checks by an independent fiscal institution would complement a new prominent role for a net expenditure rule. On the subject of procedural unification the recommendation is to adopt suggestions to merge the preventive and corrective arms but to keep the national (Fiscal Compact-related) procedure separate as it provides additional checks and balances. However, the national set of rules should be methodologically aligned with the new SGP.

The final conclusions (section 6) relate to the expected political-economic resistance to broader SGP reform along the lines suggested. This resistance can be expected to come both from Member States and the European Commission, which points to a crucial role for the European Parliament with its inherently greater impartiality on SGP issues.

1 INTRODUCTION

The history of the SGP is one of reforms and refinements. To date, three major reforms have modified and developed the set of rules which came into existence in 1997 (European Commission 2013) and which, initially, was centred on the headline deficit target of 3% of GDP for the corrective arm with only vague objectives for the preventive arm ('close to balance or in surplus'):[1]

- The first substantial reform in 2005 assigned a major role to the structural balance indicator (i.e. the balance after allowing for cyclical adjustment and the adjustment for one-off and temporary measures). Since then, the structural balance has been a crucial target indicator both for the preventive arm with its 'medium-term budgetary objectives' (MTO) and the corrective arm (with the definition of a minimum 'fiscal effort' in terms of the required improvement of the structural balance).
- The 2011 reforms in the shape of the 'six-pack' added an expenditure rule to the Pact's preventive arm, according to which the growth of expenditure (net of revenue-changing measures) must not exceed potential growth, to address the failure of too little consolidation during 'good times'. Moreover, the reform specified a debt reduction benchmark for the corrective arm (the 'one-twentieth rule') to make the 'sufficiently diminishing' debt level criterion operational.
- Finally, the 2013 reform ('two-pack' and Fiscal Compact) attempted to reinforce monitoring (inter alia through a common budgetary timeline for euro member states) and committed the Fiscal Compact's signatory countries to mirror MTO-related commitments of the SGP in national law.

All of these reforms have considerably widened the flexibility of the Pact.[2] Consequently, there are now a number of available options making it possible to take account of the business cycle, other exceptional circumstances, reform activities etc. in order to legitimise non-compliance with quantitative criteria or at least to buy time (see below 2.4).

The common motive behind these changes was to make the SGP 'smarter'. In its initial version, with its strong focus on the non-adjusted deficit of 3% of GDP, the rule had attracted severe criticism as not sufficiently paying attention to cyclical considerations and the desirable timing of consolidation measures. An influential early verdict is the one by Buiter et al. (1993): "*The fiscal convergence criteria designed to eliminate or prevent 'excessive deficits' are badly motivated, poorly designed and apt to lead to unnecessary hardship if pursued mechanically*" (Buiter et al. 1993, p. 87).

Indeed, an evaluation of the Pact's past performance shows a frequently inappropriate fiscal policy stance with a lack of consolidation ambition in the good times and harsh consolidation needs in the middle of downturns. There is wide agreement that the failure to build up fiscal buffers in the good

[1] All three of these reforms implied adjustments to the SGP's legal basis. Further reform activities are refinements undertaken within the given legal system. One important example concerns the introduction of the 'matrix' in 2015 through the Commission's 'Communication of Flexibility' later endorsed by the ECOFIN Council (European Commission 2018, p. 37), which operationalises the appropriate adjustment path under the preventive arm as a function both of the debt level (sustainability consideration) and the economic situation (anti-cyclical stabilisation consideration).

[2] The most complete collection of details is provided by the Commission's 'Vade mecum' (European Commission 2018).

times has been one of the reasons why the euro area destabilised quickly following the shocks of the financial crises in 2009 (European Fiscal Board 2017, Eyraud et al. 2017, Eyraud and Wu 2015).

Without doubt, some of these experiences and concerns have been addressed by the past SGP reforms. The SGP today is much less simplistic and therefore more flexible in real application than in the early years. However, its more intelligent construction has come at the cost of considerably increased complexity. In the meantime, the latest version of the SGP 'Vade mecum' (European Commission 2018) runs to a total length of 220 pages. The multitude of indicators, procedures and decision rules has rendered the whole construction highly complex and opaque. Moreover, the abundance of flexibility clauses has largely increased the discretion of the European Commission as the key supervisory institution.

This high complexity poses new risks for the rules' enforceability. While it is true that an overly simplistic rule – due to its bad economic rationale – cannot be effective either, the same holds for an overly complex rule. Complexity imposes costs along several dimensions.

Public awareness: A highly sophisticated rule hampers communication (Andrle et al. 2015, p. 4) to the public and, as a consequence, weakens the potential of public oversight (Kopits and Symansky 1998). Media and public awareness have a crucial function for a rule's effectiveness. Breaches of a simple rule ('3%') are more likely to be noticed by the general public than a lack of compliance with a smart rule (e.g. non-compliance with a country-specific and cyclically adjusted MTO-reduction target). Public awareness, in turn, co-determines the political cost of non-compliance for the politicians concerned. If voters (and journalists) do not notice breaches, these actors will not punish responsible politicians.

Contradictory signals: Critics of the complexity of the SGP also point to the fact that countries can exploit contradictory signals that are a natural consequence of multiple target variables. With a multiplicity of competing target variables, countries can stress those variables for which compliance is easy and, hence, apply a cherry-picking strategy. This risk is aggravated if the best-known target (the 3% rule) is the least ambitious one compared with other targets. This is definitely the case in normal or good economic times (like today) when compliance with the 3% limit for the overall deficit is much easier than meeting the debt level reduction target or the MTO/fiscal effort objectives.

Market discipline: Complexity reduces the chances not only of public oversight but also of market discipline. Highly opaque rules fail to provide interpretable signals for bond markets. The noise created by contradictory messages can also confuse market participants and impede the smooth pricing of government bonds in line with their fiscal fundamentals.

Potential collusion between national governments and referee: Flexibility with respect to various contingencies is an unambiguously positive thing in a world of benevolent decision-makers who are solely committed to the general interest. The situation is less clear if one allows for political considerations. A highly flexible SGP grants a large degree of discretion to the institutions that are in charge of assessing and enforcing the implementation of the rules (i.e. the European Commission and the Council). If these institutions pursue a broader political agenda beyond the core objectives of the SGP, this could damage the Pact's credibility. There may be collusion between national governments that find themselves in a similar situation of (impending) non-compliance and thus jointly put pressure on the referee (i.e. the Commission) to exercise its discretion by, for example, agreeing broader political 'package deals'.

Hence, any future reforms of the SGP should try to reduce complexity without compromising the improved economic foundations which have been established by the reforms. To identify the available potential for reform, the analysis first reflects on the general sources of SGP complexity (chapter 2). In the next step (section 3) the analysis identifies 'excess' complexity which may result from redundant targets and objectives. Chapter 4 summarises and compares the most prominent existing SGP simplification blueprints, followed by conclusions on the desirable direction of reforms.

2 SOURCES OF SGP COMPLEXITY

Any strategy to simplify the SGP should start with a proper identification of the sources of complexity. Table 1 summarises various sources, which are developed in more detail in this section. The first fundamental driver of complexity is the need for comprehensive contracts if there is a lack of trust in key players (i.e. Member States, Council and European Commission). Where trust is limited, there is a desire to have a Pact which, as precisely as possible, stipulates the decisions to be taken in every single fiscal and economic eventuality. Complexity may also be the result of an underlying disagreement on the right economic model, where each side tries to defend its view of the world by taking contractual precautions (e.g. by allowing sufficient stabilisation leeway), which in turn provokes countervailing precautions by other schools of thought (e.g. stronger supply-side incentives). A further major reason for complex rules stems from the desire to have a 'smart' rule that is conditional on short-run (business cycle) and long-run (growth potential) developments and also stipulates escape clauses in the event of substantial exogenous shocks of a non-economic type. Finally, complexity may simply be the legacy of a lengthy evolutionary process and a lack of courage to carry out some editorial streamlining.

Table 1 Sources of SGP complexity: classification

	Need for comprehensive contracts with		**Attempt to conceal fundamental disagreement**	**Flexibility**			**SGP history**
	Member States	Council and European Commission		Business cycle	Sustainability	Exceptional circumstances	
Problem description	Member states with insufficient focus on fiscal spill-overs	Commission and Council may lack credibility as impartial guardians of Pact	Underlying fundamental disagreement on right economic model (e.g. demand-side vs. supply-side controversy)	Built-in stabilisers Discretionary stabilisation	Demographics Structural reforms Investment	Examples: war, natural disaster, large number of refugees	SGP not designed 'from scratch' but resulted from decades-long evolution, which has created redundancies and inconsistencies

2.1 Constraints on national decision-makers

European fiscal rules – whether they are complex or simple – would not be required if there were no need to constrain national policymakers. The underlying assumption of the SGP approach is that political-economic deficiencies (Eslava 2011), the inadequate effectiveness of market discipline and the considerable cross-border externalities of imprudent fiscal policies render EMU dysfunctional without effective rules. This refers not only to the problem of a general debt bias but also to an inherent tendency towards a pro-cyclical policy stance that is inappropriate from a stabilisation perspective. Governments tend to pursue lax fiscal policies in times of buoyant growth or windfall revenues, while reserving consolidation for the bad economic times when there is a general sense of crisis. This study takes this assumption of fiscal imprudence (in terms of both sustainability and appropriate stabilisation policy) as largely given. Nevertheless, a holistic perspective should pay attention to reforms that could substantially pave the way for simpler rules, such as those that make market discipline more effective (5.1).

2.2 Constraints on the European watchdog

Major simplification potential would exist if SGP discretion were in the hands of an institution which enjoyed the universal trust of being an impartial judge that possessed first-class information and expertise. Such a trusted institution could undertake a comprehensive assessment of fiscal sustainability, cyclical needs and exceptional circumstances to judge whether a euro member state were behaving in a responsible way.

Today, the European Commission does not enjoy this kind of broad trust. Claeys et al. (2016, p. 15) report "*the perception of some stakeholders … that the Commission does not always give unbiased recommendations to the Council*". In a similar vein, Eyraud and Wu (2015, p. 28) see risks in the constant interactions between Commission staff and national authorities with the consequence that political constraints may be internalised by the Commission. The famous Juncker statement justifying the Commission's acceptance of further French delays in the adjustment path "*because it is France*" (Guarascio 2016) is anecdotal confirmation of a biased approach to SGP decision-making. Any politicised application of SGP rules with possible asymmetries between large (and influential) and smaller countries (Eyraud, Gaspar and Poghosyan 2017) will further increase demands for an even more detailed contract binding the hands of the Commission.

As long as the SGP is not primarily the responsibility of an institution with a reputation for impartiality, there will inevitably be demands for a highly detailed 'contract' which constrains the non-trusted referee.

2.3 Complexity as a veil masking a fundamental divide

Carnot (2017, p. 149) has pointed to a subtle cause of complexity, which is a potential deeply rooted disagreement on the role of fiscal rules: "*Tellingly, the SGP is simultaneously criticised as 'too austere' and 'too lax'. Observers can only agree that it has become too complex, missing the point that complexity acts as a veil masking a more fundamental divide*". A combination of more and more detailed fiscal constraints with an increasingly large set of escape clauses could be the consequence of this 'battle of ideas' taking place within each reform round of the Pact. An earlier meta-analysis of the SGP reform literature (Fischer et al. 2006) had already pointed to an underlying fundamental disagreement on how best to co-ordinate fiscal policy. This divide has recently been emphasised with respect to the example of the traditional German-French divide (Brunnermeier et al. 2016), which is also confirmed in a recent comparative survey of the German Bundestag and the French Assemblée Nationale/Sénat (Blesse et al. 2017). Addressing this type of complexity-increasing factor is hardly possible in the short-run. It would require strategies to promote convergence of economic policy views.

2.4 Economic flexibility

2.4.1 Business cycle

As far as the business cycle is concerned, any smart rule must offer flexibility along two different dimensions: built-in stabilisation and discretionary anti-cyclical policy. In severe downturns, the latter might come on top of the automatic fiscal responses that are built in because of the cyclical elasticities of taxes and expenditures.

Built-in stabilisation: It is uncontroversial that a credible fiscal rule must not disrupt built-in stabilisers of modern fiscal systems. In that sense, the underlying motivation of the far-reaching 2005 SGP reform as such is not contested: accounting for the cyclical situation in both the corrective and preventive arms is an indispensable element of any meaningful future set of rules.[3] The return to a leading role for nominal deficit targets is, therefore, not a meaningful option in any simplification strategy. Ignoring the business cycle environment would undermine the SGP's credibility even further owing to the obvious economic and social costs of the resulting pro-cyclical policy. But this fact still does not answer the question of how the built-in flexibility of the SGP can best be achieved. In the current system the structural balance is the system's lynchpin for both the corrective and preventive arms, with an increasing role – since 2011 – for an expenditure rule.

Discretionary anti-cyclical policy: The experience of the financial crisis in 2009 has inspired further SGP precautions which – on top of the built-in stabilisation mechanisms – provide Member States with scope for additional discretionary anti-cyclical activity. Examples are the flexibility matrix introduced in 2015, which quantifies how the preventive arm's adjustment path to the MTO is determined as a function of the output gap (and the debt level). Moreover, an escape clause for periods of 'severe economic downturn' was introduced in the 2011 reform (Kamps et al. 2017). In the event that this clause is triggered, a Member State is allowed to deviate from its adjustment path under the preventive arm and, under the corrective arm, deadlines may be extended.

2.4.2 Sustainability

A further complication is the natural outcome of a rule that aims to strike a balance between short-run stabilisation and long-run sustainability. Reinforced by the experience of the financial and economic crises, the intention of making the SGP more anti-cyclical also implies the need to install additional safeguards so that cyclical flexibility does not compromise the long-run sustainability objective. In this sense, a self-reinforcing cycle of complexity is set in motion.

Examples concern the dependency of the MTO on debt levels, the 'one-twentieth rule' for debt reduction in the corrective arm and the inclusion of debt levels in the flexibility matrix that defines the appropriate adjustment path towards the MTO. All of these and further provisions have a feedback function from the debt stock evolution into the required adjustment of structural deficits in terms of level and speed. Again, similar to the stabilisation issue, the key reform question is not whether or not to have such a feedback mechanism. As long as the SGP has the dual objective of stabilisation and long-run sustainability, there must be a link between sustainability indicators and short-run adjustment requirements. However, the question is whether it could be constructed in a simpler way, avoiding the multiplicity and inconsistencies of current provisions.

[3] From the beginning, the SGP has been built on this understanding. The (not precisely quantified) objective of the preventive arm was to keep the budgets 'close to balance or in surplus' in normal times. Compliance with this objective would have opened up considerable fiscal headroom below the 3% nominal deficit threshold (see 3.1).

One example of the damage caused by multiple rules is the current debt level feedback through the one-twentieth rule under the corrective arm. In principle, this rule requires countries with debt levels above 60% of GDP to reduce the difference to the reference value by 1/20 per year. In spite of some countries being in obvious and significant non-compliance with this rule, no Excessive Deficit Procedure (EDP) has ever been started on those grounds. The reason is that, as interpreted by the Commission, other rules dominate the one-twentieth rule, so it is effectively bypassed as an autonomous criterion (Deutsche Bundesbank 2017, Prammer and Reiss 2016). The consequence is that today's SGP is not equipped with an effective debt feedback mechanism – a prominent example of how the multiplicity of parallel rules is weakening the SGP's overall effectiveness, including with respect to very fundamental requirements.

2.4.3 Demographics

The long-run sustainability dimension of a fiscal rule is strengthened if it accounts for country-specific implicit liabilities that result from population ageing. The SGP does so through its rules for the calculation of an appropriate MTO. The relevant formula accounts not only for the current debt level and debt dynamics but also for the future increase in ageing-related costs.

2.4.4 Structural reforms and investment

Structural reforms may have 'J-curve' effects on public budgets. Although reforms may increase potential growth and hence public debt sustainability in the long run, they may cause a deficit increase in the short run. Liberalisation of labour markets, for example, through the reduction of employment protections can improve future employment prospects at the expense of an immediate increase in displacements or costly compensation packages (Heinemann 2006). Moreover, particular pension reforms which set up a fully-funded pension pillar may increase the recorded government deficit although – from an intertemporal perspective – the government's implicit commitments in the non-funded pillar are reduced (European Commission 2018, p. 41). The SGP accounts for all of these possibilities as, under the preventive arm, it accepts a temporal deviation from the MTO (or the adjustment path to the MTO) if major structural reforms are undertaken. Under the corrective arm, the Commission takes account of structural reform plans in its recommendation on the deadline for the correction of an excessive deficit.

Accounting for structural reforms is particularly difficult because their impact on potential growth and government balances can rarely be quantified with any reasonable degree of precision. Moreover, there is a substantial political implementation risk or the risk of future reform reversals (Deutsche Bundesbank 2017). Hence, a symmetric rule should account for reform reversals by tightening the constraints to the same extent that it relaxes the rule for reforms. The current SGP is asymmetric in this regard, as it does not foresee any tightening for growth-*reducing* reforms (e.g. new labour market regulation).

Similar to the reform issue, there is an issue with the 'quality of public finances' (Deroose and Kastrop 2008). Shifting the composition of spending towards investment – as with structural reform – could increase a country's growth potential. Again, the SGP's preventive arm permits increases in public investment to deviate temporarily from the adjustment path, whereas the investment clause is not applied in the corrective arm.

2.4.5 Exceptional circumstances

Non-economic events outside the control of national policymakers may impact on government budgets. The SGP satisfies this demand through several generalised escape clauses applicable to a variety of exogenous events (Micossi and Perice 2014). Under the corrective arm, a deficit above 3% can be considered as in compliance if it is temporary and results "*from an unusual event outside of the Member State's control and with a major impact on its public finances*" (European Commission 2018, p. 75). Under the preventive arm, these exogenous events legitimise a deviation from the adjustment path. Typical developments which have triggered this escape clause in recent years are additional spending related to the exceptional refugee inflow in some member countries and related to increased security costs in countries with major terrorist threats.

2.5 Path dependency

European fiscal rules have developed in various steps (see introduction), and the current fuzzy shape of the SGP mirrors that evolution. One result of this path dependency is the SGP's editorial and procedural clumsiness, which could be improved.

3 EXCESS COMPLEXITY

The causes of complexity described above are diverse and some of them – like the impact of fundamental economic policy dissent – are here to stay. However, the first fruitful step of any rational simplification strategy should aim to eliminate excess complexity in the SGP. 'Excess complexity' refers to those intricacies that are not a necessary consequence of desirable SGP features. For example, we should search for reform options which still allow for the indispensable flexibilities as depicted (2.4) but reduce redundancies in the form of flexibility clauses. A redundancy exists, for example, if there are several target indicators for one purpose without this variety adding any compelling value. In this case, the future design should reduce the number of operational targets and focus "*on the most economically relevant*" (Eyraud and Wu 2015, p. 31). A distinct source of potential redundancies is procedural duplications that – as described – are simply a legacy of the SGP's history but do not provide any clear intrinsic benefit.

3.1 Redundant targets

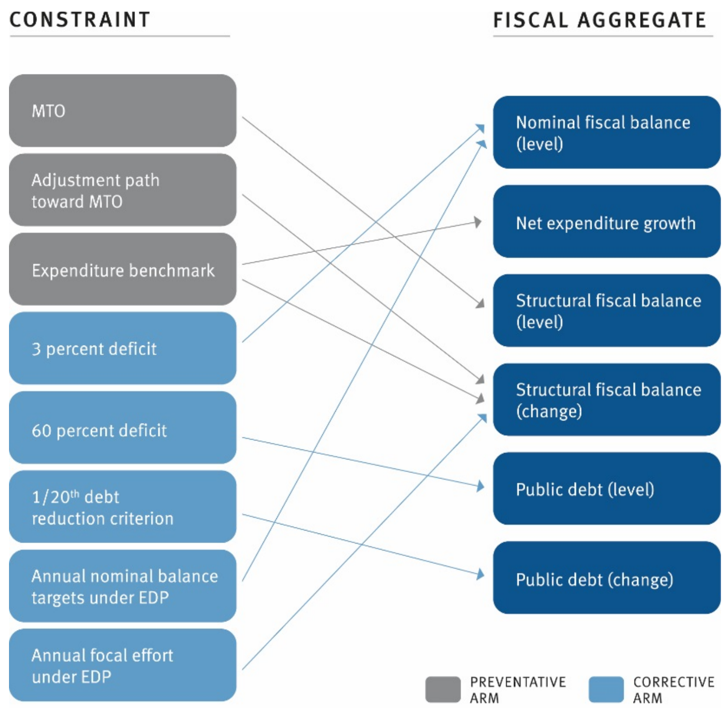
In its original version, with the 3% deficit rule, the SGP essentially focused on one single fiscal target with a clearly defined threshold.[4] In the course of its evolution, the SGP has accumulated several fiscal targets. Today, targets for the following fiscal aggregates are elements of the set of rules, often in combination (Andrle, Bluedorn, Eyraud, Kinda, Koeva Brooks, Schwartz and Weber 2015, p. 9; see Figure 1):

- Nominal fiscal balance (3% threshold and annual targets under corrective arm)
- Structural fiscal balance, level (MTO under preventive arm and Fiscal Compact)
- Structural fiscal balance, change (adjustment to MTO, preventive arm, annual fiscal effort under EDP, corrective arm)

[4] In addition there was the 60% debt rule, which was hardly applied at all given the early membership of high-debt countries like Belgium and Italy and the vague 'close to balance or in surplus' rule of the preventive arm.

- Net expenditure growth (expenditure benchmark, preventive arm)
- Stock of debt, level (60% threshold, corrective arm, determination of appropriate MTO and adjustment path)
- Stock of debt, change ($1/20^{th}$ debt reduction rule, corrective arm)

Figure 1 SGP procedures and fiscal targets



Source: Eyraud and Wu, 2015, p. 15

Andrle, Bluedorn et al (2015, p. 8) identify four distinct rules behind this current set of target indicators: the 3% nominal deficit rule, the 60% debt rule, an expenditure benchmark, and structural balance MTOs. This variety not only raises a complexity issue – it also creates an obstacle to public awareness and effective enforcement. With many targets there is a high risk of conflicting signals. This in itself weakens rule effectiveness. National politicians get the chance to shop around for the target where compliance is easiest and downplay any lack of compliance with the more ambitious ones.

On the other hand, variety of indicators is inevitable to some degree for a multi-purpose fiscal rule. A debt level anchor reflects the sustainability-safeguarding purpose. At the same time, the debt level (or change) is hardly a good indicator of the fiscal efforts of incumbent politicians; it is not under their direct control and only to a minor extent reflects current decisions. Conversely, fiscal balances and expenditure growth better reflect incumbent politicians' decisions but hardly offer a satisfactory insight on issues of long-run budgetary sustainability. Thus, a flow indicator as a yardstick for current fiscal behaviour and a debt stock indicator as a sustainability proxy should both remain in any new design.

The search for redundant targets must therefore continue within the set of flow targets, i.e. the parallel use of the nominal fiscal deficit (3% under the corrective arm), the structural fiscal balance in its multiple functions and the net expenditure rule (preventive arm). There are several arguments as to why the nominal deficit target is inferior economically to the other ones and why its deletion would not significantly change the constraints:

- Responsibility: The structural orientation since the 2005 SGP reform has been a major breakthrough and an adequate reaction to the initial criticism. Structural indicators that account for the impact of the business cycle and one-off measures correspond more closely to the incumbent politicians' responsibility than a nominal indicator.
- Stabilisation: A structural indicator is more likely not to obstruct the built-in stabilisation features of government and social security budgets. Hence, its use reduces the risk that fiscal expansions and contractions will occur in a pro-cyclical way.
- Over-determination: For a reasonable range of output gaps, the current MTOs that are based on the structural balance are more binding than the nominal 3% cap (Andrle, Bluedorn, Eyraud, Kinda, Koeva Brooks, Schwartz and Weber 2015 p. 9, Eyraud and Wu 2015, p. 17). Given usual assumptions on budgetary elasticities, the output gap would have to fall below -5% before an MTO-compliant country would exceed the 3% deficit threshold. Hence, compliance with the MTO implies compliance with the nominal deficit target in most cases.
- Target shopping: The latter argument also indicates that the less ambitious 3% target is likely to induce the aforementioned cherry-picking strategy at the expense of the MTO, which has the greater economic justification.
- Consistency with debt target: The current prominence of the 3% objective is also problematic because it lacks ambition given the lower growth potential compared with the Maastricht years: with nominal growth potential of 3%, the nominal target relates to a debt-stock steady state of 100%, which is inconsistent with the 60% rule (Andrle, Bluedorn, Eyraud, Kinda, Koeva Brooks, Schwartz and Weber 2015).

Based on these arguments, a downgrade or even outright deletion of the 3% target seems appropriate, although this would entail substantial legal problems given the current prominent position of the threshold under the corrective arm (see 5.4).

The next logical step in the search for redundant targets boils down to the competition between the structural balance target and an expenditure rule. This comparison is one of the focal points of the current SGP simplification debate.

3.2 Structural balance versus expenditure rule

3.2.1 The real-time problem of structural balances

In theory, the structural balance is an ideal target indicator as – in contrast, e.g., to the debt level – it should mirror discretionary fiscal decisions of incumbent policymakers. Moreover, unlike the nominal deficit, it is not obscured by cyclical trends. These desirable theoretical properties are challenged by considerable empirical problems. Recently, the large importance of the structural balance has come under attack, and not only in academic circles. The Dutch presidency note for an informal ECOFIN meeting in 2016 stated: "*the structural balance is unobservable, volatile and subject to major revisions ….As a result, Member States are held accountable for an indicator which to a crucial extent lies beyond their control*" (ECOFIN 2016, p. 2).

To understand this criticism, a closer look at the structural balance's rationale is helpful. This balance is meant to provide an estimate of what the government balance would look like if an economy's output were at its potential (in the absence of any temporary or one-off measures). Crucial inputs for the calculation are output gap estimates and estimates of budgetary elasticities (i.e. the reaction of the budgetary balance to cyclical GDP changes). The output gap is defined as the difference between actual and potential output. It is not directly observable, and the literature offers different methodologies from which institutions have chosen different approaches.

Even for a given approach, the 'real-time' uncertainty is high: current output gap estimates are regularly corrected substantially in subsequent periods. What is even more serious is that these estimates are biased. Errors in both directions do not cancel each other out and are skewed towards excessive cyclical pessimism. In real time, the methods applied identify output shortfalls from potential that – with hindsight – do not exist. This has been shown by Kempkes (2012) and, subsequently, by several other authors for different country-period observations: Ciucci and Zoppè (2017) survey these studies on the ex-post corrections of output gap estimates for G7, EU and euro countries from Deutsche Bundesbank, the CPB, the ECB and the European Commission. This survey confirms a bias towards an overly pessimistic real-time assessment of the current cyclical situation. Similarly, Eyraud and Wu (2015) find output gaps in the euro area to be underestimated by 1.2 percentage points in real time (compared with the ex-post revisions).

The underlying overestimation of potential output translates into an overly favourable assessment of budgetary balances in real time. For the structural balance, the average euro area overestimation amounts to approximately 0.5% of potential output (Eyraud and Wu 2015, p. 19) or even larger (Claeys et al. 2016, p. 6). The average forecast error is thus larger than the required standard adjustment in the MTO of 0.5%. But budgetary elasticities are also unreliable, particularly in times of asset price bubbles when a normal cyclical adjustment would still present the revenue situation in a falsely favourable light because windfall revenues are confused with permanent revenue increases (Carnot 2017).

As described above, the structural balance (level and change) has become the key anchor for the SGP. The empirical insights into its reliability are sobering: SGP surveillance and decision-making appears to be based on signals from an indicator that is highly unreliable. However, this does not imply that a return to the nominal balance could be promising: structural balances are still a better indicator than nominal balances because deficit fluctuations driven by the cyclical component are usually even larger than the output gap measurement error (Eyraud and Wu 2015, p. 19). This situation has intensified the search for an indicator that might be superior to both the nominal and structural balances, with expenditure growth as the prime candidate.

3.2.2 The advantages of (net) expenditure rules

Expenditure rules are becoming increasingly popular at the national level (Ayuso i Casals 2012), with the Swiss 'debt brake' – an expenditure rule in combination with a debt feedback mechanism – as a prominent and influential example (Debrun et al. 2008).

In the current SGP reform literature, an expenditure rule is regarded as having important advantages over a structural balance rule (Andrle, Bluedorn, Eyraud, Kinda, Koeva Brooks, Schwartz and Weber 2015, Ayuso i Casals 2012, Claeys, Darvas and Leandro 2016, Eyraud and Wu 2015), even though the term 'expenditure rule' stands for a whole class of possible expenditure-centred rules that may differ with respect to the spending cap (absolute versus growth; real versus nominal), expenditure items excluded (such as interest payments, investment, active labour market policy etc.) or some debt level feedback into the ceiling.

A common understanding of the debate is, however, that only a 'net expenditure rule' can be a meaningful option in the European context given the large variety of fiscal preferences across countries. A net expenditure rule limits expenditure *net of permanent revenue measures*. This clarification is of utmost political importance, as a democratically acceptable uniform fiscal rule must abstain from any binding obligation on the optimum size of government. With a net expenditure rule, even rigorous enforcement would give Member States the necessary scope to reduce or increase the size of government in line with a country's democratic decisions. The only binding constraint would be that these moves would have to be accompanied by fully offsetting permanent tax cuts or tax increases.

Key arguments that explain the large degree of support for expenditure rules are the following (see e.g. the overview in Ayuso i Casals, 2012):

- Expenditures are largely under the control of incumbent governments so that they can be held accountable for rule compliance (ECOFIN 2016). To the extent that certain spending components (most prominently interest-rate payments and unemployment benefits) are exogenously given, these items can easily be excluded from the target indicator.
- Expenditure rules are much easier to understand than structural balance rules and should therefore offer benefits in terms of communication and public awareness.
- Exuberant spending growth in good times has been identified as the major cause of the lack of fiscal buffers. Hence, a spending limit accurately targets the cause of insufficient fiscal prudence. For example, windfall revenues as a consequence of asset price booms would not translate into higher spending (relative to potential output). Thus, an expenditure rule addresses the type of misbehaviour that was observable in the later crisis countries in the 2000s.
- Simulations (Carnot 2014, Holm-Hadulla et al. 2012) indicate that an expenditure rule which limits expenditure growth to a country's potential real growth (possibly together with a debt feedback rule) has satisfactory stabilising properties. Over the cycle, a counter-cyclical spending policy would be promoted, with spending restraint in boom times and stable levels of spending during recessions.
- An expenditure rule is not hampered by a real-time measurement problem as severe as that faced by the structural balance. A rule which ties expenditure growth to potential GDP growth needs an estimate of potential growth but not – like a structural balance – an output gap estimate. Ex-post revisions of both the actual and the potential GDP *level* heavily affect the output gap whereas the impact of these revisions on potential GDP *growth* estimates is smaller. The reason is that time-series-based potential growth estimates depend to a substantial extent on past GDP realisations with smaller expected revisions compared to the current GDP. Andrle et al. (2015) provide comparative simulation results based on real-time information for an expenditure rule and a structural balance rule for Italy and France from 2001 to 2014. Indeed, measurement errors are much smaller for potential growth than for the output gap, and the expenditure rule performs much better, with a smaller difference between real-time and ex-post outcomes for the resulting debt level.

3.3 Redundant procedures

Euro area member countries are constrained by three distinct sets of rules that have similar ambitions and indicators but are non-identical as they differ in many procedural details: the preventive arm of the SGP, the corrective arm of the SGP and the national rule in line with the commitment from the Fiscal Compact. In our search for redundant complexity, the key question is whether this triad offers sufficient benefit to justify its costs. On the cost side there is the issue of conflicting signals from different

European and national procedures (Asatryan and Heinemann 2018, EU Independent Fiscal Institutions 2018, Ódor 2018). National fiscal councils and the European Commission may arrive at different conclusions and recommendations. This creates noise in communication and confuses the media and the general public. National governments can choose the more favourable assessment, which weakens the effectiveness of the rules in aggregate. The benefits of procedural separation seem very limited for the preventive and corrective arms of the SGP. Initially, both procedures were distinct, but SGP reforms have led to convergence (see below 5.4).

4 PROMINENT SIMPLIFICATION TEMPLATES

The Commission's EMU reflection paper (European Commission 2017b) briefly mentions the SGP complexity problem but does not develop simplification ideas. However, it points to the holistic challenge that "*stronger market discipline would allow for simpler fiscal rules*" (p. 28). Moreover, the paper assigns fiscal surveillance to the possible tasks of a future Euro Area Treasury but fails to provide an answer to the obvious question of why this should pave the way for more impartiality in rule enforcement.

The Commission's Proposal (European Commission 2017a) on how to integrate the intergovernmental Treaty on Stability, Coordination and Governance (TSCG) including its Fiscal Compact into Union law can be seen as an attempt at procedural alignment. This has also been a clear attempt to supplement straightforward transposition with details for national rules which are today part of the SGP but which – so far – have not been part of the Fiscal Compact (medium-term path for expenditures net of revenue measures for the legislative period; accounting for structural reforms in MTO adjustment path). However, one could argue that this would entail transferring complexity from the European rule to the national rule and might be premature given that the SGP should be simplified first before aligning national rules with the new standard.

The search for SGP simplification has resulted in a few more reform templates being developed, with the proposal by IMF authors (Andrle et al., 2015) and Bruegel researchers (Claeys et al., 2016) being the most elaborated ones that also inspired more recent contributions (Bénassy-Quéré et al. 2018, German Council of Economic Experts 2017). Their common ambition is to reduce complexity without sacrificing the Pact's dual objective of stabilisation and long-run sustainability. Others, like recently the European Fiscal Board more recently (2017), have described a few general desirable reform features without going into detail. Nevertheless, all of these contributions have a common message, which is to cut the number of parallel fiscal targets. Both the IMF and the Bruegel model favour a central role for a spending target. Table 2 gives a synoptic overview of the models, with some highlights described below.

4.1 European Fiscal Board (2017)

In its first annual report, the European Fiscal Board (2017) provides a couple of general reflections on the possible directions of reform. These reflections are only partially focused on simplification issues and also aim to address other SGP imperfections. The Board recommends a more symmetric treatment of adverse and positive shocks. While, currently, adverse shocks are accommodated through the loosening of fiscal targets, there is no corresponding swift tightening of targets if conditions turn out to be more favourable than expected. And it proposes an account modelled on the Swiss or German debt brake, where past target overruns are documented and then have to be compensated for in subsequent years.

On the subject of simplification the Board sketches general principles without going into details. These principles comprise the identification of one fiscal anchor ('deficit or debt'), the resolution of inconsistencies between the preventive and corrective arms, an agreement on one operational indicator for assessing compliance, and a clear benchmark for the required annual fiscal adjustment. Escape clauses should be well defined and only be used "*dependent on the assessment by an independent body*" (EFB, 2017, p. 63). This could be read as a cautious and veiled criticism of an overly politicised interpretation by the Commission in the current set-up. The vagueness and caution of the EFB's statements unintentionally seem to confirm the literature's critical view of this new institution as lacking effective independence and being too close to the European Commission (see below 5.2 and Asatryan et al. 2017; Asatryan and Heinemann 2017).

4.2 International Monetary Fund (Andrle et al. 2015)

The IMF proposal recommends consolidation of the SGP's preventive and corrective arms but acknowledges the need for substantial legal challenges in this case. However, a consolidated procedure would reduce complexity and inconsistencies. Ideally, this procedure would have a two-step logic whereby minor violations would trigger mild corrective actions whereas substantive non-compliance should trigger strong corrective actions or even sanctions.

For specification of the underlying rules the proposal distinguishes between a 'fiscal anchor' and an 'operational rule'. The fiscal anchor should link the rules to long-run sustainability. The authors take the view that although the debt-to-GDP ratio is not the perfect indicator, it is the natural choice for that anchor. The operational rule should give immediate guidance to policymakers and should also be under their control. Based on the arguments summarised above (3.2) the IMF template favours a rule that constrains net expenditure growth (relative to potential growth), which should have some type of (formal or ad-hoc) debt-level feedback mechanism. Explicitly, the expenditure rule should be the 'sole binding rule'. Those fiscal indicators which are the linchpins of today's SGP (nominal deficit and structural balance) could still be used to obtain additional evidence on the overall fiscal path but would cease to trigger any direct procedural consequences.

These specific suggestions are combined with brief reflections on complementary reforms such as better coordination between national fiscal councils and the European Commission or measures that would foster market discipline.

4.3 Bruegel (Claeys et al. 2016)

The Bruegel authors Claeys, Darvas and Leandro (2016) regard a major overhaul of the EU's fiscal constitution as the first-best solution. This overhaul should aim to completely remove any bailout option and introduce effective market discipline in combination with a cyclical stabilisation mechanism for the euro area. Given that this first-best scenario is politically unrealistic in the view of the authors, they paint a detailed picture of a reformed and simplified SGP.

Like the IMF proposal, the Bruegel model downgrades the structural balance and recommends an expenditure rule in combination with a debt feedback mechanism as the linchpin of the new SGP. The expenditure rule is developed and includes some interesting details. The growth of nominal 'adjusted' expenditure is kept at potential growth plus the ECB's inflation target of 2%. The nominal definition avoids the problem of any genuine real expenditure rule with respect to real-time inflation measurement. The inclusion of the 2% inflation target adds to the stabilisation function (higher real spending in times of overly low inflation and vice versa) and assists the ECB in reaching its inflation target. The adjustment of expenditure relates to interest-rate payments, labour-market-related and one-off expenditure. Investment spending is not deducted but evened out over several years. While all of these measures provide significant stabilisation leeway, the authors also suggest two precautions to ensure that the objective of long-run sustainability gets sufficient attention: a debt feedback mechanism and an overrun correction. The debt feedback would reduce maximum spending if the debt level exceeded 60% of GDP. As parameters ('open for discussion') they suggest reducing spending by 0.02 times the difference between the actual debt level and the 60% benchmark. The overrun correction establishes a memory by taking note of expenditure overruns (relative to the rule), which then have to be corrected in subsequent years.

The authors claim that this reform would not require any changes of primary law and that changes to the SGP and the Fiscal Compact would suffice.

Table 2 Overview of simplification templates

Study	Holistic dimension	IFI dimension	Operational real-time target indicator	Constraint on operational indicator	Debt feedback mechanism	Procedural	Memory for overruns	Fiscal indicators to be deleted	New provisions added
European Fiscal Board (2017)		Activation of escape clauses dependent on assessment of 'independent body'	Identification of 'one fiscal anchor'; well-defined escape clauses, including how they are triggered	Not specified	Not specified	Agree on 'one operational method' for assessing compliance (not further specified)	Past deviation from adjustment path to MTO must be compensated for	Not specified	Update EDP recommendations with unexpected improvements in economic conditions; link MTO path to MIP
IMF: Andrle et al. (2015)	Enhancing market discipline could improve compliance but seen as 'long-term endeavour'	Better coordination between national fiscal councils and Commission	Expenditure growth as only operational and binding target evidence	Potential output growth as cap on expenditure growth	Debt-to-GDP ratio above target implies additional tightening requirement for operational target	Integration of preventive and corrective arms either through outright merger ('ambitious') or better consistency ('less ambitious')	None	Structural balance (level/change) only kept as indicator for supplementary analysis (no binding target indicator)	
Bruegel: Claeys, Darvas and Leandro (2016)	Complete removal of bailout option in combination with cyclical stabilisation mechanism desirable but unrealistic	Transposition of new European rule into national law and monitoring by national IFI; establishment of a new European Fiscal Council (Board plus chairs of national fiscal councils)	Nominal expenditure excluding interest, labour-market and one-off expenditure with investment evened out over several years; adjusted for permanent revenue changes (symmetric for tax cuts and increases)	Medium-term potential growth rate plus ECB / national central bank inflation target as cap on expenditure growth	Permitted maximum expenditure growth reduced by 0.02 x (debt level above 60% of GDP); 1/20th debt rule deleted	Nothing explicit on two SGP arms	Expenditure overruns (undershooting) should (could) be corrected in subsequent years	Structural balance	

Source: author's compilation

5 RECOMMENDATIONS AND OPEN ISSUES

5.1 SGP simplification from a holistic perspective

The literature summarised above argues that SGP simplification is desirable and possible. However, all major contributions emphasise that simplification of the SGP is not merely a technical issue of optimising a set of rules in isolation from the Pact's institutional environment. Any comprehensive approach to simplification requires an awareness of the true underlying causes of the Pact's complexity. And these causes are not only the technical imperfections of the rulebook but also deeper underlying drivers such as the division of competences in EU as regards fiscal policies and the lack of trust in the current guardian of the Pact and national budgetary decision-making. Any compelling simplification strategy should therefore adopt a holistic perspective and aim to introduce institutional reforms that improve the conditions for leaner rules.

Any national and European reforms that increase the fiscal responsibilities of national policymakers, e.g. through better budgetary procedures, greater fiscal transparency, more effective democratic control, more efficient public administration or the elimination of common pool disincentives in fiscal constitutions (see 2.1) would reduce the burden on fiscal rules. In addition, any reforms that foster market discipline – e.g. when government financing terms react swiftly to the incumbent government's fiscal decisions – would enormously help to simplify the SGP. If markets consequently punish irresponsible fiscal behaviour by swiftly increasing risk spreads in government bond markets, the SGP's complicated sanction procedures (with their very limited credibility) could be substantially streamlined.

There is one major obstacle to reform that would strengthen market discipline: the risk of financial turmoil and destructive self-reinforcing bad equilibria in government bond markets. The euro area debt crisis has demonstrated that markets may react discontinuously and are prone to processes of contagion and vicious downward spirals. Nevertheless, a wealth of reform proposals has been presented which try to reconcile market discipline with financial stability. Examples are euro area insolvency procedures with a cautious and lagged implementation (Fuest et al. 2016), package deals that combine insolvency procedures with ambitious stabilisation tools (Bénassy-Quéré et al. 2018; Dolls et al. 2016), and government financing innovations which activate market discipline at the margin but do not change constraints for the existing stock of debt (Fuest and Heinemann 2017).

If any major breakthrough were possible along these lines, this would yield a huge dividend for potential SGP simplification as well.

5.2 Transforming the EFB into an independent European fiscal institution

Substantial demand for complexity arises because the Commission – with its major SGP responsibilities – is a political player and hardly qualifies as an 'independent fiscal institution' (see 2.2). It is thus not surprising that calls for a truly independent fiscal institution are a common theme in the SGP simplification literature. A breakthrough towards the depoliticised application of the SGP through the establishment of a trustworthy neutral player would offer considerable scope for substantially reducing complexity (see 2.2). If the watchdog monitoring the SGP trigger clauses had a reputation for being truly independent, there would be no need to define the conditions of all of these triggers in such detail.

Of course, the independent institution's decisions must be largely confined to fact-finding questions since it would not be accepted as decision maker on genuinely political decisions. For example, the institution could decide whether a structural reform has significant short-run budgetary consequences, or whether a certain event is really outside the control of policy makers and has significant adverse revenue consequences. This type of decision on SGP triggers does not involve any judgement on political trade-offs and, hence, can be assigned to an independent institution.

The establishment of the EFB in 2016 can be seen as a first move in this direction which, however, has so far failed to be a significant game changer. It is still the Commission which takes the SGP decisions, and the EFB has the limited task of evaluating these decisions. Moreover, the EFB scores badly in terms of the standards on independent fiscal institutions (Asatryan et al., 2017) owing to a lack of resources, responsibilities, communication facilities and, most importantly, the institutional set-up: the EFB's secretariat is integrated into the Commission's services and largely staffed with Commission civil servants, which raises substantial doubts about its effective independence.

Nevertheless, the EFB offers a natural starting point for strengthening independent decision-making in a future SGP. A two-step reform of the EFB would be sufficient for major progress. First, the EFB would have to be re-established as an independent board outside of the Commission's services, which would also include the recruitment of staff from outside of the Commission (e.g. from national central banks or national fiscal boards). Ideally, Commission staff would not be eligible (at least not without lengthy cooling-off periods prior to an EFB hiring and after the termination of an EFB contract). Second, decisions on (simplified) SGP trigger clauses should be assigned to the EFB. This would substantially pave the way for cutting out deadwood in the SGP flexibility clauses. The fundamental message is simple: independence is a substitute for complexity.

5.3 Expenditure rule challenges

Economic flexibility must remain a characterising feature of any new meaningful European fiscal rule. The question is rather to what extent reforms can safeguard the required flexibility through less detailed rules. A reduction of operational targets would be a substantial and realistic step in this respect. The case for downgrading nominal and structural balance targets in favour of an expenditure rule has been convincingly made by the above-described contributions. A focus on the net expenditure rule would mitigate some of the most pressing problems of the current SGP with respect to redundant and often inconsistent targets, the real-time measurement problem and a convincing anti-cyclicality in both good times and bad.

However, the potential downsides of expenditure rules should not be neglected and have not yet been sufficiently addressed. Net expenditure rules face at least two major empirical challenges (apart from the aforementioned but less serious imprecision of potential growth estimates, see 3.2):

- Any *net* expenditure rule requires that discretionary tax changes must be quantified with respect to their permanent revenue consequences. This is an empirically challenging undertaking with considerable potential forecasting errors. The current SGP expenditure benchmark already raises questions in this respect. Currently, the Commission tends to accept national tax measure revenue estimates without extensive cross-checks (Eyraud and Wu 2015, p. 20). This is a questionable practice given governments' incentives and the methodological challenges in precisely estimating tax reform revenue effects (let alone effects from attempts to make tax administrations more effective). National governments are frequently over-optimistic and tend to look at the revenue-increasing effects of administrative reforms, the revenue effects of tax increases and the growth effects of tax cuts through rose-tinted spectacles, so national inputs must under no circumstances be accepted at face value.

- Apart from discretionary tax measures there may be significant changes to the structural revenue situation that evolve gradually and independently of active political decisions. There are examples around the impact of global tax competition on national tax bases. A country which is totally passive in an environment of, for example, internationally falling corporate tax rates may continuously lose revenue. An expenditure rule that only adapts to discretionary revenue measures may therefore be flawed and, over time, provide increasingly poor guidance on sustainable spending levels.

Although these challenges hardly refute the substantial benefits of expenditure rules, they emphasise the importance of supporting measures.

These revenue measurement and forecasting problems are strengthening calls to combine an expenditure rule with an 'error correction mechanism' (Debrun et al. 2008) that ties changes in the spending limit to the debt level's divergence from a target level (as in the Bruegel model, 4.3). This feedback would provide compensation for upward-biased revenue estimates, as it would continuously tighten the expenditure cap with each revenue shortfall.

These problems also re-emphasise the need for more independent assessments also in case an expenditure rule becomes the centre of the SGP. In this case, a more independent cross-check of revenue estimates from national sources than at present is a must. These precautions must ensure high methodological standards of revenue estimates across Member States and careful evaluation of forecasting errors. This aspect further emphasises that independent fiscal institutions with a strong role in impartial quantification are an important ingredient of any comprehensive SGP reform package. This context once again demonstrates how technical SGP reforms and more holistic institutional reforms of euro area fiscal governance complement each other.

5.4 Procedural unification

A large number of constraining procedures entail costs (complexity, conflicting signals, see 3.3) and benefits (multiple safeguards against fiscal irresponsibility).

There appears to be a compelling case for the parallel existence of a European rule and a national rule, as originally intended by the Fiscal Compact. The anchoring of fiscal rules in national law strengthens national ownership in comparison with a purely European rule. There may be good arguments for better alignment of European and national rules as currently debated (EU Independent Fiscal Institutions 2018, European Commission 2017a), but not for abandoning this dual approach altogether. Alignment of the Fiscal Compact should be the second logical step that follows a comprehensive overhaul of the SGP and should aim to promote methodological consistency between European and national fiscal rules without limiting the independent oversight of national independent institutions (fiscal councils, national courts).

By contrast, the case for continuing the procedural separation of the preventive and corrective arms of the SGP is more controversial. Eyraud and Wu (2015) argue convincingly that the preventive and corrective arms may have been conceptually distinct originally but that a series of reforms have led to conceptual convergence. Today, both SGP arms define required adjustments in terms of changes in the structural balance, and both are equipped with escape clauses and sanction threats. All of this has raised questions about the benefits of two distinct procedures which substantially add to overall complexity. Increasingly, the only explanation for this is the history of the SGP and its path dependency, but it is no longer the optimum procedural set-up. In this sense, a unified SGP procedure as described by Andrle et al. (2015, see 4.2) – and centred on the operational target of an expenditure rule – would be a convincing reform.

A legal analysis of which reforms require treaty changes and which could be implemented through secondary legislation is beyond the scope of this study. Clearly, the prominence of the nominal deficit and debt targets in the treaty (Art. 126 TFEU) is an obstacle to far-reaching SGP reforms that intend to give very different targets a key role. The challenge appears to be greater for the 3% deficit rule than for the 60% debt rule, as the latter would retain a prominent role in any debt feedback rule for the fiscal anchor function. It is possible that a treaty change could be avoided as long as the nominal deficit rule maintains its role as a secondary indicator, but this judgement must be left to further legal evaluation.

6 CONCLUSIONS

Even though the 3% rule has severe conceptual limitations, its prominence and public awareness is nevertheless an asset of the current SGP. The European public has learned about the importance of this reference value since the euro membership qualification period in the 1990s. This long-run investment in public ownership should not be sacrificed without the realistic prospect of a much better functioning Pact and new rules that are equally well perceived and understood by the public. An expenditure rule has the potential for successful communication, but it would need substantial investment and common ownership to make it work and gain popularity outside expert circles.

Broad and wide-ranging SGP reform along these lines is an ambitious undertaking as a comprehensive reform debate risks to opening a Pandora's Box. This might see the re-emergence of longstanding controversies concerning the fundamental need for fiscal constraint, the attention required for long-run sustainability and, on the other hand, stabilisation demands. In framing the entire reform discussion it is therefore essential that simplification of the SGP is not about changing its overriding dual objectives – reconciling stabilisation needs with long-run sustainability – but achieving these objectives in a more transparent way.

A further potential problem is that national governments will not negotiate a new SGP under a 'veil of ignorance'. They can safely predict the implications of different reform options for their own country's assessment and resulting new constraints. Even though the current prominence of the nominal 3% deficit rule may be the clearest example of an outdated feature, it is currently highly appealing. The benign cyclical situation in the present economic recovery is making it easy for euro area member countries to comply with this rule. Conversely, an expenditure rule acting as a new cornerstone might impose new constraints that would become immediately binding in benign cyclical conditions. This kind of resistance might be overcome by appropriate transitional periods that relieve the immediate additional pressure on incumbent politicians.

Resistance to holistic SGP reform must also be expected to come from the reform-agenda-setting European Commission, which has a strong institutional vested interest in keeping discretionary power within the SGP and not sharing it with an independent fiscal institution. The European legislative body that probably has the best chance of taking impartial SGP reform decisions is the European Parliament, since the SGP does not constrain the European budget and, hence, the Parliament's budgetary prerogatives (as is the case with the Council representatives). Hence, a comprehensive and holistic SGP reform proposal backed by broad EP consensus could possibly improve the chances of a change for the better: a much simpler set of rules with a better prospect of successful stabilisation and sustainability policies as well as a better opportunity to communicate these rules with voters.

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