ISSUE 2016/07
MARCH 2016

A PROPOSAL TO REVIVE THE EUROPEAN FISCAL FRAMEWORK

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1 INTRODUCTION

The European Union's fiscal framework, which consists of fiscal rules, budget procedures and institutions, has been the subject of major controversies since it was put in place in the 1990s[1]. Member state non-compliance with the rules in the early 2000s, and the perceived rigidity of the rules, led to reforms in 2005. The global and European economic and financial crises led to further major changes to the fiscal framework in the form of the so-called Six-Pack (2011), Fiscal Compact (2012) and Two-Pack (2014).

Assessments of the current framework vary widely. Marzinotto and Sapir (2012) and Micossi and Peirce (2014) argue that the current rules represent a sophisticated system of surveillance and *ex-post*

1. See for instance Buiter *et al* (1993).

2. Reasons for the deficit bias include informational problems, impatience, electoral competition, common-pool problems and time-inconsistency (see for example Portes and Wren-Lewis, 2014).

3. See for example Blanchard and Leigh (2013), Holland and Portes (2012), Wren-Lewis (2013) and Barbiero and Darvas (2014).

4. The first two rules are from the EU Treaty, while the specification of the 1/20th debt reduction requirement is from the Six-Pack. The third rule originates from the Stability and Growth Pact (SGP) requirement for the budget to be *"close to balance or in surplus"*, while the MTO appeared in the 2005 reform of the SGP, and the minimum numerical requirements for the euro area come from the Fiscal Compact. The fourth rule is from the Six-Pack.

Long-term sustainability

If European fiscal rules are fully adhered to and there are no unexpected shocks, the public debt ratio should generally decline to low levels, because of the debt and structural balance rules. For example, with a nominal GDP growth of 3 percent, respecting an MTO of -1.0 percent of GDP (the minimum MTO for euro-area countries with debt below 60 percent) ensures that public debt converges to 34 percent of GDP.

Given the probability of negative shocks and the current high levels of debt in some euro-area countries, however, the debt-ratio will remain high and the 60 percent target will probably not be reached at the euro-area level for a long time, even if rules are complied with. The recent F*iscal Sustainability Report* (European Commission, 2016) concluded that there is a high medium-term sustainability risk for almost a dozen EU countries, which, in our view, could also increase when the European Central Bank ends its quantitative easing programme.

The conduct of counter-cyclical policy has an impact on public debt sustainability too. An insufficient counter-cyclical policy in good times leads to a higher debt level and the inability to provide sufficient fiscal stabilisation in bad times. An insufficient counter-cyclical policy in bad times amplifies economic and social problems, and can affect negatively potential growth and public finances in the long run, if hysteresis effects are present[6].

Countercyclical policy

The other basic objective of a fiscal framework is to support countercyclical fiscal policy both in good and bad times. Here we focus on options for bad times.

In theory, the 3 percent headline deficit rule and the structural deficit rule, if respected, allow automatic stabilisers to operate even in reasonably

6. As argued by De Long and Summers (2012), downturns can have persistent negative

countercyclical policy because it provided a large stimulus in response to the financial crisis. We conclude that such a stimulus would have been in line with the current EU fiscal rules. With the stimulus, the US structural deficit increased to 10 percent of GDP, similar to Greece, Ireland, Romania, Spain and the United Kingdom. In the case of the UK, which had been under an excessive deficit procedure since 8 July 2008, the Council of the EU on 30 November 2009 assessed that the stimulus was *"an appropriate response"*[9].

However some countries were constrained by market pressure and others decided not to stimulate their economies as much. In particular, in the largest EU country, Germany, the structural deficit peaked at a mere 2.2 percent in 2010.

When the economic cycle started to deteriorate again in 2012, fiscal consolidation continued in most EU countries, leading to pro-cyclical fiscal policy even in those countries that had ample fiscal space, as argued by Barbiero and Darvas (2014). Barbiero and Darvas also showed that public investment, the expenditure category with the greatest impact on output growth, suffered the most among the various public expenditure categories throughout the EU.

Germany corrected its excessive deficit in 2011, two years ahead of the deadline set by the Council, and fiscal consolidation continued up to 2014 when the structural balance increased to a surplus of 0.8 percent of GDP, well above the -0.5 percent MTO and also above the requirement set by Germany's own debt-brake rule. The German structural balance increased much more quickly than planned in Germany's Stability Programmes in 2010-13, highlighting the fact that the structural balance is an inadequate fiscal target because the government has only limited control over it. Therefore, we conclude that the post-2012 pro-

9. We also note that the UK was requested to increase its structural balance by 1.75 percent of GDP annually under the SGP: fiscal consolidation in the US was done at exactly the same pace.

10. For example, according to the estimated structural balance indicator, since 2013 the UK stopped fiscal consolidation, yet non-compliance with the fiscal requirements was not sanctioned. Instead, in June 2015, the Council issued a new recommendation for the UK to reach the 3 percent deficit threshold in two years, which will be supported by the expected improvement in the UK's cyclical situation.

guide fiscal policy and the European Commission's recommendations;

- The structural balance estimates are subject to major revisions and can lead to misguided policy advice;
- When a recession lingers for several years, fiscal rules at best allow the postponement of fiscal consolidation instead of suggesting a necessary repeated stimulus;
- In recent years, most EU countries were far from their MTO and therefore could not avail themselves of the options offered by the fiscal rules to support the economy with counter-cyclical fiscal policy.

Real-time measurement

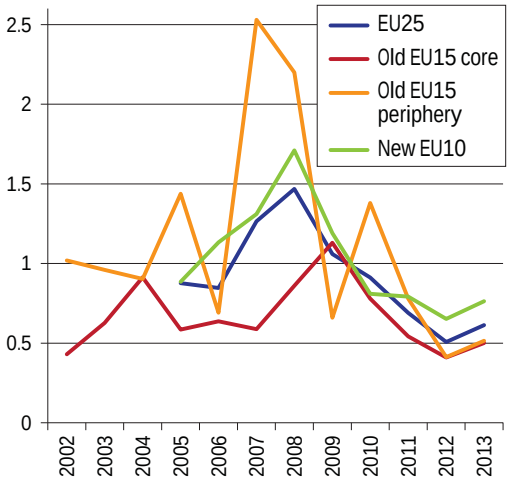
While using cyclically-adjusted targets seems straightforward and sensible in theory, it is not very helpful and can even be harmful in practice. Compliance with at least one of the four numerical rules is very badly measured in real time. The structural balance and potential output are unobservable variables and their real-time estimates are extremely imprecise and subject to major revisions.

The typical yearly revision both in the level and in the change in the structural balance is larger than 0.5 percent of GDP, ie larger than the required baseline annual adjustment (Figure 1)[11]. That is, if the Commission forecasts in spring 2016 that the structural balance will remain unchanged from 2015 to 2016, it is likely that in spring 2017 the 2015-16 change in the structural balance will be estimated as half percent or larger (either an increase or decrease). We find it unacceptable that EU's fiscal framework strongly relies on an indicator (the change in the structural balance) for which the typical one-year revision in the estimate is larger than the required policy action, especially since the revisions are much larger in more uncertain times, as indicated by Figure 1.

The revisions of the real-time estimates of the medium-term average potential growth rate (which is used for the expenditure rule) were smaller than the revisions of the change in the structural balance estimates, though Commission estimates were revised substantially during the crisis, exactly when good guidance was needed (left panel of Figure 2 on the next page). However, the estimates using real-time data from the model of Darvas and Simon (2015) were not subject to such large revisions during the crisis years (right panel of Figure 2). With the exception of the Commission's 2008 estimates, the typical one-year revision for different EU country groups was about 0.1-0.5 percentage points per year[12]. We therefore conclude that the medium-term potential growth rate estimate was a more suitable indicator than the annual change in the structural balance, especially when using a more robust technique than the Commission's current model.

On the other hand, the real-time measurement of the expenditure rule is hindered by its dependence on GDP deflator forecasts (since the rule applies to the real growth of expenditures), the inclusion of EU funding and the non-discretionary unemployment spending[13]. Furthermore, inde-

Figure 1: Average one-year revision in the real-time European Commission estimate of the change in the structural budget balance (% GDP)



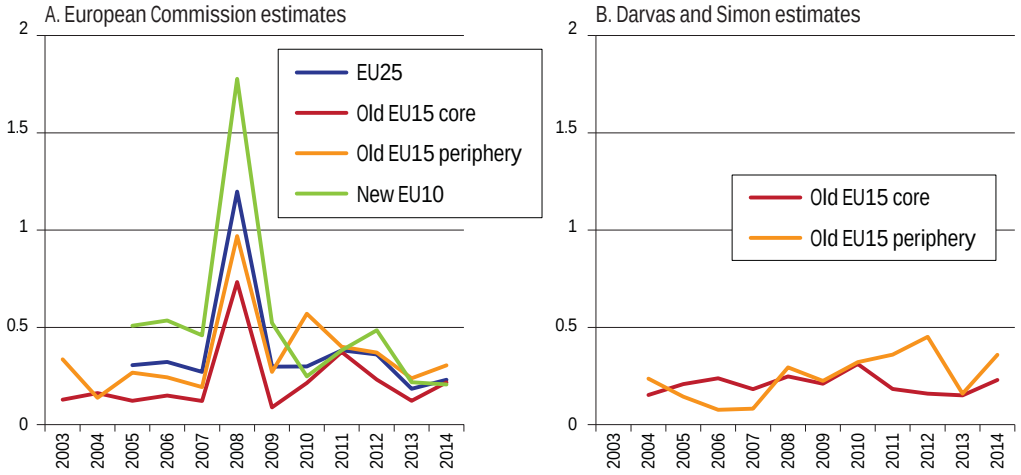
Source: Bruegel. Note: Average absolute revision of the real-time estimate made in spring of the subsequent year. For example, the last observation shows the difference between the May 2015 and May 2014 estimates for the 2013-14 change in the structural balance (absolute values of the differences averaged for the country group indicated in the legend). We could not find real-time structural balance estimates made before 2006, but we found real-time cyclically adjusted budget balance estimates made in 2003, 2004 and 2005. Therefore, for the first three years shown we report the revision in the change to the cyclically adjusted budget balance. EU15 Periphery: Greece, Ireland, Italy, Portugal and Spain; EU15 Core: other 10 countries which were members of the EU before 2004. New EU10: member states joined in 2004. Bulgaria, Croatia and Romania are not included because of data limitations.

11. The average from 2003-14 was 0.71 percent of GDP for core EU15 countries, 1.84 percent for periphery EU15 countries, while in 2006-14 it was 1.24 percent for newer member states. IMF and OECD estimates were characterised by similarly large revisions.

12. For example, a 0.3 percentage point downward revision in medium-term potential growth estimate would imply that if in spring 2016 a country is allowed to increase expenditures by 1.5 percent in 2017, in spring 2017 the allowed growth rate of expenditures is revised downward to 1.2 percent per year. Given that public expenditure amounts to about half of GDP, a 0.3 percent revision in expenditures implies a 0.15 percent of GDP impact on the budget balance, which is much smaller than the average revision in the change in the structural balance.

13. In some cases there were major revisions in the latter two factors. For example, the 2014 French Stability Programme reported that cyclical unemployment expenditures amounted to 0.2 percent of GDP, while the 2015 French Stability Programme revised the estimate to 1.3 percent. EU-funded programmes were indicated at 0.0 percent (after rounding) in the 2014 Austrian Stability Programme, while they was projected at 0.5 percent in the 2013 programme and reported at 0.4 percent in the 2015 programme.

Figure 2: Average one-year revision in the real-time estimate of the medium-term average potential growth rate (%)



Source: Bruegel. Note: Average absolute revision of the real-time estimate made in spring of a year one year later. For example, the last observation on the left panel shows the difference between the May 2015 and May 2014 Commission estimates for the 2009-18 average potential growth rate, while the right panel shows the estimates for the 2009-14 period using spring 2014 and spring 2015 data on the basis of the model of Darvas and Simon (2015) (absolute values of the differences averaged for the country-group indicated in the legend). The Darvas and Simon (2015) estimates are not available for longer-term forecasts.

pendent verification of the relevant expenditure aggregate based on publicly available data is impossible.

Implementation

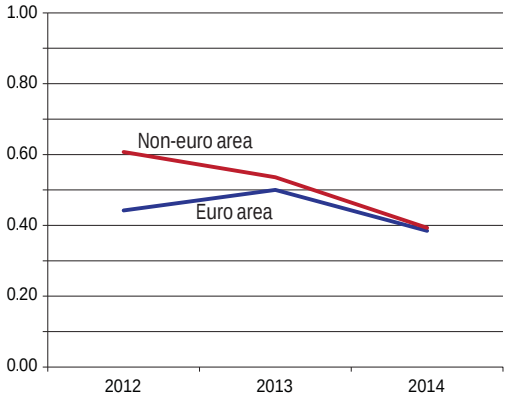
European fiscal rules are barely implemented. The 1/20th debt reduction rule will not be met by Belgium, Croatia, Finland, France, Greece, Italy, Portugal, Slovenia and Spain in the next three years, according to the IMF's October 2015 forecasts[14]. Even the European Commission's own assessment is that only a fraction of the European Semester recommendations related to the Stability and Growth Pact are implemented (Figure 3).

Credibility of sanctions

Finally, we note that the threat of sanctions is not credible. In a time of economic hardship, sanctions would make the economic situation worse (Andrle *et al*, 2015), though when the budget deficit is, for example, about 10 percent of GDP, a 0.2 percent of GDP sanction would be insignificant compared to the scale of fiscal problems.

In our view, the political dimensions of a sanction are more important. Imposition of a financial sanction may lead to backlash against the member states which voted for the sanction and against the EU as a whole, undermining the cohesion of the EU and its peoples. Backlash would be especially harsh if the perception in the sanctioned country is that the Commission's recommenda-

Figure 3: Implementation rates of the Stability and Growth Pact



Source: Bruegel. Note: We consider recommendations related to the SGP made in the context of the European Semester and the European Commission's assessments regarding the progress with the implementation of the recommendations, which is graded on a 5-step scale. We gave a score of 1 to 'full implementation', a score of 0.75 to 'substantial progress', a score of 0.5 to 'some progress', a score of 0.25 to 'limited progress' and a score of zero to 'no progress'; we report an unweighted average of those countries for which data is available for all years. The horizontal axis indicates the date of the European Semester recommendations. See Box 1 of Darvas and Leandro (2015) for further details.

14. The Commission publishes forecasts only one year ahead, which cannot be used to assess the forecast change in the debt ratio of the next three years, as the debt rule requires

whole system opaque and the real-time implementation of the rules is burdened with significant errors related to the estimation and forecasting of the structural budget balance, which can lead to misguided policy recommendations. While some improvements can be made to the current framework, such as better protection of public investment during an economic downturn[18], improved measurement of potential output and thereby cyclically-adjusted fiscal indicators[19], and clearer provisions on flexibility options, it would be better to adopt a framework that is not burdened with such problems.

In our view, the best option would be to re-design the fiscal framework from scratch, which would require a major overhaul of the EU Treaty. One way to do that would be to remove completely the bailout option, establish conditions for market discipline to work effectively, allow a large degree of fiscal independence to member states and design a cyclical stabilisation mechanism at the European level.

However, in our view such an overall of the EU's and the euro area's fiscal system is unrealistic today and therefore we do not develop this scenario in this paper. Instead, we make a proposal to revise fiscal rules so that they are more conducive to long-term debt sustainability and fiscal stabilisation, more transparent, easier to implement and more likely to be respected. We also propose the establishment of a European Fiscal Council to oversee the new framework. Our proposal requires a change to the Stability and Growth Pact and the Fiscal Compact, while the EU Treaty need not be changed[20].

The proposed fiscal rule

We propose to drop the structural balance as an intermediate target of fiscal policy. Instead, we propose an expenditure rule with a debt-feedback mechanism, which would make the 1/20th debt reduction rule redundant.

The intuition behind such a proposal is not new. For example, Pisani-Ferry (2002) proposed that the emphasis of fiscal discipline should be shifted away from the year-by-year monitoring of the deficit to a more medium-term approach that focuses on the long-run sustainability of public finances. Anderson and Minarik (2006) argued that steering on the expenditure side rather than on a cyclically adjusted deficit constraint is more transparent and less susceptible to manipulation. Turrini (2008) found that pro-cyclical bias in good times is an entirely expenditure-driven phenomenon in the euro area and expenditure rules can be helpful to curb the expansionary bias of fiscal policy. Holm-Hadulla, Hauptmeier and Rother (2012) confirmed that expenditure rules reduce pro-cyclical bias. Based on literature surveys, Fabrizio and Mody (2008) and Darvas and Kostyleva (2011) ranked expenditure rules the best among the various fiscal rules when designing fiscal institution quality indices. Ayuso-i-Casals (2012) summarised many positive features of expenditure rules. Model simulations for Germany led Brück and Zwiener (2006) to propose the replacement of the SGP deficit rule with an expenditure rule augmented by medium-term debt targets. More recently, Andrle *et al* (2015) proposed a similar setup, supported by literature review and model simulations.

Our proposed expenditure rule is similar in spirit to rules suggested in some of the above-mentioned works, but has certain specific features that we regard as important. The rule would put a limit on the growth rate of an adjusted measure of government expenditure. Table 1 on the next page compares our proposed new rule to the existing EU expenditure rule.

1 The adjusted expenditure aggregate: nominal expenditure excluding interest expenditure, labour-market related expenditure and one-off expenditure, while public investment expenditure should be smoothed over several years and accounted for in the same way that corporate investment is accounted for.

'The best option, re-designing the fiscal framework from scratch, is unrealistic today and therefore we propose a better fiscal rule and the establishment of a European Fiscal Council to oversee the new framework.'

18. Barbiero and Darvas (2014) proposed an asymmetric golden rule for public investment, while Bénassy-Quéré, Ragot and Wolff (2016) proposed an incremental public investment rule.

19. The potential output method of Darvas and Simon (2015) is conceptually intuitive and led to more reliable real-time estimates than the method of the European Commission.

20. If the Treaty is not changed, the 3 percent deficit rule would continue to exist, but it should not be given much attention in our renewed framework. It would continue to trigger the opening of an excessive deficit procedure (EDP), which should focus on the proper implementation of the expenditure rule.

expenditure amounts to half of GDP), which would necessitate only a 0.01 percentage point slower expenditure growth in the next year.

5 Consideration of revenues: a permanent increase in the level of spending is allowed only if appropriate revenue measures are introduced; conversely, a cut in taxes is allowed only if the expenditure level is cut too.

Motivation:

- A government might prefer to spend more, especially when a new government is formed after an election, given the mandate the government received. Yet long-term sustainability requires that a permanent increase in expenditures should be compensated by increased revenues.
- Conversely, we propose to allow tax cuts only if they are matched by an appropriate reduction in expenditure growth.

Thereby, our proposed rule would be conducive to fiscal stabilisation through both expenditures (via the inflation target, unemployment payments and public expenditures) and revenues (revenue-based automatic stabilisers are allowed to work fully)[25]. It would also be conducive to public debt sustainability, because of the incorporation of explicit debt correction and the elimination of the pro-cyclical bias in expenditure during good times, while limiting hysteresis effects in bad times. Implementation of our proposed rule would be much easier than the implementation of the current web of EU fiscal rules with all flexibility clauses, given that nominal expenditure is under the control of the government and the real-time estimation and measurement errors in the expenditure limit is much smaller than in the case of the structural balance indicator. The simplicity and increased transparency of the rule would allow easier surveillance and enforcement and much better communication with the general public.

Given the benefits of medium-term budgeting[26] (such as better allocation of expenditures, avoidance of the negative effects of current expenditure decisions on future expenditure[27], greater predictability and transparency, increased accountability of policymakers and higher effectiveness in stabilisation terms), our rule should also be set in a multiannual budgeting framework.

As an illustration, we simulated the real-time working of our proposed rule for some EU countries in 2004-15. We cannot fully mimic our rule, because we do not have data on discretionary revenue changes and also do not have sufficient information to smooth public investment. We therefore calculated the growth rate of nominal public expenditures excluding interest expenditure, labour-market related expenditure, and one-off expenditure, but make no correction for revenues and public investment. We compare expenditure growth to the real-time estimate of potential output growth using the Darvas and Simon (2015) model. For simplicity, we do not consider the expenditure-overrun correction.

In the pre-crisis period, our proposed expenditure rule would have disciplined Spain, Ireland and the United Kingdom (Figure 4 on the next page), countries that experienced housing booms and rapid pro-cyclical public expenditure increases. It would have disciplined Italy too, where public debt was high. On the contrary, Germany and Sweden could have spent more in 2004-07. After 2009, our rule would have allowed much more countercyclical fiscal policies than those that were actually implemented in many EU countries. The growth rate of public expenditure was inferior to our limit in Germany, Ireland, Spain and the United Kingdom, while the setback in the public expenditure growth rate in Italy in 2010 was justified, given its low medium-term potential growth estimate and the increased level of public debt (for other countries, see the Annex).

The adoption of our proposed rule would not solve directly the problem of the non-credibility of sanctions that has been present in the European fiscal surveillance framework since the adoption of the Maastricht Treaty. However, we believe that our proposed rule, which is simple, easy to implement in real time and not prone to significant errors, could lead to sound fiscal policy recommendations. Thereby, there would be stronger incentives for countries to abide by the rules. Ultimately, countries should not – and will not – observe the rules because they fear sanctions or because of peer pressure, but

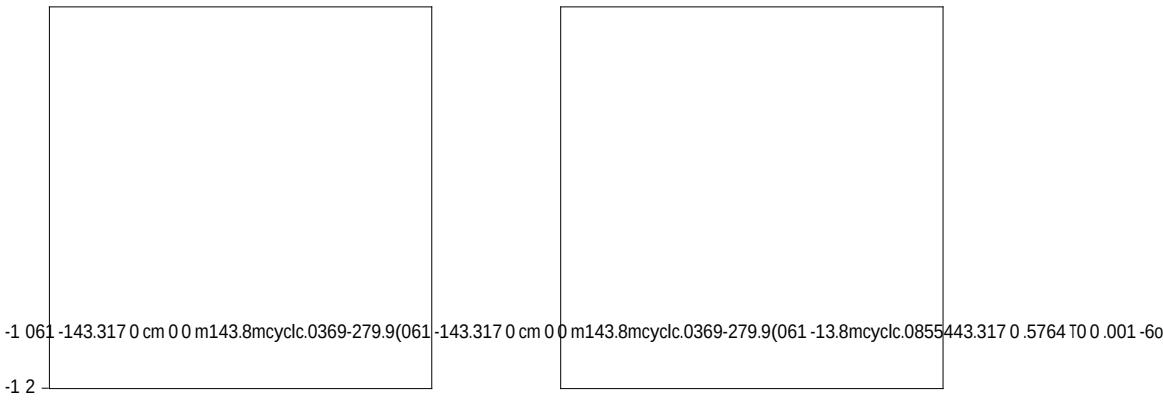
25. We share the opinion of Buti and Gaspar (2015) that budget-neutral automatic

- For a government it is easier to control the adjusted expenditure aggregate that we proposed than the budget balance, since the latter depends on unemployment expenditure and revenues too (which in turn strongly depend on the state of the economy), and on interest expenditure (which might be subject to changes in market sentiment).
- Fiscal planning under a structural balance rule very much depends on forecasts of output and inflation, while such dependence is not so important for the implementation of the expenditure rule.
- Irrespective of which potential output method is used, the estimation error and the expected revision is greater in the output gap estimate for a given year (which is needed for the structural balance estimate of a given year) than for a medium-term average of potential growth estimates (which is needed to set the limit on expenditure growth). The medium-term average of potential growth is calculated on the basis of several years, eg the past five years and the current year. Even if the current-year estimate might be subject to a sizeable revision, experience shows that the past potential growth estimate is only subject to small revision. Figures 1 and 2 demonstrate the past performance of real-time estimates and underline that the medium-term potential growth estimate is subject to smaller errors.
- Estimating the elasticity of the cyclically adjusted balance to the output gap is needed for the structural balance rule, but not needed for the expenditure rule. Thereby, only the structural balance rule is burdened with this estimation error.
- The quantification of one-off revenue and expenditure measures (structural balance rule) and discretionary revenue measures (expenditure rule) is similarly difficult in our view, and therefore there is no clear ranking between the two rules in this aspect.

In fact, the measurement problems concerning structural budget balances would have made the current smarter rules useless for Spain in the years preceding the crisis: real-time data from the European Commission and IMF suggests that Spain would have been compliant with the structural balance rules (Figure 5).

We also checked a quasi-real-time estimate of the structural balance using the potential output method of Darvas and Simon (2015). To this end, for each year, we calculated the implied elasticity of the difference between the real-time actual and cyclically adjusted budget balance to the output gap as estimated by the European Commission, and applied this elasticity to the real-time output

Real-time structural budget balance: DarvasSimon



gap estimate of Darvas and Simon (2015). We then corrected the resulting cyclically adjusted budget balance with the one-off estimates of the European Commission to obtain a quasi-real-time estimate of the structural balance using the potential output method of Darvas and Simon (2015). The results are also reported in Figure 5, indicating that Spain would have complied with the structural deficit rules even when using the real-time output gap estimates of Darvas and Simon (2015).

The consensus today, as argued for instance by Martin and Philippon (2014), is that Spanish fiscal policy was not countercyclical enough before 2008 and that Spain should have entered the crisis with an even lower debt-to-GDP level than the 35.5 percent ratio in 2007, which would have helped the country dampen the unsustainable boom before the crisis and allowed the government to have more room for manoeuvre when the crisis hit. Figure 4 shows that our expenditure rule would have constrained Spain quite significantly in the pre-crisis period, while we demonstrated above that the current structural balance rule would have not constrained Spain in 2000-08.

The conclusion for Ireland is broadly similar, though the real-time structural balance estimate based on the Darvas and Simon (2015) output gap model suggests that in 2004-06 the real-time structural balance estimate was slightly worse than the Fiscal Compact's -1.0 percent minimum value for euro-area countries with debt below 60 percent of GDP.

Transition

An appropriate transition period will be needed to move from the current system of rules to our proposed new rule. Otherwise, the different starting positions could imply similar expenditure growth limits for countries that have similar debt levels and potential growth rates, but very different budget deficits even though they have similar cyclical situations. We again would recommend a simple transition rule: for countries with budget deficits over a certain threshold (eg 2 percent of GDP), the expenditure growth limit is reduced by 0.5 percentage points per year until the threshold is reached. The threshold should be country-specific and should be calibrated, given country-specific medium-term growth and expected interest rates, so that if public debt was at 60 percent of GDP, it would stay at this level if the expenditure rule is followed. After this transition period is completed, two countries with similar potential growth rates and public debt levels will have significantly different budget balances only if they face markedly different economic situations, such as a rapid boom (leading to a budget surplus) and recession (leading to a deficit), in which case similar recommendations for two such countries would be justified.

Surveillance

To increase ownership of the rule by governments and parliaments, our proposed European rule should be transposed into national law and monitored at the national level by independent national fiscal councils. These councils should be responsible for validating the potential growth estimates used in the rule and for monitoring the consistency of the government policies with the rule during the drafting of the budget, during the budget implementation and also after the fiscal year is closed and the final numbers on the execution of the budget are available.

Still, every possible rule, including our proposed rule, has limitations and we believe that discretionary decisions are needed to face special circumstances. For example, in an exceptionally deep recession, further fiscal stimulus beyond what is allowed by our proposed rule might be justified, or a natural disaster might necessitate unusually large public investment. We propose that such decisions be taken at the European level, because of the potential cross-borders externalities. We see two options for the European-level involvement:

- The current setup involving the European Commission and the Council,
- Creation of a new European Fiscal Council.

Currently, the perception of some stakeholders is that Commission does not always give unbiased recommendations to the Council. Moreover, Mody (2014) argues that the political process always undermines the proper application of any fiscal

rule. Such perceptions and political difficulties would likely be reduced if the EU's fiscal framework were to eliminate the current opaque system of exceptions and opt for the simple fiscal rule we propose. However, in order to avoid any possibility of political mismanagement of the discretionary powers at the European level, a new European Fiscal Council (EFC) should be set up, similar to the EMU Stability Council proposal of von Hagen (2007)[28]. The mandate of the EFC should be to safeguard the proper implementation of the fiscal rule with the ultimate objectives of long-term public debt sustainability and countercyclical fiscal policy. In particular, the EFC should be entrusted with taking the discretionary decisions concerning the implementation of the European expenditure rule, such as:

- The occasions when the rule can be suspended

deemed appropriate domestically. In our view, it is unrealistic to expect that some countries will run larger budget deficits (and consequently tax their citizens more) just because some other countries do not have fiscal space and are forced to implement pro-cyclical fiscal tightening. National policymakers are accountable to their national parliaments and focus on national interests. If the euro-area or EU aggregate fiscal stance is to be managed when some countries face fiscal constraints in a recession, a centralised instrument, such as a European unemployment insurance scheme (ie an automatic mechanism) or a specific investment facility (ie a discretionary mechanism), should be developed.

5 CONCLUDING REMARKS

The EU's current fiscal framework is rather inefficient. In theory, the new fiscal rules, with cyclically adjusted targets, flexibility clauses and the option to enter into an excessive deficit procedure, allow for large fiscal stabilisation during a recession, while they can also support the sustainability of public debt. However, in practice, the implementation of the rules is hindered by badly-measured indicators and incorrect forecasts, which can lead to misleading policy recommendations. The large number of flexibility clauses makes the framework opaque and leads to never-ending bargaining between the countries that do not comply with the rules and the European Commission, which undermines trust in the rules. Compliance with the fiscal rules is low. Several politicians in countries that breach the rules regard the rules as inappropriate, while other politicians in countries that comply with the rules worry that the rules are not enforced on their partners. Preserving this inefficient fiscal framework would be suboptimal.

We recommend changing the EU fiscal framework. The first-best option, in our view, would require redesigning the whole framework from scratch, which is unrealistic. We therefore make a proposal that might be realistic even in the near term, by changing the Stability and Growth Pact and the Fiscal Compact. Our proposal would maintain an EU-wide fiscal rule with supranational surveillance. We propose to drop all rules related to the badly-measured structural balance indicator and adopt an expenditure rule with a debt-correction mechanism, embodied in a multi-annual fiscal framework.

The expenditure rule should set a limit on the growth rate of nominal public expenditure excluding interest, labour-market related and one-off expenditure, while public investment expenditure should be smoothed over several years and accounted for in the same way as corporate investment. The limit should be specified as the (appropriately-measured) medium-term potential growth rate of GDP plus the central bank's inflation target, and should be corrected for deviations of public debt from the 60 percent of GDP Maastricht debt criterion, discretionary revenue measures and possible expenditure-overruns in previous years. This European rule should be transposed into national laws and monitored by national fiscal councils. We also propose to get rid of the opaque web of flexibility clauses in current fiscal rules. Instead, an independent European Fiscal Council should be set up with an appropriate mandate, appointment procedures and accountability, to oversee the system and exercise the necessary discretion in unusual times.

This overhauled framework would be simple, transparent, easy to monitor, easy to explain and would involve a fiscal indicator that is under the direct control of the government. It would be more conducive than the current system to public debt sustainability and fiscal stabilisation, the two key objectives of a fiscal framework. The delegation of the discretionary power to an independent European Fiscal Council would eliminate the perception of a possibly improper or politically-motivated application of the rule.

Enforcement of the rules at the European level should move away from the threat of financial sanctions, which is anyway not credible in the current framework. The political consequences of an eventual financial sanction could be highly negative. The perception that the fiscal framework provides economically-sound guidance would be a much more important factor than the fear of sanctions, to give an incentive to countries to respect the rules.

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