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# **The Roles of Fiscal Rules, Fiscal Councils and Fiscal Union in EU Integration**

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## Abstract

EU-level fiscal rules have not been able to prevent the large-scale accumulation of government debt in many eurozone countries. One explanation was major flaws in the rules. Some of these flaws have now been corrected. But the failure of the rules depended also on fundamental problems of time inconsistency. The same time-inconsistency problems that the rules were designed to address also apply to the rules themselves. Fiscal councils may be subject to less of such problems than rules. Still it is unlikely that a monetary union where bail-outs of governments are part of the system is viable in the long run. The sustainability of the euro may require a restoration of the no-bail-out clause and a strengthening of the banking union in ways that would allow it to cope with the financial repercussions that could arise from allowing government bankruptcies.

*Keywords:* Fiscal rules, fiscal councils, European integration.

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The right of national parliaments to decide the government budget is usually seen as a key part of national sovereignty. Hence it is natural that the appropriate amount of fiscal integration has all along been a central issue in the debate on European integration. The issue came to the forefront with the introduction of the euro, as it was then necessary to take a stand on whether monetary policy could be centralised without a similar centralisation of fiscal policy (fiscal union). The avenue chosen was to go ahead with the common currency without full-fledged fiscal policy co-ordination. Instead reliance was put on fiscal rules at the European level.

The euro crisis with exploding government debt in some countries has vividly illustrated the shortcomings of the earlier EU rules. The crisis triggered fundamental reforms of the rules as well as attempts to co-ordinate policy decisions at European and national levels better, including the strengthening of national fiscal frameworks. The latter reforms have included monitoring of fiscal policy by independent fiscal institutions (fiscal councils). At the same time the discussion on whether a monetary union requires also a fiscal union continues.

This contribution analyses fiscal governance in the eurozone. The focus is on the long-run adequacy of the fiscal institutions, not on the handling of the euro crisis in the short term. Section 1 explains the background for the fiscal rules designed in association with the introduction of the euro and reviews them. Section 2 summarises the main problems with the original rules. Section 3 evaluates the recent reforms of European economic governance. Section 4 analyses the role of fiscal councils. Section 5 discusses fiscal union. Section 6 concludes.

## **1. The original fiscal rules**

The period 1975-1995 was characterised by substantial fiscal deficits and increasing government debt in most EU countries. Similar developments occurred in other advanced economies. This led many researchers to the conclusion that unconstrained discretionary fiscal policy in modern democracies may be subject to a *deficit bias*. Different explanations were put forward:<sup>1</sup>

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<sup>1</sup> See e.g. Calmfors (2005), Morris et al. (2006), Debrun et al. (2009) and Calmfors and Wren-Lewis (2011) for brief reviews of the various explanations.

- *General informational problems on the part of both the government and the electorate.* Neither politicians nor voters may realise the long-run consequences of current fiscal deficits. This may be due to “fiscal illusion”, i.e. insufficient understanding of the fact that the government’s intertemporal budget constraint means that current debt must be serviced through future primary surpluses (taxes in excess of expenditure excluding interest payments). Alternatively there may be over-optimism about future growth and revenue prospects.
- *Informational asymmetries between the government and the electorate.* Voters are imperfectly informed about both fiscal policy and the government’s (as well as the political opposition’s) competency. An incumbent government may exploit this to boost its re-election chances by trying to signal competency (i.e. that it can “deliver”) through spending rises or tax cuts in pre-election periods causing deficits the size or long-run consequences of which voters may not realise.
- *Political polarisation and electoral uncertainty.* An incumbent government facing uncertainty over re-election prospects has an incentive to run deficits now, as this allows it to raise expenditure or cut taxes in a way that benefits its own constituency. Such deficits have the strategic advantage that it becomes more difficult for future governments of another political colour to pursue policy according to their preferences, as they must then service the debt incurred by the current government. Put differently, the current government’s effective discount rate is raised, so that it cares less about the future than is socially desirable.
- *Common-pool problems.* Various interest groups may be lobbying for specific types of government spending benefitting them without proper regard for the long-run costs of the deficits that may result, since these costs are shared with other groups in society.
- *Time-inconsistency of fiscal policy.* There may be a temptation to over-use fiscal deficits as a tool to raise aggregate demand, and therefore output and employment in the short run, because prices and wages are slow to adjust to unanticipated shocks. The mechanism is similar to the one that may cause an inflation bias for monetary policy under unconstrained discretionary policy-making. In equilibrium,

when expectations have adjusted to actual government behaviour, such fiscal policy results only in deficits without any output and employment benefits.

- *Exploitation of future generations.* Fiscal deficits could, finally, also reflect a desire of the current generation to shift consumption in its favour (through government spending increases or tax cuts) from future generations either directly in the form of interest payments or indirectly in the form of crowding-out of investment leading to a smaller capital stock in the future.

In the 1980s *fiscal rules* came to be seen as the remedy for the perceived deficit bias of fiscal policy.<sup>2</sup> It was thought that it would be easier to agree on “constitutional” rules behind a “veil of ignorance” on how various political parties would be affected by them in the future than on actual policies in a specific situation. One way of viewing the rules that were established with the introduction of the euro is that politicians used this opportunity to introduce constraints at the European level that would have been difficult to do nationally (Calmfors 2005).

But there was also a strong perception that monetary union would reinforce the deficit bias of fiscal policy unless strong safeguards were put in place (see e.g. Keuschnigg 2012). The reason is the negative spillover effects (externalities) of deficits in one euro area member state on other member states, which means that a state running deficits is able to shift part of the cost on to others. First, under “normal” conditions this could occur because a deficit in one country raises aggregate demand and inflation in the whole union, which may induce the European Central Bank (ECB) to raise the common interest rate. Second, in more extreme situations – as occurred during the euro crisis – the fear of government bankruptcy in one eurozone country could cause investors to demand higher risk premia on government debt both there and in other member countries. This reduces the value of outstanding debt and thus destroys wealth everywhere with negative effects on aggregate demand and on the financial sector. Third, eurozone members threatened by default may in the end – as also happened during the euro crisis – be bailed out by other members (which will in the end hurt their tax payers) in an attempt to avoid financial contagion. Such concerns were another important reason for the fiscal rules established in the

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<sup>2</sup> The academic starting point for the rules-versus-discretion discussion was the seminal contribution by Kydland and Prescott (1977). See also Kopits and Symansky (1998).

euro area. This was done both in the Treaty and in the stability pact, which operationalised the Treaty stipulations. The main *economic contents* of the rules were:

- A prohibition for both EU institutions (including the ECB) and other governments to bail out an individual government that cannot meet its debt obligations (the *no-bail-out clause*).
- A *government deficit ceiling* of 3 per cent of GDP under normal conditions.
- A *ceiling for consolidated general government gross debt* of 60 per cent of GDP: if the debt ratio is larger, it should be “sufficiently diminishing” and approaching the 60-per-cent-level “at a satisfactory pace”.
- Adherence to a *medium-term objective* for the budgetary position, i.e. an objective for the cyclically adjusted budget balance, of “close-to-balance or surplus”.

*Procedural rules* were also established. To prevent large deficits from arising in the first place *multilateral surveillance* was introduced: euro area member states were obliged each year to submit economic policy programmes (so called stability programmes) for review by the Commission and the Ecofin Council (the member states’ economics and finance ministers). In case of violations of the deficit ceiling an *excessive deficit procedure* should be started against the transgressing country. An excessive deficit that was not corrected would ultimately lead to payment of a non-interest bearing deposit that could be transformed into a fine.

## **2. The rules in practice before the euro crisis**

The fiscal rules were first put to a test in the cyclical downturn of 2001-2005 when the deficit ceiling was breached by several eurozone countries. The rules did not stand the test. The most flagrant transgressions occurred when the excessive deficit procedures initiated against France and Germany were halted in clear violation of stability pact stipulations. This was justified ex post by a revision of the pact in 2005 which watered down the rules. The scope for discretionary decisions in the Ecofin Council to extend the deadlines in the excessive deficit procedure was increased. This postponed the maximum time limits for imposing sanctions if excessive deficits

were not corrected from the originally envisaged three and five years (for interest-free deposits and fines, respectively) to six-seven and eight-nine years, respectively.<sup>3</sup>

The flouting of the rules in 2001-2005 and the subsequent revisions are not surprising. The research literature had early on identified the problem that the same incentives that could make a government take socially undesirable decisions under discretion are also likely to induce such a government to ignore or abandon a policy rule that has been introduced to prevent such decisions. According to this logic a policy rule only moves the deficit bias problem from one level (discretionary decisions on actual policies) to another (the “constitutional” level).<sup>4</sup> This implies a *time-inconsistency problem* for fiscal rules. One should expect this incentive to abandon the rules to be weaker when they are embedded in an international agreement, as with the EU rules, than when they are purely national, as the abandonment then might carry additional costs in terms of loss of international prestige and trustworthiness. However, the fact that it was the leading EU powers Germany and France that were involved probably lessened the importance of these considerations.

One can identify several problems with the original deficit rules that made them hard to apply:<sup>5</sup>

- If sanctions were to be used, they could immediately become very harsh. The initial interest-free deposits and fines could amount to as much as 0.5 per cent of GDP. This “atomic-bomb character” of the sanctions probably was a strong disincentive to use them.
- The pecuniary nature of sanctions may also have been seen as a problem, since the immediate effect of fining a country with an excessive deficit is to add to the deficit.
- Each new step in the excessive deficit procedure (including sanctions) required a discretionary decision in the Ecofin Council with a qualified majority in favour. In a situation where several member states simultaneously had deficits, this facilitated the forming of blocking coalitions.

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<sup>3</sup> See Calmfors (2005) or EEAG (2006) for more detailed accounts of the breaches of the stability pact and its subsequent revision.

<sup>4</sup> This problem was first discussed by McCallum (1995) and Jensen (1997) in the context of monetary policy and central bank independence. See Debrun (2011), Debrun et al. (2013) and Debrun and Kinda (2014) for applications to fiscal policy.

<sup>5</sup> See Calmfors (2012).

- Decisions in the excessive deficit procedure form a *repeated game*. Finance ministers therefore have an incentive to act strategically. Since each finance minister may fear also ending up in the future with an excessive deficit that could be sanctioned, lenient treatment of current “sinners” can be regarded as an investment in lenient treatment of oneself in a similar situation.

The EU rules obviously did not prevent the government debt crises that arose in 2010-2012. In Greece and Portugal the crises reflected violations of the deficit ceiling already before the outbreak of the international financial crisis in 2007/2008 (in the Greek case concealed by statistical misreporting). This was not the situation in Ireland and Spain, which had fiscal surpluses before the crisis. They were, however, associated with unsustainable booms involving excessive bank lending, house price bubbles and faster price increases than in the rest of the eurozone. When the booms came to an end, the result was deep recessions and banking crises which triggered large fiscal deficits. The rules were not designed to avoid boom situations that could build up macroeconomic imbalances causing rapid government debt accumulation in a later phase of the business cycle. Nor did the rules put enough emphasis on reducing government debt in good times so as to create more fiscal room in bad times. This would have helped Greece and Italy, which both had large government debts before the outbreak of the international financial crisis.

EU leaders have chosen to ignore the no-bail-out clause. The various rescue programmes for the crisis countries and the ECB activities (both the actual purchases of those countries’ government securities in the beginning of the euro crisis and the commitment from 2012 to buy unlimited amounts of them if that would prove necessary to hold down bond yields) must be regarded as violations of the no-bail-out clause. It remains disputed, however, how this should be judged. On one hand there is the argument that such backstops were necessary to prevent a systemic financial crisis. On the other hand it has been claimed that the bail-outs create moral-hazard problems likely to cause new government debt crises in the future.<sup>6</sup>

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<sup>6</sup> For expositions of the two polar views, see, for example, De Grauwe (2011) and Sinn (2014), respectively.

### 3. Reforms triggered by the euro crisis

The euro crisis sparked a number of reforms of the eurozone's governance system.<sup>7</sup> Partly they were motivated by dissatisfaction with the earlier rules. Partly they were seen as a way of counterbalancing the moral-hazard problems arising from the rescue programmes.

The reforms can be grouped in four areas:

- Beefing-up of the deficit and debt rules
- Broader macroeconomic surveillance
- More co-ordination between European and national decision levels
- Stronger national fiscal frameworks

The sharpening of the *deficit and debt rules*, which reverses the watering down of them in 2005, involves several aspects. As regards *economic contents* the stipulation that government debt exceeding 60 per cent of GDP should be “sufficiently diminishing and approaching the reference value at a satisfactory pace” has now been operationalised: the differential with respect to that value should decrease over a three-year period at an average rate of 1/20 per year. As to *procedural rules*, new steps in the excessive deficit procedure (as well as in the new macroeconomic imbalance procedure; see below) will not in the future require a qualified majority in favour. Instead a reversed qualified majority stipulation has been introduced: Commission proposals will be adopted by the Ecofin Council unless there is a qualified majority against.<sup>8</sup> Sanctions in the excessive deficit procedure have become more graduated and can now be applied earlier than according to the original rules and also when the debt criterion is violated. In addition, sanctions have been introduced in the preventive part of the fiscal framework to deal with situations when a country “deviates significantly from its medium-term budget objective or the adjustment path to it”. Finally, common principles regarding the national statistics necessary for EU-level monitoring of public finances have been decided. A member state that misrepresents data can be fined.

A *macroeconomic imbalance procedure* has been introduced with the aim of detecting at an early stage macroeconomic imbalances that can later cause a severe fiscal crisis. The

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<sup>7</sup> European Commission (2012a, 2013) gives detailed accounts of the reforms. See also Calmfors (2012).

<sup>8</sup> The reversed-qualified-majority stipulation does not apply, however, in the case of violations of the debt criterion.

Commission is now annually producing an alert mechanism report in which a number of indicators that could signal such imbalances are monitored. The indicators include variables such as private and public debt, house price developments, credit growth, the current account, the net international investment position and the real exchange rate. If the Commission and the Ecofin Council judge imbalances in a euro area country to be dangerous, an *excessive imbalance procedure* (modeled on the excessive deficit procedure) can be initiated. In this procedure deposits and fines can be imposed if the state fails to comply with recommendations on corrective action.

Better *co-ordination between European and national decision-making* is to be achieved through a *European semester*. It defines an annual “policy cycle” which starts with the European Council (the heads of state or government) giving member states “strategic guidance”. It should be taken into account by member states when formulating their economic-policy programmes (stability programmes for eurozone members). The European Council and the Ecofin Council then evaluate the programmes based on recommendations by the Commission. Governments are supposed to take these evaluations into account in their draft budgets. These are assessed by the Commission, which can request changes before the final budget is presented to the national parliaments.

*National fiscal frameworks* have been strengthened through a number of reforms decided at the EU level. They include a balanced-budget rule (defined as a cyclically adjusted deficit of maximum 0.5 per cent of GDP under normal circumstances) and an “automatic correction mechanism” which specifies how deviations from budget balance should be corrected. A euro area member state that fails to introduce such rules can be brought before the Court of Justice of the European Union. The Court can fine a member state that does not comply with its ruling. Member states are also obliged to have in place comprehensive public accounting systems covering all subsectors of the government, to base fiscal planning on realistic forecasts (which are to be compared with the Commission’s and others’ forecasts) and to have a multi-year fiscal planning horizon.

The reforms described address several of the problems with the fiscal rules. The incentives to refrain from statistical misreporting are strengthened, it is harder to form blocking coalitions and the incentive to use sanctions is stronger when they are more graduated. The strengthening of

national fiscal frameworks is important, since economic policy-making under normal conditions still is mainly a national issue. The broader macroeconomic surveillance increases the probability of identifying and reacting to macroeconomic imbalances that could later cause fiscal crisis.

But it is an open question how much the reforms will achieve. EU-level decision-making is still a repeated game with strong incentives for a mild stance against problem countries in anticipation of similar lenient treatment of the own country in a similar future contingency. The difficulty of imposing sanctions in the excessive imbalance procedure is particularly obvious, as decisions on whether imbalances are really excessive will always be judgmental. The national budget-balance rules are subject to the great uncertainty surrounding calculations of cyclically adjusted fiscal balances,<sup>9</sup> which could open up for politically motivated manipulations. In addition, there appears to be great leeway in the way that the national automatic correction mechanisms can be constructed: they may not be more “automatic” than that the parliament should decide in such a situation on a plan to restore budget balance. Most importantly, the violation of the no-bail-out clause implies a severe *credibility problem* for any EU-level fiscal rule. If such a fundamental stipulation could be disregarded, there are likely to be expectations that also the sharpened fiscal rules could be breached in the future if considered politically convenient. The most vulnerable of the new rules is probably the one that an excess of government debt over the 60-per-cent ceiling should be reduced at an average pace of 1/20 per year, as this may prove hard for many of the crisis countries to achieve, particularly if a situation with low nominal growth persists.<sup>10</sup> Sanctions against a member state violating this debt criterion also still requires a qualified majority in favour.

In January 2015 the Commission issued new guidelines on “making the best use of the flexibility within the existing rules” of the stability pact which open up possibilities for a slower adjustment to the fiscal medium-term objectives (regarding the cyclically adjusted balance) when structural reforms are implemented or some types of public investment are undertaken in recessions.<sup>11</sup> These modifications came after political pressure from especially France and Italy which have

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<sup>9</sup> It should be noted that international organisations like the IMF and the OECD failed to realise that both Ireland and Spain had unsustainable booms before the outbreak of the international financial crisis in 2008 and therefore judged these countries’ cyclically adjusted fiscal balances to be in surplus.

<sup>10</sup> Then the automatic reduction in the ratio of government debt to GDP that would otherwise follow from the rise in the denominator (GDP) is small. A falling government debt ratio must then be achieved through further improvements of the fiscal balance, which requires more of austerity measures.

<sup>11</sup> See Manasse (2015).

both been struggling to meet the EU's fiscal requirements. These new provisions are quite likely to be used to water down the rules.

At a more theoretical level the basic question is still why one should not expect that a deficit bias under discretionary policy-making should again re-emerge as a tendency to flout the rules. The next section is devoted to this issue. It focuses on the role that can be played by independent monitoring institutions.

#### **4. Fiscal councils**

In recent years the idea that a government's fiscal policy should be monitored by a national independent fiscal institution, often labeled a *fiscal council*, has gained traction. Independent institutions with this as one of its tasks have existed for a long time in some countries including in the Netherlands (the Central Planning Bureau from 1945), Denmark (the Economic Council from 1962), Germany (the Council of Economic Experts from 1963) and the US (the Congressional Budget Office from 1974). Belgium and Austria established such institutions in 1989 and 2002, respectively. Recently the establishment of fiscal councils has become a trend. The first councils in this new wave were created in Sweden (2007), Canada (2008), Hungary (2009), Slovenia (2009) and the UK (2010).<sup>12</sup> The current interest in such institutions is reflected, for example, in OECD (2014) work, where common principles for them have been developed.

The idea of independent fiscal institutions first surfaced in the academic discussion in the 1990s.<sup>13</sup> It was initially viewed as a parallel to the delegation of monetary policy to independent central banks with the aim of eliminating inflation bias. Similar delegation of fiscal policy to an independent fiscal authority was seen as a method of counteracting deficit bias. The idea of delegating actual fiscal decisions to independent experts, however, never caught on. The probable reason was the view that fiscal decisions are intrinsically much more redistributive, and hence more political, than monetary-policy decisions since a stand must be taken on exactly

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<sup>12</sup> Hagermann (2010), Calmfors and Wren-Lewis (2011), Debrun et al. (2013), Lampreave (2013), and Debrun and Kilda (2014) provide surveys of existing fiscal councils.

<sup>13</sup> These, and later, proposals are summarised in Calmfors (2003), Calmfors (2005) and Debrun et al. (2009).

which taxes or government expenditures to change.<sup>14</sup> Therefore the academic discussion turned instead to independent fiscal councils without decision-making power but with a role as a “fiscal watchdog” and a remit to alert politicians and voters to fiscal risks. The aim is then to influence policy either directly through inputs into the decision-making process or indirectly through analysis and participation in the public discussion.

A fiscal watchdog could counteract several of the mechanisms that could cause a deficit bias (see Section 1). It could:

- *Provide better information* to both voters and politicians. This could decrease “fiscal illusion” and increase general awareness of the government’s intertemporal budget constraint.
- *Reduce informational asymmetries* between the government and the electorate by providing accurate information on actual deficits and their long-run consequences. This would weaken the incentive of an incumbent government to try to signal competency, and thus increase its re-election chances, through deficit-financed expenditure increases or tax cuts.
- *Close the possibility for a government to deliberately use over-optimistic growth forecasts* to justify deficits by either producing the macroeconomic forecast underlying the budget proposal or evaluating the government’s own forecast.
- *Mitigate common-pool problems through accurate costing* of various spending and tax cut proposals thus helping to ensure that the full budgetary costs are considered.
- *Raise the reputation cost for a government of deficits* by providing more accurate estimates of them and outlining the future consequences.
- In addition, a fiscal council could help *identify and warn against unsustainable booms* that when bursting can trigger fiscal crises.

Unofficial bodies, such as various think tanks, could in principle do the same thing. But the official mandate of a fiscal council is likely to make it more effective in pursuing these tasks, as this will probably result in much more media interest and less of suspicions of any hidden

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<sup>14</sup> See Alesina and Tabellini (2007). Some of the proposals sought, however, to address the redistribution issue by letting the independent fiscal agency only decide on the overall fiscal balance, but leaving it to the political system to determine how it would be achieved (Wyplosz 2005) or by confining the power of the agency to vary a specific tax around a base level (Ball 1997).

agenda. The impact can be magnified by stipulations – or by establishing a practice – that the government must respond to the judgments of the council.

Many early academic proposals, such as Wyplosz (2005), saw independent fiscal institutions as a *substitute* for rules, allowing discretionary policy-making with more flexibility than rules. But in practice fiscal councils usually coexist with rules, so it seems more appropriate to regard them as *complements*.<sup>15</sup> This is understandable as a fiscal rule provides a clear benchmark for judging policy. The existence of fiscal councils could also influence how rules are formulated. There is a fundamental trade-off between *simple* rules (such as a ceiling on the actual deficit), which are *easy to verify* but may be *inadequate* in many situations because they are inflexible, and more *complex* rules (referring e.g. to the cyclically adjusted balance), which are more *adequate* because of their flexibility but also more *difficult to verify*. Monitoring by independent and competent experts could permit the rules to be more complex, as this likely reduces the scope for political manipulation.

The recent reforms of EU economic governance include stipulations on independent national fiscal bodies.<sup>16</sup> Several tasks have been outlined. One is to monitor compliance with the agreed national fiscal rules. Another is to advise on the use of the automatic correction mechanism in these rules, described in Section 3, and to assess whether the triggering of possible escape clauses are motivated. The independent body should also provide or endorse the macroeconomic forecast that serves a basis for the government's budget proposal.

A relevant question is whether fiscal councils will be subject to the same time inconsistency problem for institutions as was discussed for rules in Section 3, i.e. that the underlying forces which cause the deficit bias problem under discretion will also make institutions designed to deal with the problem ineffective. More precisely, should one not expect that national governments ignore the recommendations of a fiscal council, that they constrain its activities or effectively abolish them because their monitoring activities are likely to come into conflict with the government's short-run aims?<sup>17</sup>

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<sup>15</sup> See Calmfors and Wren-Lewis(2011), Debrun et al. (2013), and Debrun and Kilda (2014).

<sup>16</sup> Lampreave (2013) and Debrun et al. (2013) give references to the relevant legal documents.

<sup>17</sup> These issues have been discussed by Calmfors and Wren-Lewis (2011), Debrun (2011) and Debrun and Kilda (2014).

The answer depends on the causes of the deficit bias in the first place (see Section 1). To the extent that a fiscal council removes these underlying causes the time inconsistency problem for the institution itself will not appear. If the deficit bias under discretion is due to general over-optimism or to imperfect understanding of the government's intertemporal budget constraint on the part of both the government and the electorate, the provision of more accurate information will indeed change the incentives of the government (and the voters). With better information there is no reason either to renege on a fiscal rule or to ignore/dismantle a council. A similar logic holds with respect to the identification of unsustainable booms, which should be in the interest of both voters and governments.

The continued functioning of a fiscal council is also beneficial for both the government and the electorate in the case when asymmetric information induces the government to try to signal competency through expenditure increases or tax cuts leading to pre-election deficits. The reason is that in a rational-expectations equilibrium it is impossible for the government to improve its re-election probability this way as its behaviour will be anticipated by voters, at the same time as it has an incentive to behave like this as long as it cannot directly affect expectations.<sup>18</sup> If a fiscal council can eliminate the informational asymmetry by providing the electorate with true information, there is no point for an incumbent government to try to signal competency through deficits. The re-election probability will be the same as in the asymmetric-information case but without a deficit. Hence a government which cares about both the welfare of citizens and its re-election chances is better-off in this situation. Therefore it has no incentive to dismantle the council.

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<sup>18</sup> The logic is similar to the one in the time inconsistency problem of discretionary monetary policy (Barro and Gordon 1983). In that case the monetary policy-maker optimises a loss function with inflation and unemployment (depending negatively on the difference between actual and expected inflation) as arguments, taking inflation expectations as given. This gives an inflation bias but without any reduction in unemployment, as agents in equilibrium rationally expect the government to create inflation. Similarly, an incumbent government that maximises a utility function with the consumption of citizens and its own expected future rents as arguments, taking the deficit expected (perceived) by voters as given, could be subject to a deficit bias (Persson and Tabellini 2000, Section 4.5). This will be the case if the electorate cannot observe the true deficit and the re-election probability therefore depends on the difference between the actual and the expected (perceived) deficit, for example because such a difference allows the government to "deliver more" in terms of government consumption, which is then taken as a signal of competency by voters. But in equilibrium the actual re-election chances are not increased as voters rationally anticipate the deficit chosen. If voters, however, have perfect information about the deficit (or the government's competency), the government has no incentive to choose a deficit.

But with other causes of deficit bias a government may indeed have incentives to ignore or dismantle a fiscal council which makes it harder to renege on a fiscal rule. This is the case if the explanation is political polarisation and electoral uncertainty, time inconsistency of fiscal policy or a desire to exploit future generations (again see Section 1). The only thing that can be said then is that the combination of renegeing on a fiscal rule and ignoring/dismantling a fiscal council entails a larger reputation cost than only renegeing on a rule when there exists no council. But it is hard to know how great the difference is.

Experience indicates that governments have indeed tried to curtail the activities of fiscal councils. The Hungarian council was effectively abolished in 2010 after having criticised the government. After disagreements with the governments, councils had their budgets cut in Canada and Belgium and in Sweden there were threats of such cuts.<sup>19</sup> To reduce the risk of such interference, strong legal guarantees are important. They could include prohibitions on taking instructions from the government and for the government to give such instructions, a long-term budget providing sufficient resources commensurate with the remit, long and non-renewable periods of office for council members, appointment procedures stressing economic expertise, and guaranteed access to relevant fiscal information (see e.g. OECD 2014). The most important safeguard for a fiscal council is, however, likely to be a strong reputation among the general public for high-quality and politically impartial work. This could be helped by regular reviews of council work made by international experts.

A further twist to the fiscal-council idea would be to set up such a council also at the European level. Indeed, this has been proposed in a recent report by the President of the European Commission (Juncker 2015).<sup>20</sup> The proposal is to establish an independent “advisory European Fiscal Board” which “would coordinate and complement the national fiscal councils”. The idea is that this should help put more emphasis on the fiscal objectives set at the European levels and achieve better co-ordination of national policies. Such a European fiscal council could also help strengthen the independence of national councils.

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<sup>19</sup> See Kopits (2011), Calmfors and Wren-Lewis (2011), Calmfors (2013) and Debrun and Kinda (2014).

<sup>20</sup> The report has been written in co-operation with the Presidents of the European Council, the Euro Group, ECB and the European Parliament.

How much difference will fiscal councils in the euro area make? As discussed, this depends on the relative importance of various causes of deficit bias, which we have little knowledge of. The discussion suggests that councils could make a difference. The most favourable case is when deficit bias depends on informational deficiencies. But even in this case it is implausible that a council could improve the situation so much that all deficit problems vanish.

## 5. Fiscal union

A recurrent theme in the discussion of the monetary union has been whether it needs to be complemented by *fiscal union*. This debate gained ground again during the euro crisis. There are different interpretations of fiscal union. Here the term is used somewhat vaguely to mean *much closer co-ordination* of fiscal policy at the EU level. According to the most radical proposals this would imply an “economic government” or a common “treasury” in the euro area, possibly accountable to the European Parliament, with an own budget and/or powers in certain circumstances to take over decision-making on national budgets or at least to veto them.<sup>21</sup> According to some proposals such arrangements could in the end lead to joint decision-making on the fiscal stance in the various member states.<sup>22</sup>

The discussion of fiscal union has followed two tracks. The first relates to joint guarantees of the public debt of individual euro area member states and the consequences for decision-making that this implies. The second track is related to fiscal transfer schemes to deal with asymmetric macroeconomic shocks.

When the euro crisis exploded, EU leaders chose to ignore the no-bail-out clause. Bail-outs took the form of both loans from newly constructed rescue funds and various interventions by the ECB (including actual purchases of government bonds, lending against bad collateral and commitments to unlimited further government bond purchases if proven necessary). Both types of support may ultimately result in large costs for tax payers in Germany and other eurozone countries not at the receiving end. The support implies great *moral-hazard risks*. The incentives to avoid large build-ups of government debt are weakened in the eurozone in general, if a

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<sup>21</sup> See, for example, Benassy-Quéré and Vallee (2014).

<sup>22</sup> This is, for example, advocated in Juncker (2015). The report only argues in favour of centralised decision-making on the fiscal stance (the fiscal balance) of member states. The latter would according to the proposal “continue to decide on taxation and the allocation of budgetary expenditures according to national preferences and political choices”.

borrowing country can expect others to service the debt if it has problems paying itself. The incentives for lenders to be cautious are also weakened, as the risk of not being re-paid is reduced when debt servicing becomes a European, and not only a national, issue.

The moral-hazard problem can be addressed by *centralising* decisions on government debt issuance to the European level or at least allowing it to veto national fiscal decisions that are considered to cause excessive debt levels. The arguments for this are even stronger if the euro area would move to *joint guarantees* of national debt. Many such proposals have been made in recent years, ranging from joint guarantees of all government debt to guarantees for only a portion of the debt, for example up to the 60-per-cent-of-GDP debt ceiling.<sup>23</sup> The proponents have argued that such joint guarantees would rule out the emergence of “bad” equilibria in situations where multiple equilibria are possible, thus avoiding defaults because expectations of them could be self-fulfilling as they raise government borrowing costs.<sup>24</sup>

The other track in the fiscal-union discussion stresses the need for a *fiscal transfer system* between euro area countries in the case of asymmetric macroeconomic shocks, i.e. diverging cyclical developments. This is an old discussion which started from the observation that within nation states region-specific shocks are counteracted by automatic fiscal transfers (mainly reductions in tax payments to the national level and increases in unemployment benefit payments). Such fiscal insurance could partly substitute for the absence of an own monetary policy in the case of country-specific shocks in the euro area.<sup>25</sup>

Today’s EU budget is far too small, around 1 per cent of GDP, to be able to play such a role. The main budget posts are support to agriculture and regional development which are not suitable for this purpose. There are different ways of setting up such a fiscal transfer mechanism. It would come about if there were a larger EU budget financed by EU-wide taxes. Another possibility is a system where fiscal transfers between national budgets are triggered based on differences in estimated output gaps.<sup>26</sup>

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<sup>23</sup> Fuest and Peichl (2012) and Schelkle (2012) provide overviews of different proposals.

<sup>24</sup> See, for example, De Grauwe and Moesen (2009).

<sup>25</sup> Majocchi and Rey (1993) and Pisani-Ferry (1993) are two early proposals.

<sup>26</sup> The President of the European Commission has recently advocated a “fiscal stabilisation function for the euro area” but without any specification of how such a function should be designed (Juncker 2015).

Several recent proposals have instead focused on unemployment insurance. For instance, Dullien and Fichtner (2013) have advocated the establishment of a European unemployment insurance scheme. Employees would pay contributions to the scheme and receive benefits from it in the event of unemployment. This would result in automatic fiscal transfers that would immediately reach citizens with a high propensity to spend in countries facing a downturn.

There are two key issues in this context. The first concerns the distinction between *insurance* and *redistribution*. For the purpose of stabilisation it is insurance, i.e. transfers when macroeconomic developments in a country deviates from “normal” that is desirable. Then transfers should be linked to deviations of unemployment from a moving average for the country in question rather than be based on the level of unemployment, which will differ among countries for structural reasons. Such an insurance scheme would not imply net transfers between countries over a longer time horizon. In contrast, a scheme based on unemployment levels could mean permanent redistribution.

A second issue is whether a fiscal transfer system should aim at mitigating all shocks (eliminating a certain percentage of them) or if it should instead be activated only in the case of very large shocks. Most proposals are of the first type. However, the need for insurance is much greater with “catastrophic” shocks to income than with small shocks, as the effects on consumption in the former case can more easily be smoothed by variations in savings or borrowing. This is an argument for high coverage only above a certain threshold (deductible).<sup>27</sup> However, as catastrophic events are rare, such insurance will in all likelihood imply substantial redistribution among countries.

There does not seem to be political support for schemes involving redistribution, at least not ex ante. Proposals from both the President of the European Council (van Rompuy 2012) and the Commission (2012b) on a “fiscal capacity” for the eurozone and joint guarantees for borrowing were shelved by the heads of state and government in the Council on the initiative of Germany and other critical states around it.<sup>28</sup> With the strong support that anti-EU parties received in the elections to the European Parliament in 2014 it is indeed very difficult to see that any moves to

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<sup>27</sup> The argument has been elaborated by Gros (2014).

<sup>28</sup> This process is described by Hacker (2013).

more centralised fiscal decisions will be politically feasible within the foreseeable future, although such proposals continue to be made from time to time.<sup>29</sup>

This raises the question of whether the present trajectory of the eurozone is sustainable. An alternative would be to try to restore the no-bail-out clause. A credible such clause would mean that there would be earlier interest rate reactions to rising government debt in a member state, which would impose much stronger market discipline on national fiscal policy. This would reduce the need for centralisation of fiscal decisions. The main reason for ignoring the no-bail-out clause was fear of a systemic financial crisis if government defaults had been allowed. But the banking union could change that. With stricter supervision and better capitalised banks as well as sufficient resources for handling a banking crisis at the European level, individual governments could be left to take care of their own debts as originally envisaged in the no-bail-out clause. The banking union in its present form does not, however, permit that. Resources in the resolution fund for banks will, also when the fund has reached the agreed size, be too small to handle a major bank crisis in Europe. A backstop with much larger resources than the earlier established rescue fund (ESM) – and with a changed focus to recapitalise banks instead of bailing out governments – would have to be created.

A full-fledged fiscal union does not seem politically feasible for a very long time to come – perhaps never – because citizens in the euro area are not prepared to relinquish national sovereignty regarding fiscal policy. However, a fiscal union – in the form of bail-outs – has already partly been established but without the logical counterparts in the form of common decision-making. This could make the eurozone dysfunctional in the long run. It remains to be seen whether EU leaders can revert to another politically more feasible track.

## **6. Conclusions**

My main conclusions are:

- It is not surprising that the fiscal rules established with the start of the monetary union did not work as planned. This reflects several shortcomings of the original rules: too harsh sanctions to begin with which made politicians reluctant to use them, too much

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<sup>29</sup> See, for example, Juncker (2015).

discretion on whether they should be used or not, too little emphasis on government debt and insufficient focus on preventing macroeconomic imbalances from arising in good times. At a more theoretical level, one should have expected the factors that explain deficit bias under discretionary decisions to lead to the flouting of rules once they had been adopted, i.e. to a time-inconsistency problem for the rules.

- Recent reforms of the economic governance in the eurozone have addressed several of the earlier shortcomings: sanctions can now be applied earlier and are more graduated, EU interventions against misbehaving countries have become more automatic, focus has increased on government debt and a procedure to identify macroeconomic imbalances in good times has been established. In addition, national fiscal frameworks have been strengthened according to common principles. Still, it is an open question whether this will be enough. The repeated-game character of EU supervision continues to provide incentives for finance ministers to be lenient against “sinners”, as this can be seen as an investment in lenient treatment of oneself in case of a similar contingency.
- Fiscal policy monitoring by independent national fiscal watchdogs, fiscal councils, has been introduced through EU-level agreements. This should strengthen the reputation costs for governments of violating the rules. To the extent that deficit bias depends on informational problems (fiscal illusion or over-optimism of both governments and electorates, asymmetric information between governments and electorates resulting in pre-election fiscal profligacy, and failures to recognise unsustainable boom situations), the activities of a fiscal council may serve to mitigate the underlying causes of the problem. If so, governments may be more time-consistent about fiscal councils than about rules. But experience suggests that governments are sometimes inclined to interfere with the activities of fiscal councils. They should therefore be given strong legal protection. They could likely make a contribution to better economic governance, but one should probably not expect too much from improved information.
- The moral-hazard problems created by the bail-outs of crisis countries could be overcome by more centralised fiscal decisions in the eurozone. Such fiscal union does not, however, seem politically feasible. There are sound arguments for a fiscal insurance system implying temporary transfers among eurozone states when cyclical developments differ, perhaps through a common unemployment insurance system. But such constructs

also appear politically unfeasible because of fears that they would imply permanent redistribution among member states.

- It is an open question whether a monetary union where bail-outs of governments are part of the system is viable in the long run without centralised fiscal decision-making. Hence the political infeasibility of such centralisation is a threat to the long-run sustainability of the euro. This suggests that it might be better to try to restore the no-bail-out clause and rely more on the market to discipline fiscal policy. This would require that the banking union is developed in ways that would allow it to cope with the severe financial repercussions that could arise from allowing government bankruptcies.

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