# Design and implementation of the European fiscal rules

*The European fiscal rules are a cornerstone of monetary union and their objective is to help promote sound public finances in the countries of the euro area, thus safeguarding the stability-oriented single monetary policy and avoiding undesired effects on other member states. Severe problems resulting from a loss of confidence in the sustainability of individual countries' public finances were revealed by the financial and economic crisis.*

*The fiscal rules and their implementation have been repeatedly amended amid the conflicting aims of curbing debt through binding rules, on the one hand, and maintaining flexibility, allowing exceptions and stimulating the economy, on the other. The lesson of the sovereign debt crisis along with increased fiscal and monetary policy risk-sharing have accentuated the need for rules to have a stronger binding force, but this has in fact played only a minor role as time has gone on. The growing importance of the European Commission with regard to the fiscal rules has not led to a stricter implementation. Instead, in agreement with the Council of the European Union, it has increasingly relied on more flexibility. The rules have become more and more complex and considerable room for discretion has been opened up. Now, it is virtually impossible to understand their implementation. There is an impression that the interpretation of the rules is partly the outcome of a political negotiation process. This is eroding the necessary binding force. As a result, the regular quantitative targets and requirements of the Stability and Growth Pact are often missed and incentives for sound fiscal policy are being sidelined.*

*Although deficit ratios have declined overall, the debt ratios in many member states are still very high. The current low-interest-rate environment is considerably easing the strain on public finances and mitigating the problems stemming from high levels of debt. Nevertheless, it is of fundamental importance that all countries rapidly achieve a sound basic position. Not least in order to sustain confidence in public finances even given a less expansionary monetary policy stance in the future, tightening up fiscal rules again would be essential. This includes a simple, transparent design and implementation of the rules. To ensure a more targeted and less political approach, it would be prudent to transfer at least monitoring of compliance with the rules from the Commission to a new or another institution (say, the European Stability Mechanism). With a clear mandate for sound public finances and without any competing political goals, such an institution would provide the basis for a more stringent application of the rules. Irrespective of this, fiscal rules alone without a basic consensus on compliance cannot safeguard the sustainability of public finances. If member states are to go on being responsible for their own fiscal policies, obtaining funding on the capital markets under their own responsibility should also be one of the things to set incentives for sound public finances. In this context, credible fiscal rules could support borrowing on the markets without any notable risk premiums. By contrast, extending mutual liability, for instance, to compensate for a loss in confidence in the public finances of individual countries due to soft fiscal rules, would further weaken the balance between liability and control.*

## Fiscal rules as a linchpin of monetary union

*The European fiscal rules …*

In the European Union (EU), the agreements on the monetary union established fiscal rules.[1] The Maastricht Treaty of 1992 introduced compliance with the reference values for the government deficit and debt ratios (3% and 60% respectively) as a general condition of participation. The Stability and Growth Pact (SGP) was adopted in 1997. This contains additional requirements and provides more detailed conditions on monitoring. Over time, the SGP has been repeatedly modified and amended.[2]

*… are vital for safeguarding the single monetary policy*

Sustainable public finances are essential for a stability-oriented monetary union to function as smoothly as possible.[3] Fiscal rules are supposed to safeguard sound public finances in the member states in addition to the incentives that arise from borrowing on the capital market under the no-bailout principle. They are intended to counteract the tendency of those with political responsibility to conduct a debt-increasing expansionary fiscal policy. The rules are supposed not least to prevent monetary policymakers from succumbing to pressure to fund overindebted countries, thereby neglecting the objective of price stability, or from redistributing risks through central bank balance sheets.

*Requirements of fiscal rules to safeguard sustainability …*

Fiscal rules should be designed in such a way that compliance with them ensures sound public finances, ie that deficits and debt are limited and can be financed on the markets (effective). They should be simple enough as well as consistent (planable). Furthermore, incentives should be set to comply with the rules, for instance in the form of credible sanctions in the event of failure to meet the targets (enforceable). Especially potential political costs could have a positive impact on adherence to the rules, say, if missing a target would lead to reputational damage. This means *inter alia* that the general public must also be able to assess compliance (comprehensible and transparent).

*… while maintaining the stabilising effect of public finances*

At the same time, the stabilising effect of public finances on macroeconomic development should not be lost. It makes sense to let the automatic stabilisers take effect by allowing cyclical deficits in a recession but, by the same token, requiring cyclical surpluses in a boom.[4] Active fine-tuning by a euro area country should be permitted only if it meets its budget targets. However, in times of particularly severe recession or crisis, it is appropriate to make provision for exceptions, with any debt incurred then having to be reduced in due course in order to reduce debt.

## Key points from European rules and overview of fiscal results

*Key targets and limits of SGP in the preventive …*

The fiscal rules for the monetary union essentially comprise two parts; the preventive and the corrective arms of the SGP. At the core of the preventive arm is the "medium-term objective" (MTO) of a structurally[5] close-to-balance budget – which, as a rule, each country has to meet, where it is generally deemed

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**1** For the most part, the European fiscal rules refer to all EU countries; however, there are some further-reaching provisions for euro area countries. This article looks at the rules for the euro area countries. The adjustment requirements for countries in an assistance programme are not set out in the Stability and Growth Pact.
**2** From time to time, the Commission now publishes a more detailed explanation of the relevant provisions (including references to the underlying legal regulations). The most recent such paper is Vade Mecum on the Stability and Growth Pact, Institutional Paper 052, March 2017. In 2012, the fiscal compact was adopted, containing inter alia the decision that the requirements of the SGP were, in principle, to be anchored in national law with provisions of binding force and a permanent character. See Treaty on Stability, Coordination and Governance in the EMU, Title III, Fiscal Compact. This article does not go further into these provisions.
**3** For an overview of other key approaches to strengthening the regulatory framework of monetary union, see Deutsche Bundesbank, Approaches to strengthening the regulatory framework of European monetary union, Monthly Report, March 2015, pp 15-37; Deutsche Bundesbank, Approaches to resolving sovereign debt crises in the euro area, Monthly Report, July 2016, pp 41-62, and the overview on p 43 in the current report.
**4** See Deutsche Bundesbank, Current fiscal developments in the euro area, Monthly Report, May 2017, pp 59-62.
**5** The structural balance corresponds to the balance adjusted for the impact of cyclical and temporary measures.

as having been met if the structural deficit does not exceed 0.5% of gross domestic product (GDP).[6] The preventive arm sets forth, in particular, how a country should proceed in the event of failure to meet this target. The general procedure in such cases is for the country in question to improve its structural balance each year by 0.5% of GDP until it meets the MTO. However, other factors, methods and exceptions are to be considered that can change this figure or justify a deviation from it. If the Commission's overall assessment ultimately finds that there are "significant deviations", a procedure would be started under the preventive arm and, if the country's response is not sufficient, the Commission may call for it to provide a financial deposit. In the event of a further deterioration of the position and if the existence of an excessive deficit under the corrective arm of the pact is established, this deposit would not bear interest. Otherwise, the deposit would be paid back with interest once the significant deviation under the preventive arm had been corrected.

*… and the corrective arm*

The corrective arm is based on the reference values for the deficit (3% of GDP) and the level of debt (60% of GDP). If either of these reference values is breached, an "excessive deficit procedure" is usually started. If the debt ratio exceeds 60%, it is still deemed to be met if it is sufficiently diminishing and approaching the reference value at a satisfactory pace. This has been operationalised by requiring the amount exceeding the 60% ceiling to be reduced by an average rate of at least one-twentieth per year over three years. If, once the procedure has been started, the Commission determines that an excessive deficit exists, this generally has to be corrected in the following year and the structural deficit ratio is to be reduced by at least 0.5 percentage point. In cases where aims are continuously breached, the Council may impose financial sanctions (fines). However, the preceding steps in the procedure now contain a large number of factors, methods and exceptions granting considerable discretionary leeway. As far as the debt ratio is concerned, it is possible to use these to ensure that no excessive deficit is established in the first place.

*Commission and Council responsible for surveillance*

The Commission monitors compliance with the fiscal rules under the preventive and corrective arms, generally within the framework of the European Semester. In November, the Commission analyses the budgetary situation based on its own autumn forecast and the draft budgetary plans submitted by the countries, looking especially at the following year.[7] In February, on the basis of its winter forecast, the Commission examines the extent to which the November statement has been taken into consideration. In May, drawing upon the spring forecast, the Commission examines the stability programmes, which the countries are required to submit by April. At this stage, Eurostat has published initial information about deficit and debt levels in the previous year. As a rule, the Commission assesses compliance with the provisions both retrospectively *(ex post)* and based on forecasts and plans; however, the preventive arm contains no sanctions for projected infringements. The Commission presents its analyses and the resulting recommendations or proposals to the Council. This serves as a basis for the Council to make its decisions within the procedure.[8]

Since the launch of the euro in 1999, there has, in the final analysis, often been a failure to

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6 If the debt ratio is significantly below 60%, the structural deficit may also be up to 1% of GDP.
7 This article does not provide any further information on the part of the monitoring process based on the draft budgetary plans. However, as there are next to no consequences, even when countries are considerably off target, the binding force is especially low. Thus, the original aim of correcting unsound developments at an early stage of parliamentary budget planning, which was the reason for introducing this additional stage in the European Semester, has not been achieved.
8 The recommendations or proposals put forward by the Commission are generally adopted if the Council accepts them by qualified majority. However, for a number of steps that were introduced in 2011 – in particular for sanctions – a reverse qualified majority is required, ie a Commission proposal is accepted if the Council does not reject it by qualified majority. As part of the intergovernmental fiscal compact, the countries have also agreed that all steps taken in an excessive deficit procedure against a member state referring to the reference value for the deficit ratio must be approved by reverse qualified majority.

*In the past, regular quantitative anchors often missed*

comply with the regular Maastricht ceilings.[9] As things stand, the deficit ratio has been in excess of 3% 109 times, ie in more than 40% of cases, and in 13 cases this lasted for longer than three or more consecutive years. The debt ratio was below 60% in far less than half of the cases (41%) and it was only Estonia, Luxembourg, Latvia, Lithuania and Slovakia that managed to keep their debt ratio below this level the entire time, while Belgium, Greece, Italy and Austria failed to show a debt ratio below 60% in any of the years in question. At present, with the exception of Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovakia, all countries are in excess of the 60% ceiling.[10] The medium-term objective of a structurally close-to-balance budget was seldom met. When assessing compliance with the fiscal rules, the severe impact of the financial and economic crisis on developments since 2008 is, of course, to be taken into consideration. It is also possible that the data look different today from the results at the time when the procedure was agreed – for instance, as a result of methodical changes – and, in individual cases, exceptional circumstances may excuse failures to meet targets. All things considered, however, the fiscal rules and their implementation cannot be hailed a success. This is also made apparent by the following more detailed examination of selected aspects and examples of concrete implementation.

## Preventive arm

*Structurally close-to-balance budget agreed*

The European fiscal targets stipulate that member states are to report a structurally close-to-balance budget. Each member state determines its own MTO, with the fiscal compact specifying that the structural deficit should, as a rule, not exceed 0.5% of GDP.

### Determining the required adjustment if targets are missed

*MTO – technically – to be rapidly reached*

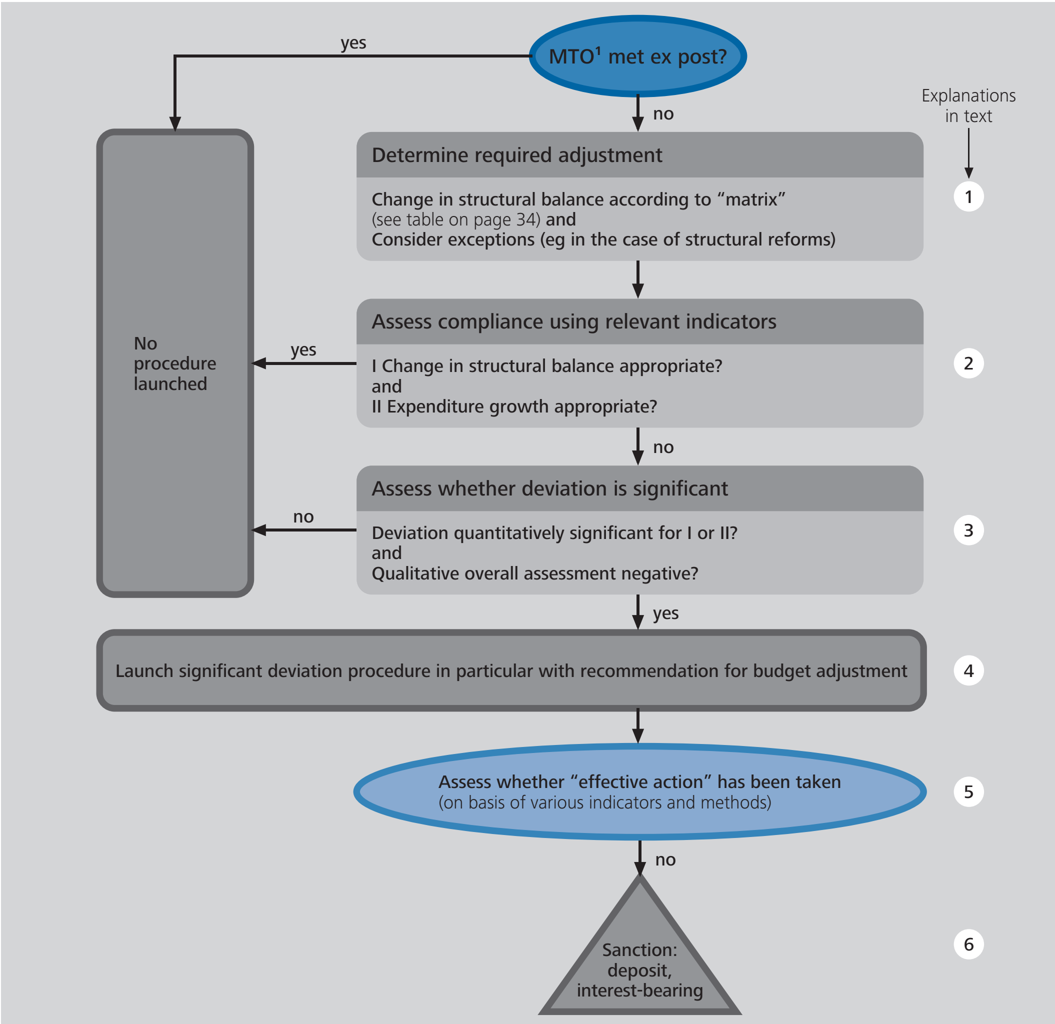
If the MTO has not yet been reached, the structural deficit ratio is to be reduced by 0.5 percentage point each year. This adjustment path (see point 1 in the chart on page 33) is fine-tuned depending, above all, on the economic situation – measured in terms of the macroeconomic output gap and potential GDP growth – and the debt level in accordance with the Commission's "matrix" (see the table on page 34). In "exceptionally bad times" and, in certain circumstances, in "bad times", it may be possible to forgo structural improvement entirely. The granulation used by the Commission asymmetrically favours lower consolidation, in particular because, in real time – at the time of assessment – a positive output gap is rarely reported.

*Exceptions for structural reforms and investment expenditure …*

A deviation from the adjustment path towards the MTO may be excused by referring to one or more exceptions. These have become ever more numerous over time. For example, structural reforms and investment expenditure can be taken into account under certain circumstances. This is intended to facilitate structural reforms that increase long-term growth potential and are, therefore, also advisable in the context of the sustainability of public finances. However, the (positive) effects on growth potential cannot be reliably demonstrated in many cases and are disputed. The granting of an exception therefore comes with considerable discretionary scope. In addition, the exception may be taken into consideration as part of an *ex post* evaluation even when reforms are only in the planning stage. By contrast, there is no provision for a tightening of fiscal consolidation requirements if measures do not have the desired effect. The investment clause contains no clear definition of expend-

9 The figures here include values from all current euro area countries, from the time of their accession. The Commission only started publishing figures for the structural balance as of 2010.
10 For more information, see also Deutsche Bundesbank, Monthly Report, May 2017, op cit.

**Simplified diagram on assessment in the preventive arm of the Stability and Growth Pact**




**1** Medium-term objective.
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iture eligible for consideration. Against this background, a wide range of expenditure may potentially be exempted from the limit under the fiscal rules if it has been made in connection with projects which are also funded by the EU budget. Furthermore, as in the case of structural reforms, there is no certainty per se that investment expenditure will have a positive impact on sustainability, and such an effect is difficult to verify. The deviation from the adjustment path, which is to be justified through these exceptions, can nevertheless be quite significant: it can amount to as much as 0.5% of GDP per clause and may not exceed 0.75% of GDP in total. The deviation from the level of the structural balance without an exception is currently limited to three years (see the chart on page 34).[11]

*… as well as for expenditure on refugees and to tackle terrorist threat*

Moreover, temporary special expenditure linked to refugees and tackling the terrorist threat, for example, may also be classified as exceptions (in the sense of an unusual event outside the

**11** Another condition for the structural reform and investment clauses is that the minimum benchmark is adhered to. This benchmark represents a value for the structural balance and is calculated by taking past output gaps into account. Compliance with the minimum benchmark is intended to ensure that the 3% limit is not breached during a normal cyclical downturn even if no fiscal countermeasures are taken.

**Matrix for specifying the required annual adjustment towards the medium-term objective**

Required annual adjustment in structural deficit ratio (in percentage points)

| Condition | Debt ratio <60% and no sustainability risk | Debt ratio >60% or sustainability risk |
|---|---|---|
| Exceptionally bad times[1] | No adjustment needed | No adjustment needed |
| Very bad times[2] | 0 | 0.25 |
| Bad times[3] | | |
| Growth below potential | 0 | 0.25 |
| Growth above potential | 0.25 | 0.5 |
| Normal times[4] | 0.5 | > 0.5 |
| Good times[5] | | |
| Growth below potential | > 0.5 | ≥ 0.75 |
| Growth above potential | ≥ 0.75 | ≥ 1 |

Source: European Commission. **1** Real GDP growth <0% or output gap < −4. **2** −4 ≤ output gap < −3. **3** −3 ≤ output gap < −1.5. **4** −1.5 ≤ output gap <1.5. **5** Output gap ≥1.5. Output gap figures as a percentage of potential GDP.

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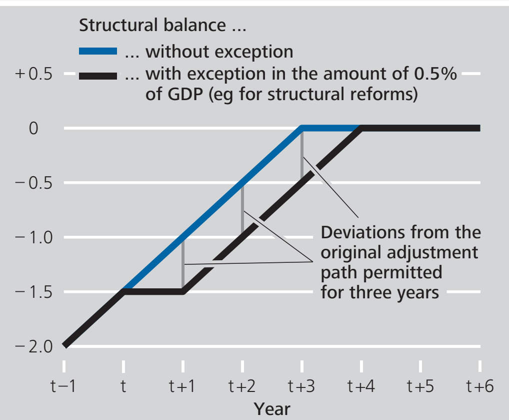
**Adjustment path towards the MTO***

as a percentage of GDP




***** Here for the example of a medium-term objective of 0. Chart based on information provided by the European Commission.

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country's control). Here, too, there are considerable problems of definition, and there exists an incentive to report regular expenditure, too, under these definitions.[12] The exceptions are to apply for a limited period only. However, the original two-year time limit applied to the additional refugee-related expenditure has now been extended by one year until 2017. As things stand, this means that the limit will therefore end at the same time as the exception in connection with tackling the terrorist threat, which was introduced later.

*Deterioration in structural deficit ratio can be excused through exceptions*

In practical terms, even an increasing breach of the MTO can be excused through exceptions. In 2016, Italy's adjustment path towards the MTO was considered to be "largely compliant", despite a worsening of the structural deficit ratio by around 0.7 percentage point, because the structural reform and investment clauses as well as the exceptional expenditure linked to refugees and combating terrorism were accepted simultaneously as justification.

## Other relevant indicator to check targets have been met

*Upper limit for the growth rate of expenditure alongside the structural deficit target*

For checking to ensure that the required adjustment has been achieved, upper limits for the growth rate of expenditure are stipulated under the preventive arm in addition to the above requirements regarding the change in the structural balance (see point 2 in the chart on page 33).[13] If a country has not yet reached the MTO, the growth rate of expenditure must be below the growth rate of potential GDP to an extent that is compatible with the required improvement in the structural deficit ratio (unless the stronger increase in expenditure will be offset by increases in revenue adopted at the same time). The original aim of the expenditure rule was that revenue windfalls were to be used to reduce deficits and not immediately channelled into increases in expenditure. This

**12** The European Commission has stated that for 2017 it would deviate from the actual procedure for Italy with regard to refugee-related expenditure. Instead of considering only the increase in expenditure compared with the previous year, which would be relevant in assessing the change in the structural balance, the total refugee-related expenditure for 2017, minus the exceptions granted in the previous years, are to be taken into account. The maximum deviation from the adjustment path towards the MTO is considerably higher as a result.
**13** For problems regarding a fiscal rule which incorporates the scale of discretionary (revenue-related) measures, see below.

was intended to prevent excessive deficits in the event that a boom in revenue is reversed,[14] and is to be welcomed in principle. However, the expenditure rule is not applied if the MTO is overachieved. Moreover, the relevant calculations are extremely complex and, in conjunction with the structural balance, tend to provide additional possibilities of exculpation.[15]

## Only significant deviation problematic

*Escalation only in case of "significant" deviation*

A deviation of the change in the structural balance and in expenditure growth from the expected adjustment path in the preventive arm is considered problematic only if it amounts to or causes a breach of 0.5% of GDP in a single year or an average of 0.25% per year in two consecutive years. A procedure in the event of a significant deviation for cases of *ex post* noncompliance could, in principle, be triggered if one of the two indicators (adjustment to the structural balance or expenditure growth) deviates significantly in this regard. However, the Commission first has to state in a comprehensive assessment, for which no specific criteria exist, that the deviation as a whole is to be considered significant in qualitative terms as well. Only in this case does the procedure begin with a warning from the Commission to the country concerned (see point 4 in the chart on page 33). This warning is followed by a Council recommendation stipulating a future adjustment path and allowing a period not exceeding five months to respond to this recommendation. If it is subsequently found that this period has not been met, the Council is required – following a Commission recommendation – to call for a sanction in the form of a deposit, made by the country with the EU, of between 0.0% and 0.2% of GDP (see point 6 in the chart on page 33). If the significant deviation is subsequently resolved, the deposit will be returned with the interest accrued (at the interest rate equivalent to the credit risk for the Commission for the relevant investment period). If the situation deteriorates to the extent that an excessive deficit (corrective arm) is found to exist, the interest-bearing deposit is converted into a non-interest-bearing deposit.[16]

## Conclusion regarding the preventive arm

*Overall, preventive arm complex, opaque and with very low binding effect*

Overall, the effectiveness of the preventive arm is low. The possibilities to conform with the rules while deviating substantially and lastingly from the budgetary objective are considerable, and the Commission has broad discretionary leeway in this respect. Thus, no euro area country has to date been judged to have deviated significantly from the adjustment path – not even when the structural deficit ratio increased. Moreover, the predictability and transparency of compliance with the rules cannot be taken as given owing to their high level of complexity. Furthermore, there is evidently often insufficient incentive to comply with the actual objective. The threat of financial sanctions is negligible in terms of their amount. As a consequence, the MTO is in many cases at risk of remaining an objective that will not be met.

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**14** An increase in revenue which is stronger than GDP growth is interpreted as a "revenue windfall", unless it results from revenue-increasing measures. The crisis in particular has shown that revenue windfalls in the run-up to the crisis were often only temporary in nature and that their reversal subsequently led to rapidly rising deficits.
**15** A change in the structural balance and expenditure growth may, owing to special methodological characteristics, deviate from each other for reasons other than revenue windfalls or revenue shortfalls. This makes it difficult to assess the results. In principle, there is a close relationship between the goals for improving the structural balance and for the growth rate of expenditure. However, a difference may arise, for example, from the fact that, in the case of the expenditure rule, reference is made to medium-term average potential growth, while the value for the current year is relevant for the structural balance. In addition, incorrectly assessing the impact of the considered discretionary revenue measures, for instance, may lead to different results. The same applies to expenditure which develops contrary to projections and is not contained in the relevant definition of the expenditure rules (eg interest).
**16** It is not clear how this sanction would be dealt with in the event of a negative interest rate.

## Corrective arm: deficit rule

### The procedure

*Procedures can be stepped up in the event of persistent breach*

As a rule, an excessive deficit procedure is launched in the corrective arm if the deficit ratio was more than 3% in the previous year (see point A in the chart on page 37). A deficit ratio of more than 3% is usually not considered to be excessive if the breach is temporary, very limited and the result of an unusual event (see point A1 in the chart on page 37).[17] The decision that an excessive deficit exists will, however, trigger a recommendation concerning by when the deficit ratio is to be corrected (ie by when the deficit ratio is at least to be reduced to 3%; see point 1 in the chart on page 37). The reference value relates to the unadjusted deficit ratio. Nevertheless, the recommendations also include quantitative targets for improving the structural balance and regarding the scale of the concrete consolidation measures to be taken. After not more than six months, the Commission has to assess whether effective action has been taken (see point 2 in the chart on page 37). In the case of a multi-year correction deadline, this assessment is to be repeated at later points in time. If the assessment produces a positive outcome, no further action is necessary; if the 3% limit is complied with on time, the procedure is terminated. If it has been confirmed that an adequate degree of effective action has been taken but the objective will not be complied with according to the projection, it may be possible to modify the recommendations. In particular, the correction deadline may be extended. If no effective action has been taken, however, the procedure is to be stepped up (giving of notice; see point 3.1 in the chart on page 37).

*Financial sanctions possible, …*

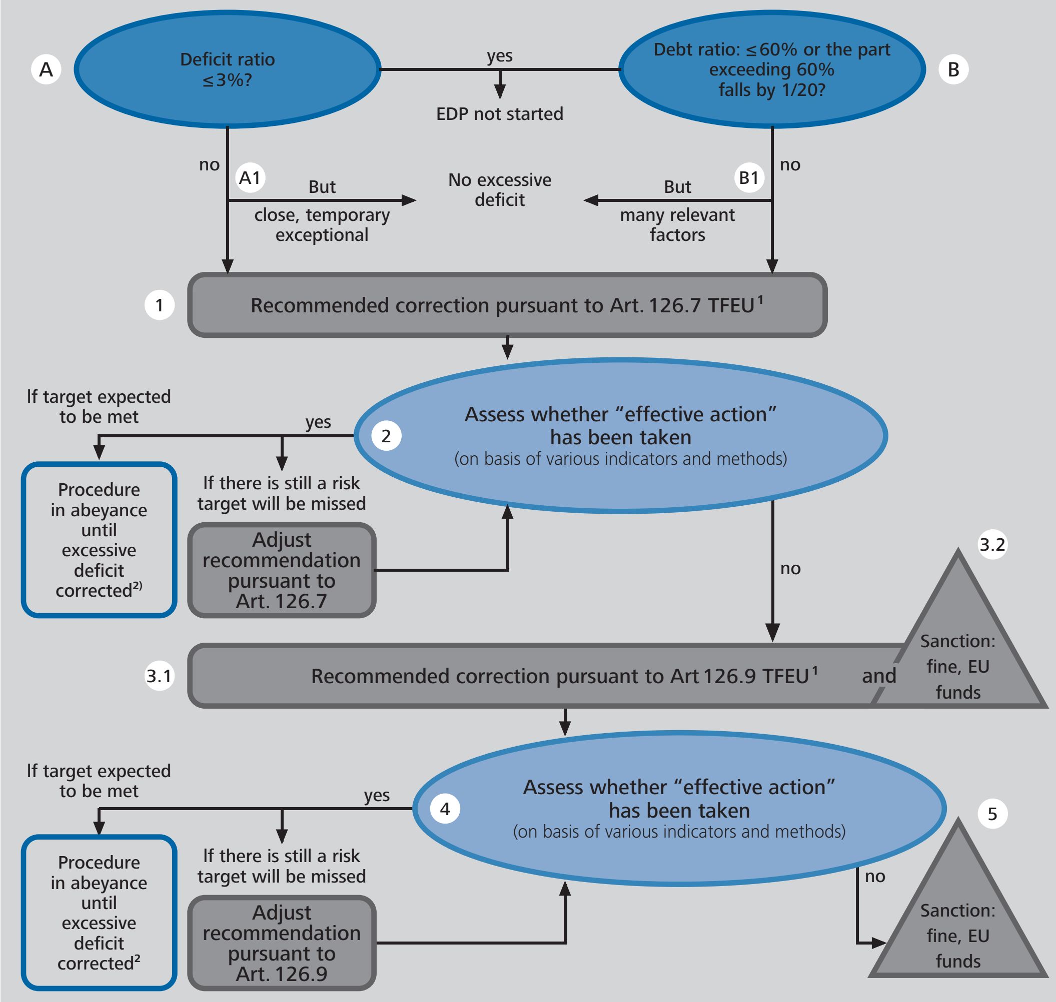
The excessive deficit procedure then also provides for financial sanctions[18] (see point 3.2 in the chart on page 37). On the one hand, a sanction is to be imposed in the form of a fine of up to 0.2% of GDP of the country concerned (in Germany, this would be currently around €6½ billion). However, the fine can be reduced to zero if the country concerned cites exceptional economic circumstances or presents a reasoned objection, and the Commission and the Council accept this. On the other hand, in addition to a fine the Commission must propose the suspension of EU budget appropriations under the European Structural and Investment Fund. This step can, in turn, be without financial consequences,[19] in particular if the necessary corrective measures that have been newly stipulated in the stepping-up of the EDP are carried out in a timely manner. This is to be assessed after a further period of not more than four months (see point 4 in the chart on page 37). If no effective action has been taken until then, in addition to the suspension of appropriations from the EU budget and the previous fine, further financial sanctions of up to 0.5% of GDP may be imposed (see point 5 in the chart on page 37). This fine may be renewed annually until the excessive deficit has been corrected.

*… but have so far not been imposed*

Financial sanctions have de facto not been imposed to date. For example, in 2013 it was found that Belgium had failed to take effective action, whereupon the procedure was stepped up. However, a sanction was not proposed. In spring of 2016, after the Commission presented its recommendation regarding Spain and Portugal only after a delay, it was eventually found in July – following Spain's parliamentary elections – that Spain and Portugal had not taken effective action in 2015. While the procedures were stepped up, the amount of the sanction proposed by the Commission and adopted by the Council was zero. The proposal regarding the suspension of appropriations from the EU budget was not immediately submitted, and

17 In principle, it is envisaged that even a planned or projected breach of the reference value is to be punished by launching a procedure.
18 Since 2011 it has been the case that sanctions are possible even at this early stage. Previously, they could only be imposed in the event of a persistent breach following the stepping-up of the procedure (Article 126.9 of the TFEU).
19 With regard to the amount of appropriations to be suspended, many provisions are to be observed, with the result that the financial burden here, too, may be small or zero.

**Simplified diagram on the excessive deficit procedure (EDP) (corrective arm of the Stability and Growth Pact)**




**1** Treaty on the Functioning of the European Union (TFEU). **2** Or, in the case of correction deadlines running several years, repeated assessments of whether effective action has been taken.
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this threat of sanctions was later rendered obsolete by the finding that effective action to correct the excessive deficit had been taken within the new time limit.

## Assessment of whether effective action has been taken

*Determining whether effective action has been taken is a sensitive point in the procedure, …*

The truly decisive step in the excessive deficit procedure described above is the assessment of whether effective action has been taken. The future progress of the procedure and, ultimately, of sanctions hinges on this assessment. Nonetheless, the relevant provisions laid down in the regulations are very vague and open to interpretation. In addition, they have repeatedly been amended, resulting in it being possible to reach a positive assessment even if the recommendations were at least *prima facie* (in some cases, substantially) not complied with.

*… but provisions with substantial procedural leeway, …*

Whereas the rules stipulate when the first assessment is to be carried out either after the excessive deficit has been found to exist or following the notice (after a maximum of six months and four months respectively), such a decision is, in the case of multi-year correction deadlines, at the discretion of the Commission.

Decisions may be significantly delayed as a result. Moreover, the provisions on the years to be included in the assessment are imprecise. When the first assessment is carried out, the projected development is to be measured against the requirements. When subsequent assessments were made as part of the same procedure, the Commission, on a case by case basis, took only previous years or also projection years into consideration. For instance, the Commission confirmed that France had taken effective action in spring 2013, which made it possible to extend the deadline by two years without stepping up the procedure. In this instance, the assessment included the projection for 2013. At the end of February 2015, by contrast, the Commission's positive assessment for France (leading to a further extension of the deadline by two years without a stepping-up of the procedure) was based only on the developments in previous years. Taking into account the projection for 2015, this probably would not have been possible, or at, least, it would have been more difficult to justify.

*… which can be used to postpone consolidation*

A further interpretation of the rules which tends to soften an effective limit on debt concerns the correction recommendations made as part of the procedure. For example, recommendations for the development of the deficit ratio are made in both structural and unadjusted terms.[20] Ultimately, however, it is sufficient to satisfy only one of these requirements.[21] However, the requirement with regard to the unadjusted deficit ratio may also be fulfilled by non-sustainable developments such as temporary measures. As a result, the fiscal efforts needed to correct the excessive deficit must be all the greater in subsequent years. But in some cases this, in turn, is exploited to extend the deadline on the grounds that the extensive structural improvement necessary is detrimental and over-ambitious in terms of its macroeconomic implications. This was the case in Spain, for example.[22] Considerable discretionary leeway exists with regard to the deadline for correction and the required adjustment path. While a correction deadline of one year and a structural adjustment of at least 0.5% of GDP per year are, in principle, envisaged, greater fiscal consolidation can be required or the correction deadline extended. For the most part, free use may be made of numerous and very vague "relevant factors" in justifying the decision.[23]

Besides the mentioned procedural leeway, in the assessment of effective action, methods have been introduced that permit the conse-

**20** Furthermore, the scale of consolidation measures (bottom-up) is recommended (see below).
**21** Only the unadjusted deficit ratio is ever taken into account to assess whether the excessive deficit was corrected and the procedure concluded in a timely manner.
**22** The intermediate target for the unadjusted deficit ratio was reached in 2014 without the required structural improvement; the final target was no longer reached in 2015, however. Then, given the highly acute fiscal consolidation needs, the subsequent stepping-up of the procedure provided for an extension until 2018 instead of the previously expected correction in 2016.
**23** The relevant factors are set forth in Article 1 (3) of Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Regulation (EU) No 1177/2011 on speeding up and clarifying the implementation of the excessive deficit procedure: "a) the developments in the medium-term economic positions, in particular potential growth including the various contributions provided by labour, capital accumulation and total factor productivity, cyclical developments, and the private sector net savings position; b) the developments in the medium-term budgetary positions, including, in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks; c) the developments in the medium-term government debt position, its dynamics and sustainability, including, in particular, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit imbalances related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government. Furthermore, the Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances."

*Specified assessment methods also open up possible loopholes*

quences to be waived if countries deviate from the recommended correction path through "no fault of their own". For instance, under the rules, the change in the structural balance reported at the time of the assessment is adjusted by means of alpha and beta corrections in order to account for unexpected developments in revenues and potential GDP before it is compared with the initial recommendation.[24] At first glance, this would seem reasonable. The outcome, however, is that member states are absolved of their responsibility for adhering to the rules. Ultimately, it is irrelevant whether the problems stemming from government debt are caused by predictable or unexpected developments. It would therefore undoubtedly be more useful to factor in a margin of safety below the deficit ceiling in the budget planning when applying a deficit procedure. Furthermore, the complex methods used for this purpose, together with the extensive data requirements, are difficult to comprehend. The member states also have a significant information advantage in terms of the data that are fed in, which they can use strategically. For instance, the quantification of fiscal policy measures on the revenue side plays a crucial role. In doing this, however, the Commission has to rely on the estimates provided by the countries – such as increases in revenue linked to an improvement in tax administration – which it is scarcely able to verify in detail.

*More indicators mean more opportunities to avoid responsibility …*

In parallel with the above-mentioned assessment of the reduction in structural deficits, fiscal policy is also to be evaluated on the basis of the scale of consolidation measures taken. The "bottom-up" approach (similar to the approach in the preventive arm of the SGP) examines whether the revenue measures, together with the change in expenditure growth, are at least large enough to achieve the recommended (structural) consolidation. Like for the beta correction, the impact of the revenue measures has to be quantified here, too, which results in the aforementioned problems arising. What is more, developments in expenditure without additional measures have to be appropriately quantified *ex ante*.[25]

*… partly because the indicators can be offset against one another*

The assessment of effective action ultimately consists of analysing whether the requirements of the bottom-up approach and the requirements for the structural improvement have been met. Although any divergences should generally be explained, this is not always possible with complete certainty. At all events, there have been past instances when effective action was deemed to have been taken even though only one of the two criteria had been met, while there had existed a marked failure to fulfil the other. Ultimately, the rules also permit a different outcome even if consolidation is judged to be insufficient under both methods – on the basis, moreover, of a final, overall assessment that contains no specific criteria. For example, in spring 2014, France failed to meet the nominal targets but was deemed to have taken effective action even though both the change in the structural balance (with and without correction) and the scope of the measures fell short of the recommendations. This was mainly because, at 0.1% of GDP, the margin by which it had missed the targets was considered negligible.[26]

*Expenditure benchmark likely to simplify matters in future*

The Commission has proposed future amendments to the methods in the excessive deficit procedure. For example, the bottom-up approach and the adjustment of the structural balance for unexpected developments (alpha and beta corrections) would be replaced by an upper limit for the growth rate of expenditure that is compatible, *ex ante,* with the recommended reduction in the deficit ratio (un-

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**24** The additional option of performing a gamma correction for other unexpected events is not specified in detail or conclusively in the rules.
**25** The recommended scope of the measures to be taken is incompatible with the desired improvement in the structural balance if developments in expenditure and revenue are misjudged at the time of the recommendation. As a result, insufficient consolidation could be excused by a forecast error.
**26** Instead of deviating from the regular process because the breach is "only" minor, the procedure could be applied as normal, but the minor deviation could be taken into account, if appropriate, when calculating the sanctions.

adjusted and structural). This would be simpler. However, the discretionary revenue measures, in particular, which are difficult to quantify reliably, also play a role here. Furthermore, this approach would ultimately continue to excuse all developments that deviate from the forecast as being out of the control of the member states. As a result, effective action could still be deemed to have been taken even if, with hindsight, the structural improvement called for has clearly not been achieved.[27] Ultimately, even if a country breaches the quantitative expenditure ceiling, the Commission could, virtually at its own discretion, continue to issue a positive overall assessment of effective action given that no specific criteria have been established for this.

## Conclusion regarding the preventive arm: deficit rule

*Rules for correcting an excessive deficit unconvincing*

All things considered, the excessive deficit procedure contains a large number of exceptions, special factors and instances of discretionary leeway, meaning that persistently high deficits above the reference value are possible while adhering to the rules. The consolidation process may be slowed down considerably. The complexity and the very extensive *ad hoc* discretionary leeway have also severely reduced the accountability and transparency of the procedure. The methods have been changed repeatedly and are difficult to understand, even for experts. The resulting impression is that the procedure is tailored to the desired outcome. To a large extent, member states have been absolved of the responsibility for actually achieving the objectives. As a result, incentives to comply with the reference values, and thus their binding effect, have been curbed. It is true that, in principle, breaches carry penalties and financial sanctions can be imposed at a relatively early stage and can be escalated if breaches are persistent. Nevertheless, previous experience of budgetary surveillance has shown this to be highly unlikely in practice.

## Corrective arm: debt rule

*Excessive deficit procedure also possible for breaches of the debt criterion, …*

In the corrective arm, an excessive deficit procedure can also be launched in connection with the debt criterion (see point B in the chart on page 37).[28] In 2011, a provision was operationalised, requiring a debt ratio above the reference value of 60% to be "sufficiently diminishing and approaching the reference value at a satisfactory pace". The requirement is considered to have been met if the gap between the debt level and the reference value has been reduced by an annual average rate of one-twentieth over the past three years. If this is not the case, the requirement is also considered to be fulfilled if this reduction takes place for the previous year and the following two years in line with the Commission's forecast. Moreover, the impact of economic activity can be subtracted in the numerator and the denominator of the debt ratio.[29] If none of these numerical targets are met, the Commission draws up a report which also reviews, in particular, the importance of the many relevant factors cited above[30] (see point B1 in the chart on page 37). These also include, for example, an assessment of "progress towards the MTO", although more detailed rules are lacking (for example, which years are to be taken into account in this regard and how). If the overall assessment, including the relevant factors, reveals that the criterion for the debt ratio has been breached, the Com-

**27** This could be because, say, expenditure components that are not included in the calculation of the expenditure ceiling do not develop as expected. Interest expenditure is factored out, for example.
**28** Although the process is known as the "excessive deficit procedure," it is generally linked to both reference values.
**29** Transitional provisions were made for member states that were subject to an excessive deficit procedure at the time the new provisions entered into force (November 2011). For a period of three years from the correction of the excessive deficit, these member states are considered to have met the requirements of the debt criterion if they make sufficient progress towards compliance with the benchmark. Progress is defined through the minimum linear structural adjustment, which, if followed, ensures that member states will comply with the debt rule at the end of the three-year transitional period. With regard to the assessment regarding the outcome in 2016, Belgium, Cyprus, Ireland, the Netherlands, Austria and Slovenia are still affected.
**30** See footnote 23 on page 38.

mission proposes that the Council declare the existence of an excessive deficit. The excessive deficit procedure then follows in the sequence described above. Here, too, a deadline is set, and targets for the unadjusted and structural deficit ratio and the scope of the measures are recommended for correcting the deficit (points 1 *et seq* in the chart on page 37).

*… but seems unlikely owing to the large number of factors*

Ultimately, there is little likelihood of an excessive deficit being identified on the basis of the debt criterion and, to date, there has been no instance of this happening. In the case of Italy, for example, the Commission's interpretation of the rules was particularly generous. Among other things, it appears that a clear breach of the debt reduction benchmark can now even be rectified by a breach of the less demanding preventive arm, provided that this breach is not deemed to be significant. As a result, the debt rule, as an autonomous criterion, has been bypassed. And even for a country with a very high level of debt, no attempt is made to set major incentives for a significant reduction. What is more, the debt rule also fails to specify precisely when compliance is to be assessed. In the case of Italy, the Commission checked the debt ratio for 2015 in May 2016 and announced a new inspection for autumn 2016. However, the report was not published until February 2017, after the referendum in Italy had taken place. It was therefore not possible to intervene at an early stage to counter any undesirable developments. Moreover, the Commission did not identify the existence of an excessive deficit, even though the February report established that, based on the Commission's forecast, Italy had failed to comply with the debt criterion. This approach was justified on the basis that failure to meet the targets could still be averted by adopting additional measures in 2017. In May 2017, the Commission declared that additional measures had been taken and that, as a result, no further process steps were necessary at that time.[31] The debt ratio has continued to climb from its 2015 level of 132.1%, and the Commission expects it to reach 133.1% in 2017. This would see the debt ratio rise to 8 percentage points above the figure at which a reduction of one-twentieth per year over three years would have been achieved.

*Debt criterion probably ineffective at time of the most recent implementation, if not before then*

Overall, it is indeed to be welcomed that the initially undefined requirements for the debt criterion have been specified. In practice, however, this has hardly made the debt ceiling any more effective. It even allows debt ratios to rise over a number of years without an excessive deficit being identified. Against this background, there are barely any incentives to comply with the requirement to significantly reduce excessive levels of debt.

## Concluding remarks

*Binding force of the SGP …*

Sound public finances in the individual member states are the cornerstone of a stability-oriented monetary union. Fiscal rules are supposed to make a major contribution to this by counteracting political players' tendency to incur debt and by strengthening confidence in the sustainability of public finances. The basic quanti-

**31** More specifically, in May 2016, the Commission had already established that Italy had failed to comply with the backward-looking part of the debt rule in 2015 and, at the same time, expected that it would also fail to comply with the forward-looking dimension. However, it justified the lack of compliance by taking the adjustment towards the MTO into account as a relevant factor. The Commission deemed it sufficient if the adjustment towards the MTO in 2016 (ie ex ante, again) were to be "broadly ensured". In other words, even a failure to comply with this factor would be acceptable, provided it was not significant. However, it did not base this judgment on its forecast, which should have revealed a quantitatively significant deviation, but instead assumed that the necessary adjustment would be achieved through additional fiscal measures. The report on the debt rule in February 2017 then established that the failure to comply with the adjustment path towards the MTO in 2016 (relevant factor) could only be deemed insignificant if a significant deviation were avoided in 2017. Because the forecast did not indicate that this would be the case either, the Commission called on Italy to take measures to cut its deficit by an additional 0.2% of GDP. According to the Commission's May 2017 report, this condition has now been met. However, the identification of a significant deviation from the adjustment towards the MTO can only be avoided because the Commission intends to deviate from the announced procedure by taking into account refugee-related costs (see footnote 12 on page 34). Against this background, the Commission concluded in May that no further procedural steps were necessary at that time.

tative requirements of the SGP do indeed provide thoroughly appropriate conditions for this. The preventive and corrective arms also contain instruments that the Commission and Council could use to request a swift correction of undesirable developments. For instance, persistent failure to comply with the rules can even result in the imposition of financial sanctions so as to incentivise countries to pursue sound budget management.

*… now no more than weak, …*

The rules and their interpretation have been repeatedly modified over time. The lesson of the sovereign debt crisis and, in particular, extended fiscal and monetary policy risk-sharing have accentuated the need for rules to have a stronger binding force, but this has played only a minor role as time has gone on. The growing importance of the European Commission in the SGP has not led to stricter implementation. Instead, in agreement with the Council (of finance ministers), it has increasingly relied on more flexible rules. These have become increasingly complex and considerable discretionary scope has been opened up, especially in terms of excusing non-compliance. Now, it is virtually impossible to understand them. There is an impression that the interpretation of the rules is partly the outcome of a political negotiation process. The rules appear to be adapted to the fiscal policy of the individual countries, rather than the other way round. Incentives to pursue sound fiscal policy have been sidelined in favour of fine-tuning the economy by means of a more expansionary financial policy and of other (economic) policy objectives. As a result, countries often fail to comply with the regular quantitative targets and requirements of the SGP.

*… but could be strengthened through extensive reforms*

Although deficit ratios have fallen noticeably overall, debt ratios remain very high in many member states. The current low-interest-rate environment is easing pressure on public finances and has made a major contribution to lowering deficits in recent years, thus significantly reducing the problems caused by high debt levels. However, member states should not rely on interest rates remaining low; it is of vital importance that all countries achieve a sound basic position through a rapid reduction of very high debt ratios. Not least in order to sustain confidence in public finances even given a less expansionary monetary policy stance in the future, tightening up fiscal rules again and restoring confidence in their effectiveness would be essential. The basic quantitative targets and upper limits of the SGP should become more important again; not least, there should be a stronger insistence on compliance with the requirement to achieve a structurally close-to-balance budget. This would entail a significant cutback in the number of exceptions, factors to be considered, and modifications. The adjustment requirements would also have to be defined on the basis of more robust and more durable methods. Furthermore, compliance with the rules should not be measured in terms of consolidation efforts, but in terms of results. In addition, the greater build-up of debt caused by failure to meet the requirements could be recorded in a control account and be paid off in due course. The rules should generally take into account the effect of the automatic stabilisers. Furthermore, it would be prudent to make exceptions for serious crisis situations. However, a more far-reaching active stabilisation of macroeconomic developments through the fine-tuning of fiscal policy should not form part of the fiscal rules. Such possibilities would still be open to member states provided they do not breach the rule limits in doing so. With objectives and methods that are, on the whole, simple and transparent, the decisions made under the procedures would be easier to follow and could then be evaluated by the general public again.

*Relieve the Commission of responsibility for fiscal surveillance*

Progress towards implementing the fiscal rules could potentially be achieved if the Commission were to transfer at least the surveillance of the budgets and of compliance with the rules to a new, specialised institution. Stricter application in general and better protection overall through more resilient public finances would be achievable, above all, if the institution were

**Overview of selected recommendations and measures**

**Financial stability**

Strengthen banks' loss absorbency: capital requirements and/or leverage ratio

Consistently deploy and refine macro-prudential toolkit

Improve integration of equity and debt markets
– Uniform legal framework
– Diversified lending

Segregate monetary policy and banking supervision

Single Resolution Mechanism (SRM)
– Adequate bail-in-able capital
– Apply bail-in rules strictly, and stringently wind down non-viable banks
– Common fiscal backstop with national loss retention

Properly regulate financial system outside the banking sector (eg shadow banks), too

**Fiscal policy**

Set up independent budgetary surveillance institution

Fiscal regime
– Simpler and clearer rules, strictly applied
– Uniform and transparent surveillance
– Reduce discretionary leeway
– Step up automatic corrective measures
– Strengthen role of debt ratio

ESM
– Conditional liquidity assistance
– Interest rate mark-ups for assistance
– Stronger role in insolvency process
– Non-standard fiscal measures to avert or mitigate haircuts

**Economic policy**

Review imbalance procedure and adapt if necessary once sufficient experience has been gathered; implement strictly

Streamline and enhance transparency of European coordination mechanisms

Take account of cross-border effects, but no fine-tuning of economic policy by central authority

**Financial stability / Fiscal policy**

Deprivilege sovereign bonds
– Capital backing
– Large exposure limits
– Adapt liquidity rules

Revise sovereign bond contracts
– Collective action clauses with single-limb aggregation
– Automatic maturity extension if ESM assistance granted

Create framework for more orderly sovereign insolvency

**Monetary policy**

Keep focus on core objective of price stability

Define mandate narrowly so as to legitimise independence

Do not undermine unity of liability and control in other areas or distort market processes

Assume no responsibility for financial stability risks caused by sovereigns' and banks' solvency problems

Avoid engineering joint liability for sovereign solvency risks via central banks' balance sheets

Institutional segregation of monetary policy and banking supervision

Deutsche Bundesbank

independent and – apart from the mandate for ensuring sound public finances – did not have any other, competing policy objectives. As before, legally binding decisions within the framework of the rules – such as identifying the existence of an excessive deficit – could continue to be made by the Council on the basis of the assessment reports. However, the preparatory work, at least, should be more targeted and less political; counteracting policymakers' propensity to borrow is, after all, the very purpose of the rules. As the sustainability of government finances plays an essential role in the context of the European crisis resolution mechanism, and since the European Stability Mechanism (ESM) is required to make assessments in this regard, a transfer of these functions to this institution could also be considered – as long as political influence on the analysis and development of any adjustment requirements can be avoided.[32]

*Further reforms also needed to strengthen the framework*

However, fiscal rules alone without a basic consensus on compliance with them cannot safeguard the sustainability of public finances. Further reforms to the regulatory framework of

32 For this purpose – and, in principle, in the event of a fundamental reorganisation of the procedure – an amendment of the ESM Treaty as well as, where appropriate, of the EU treaties would be required.

the euro area are also needed to strengthen its resilience (see the table on page 43 for the Bundesbank's suggestions on this topic[33]). One key aspect would be a realignment of liability and control. As long as member states retain autonomy for fiscal decisions, it will also be important to consolidate their responsibility. This includes strengthening financial stability, not least by reducing the negative interaction between governments and financial institutions (the sovereign-bank nexus). One major prerequisite for this would be a gradual phasing out of the existing regulatory privileges for government bonds. Agreement on an orderly procedure for the restructuring of sovereign debt in the event of a sovereign default could also help in the prevention and resolution of crises. Member states' fiscal autonomy also includes the ability to finance themselves independently in the capital markets. Credible fiscal rules should boost confidence in sound public finances in all member states and push down risk premiums. By contrast, extending mutual liability, for instance, to compensate for a loss in confidence in the countries whose budgets are stretched, would further weaken the balance between liability and control.

**33** See Deutsche Bundesbank, Monthly Report, March 2015 and July 2016, op cit. However, fiscal rules that help to achieve sound public finances are not only relevant in the existing regulatory framework of the euro area, in which responsibility for fiscal policy is at the national level. They would also be essential in a political or fiscal union, which some are calling for – that is to say, after national sovereignty has largely been relinquished.