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Adapting the EU Fiscal Governance to New Macroeconomics and Political Realities

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Abstract

Reforming the Stability and Growth Pact is regarded by almost all accounts as a top priority, although finding a political agreement on a new model seems at this stage highly problematic. The widespread consensus on the need to modify current fiscal rules has triggered a wave of new studies and reform proposals. The aim of this paper is to reflect on whether it is possible to find an optimal design of fiscal rules to promote sound and effective fiscal policy conduct in the EMU in most circumstances. This question is discussed under three different dimensions: i) the political economy of fiscal rules in the current political and economic environment; ii) the renewed theoretical debate about fiscal policy roles and objectives; iii) the currently incomplete nature of the Economic and Monetary Union and the prospects for its completion. Drawing a number of conclusions from this conceptual framework, the paper suggests a pathway for an overhaul of the EU fiscal governance, based on a more cooperative approach between the EU and national governments, presenting general principles and more specific features.

Keywords

EU Fiscal rules ; EU Fiscal policy ; EU economic governance ; EMU deepening.

1. Introduction and main content*

The widespread consensus on the need to modify current EU fiscal rules has triggered a wave of new studies and reform proposals. The aim of this paper is to reflect on a new fiscal and economic governance configuration fitting with current macroeconomics and political realities. This question will be discussed looking at three different dimensions: i) the political economy of fiscal rules in the current political and economic environment; ii) the renewed debate about fiscal policy roles and objectives; iii) the current incomplete nature of the European Monetary Union and the prospects for its completion. The main contribution of this paper is to discuss EMU fiscal policy and its governance modes taking a broad and comprehensive approach. Furthermore, drawing a number of conclusions from this conceptual framework, the paper presents ideas for a new model of fiscal and economic governance encompassing key suggestions arising from the recent literature such as: i) country-specific debt targets; ii) a more active role for fiscal policy based on fiscal policy decentralisation at Member State level; iii) a stronger focus on the quality of public finances and on the overall policy strategy; iv) safeguarding financial stability; v) a more effective enforcement system including some degree of market discipline in very exceptional circumstances.

The paper is structured as follows:

Section 2 presents extracts from the immense literature on the topic of fiscal rules, with a greater focus on the most recent proposals.

Part I reflects on particular challenges that any reform of fiscal rules will face due to the current political context and the macroeconomic environment. Specifically, section 3 highlights that tight fiscal constraints entail large enforcement costs due to present political economy factors, inherited mostly from the Great Recession. Therefore, fiscal rules reforms that do not acknowledge this reality are set to lack credibility and to reproduce some of the flaws of the current system.

Section 4.1 looks at the academic debate about fiscal policy roles and functions triggered by the Great Recession and at its implications for the EU fiscal and economic governance. A new consensus is emerging on the fact that fiscal policy should play a more active role in macroeconomic policy. In this respect the debate focuses on different fiscal policy objectives: i) stronger role for economic stabilisation when monetary policy is constrained in a zero lower bound environment; ii) additional and more persistent accommodative fiscal stance needed to cope with hysteresis and gap in aggregate demand; iii) finding space for investment and growth-enhancing expenditure to support long-term growth; v) dealing with climate change threats, compensating digital transition losers and fighting inequalities. Fiscal policy could be increasingly able to address these policy objectives as persistent low interest rates would make sustainability concerns less pressing.

Section 4.2 looks more in details at the implications arising from these arguments. It emphasizes that, besides affecting the fiscal governance design, the debate on the optimal conduct of fiscal policy adds up to political economy factors resulting in widening the existing national divergences on views and preferences about fiscal policy choices. Furthermore, as fiscal policy strategies become more complex, it is questionable whether a top-down and relatively uniform system of fiscal rules is economically reasonable and politically affordable across countries facing different economic challenges, structural weaknesses and macroeconomic conditions.

Part II discusses fiscal policy in the broader context of an incomplete EMU, where the design of a new fiscal governance framework interacts with the process aimed at endowing the EMU with necessary

* The information and views set out in this text are those of the author and do not necessarily reflect the official opinion of the European Commission.

instruments and institutions to enhance its resilience and ensure its long-term sustainability. With this regard, section 5, after discussing private and public risk-sharing channels, presents two key corollaries. The first argues that: “The larger the degree of stabilisation which can be achieved at central level with different combinations of private and public risk-sharing, the smaller is the need for stabilisation policies at national level, implying that tighter fiscal rules would be more politically affordable and economically grounded. The second corollary states that: “The larger the size of federal resources flowing to states economies for common programmes, the stricter can be fiscal rules at national level”. The current EMU configuration characterized by both little common resources and challenges in fiscal policy coordination, would call for adopting a decentralised model of fiscal relations where national authorities have larger discretion over fiscal policy choices.

Section 6 discusses benefits and flaws of strong market discipline under the assumption that if the EMU had to move towards a decentralised model, the no-bailout rules would have to be strengthened. While the benefits of strict market discipline would be theoretically remarkable, the empirical reality shows that, besides clear market failures, subnational defaults are quite rare due to high costs associated with their occurrence. Two other factors make a strong no-bailout rule problematic in the EMU context. They originate from the peculiar situation of EMU members which can be fully compared neither with other sovereign states nor with sub national entities. This fact entails: i) a bigger probability of generating self-fulfilling crisis; ii) the lack of a real federal budget as existing in fully-fledged monetary unions which allows reducing the economic costs of subnational defaults by protecting people and the provision of key public services. Without these features, the credibility of a strict no-bailout rule would continue to be limited by the severe political and economic consequences it would trigger.

Part III concludes providing ideas for traducing the findings of the conceptual framework analysed in the paper into a new model of EMU fiscal and economic governance. Section 7, starting from the assumption that the EMU would not move in the near future towards optimal design, introduces key principles to meet the hard challenge of achieving four overarching goals: i) growth; ii) fiscal sustainability; iii) financial stability; iv) political stability in the Union. To achieve these goals, the paper proposes to move towards a more cooperative approach in fiscal governance that, unlike fiscal rules, allows national governments to negotiate their fiscal targets on a regular basis. Enforcement would be granted through more automatic and gradual sanctions and a limited degree of market discipline to kick-in under extreme uncooperative behaviour. Finally, the robustness of the system cannot be granted without a broader role of the ECB to ensure financial stability.

Section 8 goes deeper in suggesting more specific design features: National governments would submit a medium-term economic plan including a debt target to be attained at the end of the mandate and detailed descriptions of measures and objectives of the overall policy strategy. One credible EU institution would be responsible for assessing the plan. A quantitative evaluation of fiscal variables would not dominate the qualitative assessment of the overall strategy. The plan would be refused in case of gross-policy errors not addressed in the negotiation phase. The paper also presents suggestions about their definition. In all the other cases, where gross-policy errors are not clearly identified, but the EU and national authorities cannot agree on the content of the plan, a critical opinion would be issued. The critical opinion is aimed at giving some credits to national authorities in pursuing their policy strategy. Later assessments of the update plan would provide additional information regarding implementation and outcomes. The enforcement system would be based on semiautomatic penalties becoming stronger the bigger are the policy flaws. It would range from small penalties in case of simple divergences between EU recommended policies and the national policy strategy, resulting into a critical assessment of the plan, to more serious and deterrent consequences to avoid and address clear-cut gross-policy errors

Section 9 discusses the advantages associated with the suggested model of governance. The assessment of the plan would provide positive incentives to domestic governments for designing a credible and grounded medium-term policy strategy. This would also increase ownership and national governments accountability. The possibility to rely more on an outcome-based evaluation would allow reducing the future enforcement costs and increase the scope for avoiding recurrent policy errors. The qualitative assessment would provide enough adaptability and flexibility, not least fostering counter-cyclical policies and promoting qualitative spending. Finally, the enforcement system, including a limited degree of market discipline, should shelter the framework from moral hazard risks without triggering dangerous financial instability.

Section 10 concludes with some general reflections on political science aspects. Specifically, it is stressed that current political environment would call for the need to enhance input legitimacy. The suggested model of governance which can be regarded as a deliberative governance system, would pursue this aim by underpinning the assessment of national policy strategy with an inclusive, high quality and transparent policy debate among EU and national actors. With this regard, enhanced input legitimacy could also result in greater policy effectiveness and adaptability to current economic and social circumstances, thus contributing to increase also output legitimacy

2. Literature review: Selected extracts

The debate on the Stability and Growth Pact and more in general on the fiscal rules in the EMU is long-dated and has given rise to a multitude of analyses and proposals. Larch et al. (2006) have analysed and classified a sample of 101 proposals to reform the SGP. This work was carried out after the first empirical failure of the SGP framework which dated back to 2003, when the Council decided not to adopt the Commission's recommendation to step up the infraction procedure against France and Germany, eventually leading to possible sanctions. A main finding of the study is that the range of analysed proposals differs considerably in several aspects. Fundamentally they diverge, beyond design and technicalities, also on the more general issue regarding SGP objectives. The variety of views reflects the underlying, long dated and theoretical debate about fiscal policy objectives, ranging from stabilization, sustainability and growth. No clear majority in one direction has been found. Against this background the authors divide the proposals in four groups: i) those which at the time, were sceptical about the ability of the SGP governance to promote sound and effective fiscal policy due to the low credibility of the whole framework coupled with flaws in its stabilisation properties. They called for deep reforms moving towards more automatic sanctions and/or stronger reliance on market discipline (Tanzi 2004, Uhlig 2002, Calmfors 2003); ii) those which considered appropriate the SGP design aimed at promoting fiscal discipline through the 3% deficit rule but rather they called for strengthening the framework by means of more independent technical institutions to be tasked with the responsibility of ensuring the proper application of the rules (Whyplosz 2002, Eichengreen 2003); iii) those which criticised the short-term and single focus on fiscal discipline of the SGP and called for reforming the framework to allow greater margins for national fiscal policy under certain conditions with the purpose of promoting growth and public investments (Bofinger 2003, Fitoussi 2002, Mathieu and Sterdyniak 2003); iv) finally, there were a number of authors arguing that the SGP should focus on long-term sustainability of public finances rather than on the short-term dimension of fiscal surveillance (Beetsma and Debrun 2003, Calmfors and Corsetti 2004, Pisany-Ferry 2002).

More recently, the widespread consensus about the need to reform the current set of rules has triggered a wave of new proposals. It is interesting to notice that several works converge on the view that fiscal rules should be simplified by focusing on a single operational target under the form of an expenditure rule to replace the different rules in place[1]. Indeed, public expenditure is regarded as the most efficient fiscal variable to be used in fiscal surveillance for two main reasons: a) the expenditure aggregate is under direct control of the government as, apart from some cyclical items (i.e. unemployment benefits), it is largely unaffected by both exogenous cyclical developments and technical

[1] European Fiscal Board (EFB) Annual Report 2018, "Reforming Fiscal Governance in the European Union", IMF Staff Discussion Note, May 2015, "A proposal to Revive the European Policy Frameworks" Bruegel Policy Contribution March 2016.

computations. This feature is not shared by other variables such as the nominal or the structural balance. The other key reasons supporting the use of an expenditure rule is the possibility to minimise the pro-cyclical bias affecting other rules by allowing revenues to fluctuate across the economic cycle (IMF 2016). Looking closely at the design of the expenditure rule, most proposals agree on the fact that the growth rate of expenditure should not exceed the potential growth rate of the domestic economy. However, given the current macroeconomic environment characterised by high debt and anaemic nominal output growth, a correction factor, reducing further the allowed expenditure growth, needs to be applied in order to put the debt/GDP ratio on a downward path. A second feature, common to most of these proposals, is that the operational target should be consistent with an underlying path for debt reduction more often suggested as the converge towards the 60% debt target of the Maastricht Treaty (the debt anchor).

The use of the expenditure rule as an operational target for debt reduction is also included in the few proposals which discuss fiscal rules reform following the wider approach of an overall reform of the EMU[2]. The study carried out by a group of French and German economists proposes an expenditure path consistent with a debt reduction target, based on a rolling medium-term reduction target, which would not be determined by a formula, rather being agreed by national governments and the EU fiscal watchdog. The expenditure path would also take into account other factors, such as growth-enhancing structural reforms. Some proposals also include setting up a compensation account, following the model of the German debt brake framework, to compensate expenditure overruns (German Council of Economic Experts 2018). Another feature common to a number of proposals consists in envisaging the possibility to deviate from the rules in case of large negative downturns and extraordinary events delegating this kind of key decisions, involving a certain degree of discretionary judgment, to an independent technical body (EFB 2018, Benassy Quéré et al. 2016).

Beside the objective of simplification, a number of actors, recognising that the abrupt decline of public investment is also an indirect consequence of government misbehaviour in the attempt to comply with the rules, call for corrections in the system aimed at addressing this political economy failure. The request to promote an environment favourable to public investment is central in the views of representative of social and regional stakeholders[3] who generally advocate the introduction of some sort of golden rule. Several economists, who also share this concern, argue for a specific treatment of public investment in the design of fiscal rules. This treatment should be aimed at recognising the long-term value of this spending category, for instance by spreading out investment expenditure over different years, in line with the economic recording principle applied in private corporations' balance sheets (Zsolt and Clayes 2016, Blanchard 2019).

While, the design of the fiscal framework is central in the literature, a new impetus is emerging in the debate on rules enforcement. A common view among experts points to increase the automaticity of sanctions to enhance their credibility and therefore their deterrent properties. Instead of relying on pecuniary fines which have proved to be politically non-viable, is it often proposed to limit access to EU common instruments. Authors refer both to those common funds already existing (EU funds) and to those linked to instruments which would possibly see the light in the future (i.e. allocations for economic cycle stabilisation). A strong view in the debate is that hard market discipline linked to strong no-bailout rule would be the most effective enforcement mechanism and would allow overcoming divergent and crystallized views on EMU deepening between the "Nordic" and the "Southern" vision, thus opening the way to the introduction of additional risk-sharing mechanisms (Benassy Q. et.al 2018).

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[2] Benassy-Quéré A., M. Brunnermeier, H. Enderlein, E. Fahri, M. Fratzscher, C. Fuest, P.O. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Véron, B. Weder di Mauro and J. Zettelmeyer (2018): "Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Area Reform", CEPR Policy Insight, no 91, January;

[3] European Economic and Social Committee, Opinion on the Reflection Paper on Deepening the Economic and Monetary Union, 19 October 2017; The European Committee of the Regions, Opinion on the Reflection Paper on Deepening the Economic and Monetary Union, 30 November 2017.

The need to find a difference balance between market discipline and the current rule-based framework is also recognised in some preliminary European Commission reflections over the future of fiscal rules[4]. In particular, without entering in details, the Reflection Paper on EMU deepening suggests that new fiscal relations between the EU and the member states could involve a different mix combining some larger room for manoeuvre for national policymakers, enhanced powers for national fiscal councils and a stronger role for the markets to discipline government conduct. In such a system the surveillance framework might actively step in only to correct gross policy errors, while market judgment over national fiscal policy should represent the key deterrent to discourage policymakers from accumulating excessive debt, due to the increasing sensitivity of the risk premium paid to issue sovereign bonds. The key role of market discipline, underpinned by a strict and credible no-bail out clause, to promote sound fiscal policy is the central argument of those authors who also question the legitimacy of supranational institutions to design a strict-jacket to fiscal policy which largely remain a national prerogative. With this regard, Wyplosz (2013) argues that the Euro Area should adopt a decentralised fiscal policy system allowing increasing subnational borrowing autonomy coupled with a credible no-bailout rule to ensure that the costs arising from sovereign default would not involve other member states.

Part I: Fiscal rules in the current macroeconomic and political environment

3. The political economy of EU fiscal rules after the Great Recession

From the recent fiscal rules literature, a large consensus emerges about replacing the current system of rules with an operational target centred on an expenditure rule and a debt anchor. Indeed, this design would address some of the drawbacks of the current framework. First, the rule-based framework would gain in terms of simplicity and transparency with some progresses in terms of flexibility compared to the current system. In fact, by allowing public revenues to fully fluctuate over the economic cycle, expenditure rules reduce the pro-cyclicality characterising nominal rules and the fiscal adjustments required under the current system, even if it is now based on the structural balance. Moreover, additional discretion aimed at increasing the stabilisation properties of the framework could be granted during exceptional economic circumstances (i.e. large downturns). Finally, some criteria could be appropriately conceived to foster public investment.

Can this overall design be regarded as an optimal solution? This paper argues that, although it would represent a clear improvement compared to the current system, there are different reasons suggesting that it would not address fundamental weaknesses of the rule-based system.

A first set of concerns involves the political economy dimension of the suggested reform. The literature about fiscal rules emphasizes that their influence on national governments' stems from increasing the reputational costs in case of deviation. In this respect, simpler fiscal rules increase the probability of compliance by facilitating their monitoring by external pressure groups – i.e. the public and the market (Schuknecht 2004). However, if these pressure groups fail to exert genuine pressures on national authorities, simple fiscal rules have the same probability to be neglected than more complex rules. The same is true for more efficient and better designed rules. In general, fiscal rules’ ability to constrain national governments rests on the inherent and general confidence of the different stakeholders about the benefits of fiscal discipline, or more in details on the costs/benefits analysis concerning the different level of public deficit with respect to different economic circumstances. After Maastricht and prior to the adoption of the Euro, when the benefits of fiscal consolidation were widely accepted and not questioned, national policymakers could pursue a restrictive fiscal policy without facing negative political consequences. This benign environment was also strictly connected to the objective and the consequent rewards of entering in the club of countries adopting the euro. Already in years 1999-2000, the political affordability of restrictive fiscal policy reached its limits. In fact, following large fiscal

[4] See the Reflection paper on the Deepening of the Economic and Monetary Union, European Commission 2017.

consolidation in previous years to attain the goal of being part of the currency union, several governments made use of favourable economic conditions to reduce their level of primary surplus.

Today national authorities' willingness to stick to hard fiscal discipline is further reduced due to other circumstances. Leaving aside the question on whether pro-cyclical fiscal consolidation undertaken during the peak of the sovereign debt crisis was needed and was appropriate in size, the relative low benefits it produced in terms of public debt reduction and output recovery, has significantly undermined the confidence of an important share of European population, especially in southern countries, about the fiscal policy prescriptions originated in the European policy environment. After significant fiscal cuts and social costs caused by the economic crisis and the pro-cyclical fiscal response it triggered in the attempt to regain market confidence, national policymakers have now very low political capital for active public debt deleveraging. Against this background, EU fiscal policy must face the reality that the benefits of tight fiscal discipline, as a general principle for sound policymaking, are increasingly put into question. Thus, the public does no longer exert genuine pressures on policymakers in this regard. In addition, the crisis has also showed that markets' ability to price correctly the risks related to national economy fundamentals suffers from several flaws. To this extent, the confidence of the public towards markets assessment is also low. Thus, even the increase in sovereign spreads is not enough to attenuate the growing demand for balancing fiscal discipline with other policy goals, in particular supporting growth, public investment and reducing inequalities.

The policy space available for national authorities to follow fiscal consolidation strategies is also reduced by the fact that in a scenario of low nominal growth and subdued public revenue, coupled with some degree on public savings already made in previous years, the room for further reducing public expenditure or increasing taxes is not big. For instance, in some countries a general reduction of public expenditure would imply reducing the size of the government, affecting, in some cases, well-established national social practices and involving far-reaching and complicated reforms in key areas of government spending and institutional organisation[5]. Apart from the costs and benefits of such far-reaching reforms, recently there have been several examples across EU countries of social uprising not only caused by substantial reforms but even by more circumscribed and limited tax hikes or marginal reduction in spending, signalling that the political limits for these policies have been reached[6]. This is witnessed by the political costs borne by those governments which have undertaken in the past fiscal consolidation and structural reforms resulting in their replacement with new governments with alternative policy agendas. However, also national governments characterised by a more positive discourse on fiscal discipline are now experiencing a certain degree of reform fatigue and the need to move closer to voters' demands. While voters confronted with deteriorating social conditions and concerned about mounting inequalities and stagnant income ask for strengthening the social safety net and/or reducing taxation, the restrictive fiscal policy needed to achieve a steady reduction in public might not allow addressing their concerns. This is particularly true in high-debt countries where the policy space and the room for fiscal consolidation are quite small.

Taking as a reference, the estimates of the EFB about the structural primary balance required to comply with their proposed Expenditure Rule, it emerges that high-debt countries would need to substantially increase their structural primary surplus in the short term, while also raising the long-term

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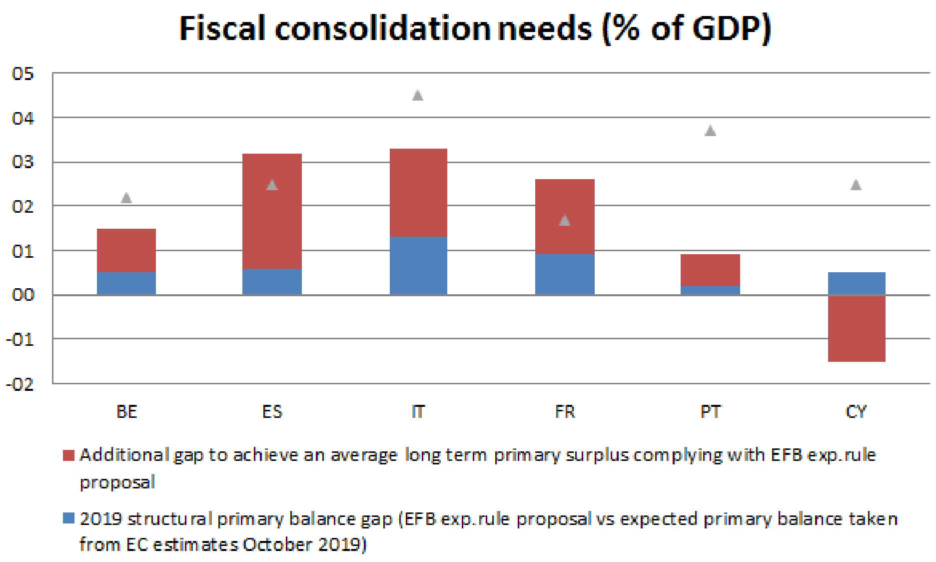
5 For instance, Lorenzani and Reitano (2015) in their analysis on Italian public expenditure argue that it may be difficult to significantly compress Italy's primary expenditure in the future, while leaving the current perimeter of State action unchanged. For more detailed info see: Italy's spending maze runner. An analysis of the structure and evolution of public expenditure in Italy, European Commission, Discussion paper n.23 December 2015.

6 A very strong example is represented by the demonstrations of the so-called "Gillets jaunes" following the intention of the French government to increase the excise duty on fuel. Their protests have led to retract the proposal and even to adopt accommodative measures. It is quite telling that this choice, although motivated by potentially extreme social backlash, was taken by a government in general keen of reforming the system..

level of the primary balance[7]. The average long-term primary surplus requirements are lower for those countries with higher potential growth rates (France, Belgium), while they are sizeable for countries with lower potential growth (Italy, Portugal). Building up large primary surpluses and keeping them stable for a long period of time, as needed to achieve mild debt reduction[8] is very challenging as it eventually conflicts with the political economy reality. Even short-term increases in the primary surplus do not seem politically viable at current time, especially if a new deterioration of economic conditions should materialise. High-debt countries keep being challenged by low growth (as in the case of Italy where the Output Gap has not closed yet) or high unemployment (as in the case of Spain that despite a positive Output Gap, it is still experiencing a 13% unemployment rate). In this context, aside from other considerations, the cost for the enforcer – i.e. the Commission - to ensure compliance with the rules is

Chart 1: Primary surplus requirements under the EFB expenditure rule proposal



Source: EFB and author's calculations

Fiscal rules have already been revised in different occasions in recent years. Several flexibility clauses have been applied after the peak of the crisis to enable national governments deviating from the fiscal consolidation path set by the SGP. The economic grounds for the flexibility clauses introduced by the Commission was to consider the exceptional economic circumstances leading, in a number of cases, to very demanding and counterproductive fiscal efforts to comply with the rules. Despite better economic conditions, this is still the case for some countries with high debt levels, that, for instance, are deemed compliant to the debt rule only by progressively taking into account other relevant factors and additional flexibility. Against this background, the economic rationale calling for flexibility in the application of

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[7] The required primary surplus in the long-term is estimated under the hypothesis that the economy grows at its potential rate. In this case the structural primary surplus is equivalent to the primary surplus. In case the economy grows below potential, the structural primary surplus should not be affected (i.e. more consolidation would not be needed). However, it has been widely observed that real budget elasticities can deviate substabtially for that used to compute the cyclically adjusted primary balance. Furthermore, elasticities are not symmetrical over the cycle, implying that substantial swings in the business cycle would also affect consolidation needs, in particular translating in larger consolidation requirements during periods of low growth.

[8] Maintaining the structural primary surplus at very high level for a long period of time and assuming the economy growth at its potential, would in any case result in debt levels which are not sheltered from sustainability concerns. For instance, Italy's government debt would still amount to 97% of GDP while Portugal's government debt would amount to 83% of GDP.

the rules has been outplaced by political pressures, which has given rise to a proliferation of reasons advocated by national governments to obtain additional margin of manoeuvre (i.e. cost incurred for migrant crisis, cost incurred for natural catastrophes). This situation has triggered a debate on whether the role of the Commission as independent enforcer has been undermined by powerful political forces. In this regard, there are proposals calling for moving crucial and controversial fiscal policy decisions to different bodies, as for instance the ESM, which should be better equipped to resist political pressures. It has also been argued that it could be more efficient to separate the role of the enforcer from that of the judge. However, the continuous recourse to escape clauses has not to do with flexibility design, but to political economy reasons. Thus, the ability of the political economy forces to interfere with fiscal rules enforcement is not strongly related with the institution in charge of this task. Rather it stems from natural conflicts between national and European policymaking in one side, and from the conflict between the technical and the political nature of fiscal policy on the other side. These two sources of conflict are both amplified by the current incomplete nature of the EMU including the lack of any sort of political Union, and by the renewed debate of the optimal conduction of fiscal policy.

4. The fiscal policy debate and its implications for the EU fiscal and economic governance

4a) The fiscal policy debate

New factors add up to the usual difficulties that EU institutions have always faced to enforce fiscal rules. Besides political economy reasons, the renewed debate on the role and the functions of fiscal policy, triggered by the macroeconomic environment unfolded in the aftermath of the Great Recession, further complicates fiscal policy coordination at EU level.

The so-called period of Great Moderation, characterised by inflation under control, decreasing unemployment and lower output volatility, cemented a widely accepted consensus over fiscal policy functions. Most economists used to agree that the fiscal policy should have mainly focused on long-term sustainability of public finances. Monetary policy was in fact considered superior for smoothing output shocks compared to discretionary fiscal policy due to policy errors, lags and distortions. This consensus was at the base of the design of the Stability and Growth Pact which gives stronger emphasis to the sustainability objective, while leaving stabilisation to the partial functioning of automatic stabilisers[9]. This was motivated, beyond traditional political economy considerations (deficit bias, electoral cycles, rent-seeking by governments) also by the need to avoid fiscal dominance and taking into account cross-border spill overs associated with national fiscal policies in a currency union.

This consensus has been eroded by the new macroeconomic scenario characterising the EU and the world economy following the Great recession. The main factor behind rethinking the approach towards the use of macroeconomic instruments is monetary policy effectiveness hampered by interest rates attaining the zero-lower bound (zlb). This situation has produced a general shift among economists, also among some of those firmly supporting the old consensus, which increasingly advocate a more active role for discretionary fiscal policy to stabilise the economy during zlb recessions and to address deflationary tendencies (Cristiano et al (2011), Draghi 2019). The stronger emphasis on escape clauses included in several reform proposals, aimed at deviating or even suspended fiscal rules in particularly negative economic circumstances, partly reflects this orientation.

However, the debate about current macroeconomic conditions and macroeconomic policy tools goes much far, also in light of the modest pace of the post-crisis recovery and to its peculiar features. The fall in real interest rates has led many authors to reflect on the related macroeconomic implications. The possible threat of secular stagnation, resulting in a long period of subdued output growth in developed

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9 The SGP allows the functioning of automatic stabilisers for stabilisation purposes up to the 3% deficit limit, afterwards the excessive deficit should be corrected, mainly by pursuing a certain degree of fiscal effort in structural terms.

countries[10] is regarded as a possibility. In any case, low real interest rates entails the possibility that periods where the economy is in a zlb environment are likely to be more frequent in the future[11] (Summers (2016), implying that fiscal policy would need to support more often monetary policy for cyclical stabilisation (Eggerston and Krugmann 2016).

Furthermore, the persistence of a situation where the full employment interest rates is in negative territory leads to a slack in labour market which does not vanish with the closing output gap. This implies higher levels of structural unemployment and under-employment as well as low rates of active population, causing persistently lower aggregate demand, not reflected in the assessment of cyclical conditions based on the output gap and the NAIWRU (Ball 2014, Pichelmann and Schuh 1997). Against this background, fiscal rules associated with escape clauses designed around a normative concept of severe downturns, are likely not to fit with the need of a more protracted accommodative fiscal policy. Even if fiscal stimulus is not needed or not affordable in some countries, compliance with fiscal rules risks having contractionary effects in a persistent stagnant economy. In fact, while a protracted discretionary fiscal stimulus will finally hit sustainability constraints if it is not able to raise output to a sufficient degree able to compensate for higher borrowing costs, an ambitious debt reduction path is also an unrealistic and self-defeating strategy in an economy characterised by excessive savings and low inflation (Koo 2014). When aggregate demand is squeezed by the need of all private agents in the economy to deleverage, the state would be the only agent capable to invest to absorb excessive savings and address deflationary tendencies (Koo 2011).

An alternative angle to observe the “new normal” in macroeconomic variables is the reduction of the potential rate of growth of the economy regarded as the main factor to explain current anaemic output growth. According to this view, low potential growth is driven by supply-side constraints such as sluggish TFP, negative demographic trends, declining labour inputs, high debt burden, barriers to investment (Gordon 2012). Other scholars, by looking at the sluggish and atypical recovery following the great recession, have focused on hysteresis caused by deteriorating workers' skills due to long periods of time spent outside a changing labour market, leading to a permanent downward shift in labour force participation[12] (Summers Blanchard 1986).

Both demand and supply side considerations can be consistent with the general idea that fiscal policy should play a more active role to support the economy. In fact, this can be justified both for counter-cyclical purposes and to support potential growth. In this respect, the secular stagnation hypothesis and the more traditional view on supply-side shocks find a common ground in the beneficial effects of public investment and other growth-enhancing expenditure items. In fact, public investment would have the advantage of supporting aggregate demand and hence directly absorbing excessive savings, while at the same time “mission oriented” public spending programmes could raise long-term potential growth by stimulating productivity and the innovation capacity of the economy (Mazzuccato, Deleidi 2018). In this respect, it has been emphasized that the current situation of very low real interest rates is regarded as the most appropriate for embarking in large scale public investment projects, as borrowing costs are minimal (Pisany-Ferry 2019, Blanchard 2019).

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[10] The underlying factors supporting the secular stagnation hypothesis i.e. unfavourable demography, low productivity, high public debt level and consequent fiscal consolidation needs, single monetary policy are features characterising at different level several European countries thus,while the threat of secular stagnation was mainly advocated in the US context, it could turn to be a more concrete European disease (Crafts 2014).

[11] This hypothesis rests in particular on the observed reduction of the natural real interest rates which raises the concrete possibility that the full employment real interest rate is in negative territory. Even if this interest rate level could be attained, this would entail to financial stability risks as very low real interest rates could cause unsustainable asset price bubbles.

[12] Other scholars (Dosi et all 2017, Ball et al 2014) regard labour market hysteresis as direct consequences of declining aggregate demand in periods of severe downturns rather than to supply-side factors such as in the insider-outsider hypothesis of Summers and Blanchard. For these scholars, low investment and poor rates of innovation as well as declining entry dynamics are better candidates in conjunctions with the resulting skills deterioration, for explaining long-run unemployment spelling into lower output growth.

Moving beyond the traditional limits of fiscal policy functions, albeit most scholars keep regarding other objectives such as redistributive and social policies in isolation from macroeconomics and fiscal policy choices, it is increasingly recognised that inequalities can have considerable effects on output growth[13]. In this respect, the debate on the redistributive role of fiscal policy, in particular concerning the impact of fiscal consolidation on inequality, is also gaining prominence in the literature. Several studies suggest that fiscal consolidation episodes are usually associated with increases in income inequality[14]. Against this background, fiscal policy should also consider the goal of reducing inequality together with addressing its root causes. Finally, other pressing priorities of today time are to find resources to finance sizeable investment for climate change mitigation and to cope with technological change losers. In this respect, tight fiscal constraints can also affect the government capacity to intervene quickly and to design effective and comprehensive policies for these purposes.

To conclude, the link between the fiscal policy debate and the political economy issue discussed in the previous section should be highlighted. In fact, irrespective of the merit of the different views about the appropriate fiscal policy strategy, the intense debate which is taking place on this subject increases the existing divergence in the EU about the appropriate and desired fiscal policy mix. This adds up to the difficult political economic environment in which fiscal rules are enforced by increasing national authorities' legitimacy to ask for deviations from the agreed rules.

4b) Main implications for the EU fiscal and economic governance

Although preferences about the policy goals linked to investment and growth-enhancing spending may differ, their crucial role is not questioned. However, the current economic governance framework does not favour an investment-led growth strategy. On the contrary there is evidence that it even affects the quality of public expenditure (Bacchiocchi et al, 2011). Growth-enhancing spending categories such as R&D, education or investment in human capital are all characterised by time inconsistency, even more than in the case of infrastructure investment. In fact, while their budgetary costs are borne in the short-term, their benefits materialise in the very long-run. It follows that policymakers have low incentives to invest in these items which are crucial for long-term growth prospects. The time inconsistency effect becomes particularly damaging in case of financially-constraint governments. In order to meet expenditure targets, they have an incentive to reduce growth-enhancing expenditure rather than cutting other expenditure categories which may provoke negative voters' reactions and therefore diminishing the probability of being re-elected. These perverse incentives further weigh on output growth and in turn undermine public debt sustainability. All the proposed expenditure rules are silent about public spending composition, except with regard to some special treatment for traditional investment spending. However, any type of investment clause is suboptimal as growth-enhancing expenditure categories are not necessarily limited to those entering in the standard definition of public investment. Given the heterogeneity of spending programmes with growth-enhancing characteristics, ranging from education, training, human capital investment, infrastructure, and the broad set of innovation policies, it is difficult to conceive an investment clause in a way to cover all these spending categories and without creating distortions in the allocation of public expenditure.

Furthermore, more flexibility on annual fiscal policy targets would also be instrumental to promote the implementation of structural reforms. Short-term budgetary costs arising in connection with the adoption of structural reforms can directly arise from the resources needed to finance certain reforms,

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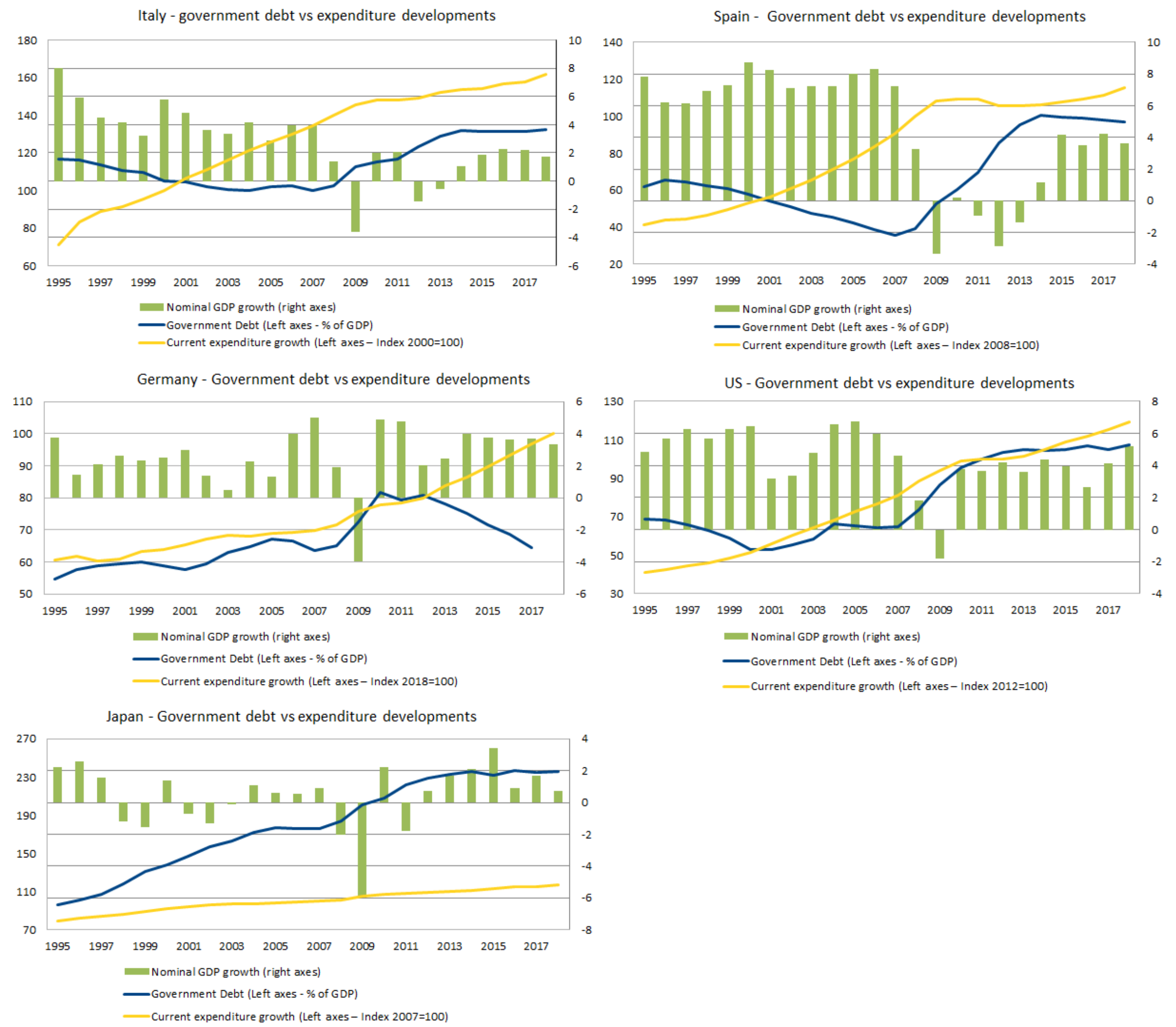
[13] See for instance OECD report 2015, "In it together. Why less inequality benefits all" and Ostry, Jonathan D, Andrew Berg, and Charalambos G Tsangarides (2014), "Redistribution, Inequality, and Growth", IMF Staff Discussion Note 14/02.

[14] See for instance Laurence Ball, Davide Furceri, Daniel Leigh, and Prakash Loungani (2013) on The Distributional Effects of Fiscal Consolidation, IMF working paper and Agnello L. and R. M.Sousa.2014. "How Does Fiscal Consolidation Impact on Income Inequality?" Review of Income and Wealth60 (4): 702–26. Roe M. J. and J. I.Siegel.2011. "Political Instability: Effects on Financial Development, Roots in the Severity of Economic Inequality." Journal of Comparative Economics39 (3): 279–309.

such as those in the field of pensions and active labour market policies (Razin and Sadka, 2002). These costs may lead to a deterioration of the budget balance in the short term (Sajedi, 2018). Furthermore, the presence of multiple transmission channels indicates that structural reforms have both contractionary and expansionary effects on aggregate demand in the short run (European Commission 2018, QREA). Political economy considerations can also require compensating the losers and stimulating the economy in order to gain sufficient political capital to implement difficult reforms (Eichengreen and Wyplosz, 1998). In general, the higher the upfront cost of structural reforms, the bigger is the probability that fiscal rules will prevent their adoption, thus sacrificing future growth for present stability (Beetsma, Debrun 2003). Depending of the specific features of national economy, the OECD estimates that reforms with the largest effect on potential growth such as those in the field of active labour market policies and taxation, are also those which entail substantial budgetary costs. The existence of a trade-off between fiscal objectives and structural reforms is recognised by EU fiscal rules through a structural reform clause. However, it does not seem feasible to codify with a specific clause the complex link between fiscal policy and the wide range of structural reform policies, not least because it would add up to other escape and investment clauses. This would generate different layers of exceptions conflicting with the objective of simplification.[15]

[15] The European Commission has proposed a budgetary instrument for convergence and competitiveness aimed at fostering structural reforms to be included in the next EU budget. However, the limited size of the resources allocated to the instrument leaves doubts on its effectiveness regarding its ability to exert proper government incentives towards implementation of major structural reforms.

Chart 2: Trends in Current expenditure, General Government debt and Nominal GDP growth



Source: Eurostat

On more general grounds, it should be taken into account that the larger role that fiscal policy would need to play at present time puts into question the economic rationale for capping each year the annual growth rate of expenditure to the potential growth rate of the economy. Moreover, as noted before, high debt countries, especially those where potential growth is particularly low, can possibly experience substantial debt reduction only if expenditure grows less than potential output. In this case, the choice about an appropriate and efficient policy mix between investment, debt reduction and structural reforms is particularly complicated. With this regard, it is questionable whether such public expenditure policy would be consistent with addressing several policy objectives which could require a more accommodative fiscal stance.

Charts 2 show that public (current) expenditure dynamics are not immediately correlated with debt developments. This consideration is not meant to undervalue the importance of pursuing counter-cyclical policies in good time, also by avoiding the full use of windfall revenue. The purpose is rather to emphasize that nominal growth is the key factor behind significant debt reductions. In fact, when nominal growth is low, even stabilising the nominal evolution of expenditure is not enough to prevent the debt ratio to rise, as the case of Japan clearly shows. In this context, only putting the level of public expenditure on a clear downward path might trigger a reduction in the debt ratio, leaving aside any considerations about fiscal multipliers. However, in the long-term, despite the marginal debt reduction which could be attained, sustainability risks would persist due to the week revenue raising capacity of the economy and the surge in debt occurring during severe downturns.

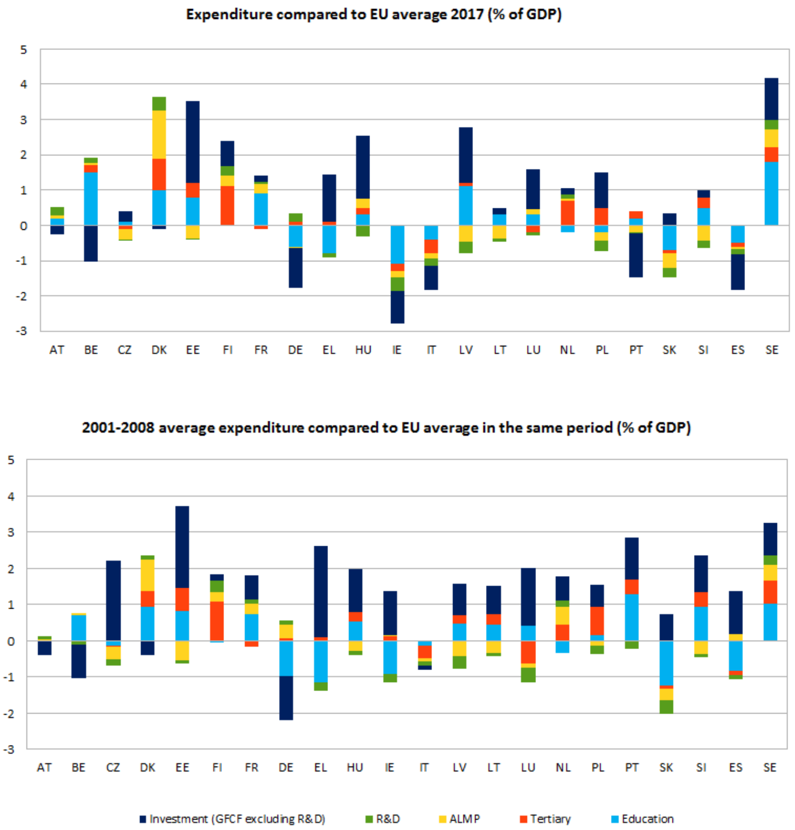
The charts also allow drawing different considerations about the link between expenditure and debt developments: a) In Italy prior to the Great Recession reducing current expenditure growth could have resulted in a greater debt reduction. However, putting expenditure under control has not been enough to drive the debt ratio down, after its sudden rise caused by the great recession and the sovereign debt crisis; b) Germany managed to keep expenditure trends under control and avoid public debt expansion during a period of subdued nominal growth. However, it is only after the crisis, when nominal GDP growth increased, that the debt ratio has substantially decreased, despite more dynamic expenditure growth; c) Spain's debt decreased massively up to 2007 due to high nominal growth. While expenditure has skyrocketed, especially in the last years prior to the crisis, it would have been politically difficult to resist spending demands by advocating the goal of reducing debt beyond 30% of GDP. Spain overheating was caused by macroeconomic factors and in this respect countercyclical expenditure policy would have not been enough to avoid fuelling the financial bubble and to prevent the subsequent sudden increase in public debt; d) In US public expenditure has followed its natural long-term trend of growth but at the same time it has been used in the short-term for countercyclical purposes. Overall, the charts also provide evidence that sudden and massive debt increases occur in periods of subdued nominal growth highlighting the critical need to increase the resilience of the economy and to ensure adequate output stabilisation to minimise the effects of severe downturns. Coping with short-term spikes in sovereign borrowing costs is also crucial to prevent sharp rises in interest rates pushing the debt ratio up.

Against this background, the optimal government strategy to ensure debt sustainability may differ from country to country. In some cases, it could be worth to follow a complicated but potentially more effective alternative strategy compared to simple fiscal consolidation. This would be aimed at keeping the debt under control in the short-term while in the future, during good time periods, passive debt deleveraging based on higher nominal growth and prudent fiscal policy could result in a more substantial debt reduction (Rawdanowicz 2013). This strategy assumes the adoption of a balanced and not necessarily simultaneous mix of savings and growth-enhancing expenditure.

Chart 3 presents a rough definition of expenditure needs in selected EU countries focusing on a non-exhaustive set of growth-enhancing expenditure categories and computing the gap from the EU average. This chart shows that a number of countries present a suboptimal expenditure composition. Countries with low potential growth rate such as Italy and Spain have expenditure below the EU average in all the growth-enhancing items displayed in the chart, with a gap accounting for almost 2% of GDP. The charts also show that the expenditure gap widened in recent years, in particular in those countries mostly hit by the sovereign debt crisis. The comparison of this chart with that displaying the consolidation needs for high-debt countries (chart 1) highlights the very narrow path characterising fiscal policy choices at present time and emphasizes the need to follow ambitious, well-designed and tailored country-specific fiscal policy strategies. Indeed, as fiscal policy conduct becomes more complex one could also question whether a top-down and relatively uniform system of fiscal rules is economically reasonable across countries facing different economic challenges, structural weaknesses and macroeconomic conditions[16].

[16] The EFB (2019) suggests making the adjustment in government debt country-specific by modifying the single reference value of the SGP.

Chart 3a 3b: Possible expenditure needs looking at some growth-enhancing items



Source: Eurostat, OECD and European Commission (JRC)

To conclude, the key message arising from the considerations made in Part I is that a rules-based fiscal policy framework maintaining almost exclusively as central policy objective that of debt reduction, (although with some stabilisation and counter-cyclical feature) face strong economic and political challenges. The broader rationale of fiscal rules is to address political failures and, in the EMU, also to prevent moral hazard, spill overs and fiscal dominance. These are the goals one should have in mind when reforming the economic governance system, rather than focusing on rules designed to achieve a mechanical and uncertain reduction in debt levels. In fact, fiscal rules alone, cannot always generate public debt deleveraging as this is an extremely complex economic goal, influenced by many factors and attainable following policy strategies which can vary from country to country.

Table 1: Roles and objectives of Fiscal Policy: General debate and the EMU dimension

TRADITIONAL MAINSTREAM CONSENSUS

Conventional wisdom	**EMU context**
Fiscal policy neutrality: Monetary policy is more efficient for stabilisation as it is: unbiased, immediate, does not entail risks of private investment crowding out.	National fiscal policy in the EMU should: - Ensure public finance sustainability; - Allow for the functioning of automatic stabilisers; - Discretionary fiscal expansion rarely needed; 3% deficit rule was consistent with this approach.

RECENT DEBATE HAS ERODED CONVENTIONAL DOCTRINE

Theoretical arguments once marginal have become important:	***SGP framework requires an updating:***
Discretionary fiscal stimulus needed for stabilisation when monetary policy is at its zero-lower bound.	Fiscal rules and default risks imply that automatic stabilisers cannot operate fully.
Hysteresis and structural demand weaknesses call for additional and more persistent fiscal policy supporting role.	Discretionary fiscal stimulus envisaged only in extraordinary circumstances. Broad political consensus is required.
Financing of investment and growth-enhancing expenditure is needed to support long-term growth. Low interest rates increase the scope to finance investment through debt.	Fiscal rules can exert perverse incentives on investment and growth-enhancing policy strategies.
Addressing climate change threats call for financing sizeable investment without delay.	Not envisaged
Compensating technological change losers and fighting inequalities should also be considered in the fiscal policy strategy.	Not envisaged

Part II: Fiscal rules in the context of the reform of the European and Monetary Union

5. Fiscal relations and common instruments in an incomplete EMU

The discussion about the optimal conceptualisation of the fiscal rule-based framework cannot be made in isolation from the role and functioning of fiscal policy in the EMU, which in turn is largely affected by its institutional architecture. In Federal Countries macro-fiscal policies between levels of governments are coordinated by a mix of the following four types of arrangements (Cottarelli 2012).

- Direct (administrative) controls by the central government.
- Fiscal rules
- Cooperative approaches that unlike fiscal rules allow subnational governments to negotiate their fiscal targets on a regular basis.
- Market discipline.

In this regard the purpose of this section is to emphasize crucial trade-offs and inter-linkages between the EMU architecture and the fiscal surveillance framework to underpin a reflection on an appropriate mix of these four models which could best fit with the current and the most likely future configuration of the EMU.

A first nexus which has been largely analysed in the literature and already mentioned in previous sections of this paper is that the European Monetary Union lacks adequate tools to smooth the effects of asymmetric shocks hitting national economies.[17] Furthermore, the crisis has also showed that adequate fiscal stabilisation tools are crucial to complement the role of Monetary Policy in a zero lower bound environment. To cope with this situation, the optimal solution would be to endow the EMU with a central fiscal stabilisation capacity having an adequate size to smooth the impact of both common and idiosyncratic shocks. However, while this view is agreed by EU and international institutions, it is not broadly shared among EU member states as there is political and theoretical resistance to endow the EMU with a central stabilisation function. While the political reluctance against any form of fiscal union stems from the well-known moral hazard argument and the fear of paying for external troubles, the theoretical resistance finds its ground in those studies emphasizing that private risk-sharing channels are found to absorb the largest part of the shocks in other federations, like the US[18]. Against this background, the completion of the Banking Union and the development of an integrated Capital Market Union should be prioritised to attain adequate shock absorption, while central fiscal stabilisation would not be strictly needed. Leaving aside the difficulties encountered in the context of the ongoing negotiations among Member States to complete the Banking Union with a European Deposit Insurance Scheme, it should be emphasized that a fully integrated Financial Union on the model existing in the US will take very long time to materialise in Europe. This is due to different factors leading to home bias and predominance of bank credit financing such as asymmetric cross-border information and the large share of SMEs in the European economy. Against this background it is very likely that in the medium-term private channels will continue to smooth a much lower share of idiosyncratic shocks compared to the US.

Furthermore, public risk-sharing pointing to the establishment of some sort of fiscal union should not be regarded as an alternative to private risk-sharing, rather both have to be seen as complementary (Farhi and Werning 2012, Asdrubali and Kim 2004). A first reason is that private agents might fail to own the optimal level and composition of cross-border assets ensuring adequate stabilisation (Farhi and Werning 2012). This argument gains relevance when the size of cross-border holdings is low as it occurs in the initial phases of the development of the CMU. However, there is a concrete risk that cross-border holdings could grow very slowly without reaching a significant size in the near future. Beside a natural degree of home bias, the current situation where macroeconomic conditions differ across EU countries and certain national economies are particularly fragile to asymmetric shocks, keeps risk-adverse investors away from these countries. In this respect, by ensuring a certain degree of protection from idiosyncratic shocks, a meaningful fiscal union could lower risk-premia on cross-border investments, leading to the rise of cross-border ownership of assets (Alcidi and Theurion 2018). In addition, it would

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[17] The empirical evidence of the crisis has also shown that common shocks can also produce asymmetric effects in terms of depth and length of the recession, also linked to the impact of the different magnitude in financial cycles. A detailed analysis of this topic can be found in Alcidi C. (2017) "Fiscal Policy Stabilisation and the Financial Cycle in the Euro Area" European Commission, European Economy Review, Discussion Paper No.52.

[18] Cross-border shock smoothing through private risk-sharing in the form of capital market channels linked to cross-border ownership of assets and labour mobility are estimated to absorb 39% of the shocks in the US, while public (interstate fiscal transfers) are found to contribute only to 13% (Astrubali et al 1996). However, looking also at the intertemporal stabilisation capacity of different instruments of the US Federal Budget it is shown that public channels achieve additional 11% stabilisation (Nikolov and Pasimeni, 2019). In the EU the same kind of private channels are able to smooth only 6% of the shocks (Nikolov 2016). The stabilisation property of EU member states' budgets was stronger than in the US prior to the Great Recession however, this channel has been strongly hampered during the last crisis following tensions in sovereign bond markets.

help reducing, to a certain extent, the pro-cyclical response of the credit market observed in the EU during the crisis, resulting in massive capital flights from those economy mostly hit by the recession.

These considerations allow drawing a fundamental corollary about the link between central and (regional) stabilisation:

- The larger the degree of stabilisation which can be achieved at central level with different combinations of private and public risk-sharing, the smaller can be the margin for stabilisation allowed at national level, implying that tighter budget constraints can be more politically sustainable and economically grounded. On the contrary, lower stabilisation tools at central level necessarily calls for more room for fiscal stabilisation at national level.

Moreover, we have analysed in previous sections that there is an increasing stream of the literature emphasizing the fact that the role of fiscal policy in the current macroeconomic scenario could go beyond its pure short-term stabilisation property. Political and economic considerations question the scope for submitting to hard fiscal constraints items such as investment programmes, innovation, education and social policies including active labour market policies and adequate unemployment protection. Indeed, in fully-fledged Monetary Unions, when States/Regions are subjected to tight fiscal rules, key spending functions in terms of infrastructure and innovation, as well as other common functions such as health and defence, are carried out at Federal level. The extent of fiscal transfers flowing from the federal level also justifies a strict control over subnational debt and spending.

On this basis a second fundamental corollary can be drawn:

- The larger the size of federal resources flowing directly or indirectly to states economies, the smaller is the room for manoeuvre needed at lower level, allowing the possibility to set more stringent fiscal rules, such as balanced budget rules.

The EMU fiscal policy reflections often neglect the implications of the second corollary in its policy debate. In the original SGP configuration, while there was broad consensus on a neutral role for fiscal policy, it was also assumed that fiscal rules were not in conflict with other policy objectives. In the current macroeconomic scenario, it is questionable if it is still the case. Indeed, fiscal rules designed around rigid balanced budget rules and borrowing limits are quite common in subnational entities belonging to a Federation (IMF 2012). On the contrary, national fiscal rules leaves more space to governments for implementing their desired expenditure and revenue policies. In this respect, the inherent principle underlying most national fiscal rules is that they are not set in stone and the use of fiscal targets to promote fiscal discipline is periodically made consistent with other goals that national governments are willing to attain. Sometimes this results in lowering the ambition of the fiscal targets[19].

[19] For instance, in Japan the Abe's administration has removed the expenditure ceiling set by previous government. In US spending caps have repeatedly been replaced by bipartisan agreements. In Russia a balanced budget rule was abolished in 2012 as a result of the global financial crisis. Recently, a debate has also started in Germany regarding the opportunity to reviewing the Debt Brake adopted in 2009.For detailed information about content and design of fiscal rules across the world see: IMF (2017) "Fiscal Rules at a glance".

Chart 4: Institutions, fiscal rules and market discipline in a federal perspective

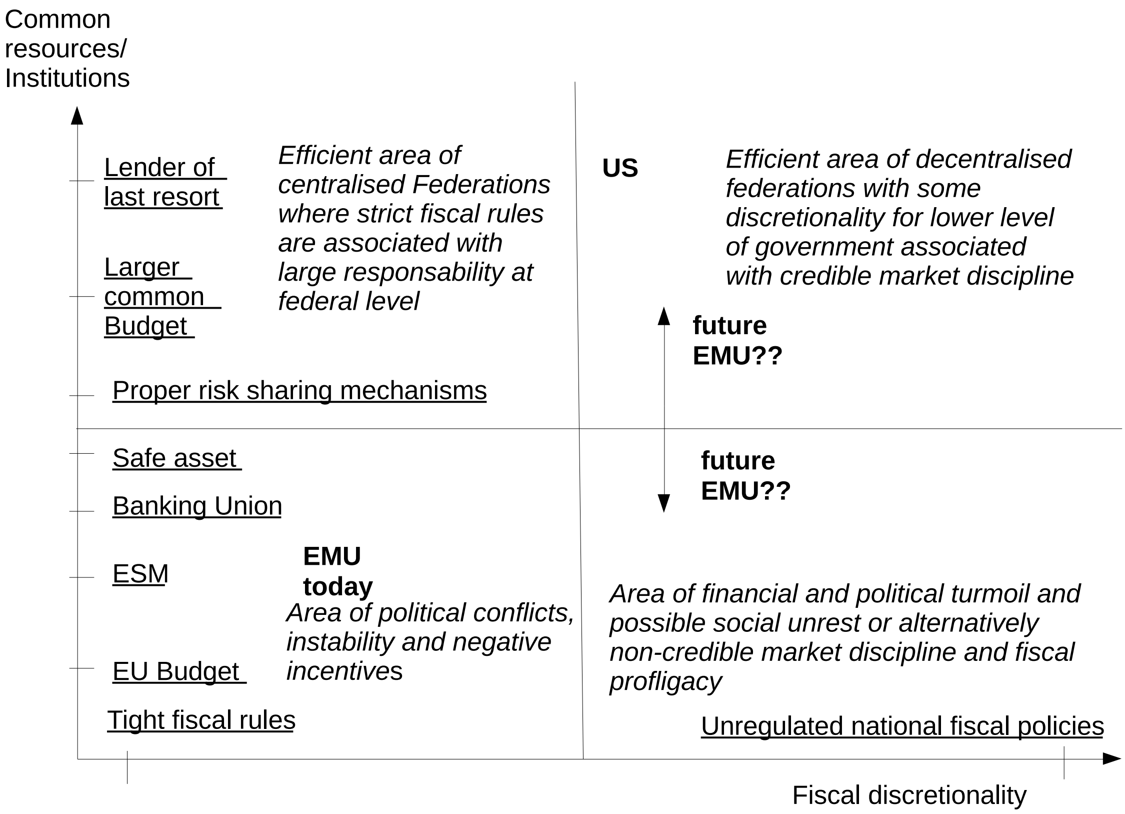

Chart 4.2 displays the concepts expressed above and introduce the issues that will be presented in next sections. On the vertical axes are found the types of common institutions and resources which are typically found in fully-fledged monetary unions.[20]. On the horizontal axes, fiscal policy moves from tight fiscal control from the centre to larger discretion for lower levels of government. The EMU today is in the bottom left quadrant characterised by political tensions and risk of financial instability. This is true despite the creation of the ESM and the possibility to attain the full completion of the Banking Union which could allow reducing the direst consequences of a financial crisis. Today, the EMU also shares some features of centralised models of federations based on relatively strict fiscal rules often associated with administrative sanctions and soft market discipline as member states bailout is no longer excluded. However, the EMU toady shares very little features characterising central federations. The peculiar structure of the EMU would better fit with a decentralised system based on larger discretion and more cooperation on setting fiscal targets, as EMU national states receive very little transfers from the centre and enjoy full sovereignty on taxation (Wyplozs 2011). Furthermore, EMU governments have also different preferences in terms of fiscal policies strategies leading to difficulties in imposing hard fiscal constraints as well as reluctance to move towards a minimal Fiscal Union (moving to the upper left quadrant). However, moving towards a decentralised model would also entail reinforcing market discipline to avoid fiscal profligacy. These considerations have triggered a large debate on the opportunity to strengthening the no-bailout rule found in Art.125 of the TFEU. The chart anticipates some main findings of the next section pointing to the fact that without a minimal set of common institutions and instruments, strong market discipline will likely result in causing financial instability, in turn generating political turmoil and social backlash which could undermine EMU resilience (EMU moving to the bottom-right quadrant).

[20] The ESM and a Securitised Safe Asset are not typical institutions/instruments which are found in fully-fledged federations. They originate from the peculiar nature of the EMU lacking essential elements of a proper federation.

6. Market discipline at the core of the EMU fiscal governance? Opportunity and risks

The arguments in favour of strengthening market discipline in the EMU are:

- The creation of the ESM and the resources provided to those countries which lost market access during the sovereign debt crisis, have undermined the credibility of the existing no-bailout rule. This is regarded as a source of potential increase in moral hazard risks.
- Political negotiations on deepening the EMU are centred on the (fallacious) balance between risk sharing and risk reduction. Thus, increasing market discipline could allow overcoming political resistance towards additional risk-sharing mechanisms, such as EDIS and fiscal stabilisation instruments.
- Market discipline would enable markets to conduct a genuine assessment about liquidity, credit and default risks associated with government debt, reflecting this information into borrowing costs and therefore exerting proper incentives on policymakers to discourage excessive indebtedness. Against this background, market discipline would also provide incentives for pursuing sound fiscal and economic policies, as interest rates would be sensitive to the quality of government conduct.
- By assigning a central role to the markets in fiscal surveillance, the rules-based system of surveillance could be scaled down, therefore overcoming problems related to his design, effectiveness and legitimacy. National authorities could enjoy increasing space for tailoring fiscal policy to national preferences within the limits set by markets evaluation of government policies.

Despite this bright picture, what actually occurs in reality deviates considerably from these theoretical assumptions due to several failures characterising market functioning:

- Markets assessment is not always robust as it is characterised by a non-linear reaction to information about borrowers' creditworthiness, implying lags and asymmetric pro-cyclical behaviour[21]. Consequently, markets tend to misprice risks with respect to the real fundamentals of the economy. During crisis periods they tend to over-react by over-pricing risks well beyond what the economic fundamentals would indicate. Conversely, in good time, they tend to overlook weaknesses. By over-reacting during crisis period, markets risk pushing an economy in a bad-equilibrium due to the materialisation of self-fulfilling prophecies. This occurs since rising interest rates further deteriorate market perceptions about debt sustainability, triggering a vicious circle of continuous increases in interest rates and deterioration of sovereign debt solvency. Market pro-cyclicality is particularly harmful as it risks turning simple liquidity crises in solvency crises. This can occur more easily in a monetary union due to credit market integration, and the free movement of capital across-borders causing a sudden stop crisis (Baldwin et. al. 2015).
- The probability of ending in a bad-equilibrium scenario is bigger the larger is the stock of existing debt. To this extent, implementing strong market discipline mechanisms in the EMU context of high legacy debt and sustainability concerns can results particularly difficult and risky. Before a credible no-bailout rule could be enforced, some solutions to cope with the high stock of legacy debt should be explored (Corsetti et al. 2015). Increasing tensions in the sovereign bond markets risk also jeopardising the role and the function of the ESM. The latter has been created in order to manage liquidity crisis resulting in loosing market access that do not affect states solvency. However, given that its lending capacity is capped, a proliferation of ESM interventions will weaken its firepower. Furthermore, the difficulties arising in distinguishing between liquidity and solvency crisis makes ESM participation uncertain, therefore amplifying financial markets instability (Tabellini 2016, Obstfeld 2013).
- The enforcement of strong market discipline in the EMU is complicated by the hybrid statute of EMU countries which can neither be considered as subnational entities nor as ordinary sovereign

[21] The Delors' report already acknowledged market failures as one of the main reasons for complementing the no-bailout rule with fiscal rules.

states. In fact, sovereign states not belonging to a monetary union naturally face a certain degree of market discipline as there is no or very little room for financial assistance from supranational bodies[22]. Nevertheless, their budgetary constraint is potentially softer during a liquidity crisis, as it depends on the available space for central bank intervention in sovereign bond markets. Consequently, a sovereign default can be avoided or at least postponed as long as central bank intervention does not produce unsustainable inflation developments, depletion of foreign currency reserves and depreciation of the domestic currency. Default risks diminish in line with the ability to keep the implicit interest rate on government debt below the growth rate of the economy so that the inter-temporal budget constraint is satisfied. While in the long-term government borrowing costs strongly depends on the fundamentals of the economy, in the short-term central bank intervention in the sovereign bond market can be successful in coping with liquidity crisis and sustainability concerns. In the EMU, the ECB cannot unconditionally intervene in the bond markets so outstanding national debt in euro is in fact equivalent to debt issued in a foreign currency, thus carrying stronger risks of default (De Grauwe 2013).

- A second set of arguments which makes the real enforcement of strong market discipline not very credible in the EMU is that the premises to minimise the impact of a sovereign default on the real economy and on the domestic and the European banking system have not been created. In this regard, it is often argued that the full completion of the banking union would be needed in order to fully break the sovereign-bank feedback loop. The completion of the banking union is complicated by the fear that large exposure of national banks portfolio to sovereign bonds would increase the costs and the probability of bank restructuring involving a larger size of common resources. This is one of the reasons justifying the proposals to reduce banks sovereign exposure by either changing the regulatory treatment of sovereign bonds lifting the current zero risk weight provision or by imposing concentration charges to banks' sovereign bonds holdings. However, these measures risk heightening liquidity troubles in sovereign bonds markets (Micossi 2018). With this regard, a well-sequenced package including the creation of a European safe asset is by some authors regarded as the optimal solution to allow these changes to take place without jeopardising financial stability, while at the same time reducing the consequences related to a sovereign default (Buti et al 2018). However, while a safe asset is crucial to reduce liquidity risks and to reduce the cost of a default for the financial system, a sovereign bail-in remains potentially devastating for the real economy as it exacerbates the recession, force governments to run very restrictive fiscal policies and exert second-round effects on the national banking system due to rising non-performing loans (Trebesch and Zabel 2016). Furthermore, self-fulfilling risks will not disappear if a considerable share of national outstanding debt would be subject to strong market discipline.

The high costs associated with government defaults explain why they are very rare events even in subnational debt crisis, where they entail lower economic and social costs than in the case of sovereigns. In fact, in subnational entities, as crucial public expenditures are financed at the federal level, the consequences of a default become less disruptive. A closer look at the US experience with the no-bail out clause also allows identifying its specific characteristics and the overall institutional and economic context in which the clause operates. Subnational government debt accounts for only 13% of Federal Government Debt. This shows that the bulk of key expenditure functions (i.e. healthcare, education, defence, welfare) are financed directly or indirectly (through transfers) from the federal level. Since the bulk of the debt burden is carried by the federal government, debt-borrowing limits to US states are credible and easier to be enforced. Moreover, these limits are not very rigid as they allow US states and local government to issue bonds to fund day-to day obligations and to finance capital projects. Moreover, the size of states and local government bonds in the portfolio of US Banks is low as banks can easily invest in federal bonds fully guaranteed by the combined strength of the US and the Federal Reserve. These implies that spill overs and systemic risks arising from subnational defaults are low. Nonetheless,

[22] International institutions such as the IMF can provide support under the form of conditional foreign currency lending.

past experiences show that the no-bailout rule has gained credibility in relation to increasing Federal government's responsibility over social insurance functions over time. The consequent limitation of the social costs arising from state's default has reinforced its political acceptance and has therefore strengthened perceptions about its concrete application (Kinkergaard 2017).

Despite the above considerations, the empirical experience shows that the threat of adverse consequences arising from political and social costs and adverse financial spill overs for other subnational states have frequently led federal governments (not only the US) to prefer bailing-out local governments (Cordes et al. 2015). Very few cases of resolution of financial crisis without federal government intervention can be empirically observed[23]. Examples of debt restructuring without central governments support have also been quite rare and tend to be motivated by strong financing constraint characterising also the federal government.[24] Debt restructuring has been more common at municipal level.[25]

Against this background, the combination of higher probability of market failures, in particular self-fulfilling crisis and the international experience in the application of the no-bailout rule, suggest that a system where sovereign default becomes possible and somehow likely, entails very strong risk of financial instability and economic disruption. In this respect, it is doubtful whether the package proposed by the 7+7 economists (concentration charges, EDIS, Securitised Safe Assets, ESM liquidity provisions, rainy-days stabilisation fund) would be sufficient to minimise the high costs associated to a default. In any case, the implementation of this package faces the difficult challenge of agreeing on the building-up of multiple risk-sharing mechanisms entailing the pooling a non-negligible amount of national resources. Furthermore, the effectiveness of these mechanisms in minimising the cost of a sovereign default risks seems low, if not associated to more conventional federal instruments, such as a larger Euro Budget with stabilisation properties, common investment programmes and an adequate welfare safety net.

A sovereign default of a developed national country being part of an incomplete, fragile and young monetary union which materialise only due to public debt overhang (without long periods of unsustainable external debt position and skyrocketing inflation as typically occurs in developing countries) risks being never fully digested in the national contest. This is likely to undermine the trust and the cohesion of the EMU. The experience of the Great Recession have shown that less disruptive events, compared to sovereign defaults, have already provoked non-negligible political consequences.[26] To conclude, despite all the efforts to improve the framework, there are concrete risks that in the current EMU context, strong market discipline would fail to create the right incentives to government as the no-bailout rule would not be credible. Alternatively, in case it would be enforced up to a sovereign default, it would entail large costs for the concerned country and carrying economic spill overs and high risks of a political backlash which might trigger devastating consequences for the EU integration project as a whole.

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[23] Examples are the US states insolvency in mid-1800s and the crisis of Canada provinces.

[24] E.g. Mexico in the mid-1990s and Argentina in early 2000s.

[25] A number of countries (US, South Africa, Hungary, Mexico) have adopted legal frameworks for the resolution of SN debt crises, primarily for local ones. However, experience with their practical application is still quite limited.

[26] See for instance Guiso, L, H Herrera, M Morelli and T Sonno (2019), “Global Crises and Populism: The Role of Eurozone Institutions”, *Economic Policy* 34(97): 95-139.

Part III: Towards a new model for the fiscal and economic governance based on a cooperative approach

7. Principles for an overhaul of the EMU Economic Governance

The considerations made throughout the previous sections suggest that the rule-based framework should play a less central role in the future economic governance. This statement finds support from the following considerations:

- Fiscal rules suffer from design and enforceability problems that are likely to persist whatever reform of the rules would be adopted. These flaws are particularly relevant in the EMU situation as top-down and relatively strict quantitative fiscal rules do not seem to fit with the incomplete structure of the EMU, where the low size of the resources managed at supranational level entails larger stabilisation and investment needs at national level.
- The renewed debate over the functions and the roles of fiscal policy in the current macroeconomic scenario shows that a large and shared consensus over running a neutral fiscal policy is no longer present. This complicates the political economy difficulties arising in prescribing a one-size-fits-all fiscal policy strategy to Member States.
- The economic opportunity of imposing hard-budgetary constraints to Member States is also questionable in the current macroeconomic environment. Indeed, complying with fiscal rules is not a sufficient condition to ensure fiscal sustainability in a scenario of high debt level and low potential growth. In certain cases, the huge efforts which would be needed to ensure full compliance with the most proposed types of expenditure rules, would not produce a significant reduction in the debt/GDP ratio over a time horizon of 20 years. This implies that inevitable and temporary deviations from the fiscal rule path, coupled with negative phases of the economic cycle will cause a lower debt reduction that risks resulting in a negligible outcome in terms of sustainability.
- A more consistent strategy combining fiscal responsibility with proper stabilisation and growth-enhancing policies could, in specific cases, produce better result in the medium-terms with regard to debt reduction, full employment and nominal output growth. The latter is the crucial factor to achieve smooth, significant and sustainable public debt deleveraging. In some instances, hard budgetary constraints do not seem to leave financial resources and political space for growth-enhancing policies.
- A model of fiscal policy decentralisation corroborated by strong market discipline entails the risk of triggering financial instability in the current EMU configuration, also affecting fiscal sustainability. Even after fiscal sustainability were to be regained through a sovereign (even if orderly) default, permanent losses in output would in any case occur, affecting in turn political sustainability.

Against this background the (perhaps impossible) challenge would be to design the fiscal governance in order to attain four overarching goals.

- growth 2) fiscal sustainability 3) financial stability 4) avoiding causing political instability

The current system focuses mainly on fiscal sustainability while there are signals of a trade-off between growth and financial stability. During the crisis financial instability jeopardised fiscal sustainability. The latter was regained at the expenses of growth. Today this trade-off did not fully vanish as several countries keep experiencing subdued and non-genuine rates of growth characterised by high unemployment and low activity rates, bad quality job creation and low investment. At the same time, the attempt to stimulate aggregate demand and raise potential output through growth-enhancing spending risks spurring financial turbulence due to existing sustainability risks.

In this respect the paper argues that one of the best solutions to achieve at least the first three goals, consists in building up meaningful common instruments at EU level. However, this paper also assumes that this scenario does not seem politically feasible for the time being. The alternative option, notably the decentralised model based on strong market discipline also implies considerable risks given the lack of adequate instruments to minimise its costs. With this regard, an attempt to maximise these four overarching goals could be made by redesigning the fiscal framework on the basis of the following principles:

- The central role of fiscal rules in fiscal surveillance should be reduced by moving towards a cooperative governance system where fiscal targets and the medium-term macroeconomic strategy are periodically negotiated by a competent EU authority and the national government. Stronger attention should be dedicated to the quality of the policies implemented at national level including a stronger focus on results. Quantitative targets can be an instrument for this evaluation. The SGP philosophy was to be neutral with respect to specific policy choices and rather focusing on quantitative macro targets, to avoid interference with national sovereignty. However, given the small margin available for fiscal policy choices in some EU countries, hard fiscal constraints can be perceived as intrusive as discussing more in details the whole policy strategy. Moreover, the European Semester Process and the Macro-imbalance surveillance resulting in Country Specific (policy) Recommendations (CSRs) are already moving in the direction of a more qualitative surveillance process. This qualitative approach would allow enjoying enough margins of flexibility, promoting high-quality budgetary and economic policies and ensuring ownership and accountability in national authorities' policymaking. The joint evaluation of both the fiscal and the overall medium-term policy strategy pursued by national authorities will allow strengthening the link between policies and objectives, between fiscal and macroeconomic policies and between demand side and supply-side structural policies.
- Financial Stability can be considered as a key European public good. Thus, it is crucial to minimise risks of financial turbulences in sovereign bond markets by addressing excessive pro-cyclical and erratic market reactions not justified by changes in national economy fundamentals. In this regard, addressing short-term financial turbulences through the ESM could result in a too cumbersome and length process not fit to cope with temporary market volatility. The system should be made resilient to market reactions triggered by relatively ordinary political and economic events such as small deviations from the rules, short-term increases in deficit and debt, contingent divergences between European Institutions and national governments and markets tensions linked to democratic elections. All these events can lead to an increase of redenomination and liquidity risks (Gros 2018, De Grauwe 2016). They are not strictly linked to the assessment of economy fundamentals. The former, in particular, arises from the fear that political events, including conflicts between national and EU institutions on fiscal and macroeconomic policies could translate in an escalating crisis jeopardising the Euro membership[27]. In general, while a larger degree of market sensitivity to national policies would be beneficial, it is crucial to avoid continuous market threats. In fact, one of the main benefits for the adoption of the currency union was to shelter Member States from recurrent currency crisis. While in the monetary union exchange rate risks and inflation are under control, the post crisis situation where sustainability and redenomination risks are large, volatile and linked to political developments, exposes the EMU to instability. A currency union made fragile by continuous tensions in sovereign bonds markets, which would prove to occur even more often than in countries with their own currency, would see

[27] Analysing the reasons behind the increase in the risk-premia of Italian sovereign bonds during Summer 2018, Gros argued that one half of the overall increase could have been related to investors' concern about the country leaving the Euro, associated to government authorities attitude, rather than to fiscal sustainability concerns. For more info see: "Italian risk spreads: Fiscal versus redenomination risk" VoxEU.org 29 August 2018.

its benefits shrinking and distributing unevenly across Member States, thus being not politically sustainable in the long term. The ECB Outright Monetary Transactions (OMT) programme has been crucial to stop speculation and expectations of sovereign defaults. However, it has been noticed that the conditionalities attached to the OMT and the difficulties to distinguish between liquidity and solvency crisis make the instrument dependent to the political context and therefore not fully credible in every situation (Cohen Setton and Vallee 2018, De Grauwe 2013), The key implication is that the lack of a proper lender of last resort for EMU sovereigns, makes liquidity crisis more likely as markets tend to ask for higher yields to compensate for higher default probability and redenomination risks (Bofinger 2018, Bini-Smaghi 2018). With this regard, to addressing this inherent weakness of the EMU would require setting up a minimum lender of last resort, for example by making the OMT an ordinary instrument in the hands of the ECB, enlarging its intervention scope for solvent countries while maintaining some forms of conditionality.

➢ Avoiding gross-policy errors and addressing moral hazard through a gradual and semi-automatic enforcement system becoming stronger the bigger are the policy flaws. It would range from small penalties in case of simple divergences between EU recommended policies and the national policy strategy, to more serious and deterrent consequences to avoid and address clear-cut gross-policy errors. A robust and credible system of enforcement mechanisms to replace the current ineffective and non-credible system of sanctions would balance the inherent increase in moral hazard risks related to additional discretion in national fiscal policy choices and to the wider scope of the OMT backstop.

8. Details of a suggested model of fiscal and economic governance

This section presents several features which could characterise a model of governance consistent with the above principles. These suggestions are made without being naive on the fact that further analyses and refinements would be needed to reach an optimal design. Keeping this is mind, the main feature of system is to base the monitoring of domestic fiscal and economic policies developments on a Medium-Term Economic Plan (for simplicity as of now it will be called "the Plan"). The latter should be negotiated and agreed between the new elected government and a responsible EU Institution[28]. In principle it should be valid for the 4-5 years natural duration of the government mandate. The Plan should include:

- Macroeconomic projections;
- A medium-term budgetary framework;
- Detailed expenditure targets, including concrete and measurable objectives to increasing the efficiency of public expenditure;
- An analysis of the quality of public expenditure with adequate planning and descriptions of investment and other growth-enhancing expenditure programmes, including measurable and detailed targets.
- Policies focusing on addressing key CSRs as those linked to correcting macroeconomic imbalances;
- Policies focusing on addressing other CSRs.

[28] The paper does not dig into the Institutional details of the model. However, the suggested set-up implies that the Institution responsible for assessing the Plan should enjoy a large degree of credibility and independence as it will necessarily use some discretion in its judgment. In this respect, the creation of a European Minister of Finance would be an element of the institutional set-up, although surely not the only one, which could well fit with the economic governance design proposed in the paper.

The EU would provide its agreement after a comprehensive evaluation of the Plan. EU access to key and detailed information for an in-depth quality assessment should be granted. The medium-term budgetary framework should focus on a debt target to be attained at the end of the government mandate and on the underlying primary balance targets. It should also detail consistent annual expenditure targets as well as revenue projections. The policy dialogue with the EU would firstly be centred on the ambition of the medium-term debt target suggested by the government. One question is how to assess its appropriateness, as this is a key issue where both political preferences and economic approaches may diverge. The options would wary between two extremes: The first one would rely on a sort of reference fiscal rule such as a simplified debt reduction benchmark and/or a reference expenditure benchmark. In case the plan would not comply with the reference rule, the government should motivate the deviation according to the "comply or explain" principle. The alternative would consist in evaluating the Plan purely based on a set of qualitative criteria for sound policymaking[29]. These criteria would be adopted each year by the Council and a supranational EU assembly (an EA committee of the European Parliament or a chamber composed of national parliaments' members) starting from the Euro Area recommendations proposed by the Commission. This would allow taking into account contingent policy prescriptions tailored to the evolving macroeconomic context. In both cases it would be the discretionary judgment of the competent EU Institution aimed at detecting gross-policy errors and deviations from sound policy-making that would drive the decision about accepting, refusing or expressing a critical opinion on the plan. National fiscal councils can also play an important role in providing opinions about the Plan.

The definition of gross-policy errors is a crucial topic as an agreement between different positions would be difficult. In fact, from this provision will depend the extent of national discretion that the system allows, the conditionality for ECB intervention to ensure financial stability and both the tightness and the credibility of the enforcement mechanisms. The proposal of this paper is to restrict the (qualitative) definition of gross-policy errors to serious cases. Circumscribing gross-policy errors could increase the probability that the whole model of governance would be widely accepted at EMU level, including regarding the application of viable and credible semi-automatic sanctions.

Based on the above, gross-policy errors could be defined as follows:

÷ Straightforward and strong pro-cyclical fiscal policy assessed by looking at a set of variables such as the output gap, labour market and financial cycle indicators.

÷ Strong presumptions of unsustainable debt developments arising from the planned budgetary strategy. In this respect the DSA (Debt Sustainability Analysis) should focus on medium-term developments without embarking in long-term uncertain projections. Little increases in government debt and short-term changes in the (r-g) debt sustainability condition should better not be regarded as sufficient to define an unsustainable fiscal policy. This is particularly true if the underlying fiscal policy strategy was focused on growth-enhancing measures and/or on smoothing the effects of a large downturn.

÷ Strong risks of building-up excessive macroeconomic imbalances, in particular concerning the accumulation of large current account imbalances and high probability of fuelling financial bubbles.

÷ Clear negative spill overs arising for other EU Members, including in particular clear-cut conflicts between national fiscal policy and monetary policy objectives. Clear conflicts with the agreed Euro Area fiscal stance could be a further source of concern[30].

[29] Qualitative standards for fiscal policy assessment are also suggested by Blanchard (2019) with the purpose of enhancing fiscal policy conduct in a scenario where macroeconomic policy becomes more complex than before.

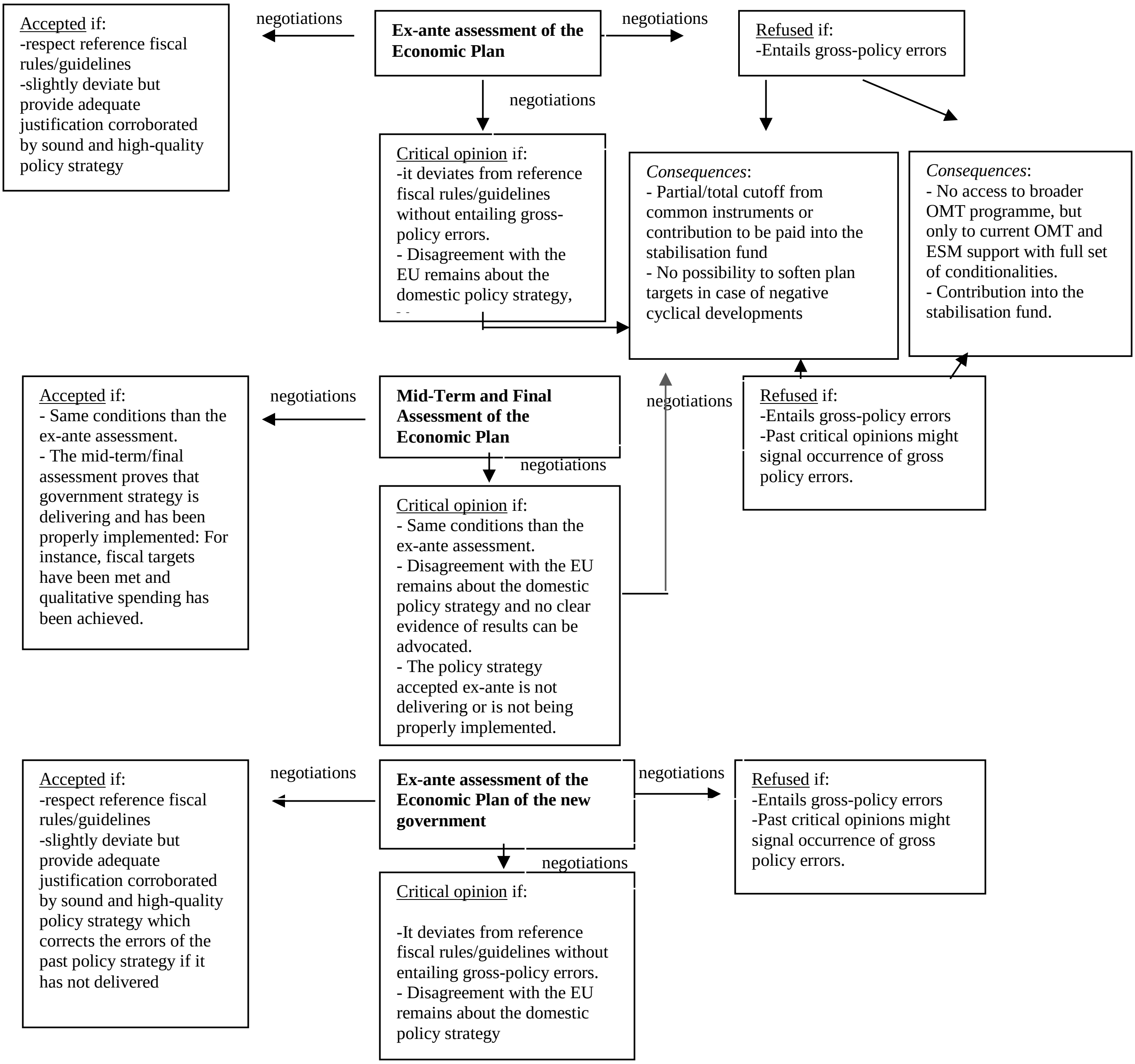
[30] As the contribution to the Euro Area fiscal stance and monetary policy spill overs are mostly relevant for large Member States and the bigger economies, this provision could allow rebalancing, at least partially, the stronger political power of large Member States in the negotiation with the EU.

In all the other cases where gross-policy errors are not detected but the Plan does not comply with the reference fiscal rule or it does not fully respect sound fiscal policy principles, and the EU is not satisfied with the motivation advocated by the national government to justify such deviations, a critical opinion should be issues. The critical opinion would represent an intermediate judgment which does not imply a formal refusal of the Plan. In this respect, it is crucial to emphasize that the supposed deviations from sound policy-making should be monitored and addressed in the medium term-through successive assessments of the updated Plan and following a cooperative approach aimed at granting initial credit to the strategy pursued by national authorities. National expenditure targets could be regarded as the main operational target to assess from the fiscal perspective the implementation of the Plan, without embarking in a rigid “one size fits all” expenditure rule definition.

The Plan should be assessed in three different moments (initial assessment, medium-term assessment, final assessment) during the (natural) duration of the government mandate. This would enable a gradual application of the enforcement instruments becoming tougher step by step. A refusal of the plan due to detection of gross policy errors would imply that the broader OMT programme would no-longer shelter national debt from possible large increases in risk premia. Furthermore, a contribution of about 0.25% of GDP directed toward a stabilisation fund should also be envisaged. In this scenario public debt vulnerability would be equivalent to that implied by the current system as ESM intervention and the current OMT programme with the full set of conditionalities could still come in support to address liquidity troubles and self-fulfilling prophecies. The main difference compared to the current system is that redenomination risks and self-fulfilling prophecies stemming from exogenous events, such as the impact of an economic crisis, would not jeopardise government debt sustainability, provided that gross-policy errors are avoided. A residual tail risk of debt restructuring would stay in case of insolvency, and it would be extremely costly in political and economic terms, especially if a full Financial Union, endowed with a safe asset and EDIS, would not be developed. However, this threat would be more credible as it is purely related to extreme uncooperative behaviour of national governments, while the high costs associated to this very negative scenario should represent a strong incentive to push the government to abandon its unsustainable fiscal strategy. For the other types of gross-policy errors, which do not have a strong impact on debt sustainability in the short-term, the contribution of 0.25% of GDP would represent the real deterrent. Rather than be regarded as a sanction it should be seen an insurance premium to partially cover the risk that the national strategy would weaken domestic and EMU economy resilience. To safeguard financial stability and political ownership especially in the ex-ante phase, the critical opinion should instead imply limited penalties such as a partial cut-off from common resources or, in alternative, it could trigger a lower insurance premium into the stabilisation fund than in the case of gross policy errors, accounting for around 0.05%-0.1% of GDP. These contributions should be semiautomatic[31] and be required as soon as the plan fails to be approved. The medium-term assessment could move in all direction, maintaining the critical opinion, refusing the plan as a whole or ending up in accepting it. The important difference is that both the EU judgment and markets reactions would be based on a first observation of the implementation and the outcome of the government strategy providing information about the credibility and the quality of the government plan. The final assessment will be increasingly based on concrete results, *in primis* the attainment of plan’s targets, so that future assessments will enjoy stronger legitimacy by using information about past records, thus increasing the evidence-based nature of the framework.

[31] Semi-automatic means that the European Council could retain the faculty to cancel the payment with a vote requiring either qualified majority or even unanimity.

Chart 5: The cooperative governance system



9. Advantages of the cooperative governance

The "grey" area of the proposed governance, when the Plan is subject to a critical opinion without being refused is a crucial and sensitive feature of the cooperative framework, but also the one with the largest potential for improvements compared to the current system. The main scope for improvements involves the following areas:

Preventing gross-policy errors

First of all, in exchange of the increasing discretion allowed at national level and the safeguard of financial stability, the prevention and correction of strong and clearly identified gross-policy errors becomes more rigid as the enforcement mechanisms are quite strong and semi-automatic. The adoption of counter-cyclical policies, when different indicators point to a clearly expansionary economic cycle, could be more easily enforced or government would be forced to accumulate extra resources into a stabilisation fund. Counter-cyclical policies could also be promoted also by providing for symmetrical provisions to cope with non-expected movements of the economic cycle. The possibility of softening Plan's targets when nominal growth falls short of projections, provided that the Plan, including its macroeconomic and fiscal projections, is accepted, could be exchanged with the requirement of strengthening fiscal targets when growth exceed expectations.

Fostering accountability and sound policymaking of national authorities

National governments have incentives, besides avoiding gross-policy errors, also to take into account comments from the Commission in order to have their Plan approved. Furthermore, as the attainment of the medium-term targets of the Plan would represent one of the main criteria to judge government credibility and to drive next assessments, national governments' accountability with regard to their medium-term strategy would increase, potentially leading to promote quality policymaking, The government would have the incentive to formulate its economic Plan on the basis of high quality expertise and realistic objectives, in order not to be made accountable for missing the targets. The memory of the assessment process included in the different round of evaluations allows reducing the future enforcement costs for the enforcer and increase the scope for avoiding recurrent bad policies. The need to formulate credible and high-quality policy strategy increases for non-compliant governments because, besides EU authorities' assessment, borrowing costs will also depend on markets evaluations. The latter could also differ from that of the EU, implying basically that risk premia would not increase following the critical opinion. What the framework , will manage to avoid, thanks to the power of the broaden OMT programme, are large market reactions mostly driven from the expectations about the self-fulfilling materialisation of a very negative scenario, rather than on the genuine assessment of the government strategy.

Increasing national ownership and improve the legitimacy of the framework

The cooperative framework would allow taking care of different preferences at national level in terms of key policy objectives (for instance a focus on reducing inequalities) or from different views about the most effective policy strategy needed to attain a shared objective. For instance, in a macroeconomic environment of low inflation and relative high unemployment, an expansionary fiscal stance cannot be defined clearly pro-cyclical and it could be simply put under enhanced scrutiny when it is not in conflict with monetary policy and if it does not risk fuelling excessive macroeconomic imbalances. In these cases, the assessment of the plan should be strongly driven by the qualitative evaluation of the underlying policy strategy. This implies that high-level, transparent and participated dialogues and debates on policies, goals and strategy, involving also national actors such as national fiscal councils, should become part of the EU governance. The dialogue should be non-dogmatic and open to different policy measures. It should consider multiple goals and their interdependence, while avoiding the imposition of pre-determined measures from the top. This would make the European governance framework more legitimate as it would reduce its prescriptive nature in terms of annual fiscal targets and focus more on medium-term outcomes. Indeed, negotiations are already occurring when a country is at risk of violating fiscal rules, before opening up a formal procedure. However, this *ad-hoc* and somehow disordered negotiations generate dissatisfaction from compliant governments without leading to effective economic outcome. A high-quality policy debate could also lay down the rudimental fundamentals and the necessary attitude for the birth of some form of Political Union in the future, precondition to proceed with a deeper phase of EU integration.

Shifting the focus of economic surveillance on the implementation of a comprehensive high-quality policy strategy

The policy dialogue underlying the cooperative governance allows focusing the attention on the overall policy strategy, including the different crucial drivers of debt sustainability, thus avoiding penalising growth-enhancing items. Rigid numerical fiscal rules don't allow this kind of assessment. Furthermore, what captures strong media coverage and political attention is the annual compliance, in particular with respect on whether a formal procedure for non-compliance will be opened. Therefore, the European Semester, which is the governance process where macroeconomic, structural and growth-enhancing policies are discussed and promoted, remains confined in the world of technicians, while both politicians and the general public are not interested in that debate. The low profile of the debate can also affect the quality of the process surrounding CSRs formulation. Low attention is dedicated to ex-ante and ex-post analyses of the suggested policy, on their ability to attain the specific outcomes, on their consistency with other policies including trade-off, costs and results. This is also due to the fact that CSRs are not binding, and their assessment does not bear political consequences. At the same time, making the CSRs strictly binding, without a proper discussion on goals and measures, would be politically unfeasible, not least because CSRs generally touch exclusive national competences.

Endowing the system with the necessary degree of flexibility and adaptability

The cooperative governance is also characterised by a high degree of flexibility and adaptability providing for the possibility to adapt the assessment based on current economic and, to a certain extent, on political circumstances. The scope for taking into account specific and contingent national needs will produce gains in terms of acceptance by the European people. The economic governance would be better perceived as a framework aimed at promoting good policies rather than simply focused on keeping public finances in order. The yearly adoption of sound policy principles, starting from the Euro Area recommendations, would lead to more fiscal and macroeconomic policy coordination and would provide additional adaptability of the framework to the present macroeconomic environment.

10. Conclusion

This paper has presented a conceptual framework where EMU fiscal policy and its governance modes are analysed looking at different dimensions. Findings converge on the need for a deep rethinking of fiscal policy and fiscal rules. One main message of the paper is that out of the box reflections about the future design of the fiscal and economic governance should be motivated by the overarching goals of making the EMU resilient and sustainable in the long-term. However, besides technical considerations, the conceptual framework of the paper is also contaminated by more general topical aspects such as the crisis of democracy and the surge in populist and nationalistic sentiments across the EU. Another message arising from this paper is that the framework in which EU policymaking takes shape has a role in amplifying or containing these issues. EU fiscal and macroeconomic policies, due to their weight in the public debate and perceptions, are two fields where complexity and technicalities interacts with the intricate aspects of democracy and legitimacy. In this regard, the well-known concept of output legitimacy has newly gained credit given results and political effects of the crisis. In this regard, EMU resilience can be strengthened mainly by promoting effective and inclusive policies balancing their effects across national economies and groups of population. Thus, preventing financial instability becomes particularly crucial to preserve output legitimacy. Furthermore, recognising the weaknesses of being part of an incomplete monetary union would be a prerequisite to move from crystallized dogmas and attain a more robust institutional architecture. The concept of input legitimacy is also central in the reflections of the paper about the overhaul of the governance system. The overarching principle is that mutual respect and recognition of different preferences, views and objectives are the basis for generating trust and support in EU integration. From this assumption stems the call for a more cooperative approach between national governments and EU institutions in the formulation of fiscal and macroeconomic policies. Recognition also requires less prescriptive policies from the centre and an outcome-based approach. The EU should promote respect and recognition by becoming the fora for high-level policy discussions rather than a space where 27 national and political interest engage in conflicts and negotiations, within a rigid technical framework. The cooperative governance can be regarded as a model of deliberative governance based on a policy dialogue between national governments and the EU, in opposition to the concept of deliberative intergovernmentalism developed in relation to the stronger role played by the Council and the Eurogroup in the last years on macroeconomics and fiscal policy outcomes (Puetter 2012). Indeed, policy assessments and actions would be based on the Community method underpinned by an inclusive and transparent debate, thus moving away from the opacity characterising key intergovernmental decisions in these fields. With this regard, the role of the EU can be crucial to allow national actors regaining trusts in national and supranational policymaking by strengthening general confidence on the fact that the ultimate goal of the EU governance system is to promote high quality and inclusive policies despite different preferences. Accountability and responsibility, coupled with resolute enforcement in case of severe uncooperative behaviour, are also key determinants for mutual trust and respect. All these considerations can easily be regarded as wishful thinking. Indeed, the ongoing process of EU reforms casts a mixed picture of optimism and disappointment. However, continuing with the current mind-set and ignoring the elephant in the room of increasing political, economic and social sources of vulnerability can be equally frustrating, besides being extremely dangerous.

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