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Fiscal and other rules in EU economic governance: helpful, largely irrelevant or unenforceable?

Iain Begg[1]

Abstract:
EU Member States, particularly in the euro area, have been pushed to adopt more extensive and intrusive fiscal rules, but,what is the evidence that the rules are succeeding?. The EU level Stability and Growth Pact (SGP) has been – and remains – the most visible rule-book, but it has been complemented by a profusion of national rules and by new provisions on other sources of macroeconomic imbalance. Much of the analysis of rules has concentrated on their technical merits, but tends to neglect the political economy of compliance. This paper examines the latter looking at compliance with fiscal rules at EU and Member State levels, and at the rules-based mechanisms for curbing other macroeconomic imbalances. It concludes that politically driven implementation and enforcement shortcomings have been given too little attention, putting at risk the integrity and effectiveness of the rules.

Key words:
Fiscal rules

European economic governance

Macroeconomic imbalances

Political economy of compliance

Fiscal councils in Europe

JEL classifications: E61, F42, H11, H61, H77, H81**Introduction**

In response to the severe crisis that erupted in the euro area after the dire state of Greek public finances was revealed, the thrust of many economic governance reforms has been to strengthen rules intended to tie the hands of policymakers. Despite persistent academic criticism of the Stability and Growth Pact (SGP), it continues to be at the heart the EU approach, although in the wake of the crisis it has been further reformed and supplemented by additional obligations affecting budgetary policy. These include the Fiscal Compact (agreed in 2011) and the 'two-pack' (agreed in 2013) which requires Euro Area members to submit draft budgets for scrutiny in the autumn before they are adopted. As part of the reforms, EU countries have had to introduce domestic fiscal rules consistent with meeting a medium-term objective (MTO) to maintain fiscal sustainability.

Recognising the role of other macroeconomic imbalances in causing problems in certain Member States, another innovation was the creation of an Excessive Imbalances Procedure (EIP), with many similarities to the SGP as an instrument of governance. It has preventative and corrective arms, along with the possibility of financial penalties for non-compliance. The European Commission

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monitors a series of indicators including ones relating to the external accounts, the housing market, credit conditions and unemployment; latterly, various other, social, indicators have been added. Where these point to potentially disruptive imbalances, an 'in-depth review' is conducted for the Member State to establish how much imbalance exists.

On the face of it, these reforms, together with the moves towards banking union, the creation of a permanent bailout fund in the shape of the European Stability Mechanism (ESM) and the broadening of the role of the European Central Bank (ECB) amount to a far-reaching and substantive reform of economic governance. Assuming the implementation of further reforms following up from the *Five Presidents' Report* (Juncker et al., 2015), an optimistic perspective is that enough has now been done, or is in train, to resolve the flaws in the Euro Area's policy architecture. However, the design and establishment of policy mechanisms and processes are only part of the answer and leave open the parallel question of whether enough has been done to solve the basic political economy shortcomings in compliance.

This paper examines the emerging evidence on outcomes to try to answer this latter question, and finds cause for concern. The next section discusses why resort to rules gained favour, recalling some of the main objections raised in the literature. Subsequent sections look, respectively, at experience of: compliance with EU fiscal rules and measures with preventative aims; national fiscal rules; and rule-based governance of other macroeconomic imbalances. A discussion of the political economy of compliance with rules and concluding comments complete the paper

The case for rules

Rules constraining policy-makers are, very simply, advocated to curtail political incentives to adopt policies likely to benefit the policy-makers, rather than the interests of the economy. They are a component of a wider, and rich, literature on the governance of (mainly) fiscal policy, although there are similar discussions around monetary policy. It encompasses issues such as the nature of the 'contract' between citizens as principals and their governments as their agents (Besley, 2007), the most appropriate design of institutions (Hallerberg et al., 2007), and transparency (Begg, 2014), as well as the narrower question of numerical rules to guide policy-making (Kopits and Symansky, 1998; Wyplosz, 2012; Portes and Wren-Lewis, 2015; Bergman and Hutchison, 2015). Aligning economic and electoral cycles to maximise the chances of re-election in an 'opportunistic business cycle', bribing electorates and favouring core supporters are all examples of behaviour extensively studied in the political economy literature (see, notably, Drazen, 2000). There is a general presumption that short-term considerations will dominate the policy discourse, hence rules are needed to make longer-term policy goals more salient.

Numerical rules, according to Kopits and Symansky (1998: 2), should be understood 'in a macroeconomic context, as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance', usually relating to variants of the budget balance or government debt, or both, or to aggregate public spending. They go on to stress that a rule 'is intended for application on a permanent basis by successive governments…[and] … to be credible, it must involve commitment over a reasonably long period of time'. Crucially, they distinguish a rule from the shorter-term targets imposed on a country subject to a macroeconomic adjustment programme, because the latter will tend to be time-limited. Permanence does not, however, mean rules cannot be changed: what can be enacted can also be altered or undone and there are plenty of examples of rules being jettisoned when they become politically inconvenient. Drazen (2004), for example, refers to the rapid demise of the Gramm-Rudman-Hollings rule adopted in the US in 1985, while Kopits (2012: 153) notes how, when the current administration came to power in Hungary with a large parliamentary majority, it 'inherited a rules-based fiscal framework which it chose to ignore'.

Fiscal rules have been repeatedly advocated by bodies such as the IMF and the OECD, in the interests of good economic governance, with transparency also seen as a necessary ingredient (Bernanke, 2010). However, resort to rules poses a delicate governance challenge for the EU and its Member States, because they impinge on one of the core functions of the state and its relationship with citizens. The common-pool problem is at the heart of this dilemma insofar as the democratic process will tend to favour decisions pandering to current generations or interests, neglecting the longer-term; indeed, Wyplosz (2012: 499), noting the ubiquity of the bias towards deficits, says 'the surprise is that some countries could be free of the bias'.

Unlike competition policy or monetary policy, where delegation of operations, though not objectives, to an agency is the norm and can be defended on the grounds that the policies concerned, although they may involve distributional issues, require technical rather than political decision-making, fiscal policy is politically much more sensitive because it concerns the role of the state and goes to the heart of distributive politics. In short, as a core function of the state it is deemed to require democratic legitimation and not just the 'output' legitimation derived from good outcomes. A further point stressed by Wyplosz (2012) is that rules – despite the rationale of dealing with time-inconsistent politicians – can themselves function in a time-inconsistent manner if they lead to sub-optimal commitments. Even if the motivations of politicians are beyond reproach, targets or rules that lead them to prefer spending or tax options that meet these tests, rather than achieving a wider welfare objective, will have suboptimal outcomes.

In the context of European integration, and especially the governance of the Economic and Monetary Union (EMU), a further, distinct justification for rules is to reduce damaging cross-border externalities. Rules, in this sense, serve as instruments for policy coordination and can be seen as a partial alternative to the explicit re-assignment of fiscal policy competencies to the supranational level. Here, too, there is a complication: with a common currency, monetary policy can only be used to deal with symmetric shocks, with the implication that fiscal policy has to take on asymmetric shocks. Yet the push towards common rules inhibits this use of fiscal policy (Portes and Wren-Lewis, 2015).

The costs of breaching a rule are, in many cases, reputational. But there has been increased resort to embedding the rule in a judicial framework. This can lead to the paradox that a government will change a rule rather than be caught breaking it (Drazen, 2004). Thus, looking at the history of fiscal rules in the US, Bernanke (2010) notes that the attempt to impose rules in 1985 (the Gramm-Rudman-Hollings law passed by Congress with the aim of eliminating the deficit over five years) had to be abandoned because it proved to be unattainable. He attributes this failure to the fact that the rule focused on the deficit, which is only partly under the control of the authorities because it is subject to the effects of unpredictable economic developments. Bergman et al. (2016) find that fiscal rules do result in improved primary balances, but only if there is a strong governance framework at the national level. They also note that because the Fiscal Compact reinforces balanced budget rules and obliges countries to enhance independent scrutiny of fiscal policy, it is likely to reduce deficit bias in the EU. A possible implication of their findings is, though, the paradox that rules seem to work best where they are least needed, because the government is efficient.

EU fiscal rules

Although the long-run evidence on fiscal rules is reasonably persuasive on their success in assuring fiscal sustainability, the resort to rules in the EU has a broader rationale in achieving effective coordination. Critics of the euro have long highlighted the absence of a fiscal stabilisation capacity as a weakness of the Euro Area, among other gaps in what a durable (if not necessarily 'optimal') currency area needs. Under EMU, lacking a federal competence for fiscal and structural policies to complement the supranational monetary policy, various mechanisms of coordination have been established, albeit with a decidedly uneven track-record. The nature of the governance relationship is also a consideration, insofar as it entails the EU level monitoring and setting rules and targets for the national level, rather than subjecting national decision-makers to domestic constraints.

According to estimates by the European Commission of its "fiscal rule strength index", all Member States either increased or maintained the strength of their medium-term fiscal frameworks between 2010 and 2014.[2] Yet, if judged purely by the budgetary indicators of EU Member States today, the verdict on fiscal rules would be pretty negative, even making allowances for the difficult circumstances of recent years which were hardly conducive to strengthening budgetary sustainability. Taking the five-year period from 2012, when the most acute phase of the successive crises ended, there is a mixed picture. Deficits have come down in the great majority of Member States; and in the few cases where they have risen, the governments had the requisite fiscal space to accommodate the increases. However, the public deficits in two of the Euro Area's economies assisted during the euro crisis continues to worry the European Commission and vulnerabilities in several others have been highlighted in the annual country-specific recommendations issued as part of the 'semester' process.

The debt picture is much less positive. In seventeen Member States, the debt-to-GDP ratio increased between 2012 and 2016. The unweighted average of debt ratios in the EU rose by 3.6 percentage points between 2012 and 2016, with increases of 12 points or more in six countries (Greece, Spain, Croatia, Cyprus, Slovenia and Finland). At the other end of the spectrum, the debt ratio in Ireland fell by 31 points. The average debt ratio in 2016 is projected to be 72.3%, having been 68.7% in 2012 and 43% in 2007. Only eleven Member States are projected to have debt ratios in 2016 below the 60% threshold, six of them in central and eastern Europe, along with Denmark, Luxemboug and Sweden. Six countries will still have debt in excess of 100% of annual GDP (Belgium, Greece, Spain, Italy, Cyprus and Portugal); and a further six will be in the range of 80-100% (Ireland, France, Croatia, Austria, Slovenia and UK).

Over the long term, work undertaken by Andrle et al (2015) shows that, despite the many reforms that have taken place in the governance of fiscal policy in the EU, compliance remains disappointing. They note that half of the Euro Area members have missed the 60% debt target more than half the time since 1999 and, while the record on the 3% deficit target is a little better, especially in the 'good times' between 1999 and 2007, Greece and Portugal have missed the target in most years. But the

[2] http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm

politics rather than the economics of compliance arguably give most cause for concern. In the early years of the SGP, the now notorious rejection of sanctions in 2002/3 for breaches of the limits by France and Germany (it is often forgotten that Portugal was also in breach) undermined the credibility of the Pact.

The Kafkaesque outcome of the latest episode of enforcement of EU fiscal discipline, concerning Portugal and Spain, illustrates how tricky enforcement is. Both Member States were found in mid-July 2016 to have done too little to rein in their excessive deficits and should, consequently, have been fined under the rules of the SGP. Yet, as the headline of a press release from the Council of Ministers put it on 8 August,[3] the 'Council agrees to zero fines and new deadlines for Portugal and Spain'. For Spain, the Council found that 'exceptional economic circumstances that would warrant a reduction of the amount of the fine do not exist'. Instead, Spain's efforts to transform its economy were deemed to justify cancellation of the fine.

Four observations are worth making about the lack of adherence to deficit and debt rules. First, and unsurprisingly, the Member States subject to formal macroeconomic adjustment programmes (including Spain which had a limited programme targeted at the banking sector) are in most cases the worst performers, although the extent of the improvement in the exceptional case of Ireland invites caution about drawing too firm a conclusion. Second, the risks to fiscal sustainability in the EU are arguably greatest in a number of Euro Area countries, although the UK is a striking exception. Third, there is no clear indication of a richer/poorer Member State cleavage, nor of a systematic divide between creditor and debtor countries. On the basis of these indicators, the Czech Republic and Estonia are among the most fiscally sound countries, as is Luxembourg; Germany has made great strides in curbing its debt accumulation, but two countries often bracketed with it (the Netherlands and Austria) have not. The fourth, more intriguing, finding is that three of the largest Member States (France, Italy and the UK) as well as Spain have vulnerable fiscal positions, while Germany and Poland look to be in better shape.

The preventive approach: advance scrutiny of budgets

The new procedure (the "two-pack") under which Euro Area countries submit draft national budgets to the Commission by mid-October each year for scrutiny has now been applied four times since the legislation was passed in 2013, providing additional empirical material. In the 2015 assessment (of the budgets for 2016), five countries were deemed to be at risk of non-compliance with the SGP, seven broadly compliant and five compliant, a slight improvement (as measured by the numbers in each category) compared with 2014 (table 1). By contrast, and despite the (admittedly still tentative) improvement in overall macroeconomic conditions, the verdicts for 2016 (concerning the 2017 budget plans) are less favourable. While the same five countries (Germany, Estonia, Luxembourg, the Netherlands and Slovakia) were in line with the obligations they face under the SGP, the number at risk of non-compliance has increased from five to eight (one of which, Cyprus, is assessed for the first time).

At the start of the process, in 2013, only two countries were deemed to be compliant (Estonia and Germany), while three others (France, the Netherlands and Slovenia) were 'found to be compliant, but without any margin for possible slippage, as this would put the correction of the excessive deficit

[3] http://www.consilium.europa.eu/en/press/press-releases/2016/08/08-excessive-deficit-portugal-spain/

at risk'. This second category was not used subsequently. What emerges from the examination of the four annual outcomes is that although some countries are consistently compliant, the process does not seem to be influencing others. Indeed, Spain, consistently in the last category, was highlighted in 2014 as being unlikely to achieve a 'durable correction'.

Table 1 Compliance of planned budgets with SGP

Year Assessment	2013	2014	2015	2016
Compliant	DE, EE	DE, IE, LU, NL, SK	DE, EE, LU, NL, SK	DE, EE, LU, NL, SK
Broadly compliant [or no margin for slippage - only used in 2013]	BE, FR, NL, OS, SI, SK	EE, LV, SI, FI	BE, IE, FR, LV, MT, SI, FI	IE, LV, MT, OS, {FR}
At risk of non-compliance	ES, IT, LU, MT, FI	BE, ES, FR, IT, MT, OS, PT	ES, IT, LT, OS, PT	BE, IT, CY, LT, SI, FI, {ES, PT}
Subject to MAP Not in Euro	EL, IE, CY, PT LV, LT	EL, CY LT	EL, CY	EL

Source: Own elaboration from Commission reports on draft budgetary plans 2017[4]

Key: red text is a deterioration from the previous year; green is an improvement; {countries in square brackets are under the corrective arm of the SGP in 2016}

Assessments of national fiscal rules

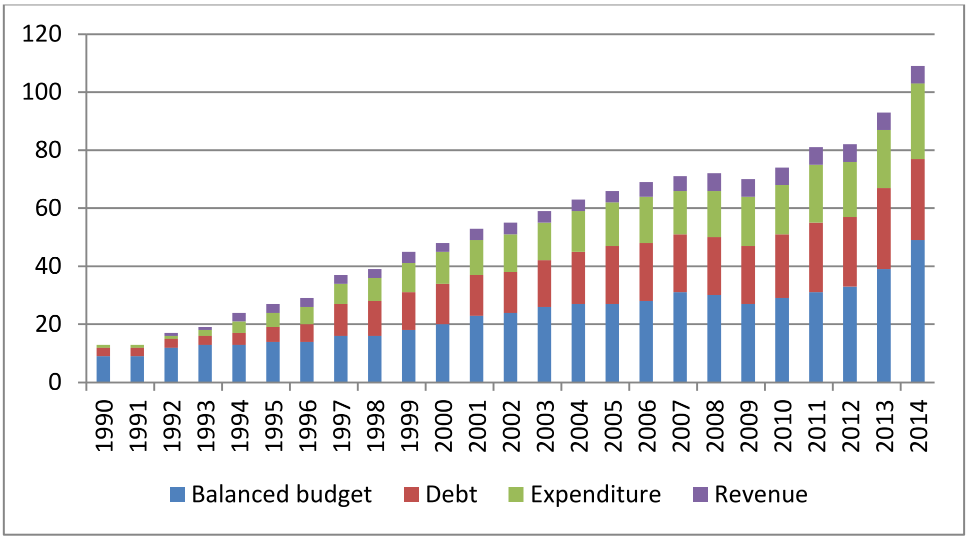
Concerns about the credible enforceability of EU rules (especially the SGP) lay behind the enactment of Council Directive 2011/EU/45 of 8th November 2011 'on requirements for budgetary frameworks of the Member States'. According to Article 2(c) of the directive, a fiscal framework should include 'country-specific numerical fiscal rules, which contribute to the consistency of Member States' conduct of fiscal policy'. Chapter IV of the directive then spells out what is expected. In particular, Article 5(a) stipulates that the national rule should promote 'compliance with the reference values on deficit and debt set in accordance with the TFEU'; in other words, the national rule has to facilitate adherence to the SGP.[5] Although Article 6.2 mentions escape clauses, it states that these should apply only in 'a limited number of specific circumstances' consistent with fulfilling TFEU obligations, and 'stringent procedures' are required if non-compliance is to be permitted.

A figure 1 reveals, there has been a steady rise in the number of national fiscal rules in the EU, such that by 2014 there was an average of four rules per Member State, compared with a total of just twelve in 1990. Most target the current budget balance, but there is also a growing number of rules aimed at restraining debt and setting limits on government expenditure, as well as a few prescribing how unanticipated increases in public revenue should be used. Although there is national discretion in how to transpose the directive, most Member States either already had appropriate legislation or

[4] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/communication_to_euro_area_member_states_2016_dbp_en.pdf is the most recent, published on 16th November 2016
[5] TFEU is the EU's Treaty on the Functioning of the European Union

have now put it in place. Most of the rules are enacted through specific legislation, but some of them are written into constitutions.

Figure 1 **Number of fiscal rules in the EU**



Source: European Commission *Fiscal Rules Database*

In parallel, the steady increase in the number of countries setting up independent fiscal councils (FC) has generated more scrutiny of how governments approach these rules. However, these councils have very varied mandates and some have less independence from government than the EU legislation foresees. An overview by Deutsche Bank Research explains the range of different approaches adopted for these councils, with some taking responsibility for official forecasts, as well as offering opinions on government plans and their execution, while others have a mandate limited to the latter.[6] Fiscal councils should not be confused with audit bodies charged with verifying the probity of public spending, although the function of an FC may be performed by an existing audit body: in Finland, as an example, a division of the National Audit Office carries out the FC mandate.

It is also noteworthy that according to an IMF study (Buva et al., 2015), the short-term nature of restrictions or the fact that the rules have been so prone to revision (the Czech Republic and Slovenia) means that they hardly qualify as fiscal rules. Neither the Czech Republic nor Poland has a fiscal council, and neither country is bound to introduce one because they are not signatories of the 'two-pack'. Slovenia's fiscal council – as a full member of the euro area, it is subject to the two-pack obligation – has been stalled because of political problems, notably the rejection in the spring of 2016 of the government nominees for its membership. There was a consultative council in place from 2009 to 2012, but it ceased operating because of a lack of government support.

Because FCs are, in most cases, also new to the governance framework, only a qualitative review of their assessments is possible, not least because in some countries (such as Spain, or Germany for sub-national government) the new rules are still being phased in. Relevant findings from recent reports issued by fiscal councils nevertheless reveal a number of common features, in addition to

[6] https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000407361/Better_budgeting_in_Europe%3A_What_can_Fiscal_Counci.pdf

confirming the deviations from the SGP rules already identified by Commission monitoring. Key points include:

- Only few of the assessments give a clean bill of health to the respective governments and even some of those use qualifying words in their judgements, signalling that minor deviations are being ignored. An example is Malta where the latest verdict from the *Maltese Fiscal Advisory Council* is that the government's plan 'broadly meets the requirements prescribed in Article 39 (8) of the Fiscal Responsibility Act'. Similarly, according to the *Ufficio Parlamentare di Balancio* (UPB), the deviation from the Italian expenditure rule in 2016 'should not be significant', at barely 0.3% of GDP.
- In several countries (examples are Austria, Slovakia and Spain) the deficit is considered by the FC to be more of a problem than is recognised by the government, and there is particular concern (Finland) about the lack of attention to the MTO. Thus the Austrian *Fiskalrat* judges that both the MTO and the structural adjustment ratio deviate significantly from the rule, whereas the government view is that it is a deviation, but not a significant one.
- As exemplified by Italy, issues of interpretation render judgements difficult, particularly where a country seeks relief from the terms of the SGP, making use of the 'guidance' issued by the Commission.[7] For 2017 and 2018, the UPB nevertheless concludes, somewhat delphically, that budget plans 'do not represent an adjustment path towards the MTO that is consistent with the current interpretive framework of the European fiscal rules as transposed in Italian law'.
- Some Member States have fiscal positions, especially on public debt, much more favourable than the new rule (Bulgaria and Lithuania, for example) .
- Expenditure rules seem to be less binding (the Romanian *Consiliul Fiscal* calls them 'soft') than the hard rule of the deficit ceiling. Where, as in Sweden, the government has undertaken to fund any increase in spending by raising extra revenue, there can be concerns: the *Finanspolitiskaradet* qualified its 2016 verdict and finds[8] that both the fiscal balance and the absence of a commitment to fund unexpected expenditure mean that Sweden is in 'breach of the fiscal framework'.
- Expenditure rules often cover only a proportion of public spending, adding to the scope for ambiguity. Thus, the Finnish National Audit Office is critical of the amount of expenditure outside the spending limits, which accounts for just under 30% of total government outlays.
- There are instances of disagreement about the interpretation of expenditure rules, implying a lack of certainty (and hence transparency) in the application of the rule (Ireland, Spain).
- Several FCs draw attention to implausibly optimistic assumptions by governments (Portugal, Ireland). For example, the *Irish Fiscal Advisory Council*'s own projections of the future fiscal balance are more cautious than those of the government, with the government expecting revenue to be more buoyant than the Council deems prudent.
- The intensity of criticism varies, raising questions about how much notice is taken of findings that governments are ignoring rules. The *Haut Conseil des Finances Publiques* (HCFP) notes[9] that estimates of the structural deficit in France built in to the draft budget for 2017 are lower than those published by international organisations and that the government's growth forecasts are

[7] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
[8] www.finanspolitiskaradet.se
[9] file:///H:/Avis_nHCFP20163_PLFPLFSS.pdf

on the optimistic side. The HCFP also argues that the government forecast is less prudent than in the two previous years and, in what press commentators consider to be an unprecedentedly severe verdict, doubts the ability of France to meet its obligations under EU rules. Conversely, in Belgium, the most recent opinion of the *Conseil supérieur des finances* describes as moderate the shortfall in attaining the MTO in 2015, noting the special circumstances associated with the influx of refugees in allowing the deficit to grow.[10] But the report does not go much further than largely agreeing with the analysis of the European Commission.

- One explanation is ambiguity about how rules should be applied. In Spain, the government claims that non-compliance in a single year does not need to be corrected in the subsequent year. For *AIREF*,[11] this is considered not only to be inconsistent with the EU definition of an expenditure rule, but also to distort 'the objective of any international rule of fiscal discipline in public expenditure'. *AIREF* notes further that the debt trajectory is not compliant with the rules and ascribes some of this to inappropriate rules for sub-national authorities.
- More generally, the FC assessments highlight methodological differences – both with their respective governments and, in some respects, with the approach advocated by the European Commission – in relation to the best way of calibrating the output gap, validating forecasts and projecting expenditure growth. In Slovakia, for example, the *Council for Budget Responsibility*[12] explains why its output gap estimate differs from that of the Ministry of Finance, with the latter consistently higher.
- Several FCs complain of slow or incomplete provision of necessary data and overly compressed timetables for key assessments (Spain, Ireland, Sweden), although evaluation work on Ireland (Jonung et al., 2015) suggests that ministry officials dispute elements of these criticisms. In Italy, the UPB says its work is hampered because budget projections are based on the assumption of unchanged policies and not the planned level of spending (as the relevant law seems to demand).
- In some cases (examples are Estonia, Lithuania and Sweden), the FC suggests how government should go beyond the existing rule, as in this statement from the Estonian one: 'the Fiscal Council recommends that a state budget be passed that sets a target of a small structural surplus for 2017'.[13]
- From a different angle, Italy is an intriguing case because of the successive requests from its government to be allowed to deviate from the EU rules. The UPB assessment appears to regard the breaches of rules as to be expected and is muted in its language (similar reticence is in evidence from the Belgian FC).

Rules on non-fiscal imbalances

In principle, the strengthening of surveillance of macroeconomic imbalances other than in the fiscal policy domain is one of the key governance innovations of the last few years, with the potential to engender a more rounded approach to the oversight and coordination of national policies. By embracing much the same procedures as the SGP, including the resort to legal instruments and the

[10] http://www.conseilsuperieurdesfinances.be/sites/default/files/public/publications/csf_fin_2016_07.pdf

[11] http://www.airef.es/en/contenidos/informes/732-report-on-compliance-with-the-budget-stability-and-debt-targets-and-with-the-expenditure-rule-2016-by-the-different-public-administrations

[12] www.rozpoctovarada.sk, Council for Budget Responsibility (CBR) in English

[13] http://eelarvenoukogu.ee/files/2016_Opinion_%20Summer_Forecast.pdf

possibility of sanctions, the EIP can be thought of as adding to the rules-based approach to macroeconomic policy. These parallels inevitably prompt similar questions about effectiveness.

An overview of imbalances in 2015 (European Commission, 2015) points to improvements in some areas, but notes the emergence of new problems in others, notably in external liabilities. It attributes reduced current account deficits more to falls in demand for imports, associated with lower GDP, than improved competitiveness, while the large surpluses observed in some countries are associated with weak investment rates. The overview calls for 'more symmetric rebalancing' (European Commission, 2015: 5), alongside more effort to deal with structural weaknesses, including the legacy of high private debt. In appealing to 'systemic countries' to use their 'available fiscal space', the report seems to come as close as is politically feasible to demanding that Germany do more to boost domestic demand in the wider EU interest. However, although the scrutiny of imbalances is now into its fourth year, it is questionable whether it is having much effect on Member State policies.

Although there has been repeated tweaking of the approach to surveillance, now encompassed within the European semester, it consists of three main steps. First, the Commission examines a range of indicators (the 'alert mechanism') to identify potential imbalances, making use of numerical thresholds, such as the extent of an external payments deficit or (importantly) surplus. Second, for those Member States in which there is prima facie evidence of imbalance, an 'in-depth review' (IDR) is then conducted. The third stage is for the Commission to assess the extent of the imbalances and, if deemed sufficiently serious, to recommend corrective action (potentially backed by financial sanctions for failing to deal with the imbalance). Table 2 provides an overview of the verdicts in three annual cycles.

Table 2 Assessments of macroeconomic imbalances, based on in-depth reviews

<table>
<tr><th></th><th>2014</th><th>2015</th><th>2016</th></tr>
<tr><td>Excessive imbalances with corrective action plan</td><td>NONE</td><td>NONE</td><td>NONE</td></tr>
<tr><td>Excessive imbalances which require specific monitoring and continuing strong/decisive policy action</td><td>SI</td><td></td><td rowspan="2">BG, CY, FR, HR, IT, PT</td></tr>
<tr><td>Excessive imbalance which require specific monitoring and strong/decisive policy action</td><td>HR, IT</td><td>BG, FR, HR, IT, PT</td></tr>
<tr><td>Imbalances which require specific monitoring and strong/decisive policy action</td><td>IE, ES, FR</td><td>IE, ES, SI</td><td rowspan="3">DE, IE, ES, NL, SI, FI, SE</td></tr>
<tr><td>Imbalances require monitoring and strong/decisive policy action</td><td>HU</td><td>DE. HU</td></tr>
<tr><td>Imbalances require monitoring and policy action</td><td>BE, BG, DE, NL, FI, SE, UK</td><td>BE, NL, RO, FI, SE, UK</td></tr>
<tr><td>No imbalances</td><td></td><td></td><td>AT, BE, EE, HU, RO, UK</td></tr>
<tr><td>In adjustment or BoP programme (hence no in-depth review)</td><td>CY, EL, PT, RO</td><td>CY, EL</td><td>EL</td></tr>
</table>

Source: own elaboration from European Commission web-site

In the 2016 cycle, the Commission simplified the classification of imbalance to four categories, albeit with no Member State placed in the most severe one in which a corrective action plan is required. Instead the countries subject to IDRs are split three ways into those with 'excessive imbalances', those with 'imbalances' and those found to have 'no imbalances'. Four Member States previously found to have the lowest class of imbalances are now deemed to have no imbalances and two countries newly subject to IDRs are also found to have no imbalances.

The judgements for 2016 will, or should, raise many an eyebrow. In 2015, the UK was described as having a shortage of housing expected to persist and to 'continue to deserve attention'. Its current account deficit was identified as a problem in 2015 (as it was also in 2014) and remains well above the 4% threshold. Yet just a year later, the verdict on the UK was 'no imbalances'. Even if, as might be imagined, this was for political reasons, it signals that imbalances can be swept under the carpet when expedient. For Sweden, in 2015 and again in 2016, high private debt and housing were seen as sources of imbalance, featuring as the one and only country-specific recommendation addressed to a country in the 2016 cycle. The contrast with the UK in interpretation is striking.

Germany and France were both graded more severely in 2015 than in 2014, yet even though the German external surplus in 2016 was marginally higher than in previous years (and bearing in mind the cumulative effect of a persistent surplus, as well as projections that the surplus would creep higher still), Germany remains classified as being merely in imbalance, rather than excessive imbalance or a demand for corrective action. As with the SGP, doubts can be expressed about whether the economics behind the EIP are well-conceived, but from a governance standpoint, the inconsistency in application and the political over-ride that seems to occur does not inspire confidence.

Discussion

'Useless laws weaken the necessary laws' Montesquieu, *The Spirit of the Laws*

There may be something of a paradox around rules, namely that they are not really needed in countries in which institutions are strong enough to ensure sustainable fiscal and other economic policies, but do not work where needed because institutions are weak. Rules can, however, be inappropriate for a plethora of reasons, giving politicians a pretext for being dismissive of them. Indeed, in a prescient warning, Bayoumi and Eichengreen (1995: 46), drawing on analysis of US experience of stricter rules, argued that rules preventing national governments from using fiscal policy to counter cyclical movements would result in 'less fiscal stabilization and … greater output volatility'. Rules can be so pro-cyclical, especially in periods of economic slowdown, that they become economically perverse by entrenching stagnation, yet also provide too little incentive for fiscal retrenchment in good times. Exceptions to rules or deviations from their implementation, on the other hand, can weaken their rationale, while creative accounting can undermine the application of rules, while possibly also distorting priorities.

However, just testing whether rules are complied with neglects the fact that they often tug fiscal policy towards the target enshrined in the rule: the speed limit on the road may be 120 kilometres per hour (kph), the observed average speed may be 130 kph, but the instances of 150 kph or more are rare. In this sense, the presence of the rule has an impact missed by looking only at full compliance. The examination of EU fiscal rules by Reuter (2015) yields convincing evidence of their restraining effect on the extent to which governments allow fiscal positions to deviate from targets, even though rules were only complied with in about 50% of the years he studied. His results do, however, have to be qualified because the dataset he uses excludes a sizeable number of 'rules' identified elsewhere because they are, for one reason or another, either less legally binding or the data do not allow them to be tested. His results therefore relate mainly to the 'harder' rules in place, but they nevertheless offer interesting lessons. Breaches of expenditure rules, for instance, did not elicit reactions from governments, in contrast to debt and balanced budget rules.

Moreover, the extent of overlap of rules makes it awkward to evaluate the success of any individual rule – see for example the complex interplay described by Guerguil et al. (2016). These authors find that there is great variation in the link between fiscal rules and counter-cyclicality, with rules that are investment friendly or include other exemptions more likely to avoid pro-cyclicality. However, exemptions increase the risk of creative accounting being used to circumvent rules. There is also doubt about whether EU rules have the same resonance as national rules. Kopits (2012: 152) asserts that 'contrary to earlier beliefs, a supranational framework, such as the EU Stability and Growth Pact, can serve merely as an envelope for national fiscal rules, but cannot be a substitute for them'. He goes on to argue that home-grown rules, arrived at as a result of a broad consensus among domestic actors, are an essential part of fiscal discipline – implicitly criticising the initial insistence in the EMU policy framework on top-down policies. He also condemns weak enforcement at EU level.

Lucio Pench of the European Commission, in thoughtful comments at a Bank of Italy seminar[14], observes 'that it is practically impossible to infer from the texts of the SGP how the rules will be applied to concrete cases without a detailed knowledge of' the various documents issued by the Commission. He also refers to the 'uneasy co-existence' between the political and judicial elements of the framework, and describes how the lack of a central authority both explains the complexity of EU rules and undermines enforcement, with a lack of trust exacerbating the problems. Fabrizio Saccomanni, in comments at the same meeting, echoes Pench's concerns about trust but also identifies a further paradox that, despite more extensive rules, 'discretion has also increased'.

Other paradoxes of the increased reliance on rules in EU governance can also be identified. As Debrun et al. (2008) show, the kind of rules affects whether or not they are pro-cyclical, with balanced budget rules likely to amplify cycles, whereas expenditure and revenue rules are more likely to be counter-cyclical. Often, it is not the rule per se that matters, but how the triggers for sanctions interact. In normal(ish) times, the interplay may not matter much, but if a budget balance deteriorates sharply because of an economic downturn (whether cyclical or structural), it is more likely to lead to breaches of rules. The ensuing double paradox is that the rule bites most when it is least appropriate, yet as exemptions become more logical, the very basis of rules is undermined.

Concluding remarks

'Slow delivery on promises made is a phenomenon that more and more risks undermining the Union's credibility' – Juncker, 2016 State of the Union address

There has been extensive, if not always fully appreciated, recasting of economic governance in Europe since the financial crisis in 2007-9 and, more so, since the euro crisis from 2010 onwards.

14 http://www.bancaditalia.it/pubblicazioni/collana-seminari-convegni/2016-0020/Beyond_the_Austerity_Dispute_-_New_Priorities_for_Fiscal_Policy.pdf

Although disputes about the underlying economics rumble on, there is a logic to the overall architecture and some of the reforms undertaken have been bolder than is customary for a Union not renowned for its decisiveness and ability to see the bigger picture. The reforms have also corrected some of the shortcomings in EMU, though more remains to be done. The new policy framework is, nevertheless, open to the criticism that it entrenches one view of an optimal approach to macroeconomic governance – notably reliance on rules – at the expense of others.

In reviewing its role in Euro Area fiscal surveillance, Kopits (2016: 9) finds that the IMF relied too much on the EU, but also that although some of the recent EU reforms are well intentioned and the numerical rules sound, 'the difficulty of measuring these metrics in real time can render them ineffectual'. His comments reflect a longstanding concern about EU economic governance that implementation rarely lives up to expectations. Some slippage may be built into the design or into the mechanisms of operation, but what is more damaging is the propensity for rules either to be ignored or regarded as tangential to policy priorities. The evidence on post crisis compliance with both fiscal rules and expectations on macroeconomic imbalances is not encouraging. It suggests that discipline emanating from 'Brussels' has too little effect and, as a direct consequence, will not result in the extent of coordination of policy considered necessary for EMU.

At the EU level, episodes such as the 2002/3 one involving France and Germany or the 2016 decisions on zero fines for Portugal and Spain can, at a stroke, undermine commitment, with the attendant risk of rendering the rules ineffective. Such politically approved breaches mean that in the absence of unambiguous automaticity in implementation, even the most cleverly conceived rules will not achieve their aims. If, in addition, governments actively search for ways around rules, be it through statistical fudging, redefinitions of coverage or the meaning of a cycle, let alone explicit use of escape clauses, the very philosophy of rules as an approach to tie the hands of governments will progressively lose conviction.

An unanswered question is whether any restraining effect of fiscal rules is enduring. More generally, fiscal rules or supply-side rules may be vulnerable to a variant of Goodhart's Law, asserting that as soon as a variable is targeted for policy purposes, it becomes unfit for purpose. Potential solutions to such shortcomings are partly to be found in judicious design and careful attention to the incentives facing governments, but other political economy dimensions of rules, especially their enforcement and acceptability to the public, also have to be given attention. The extent of breaches of rules identified in this paper suggests these shortcomings may be intractable.

Rules-based governance in the EU may, therefore, have reached its limits because of the many shortcomings in the approach, with the implication that something more or different is needed. As Larch (2016: 4) has argued, things might have been worse had rules not been adopted, but 'when push comes to shove, adherence to and enforcement of the commonly agreed EU fiscal rules remains imperfect at best'. National rules might fare better if, as Kopits (2012) believes, they stand a greater chance of securing a consensus among national actors, but the evidence on implementation presented in this paper is not encouraging. It suggests that quite apart from technical questions of the optimal design, the natural instinct of governments is to find ways of maintaining their scope for discretion. Even if the existence of a rule does inhibit excess, political economy arguments point to a gradual weakening of commitments to respect rules.

Is there another way? Larch (2016) makes the interesting suggestion of separating the stabilisation function of fiscal policy from its distributive and allocative ones. Plainly, the macroeconomic dimension of fiscal policy cannot be wholly divorced from its distributive role, but very different mixes of allocative and distributive outcomes are conceivable within the same stabilisation parameters. His proposal is that an independent body, perhaps the fiscal council, should decide on the fiscal stance, leaving the composition of taxes and spending for political decision. There would be formidable problems of accountability and, even more so, of legitimacy, but these also arise with rules and if the latter fall short of, or seem incapable of, achieving the desired economic outcomes, then a second-best may be an improvement.

Fundamentally, though, the EU faces the dilemma that reliance on fiscal and other rules is not enough to assure sustainable macroeconomic stability in a context in which politicians are not only adept at circumventing them, but garner popular support for doing so.

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