Rethinking the governance of economic and monetary union: Should rules continue to rule?

Although the EU economy has returned to a period of stable growth since the Eurozone crisis, several key issues in the governance of economic and monetary union remain unresolved. Drawing on results from the Firstrun project, **Iain Begg** *provides an overview of current concerns and outlines five recommendations to help further the debate.*

The turbulent times of the last decade have prompted a wide-ranging reassessment of the architecture, principles and governance of economic and monetary union (EMU). Although the EU economy is showing welcome signs of returning to more stable growth and there is a consensus that the reforms to date have ushered-in a more robust and resilient framework, many key issues remain to be resolved. In particular, shortcomings in the hitherto dominant rules-based approach have prompted a search for new solutions. Among the concerns are:

- The continuing bias towards pro-cyclicality of the rules
- The absence of incentives for tighter fiscal policies in good times, capable of building buffers against future downturns
- The lack of emphasis on public investment
- The definition and application of escape clauses. These are both necessary to provide flexibility, yet often susceptible to manipulation by governments and even the possibility of governments shifting the blame to the EU level for unpopular, though economically sound, policies.

This article summarises some of the principal messages from a longer policy report, itself an overview of policy-relevant findings from several of the contributors to the *Firstrun* project. It focuses on three main themes: fiscal and other macroeconomic policy rules; the scope for Fiscal Councils to enhance governance and the ensuing risks; and the imperative of achieving better legitimation of the processes and mechanisms.

Key messages on rules

Much of the academic interest in rules has been on their design and the importance of well-aligned incentives, but a broad consensus is that the EU system of fiscal rules has become too complicated and that they are too prone to lead to inappropriate policy prescriptions. Doubts have grown about the economics behind rules, not least where they have led to fiscal policy tighter than was warranted at a time of enduring stagnation. More specifically:

- Despite efforts to refine rules and to extend their reach, notably to include sources of imbalance other than public finances, they are dogged by shortcomings in compliance.
- The success of fiscal rules is open to doubt. Although headline deficit indicators have improved markedly, public debts have not. However, it may be that rules deter governments from exceeding target thresholds by as much as they might otherwise do.
- Commission scrutiny of ex-ante compliance with the Stability and Growth Pact in national budgets reveals a persistent risk of non-compliance by a number of Member States.
- In the early-warning stage of the macroeconomic imbalances procedure (MIP), insufficient account is taken of the heterogeneity of national circumstances. The policy implication is that the process could be made more effective by selecting indicators best-suited to capture specific national risks.
- A more fundamental question is whether the whole MIP process can be made more relevant to national policy-making. If not, it is open to the charge of irrelevance and an implication is it might as well be discontinued.
- The project's findings raise concerns about the political economy factors affecting the implementation of rules, as opposed to their design. Evidence from *Firstrun* case studies suggests a more insidious political economy dimension to these concerns, namely the perception that enforcement is avoided when it becomes politically inconvenient.
- The policy implication is that, although rules are potentially useful where governments struggle to adopt time-consistent policies, their effectiveness depends on the quality of implementation.

Rules will undoubtedly continue to be part of the EU economic governance framework, but an over-arching message from this report and, more generally, from the Firstrun project is that reliance on them will not be enough to guarantee sustainable public finances, let alone macroeconomic stability. Other implications include:

- Where rules and other facets of governance risk accentuating not just economic problems, but have adverse social consequences, they should be revisited, irrespective of the aggregate macroeconomic arguments.
- Debt rules in particular should be reconsidered, because they too readily neglect the asset side of the public balance sheet, militating against the kinds of public investment that might be used to restore underlying growth performance.
- Given that private risk sharing can play a significant role in attenuating asymmetric shocks, the balance between the market and governments in the governance of the euro may need to be both recast and better regulated.

Key messages on Fiscal Councils

Among recent governance reforms was the expectation that independent Fiscal Councils charged with monitoring fiscal sustainability would be introduced. Nearly all Member States now have these bodies and there is also now a European Fiscal Board which advises on, *inter alia*, the euro area fiscal stance. The role and influence of Fiscal Councils has been examined in *Firstrun* research from two perspectives: how they have affected policy-making and whether they add to concerns about the legitimacy of governance developments. Because, in many cases, they have only recently been established, assessments have to be tentative, but key points include the following:

- Fiscal Councils tend to be more cautious than governments in their assessments of fiscal conditions, but their influence is varied, depending on the national context.
- If they prove to be systematically too pessimistic, the councils' credibility may be undermined – what might be called the *'crying wolf'*
- How effectively Fiscal Councils communicate with other stakeholders varies: some have been able rapidly to become prominent in national public debates, including being solicited by the media, while others struggle for oxygen.
- This '*political relevance*' risk could be compounded if governments are also able to place obstacles in the path of the councils, such as by restricting access to data or providing too little time or too few resources to enable the council to function effectively.
- A third worry is more pernicious: governments may actively seek to neutralise the council. In this regard, the appointments process matters: if governments or the political parties behind them are able to pack the council with members expected to be less willing to be critical, the benefits of independent scrutiny will be jeopardised.
- What might be called an '*emasculation*' risk has already been seen in Hungary, and *Firstrun* case studies found anecdotal evidence of other councils in danger of being compromised in this way.
- A particular sensitivity is how to factor Fiscal Councils into legitimation and accountability.

Legitimation challenges and the fiscal constitution

The need to reconcile legitimation and effective governance has repeatedly been acknowledged – not least as one of the four pillars of both the Four and Five Presidents reports, but solutions have been difficult to find. The root problem is to reconcile the desire for collective discipline, portrayed as being in the common interest, with national autonomy and democratic choice, so that:

- Seeking further to redesign or recalibrate rules as the cornerstone of EMU reform is likely to offer a false prospectus. Instead, what is needed is better definition of the EU's fiscal constitution and, within it, of how the different elements of public finances – including the EU budget and any new fiscal capacities – are brought together.
- Rules may still have a place but a more limited one and, because of the implicit contract between voters and tax-payers, on one side, and decision-makers on the other, the political dimension of fiscal policy has to be centre-stage.
- Even if rules can be well-designed and offer adequate incentives to Member States, they will struggle if enforcement is lax. A solution may be to opt for national rules on the grounds of 'ownership': unless national policy-making systems, the decision-makers central to them and national electorates have a stake in making rules work, they are likely to be ineffectual.

Recommendations

> *'You cannot run a single currency on the basis of rules and statistics alone. It needs constant political assessment, as the basis of new economic, fiscal and social policy choices' – Jean-Claude Juncker*

Many contributions to the debate on the future of EMU governance have sought to find ways to balance the sharing of risks and the control of risks in the policy framework. A recent example is the 'Saint Nicholas' package of proposals from the European Commission for a series of initiatives to deepen EMU, through assorted measures to improve the institutional mix. A further high profile intervention was by the group of fourteen French and German economists proposing a compromise approach aimed at bridging the long-standing differences between advocates of risk sharing and risk controlling. Unsurprisingly, the latter has elicited conflicting reactions.

The following recommendations, derived from the *Firstrun* findings, are put forward to further the debate and to emphasise the importance of reconciling what is economically desirable with what is politically feasible. Two underlying messages are that neglect of the political economy dimensions of governance reform would be perilous and there should be greater urgency in arriving at solutions.

Recommendation 1*: the proliferation and complexity of fiscal rules should be rationalised with the emphasis placed on debt sustainability and on national rules.*

Recommendation 2*: institutional relationships which are crucial to the implementation of rules should be recast to ensure a better balance between enforcement, compliance and appropriateness.*

Recommendation 3*: recognising that the macroeconomic imbalances procedure is having only a limited impact on national policy choices, it may be better to revert to softer forms of coordination, with a greater emphasis on carrots than sticks.*

Recommendation 4*: Fiscal Councils can become significant actors in economic governance, but their role within the governance framework has to be better developed and integrated with the surveillance emanating from the EU and international institutions. Efforts have to be made to strengthen the legitimacy of councils.*

Recommendation 5*: although legitimacy concerns around the evolution of governance have repeatedly been highlighted, they have yet to be adequately addressed and should be accorded higher priority.*

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Note: This article is based on a policy brief which draws results from the Firstrun project. It gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Andrés Nieto Porras (CC BY-SA 2.0)

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