In-depth analysis

Euro-area fiscal stance: definition, implementation and democratic legitimacy

External authors: Esther Ademmer, Claire Boeing-Reicher, Jens Boysen-Hogrefe, Klaus-Jürgen Gern, Ulrich Stolzenburg

Kiel Institute for the World Economy

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Claire Boeing-Reicher
Jens Boysen-Hogrefe
Klaus-Jürgen Gern
Ulrich Stolzenburg
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Abstract

In its current approach to achieve an appropriate euro area fiscal stance, the EU Commission asks countries with fiscal space to provide extra stimulus in order to compensate for countries that are constrained by debt sustainability considerations. However, the aggregate fiscal stance is not a particularly useful concept since it abstracts from too much relevant information at the country level. In particular, excessive stimulus in one country is likely to generate welfare losses there, since this may compromise fiscal sustainability and/or cause its economy to overheat. Additional spending in one country can help other countries only if (1) there are significant trade spillovers and (2) monetary policy does not respond to the increase in economic activity. Even then, the composition of national fiscal policies may be inappropriate, since additional spending may be called for in countries where it is not needed. To overcome these problems would entail moving towards a fiscal union (e.g. by implementing a cyclical risk-sharing mechanism), which can potentially loosen fiscal restrictions, but introduces risks of moral hazard and persistent one-sided transfers.

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AUTHOR(S)

Esther Ademmer
Claire Boeing-Reicher
Jens Boysen-Hogrefe
Klaus-Jürgen Gern
Ulrich Stolzenburg
*Kiel Institute for the World Economy*

RESPONSIBLE ADMINISTRATOR(S)

Jost Angerer
Economic Governance Support Unit
Directorate for Economic and Scientific Policies
Directorate-General for the Internal Policies of the Union
European Parliament
B-1047 Brussels

LANGUAGE VERSION

Original: EN

ABOUT THE EDITOR

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E-mail: egov@ep.europa.eu

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LIST OF ABBREVIATIONS

EA    Euro Area
ECB   European Central Bank
EMU   European Monetary Union
EFSI  European Fund for Strategic Investments
EP    European Parliament
ESM   European Stability Mechanism
EU    European Union
GDP   Gross Domestic Product

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EXECUTIVE SUMMARY

- The fiscal stance is defined according to business cycle stabilisation criteria, but it is judged according to both business cycle stabilisation criteria and fiscal sustainability criteria. Fiscal (i.e. debt) sustainability is a national responsibility and, so far, only national authorities can conduct fiscal policies.
- Therefore, the joint fiscal stance is not a useful concept, since this abstracts from too much relevant information at the country level.
- If debt sustainability at the country level were no problem, then all Member States could conduct fiscal policy according to their own cyclical needs. If all countries had the same view on this, and if spillovers were small, then the desired joint fiscal stance would arise without additional measures.
- However, some countries are restricted in their ability to react counter-cyclically to economic downturns, since debt sustainability concerns and fiscal rules do not allow for a more expansionary fiscal stance. The extent of this problem can be measured by looking at the aggregation of national fiscal stances, which became restrictive during the euro area recession of 2012 and 2013.

The current EU approach:

- The EU Commission asks countries with sound debt positions to provide extra fiscal stimulus (currently the case with Germany). This stimulus is intended to loosen the joint fiscal stance and to indirectly help countries that cannot afford a more expansionary fiscal stance. However, the EU Commission has no budgetary power to accomplish this directly.
- However, countries with sound debt positions have little incentive to do this. This is because additional stimulus in a country beyond its own business cycle needs is likely to generate welfare losses there, by compromising fiscal sustainability and/or causing the economy to overheat. Pushing the economy into a state of overheating could set the seed for a future crisis, while at the same time reducing the future fiscal space needed to help smooth the adjustment process. Furthermore, requiring boom countries to engage in more fiscal stimulus will induce more business cycle divergence among euro area members.
- Does this approach at least help other countries? This depends on the size of spillovers and the responsiveness of monetary policy, the latter of which affects all euro area members. If trade spillovers are low, but monetary policy is responsive, then stimulus in one country may even exert a contractionary effect on other countries due to tighter monetary policy.
- Additional spending in one country can help other countries in a narrow environment: if (1) there are significant trade spillovers and (2) monetary policy does not respond substantially to the increase in economic activity. Moreover, (3) such a policy appears reasonable only in a situation where monetary policy does not successfully stabilise euro area output. Even if these conditions are fulfilled, the composition of national fiscal policies may still be inappropriate, if additional stimulus is carried out in countries where it is not needed.
- As a result, targeting an aggregate fiscal stance will be politically contested in some euro area members and is unlikely to become legitimated by simply claiming to represent a more efficient approach to euro area fiscal policy-making. The current and proposed approaches to euro area fiscal policy-making are not transparent and do not strongly involve bodies that are directly legitimated, (such as the European Parliament). As a result, there are substantial concerns about democratic legitimacy.

What else could be done?

- Less restrictive fiscal rules could help only to a limited extent as they would not remove restrictions of national fiscal policies caused by concerns over debt sustainability, which are at the heart of the asymmetries.
- A joint budget to support fiscal stabilization policies could be created, to be financed by member state contributions. Support would be granted to countries hit by asymmetric shocks.
The activities of such a central fiscal authority could both involve redistribution between Member States (net transfers) and redistribution over time (net lending).

- Resources from this joint budget could either be used directly (centralized spending decisions), or acquired funds could simply be redirected to Member States (national spending decisions). The latter is preferable in our view.

- In theory, a stabilization fund that allows for net transfers could help to partly loosen the fiscal restrictions faced by some Member States during crises and to better synchronize business cycles, since transfers constitute an additional source of spillovers. Moreover, a fiscal authority that redistributes funds intertemporally in response to euro-area-wide recessions might be considered useful in an environment where monetary policy is ineffective at stabilizing output. However, several problems arise:

1. The stabilization mechanism would have to address only genuine cyclical risks, despite the fact that output gaps are poorly measured, and assessment of cyclical needs would become an even more contentious issue;
2. Asymmetric shocks can be the result of bad policies, which might trigger net transfer inflows (moral hazard).
3. Net transfers to crisis countries run the risk of reducing the pressure to conduct appropriate structural reforms to address the fundamental causes of the crisis. Transfers also weaken market forces that help to overcome macroeconomic imbalances. Therefore, a risk-sharing mechanism may perpetuate structural problems and trigger permanent transfers in one direction.
4. A stabilization fund reduces the need for national policymakers to cushion macroeconomic shocks themselves. Therefore, incentives to reduce high debt levels (and to seek fiscal space) could be damaged.

- In a fiscal framework that gives more responsibilities to the euro area level, the assessment, determination, and implementation of an appropriate aggregate fiscal stance would require a process that is transparent and responsive to euro area wide political preferences. Such a process is unlikely to be achieved in the current fiscal coordination framework; instead it would require an encompassing institutional reform of the EU.
1. INTRODUCTION

Of the three textbook functions of fiscal policy – allocation, distribution, and stabilization, stabilization gives the main justification for considering fiscal policy at the euro area level. Traditionally the objective of fiscal policy in a state is threefold (Musgrave, 1959): providing public goods (allocation), organizing transfers between individuals or regions to implement a desired secondary income distribution and to foster economic cohesion (distribution), and smoothing economic activity over the business cycle (stabilization). However, the unique and complex institutional structure of the European Union complicates the interpretation and conduct of fiscal policy along these lines. With respect to allocation, the euro area represents only a part of the European Union and most public goods are not specific for this group of countries. Obvious candidates for European public goods relate either to the whole EU (such as infrastructure, research, and diplomacy), or to a different subset of countries (such as expenditures associated with security, border controls, and refugee policy for countries in the Schengen area).¹ Financial stability, which could be considered an EMU-specific public good, is handled by the ESM and by the ECB. Meanwhile, with respect to distribution, fiscal systems that redistribute personal income are provided at the national level, and there already exist European-wide interregional transfers to make up for geographical or historical disadvantages and improve convergence. These transfers are organized by the European Union as a whole using structural funds, regional funds, or cohesion funds. What remains is the issue of stabilization.

There may be demand for active stabilization policies throughout the euro area, when euro area monetary policy is ineffective. Normally, monetary policy should be expected to be the main instrument of aggregate stabilization policies for the euro area, at least as long as counter-cyclical monetary policy is consistent with the ECB’s mission to achieve price stability in the medium term. Meanwhile, national fiscal policies would be responsible for smoothing country-specific business cycles, either through automatic stabilizers or discretionary anti-cyclical policies. This would imply expansionary fiscal policies in countries facing a downturn relative to the euro area aggregate but restrictive policies in countries facing an upturn. This pattern would automatically deliver an appropriate aggregate fiscal stance in the euro area. However, there may be situations in which monetary policy is ineffective or is otherwise unable to provide sufficient stimulus to get the aggregate euro area economy out of a slump, such as in recent years with interest rates at the zero lower bound (Gern et al. 2015a). Then fiscal policy would have to step in.

If some countries are restricted in their ability to react counter-cyclically to economic downturns, this will prevent an appropriate fiscal stance from emerging. Debt sustainability considerations and fiscal rules may not allow for the appropriate expansionary fiscal policy stance at the national level; and may even prevent automatic stabilizers from operating properly. This has been the case during the recent sovereign debt crises. In 2012 and 2013, financial markets pushed the crisis countries into pro-cyclical fiscal tightening in order to promote fiscal sustainability.² At the same time, the non-crisis countries have not engaged in an offsetting fiscal expansion. As a result, the aggregate fiscal stance became contractionary and pro-cyclical (see Figure 1).

This uneven fiscal contraction has motivated the debate about how (or if) to enforce an “aggregate fiscal stance” in the euro area. Since 2012, the European Semester’s recommendations have included a recommendation on the aggregate fiscal stance, although there is no specification as to what this would look like (Darvas and Leandro 2015: 11). The notion of the aggregate fiscal stance has been introduced into the regulation on monitoring and assessing national draft budgetary plans in the European Semester cycle (Article 7). This notion has also been addressed in the annual growth survey of 2016 (annual policy priority report by the EU Commission), and has been emphasized by ECB president Mario Draghi (2014). In addition, advising on the appropriate aggregate fiscal stance is one of the main tasks assigned to the newly established Advisory European Fiscal Board.

¹ The categorization of defense expenditures is complicated by the fact that not all EU countries are NATO members.
² The perceived lack of sustainability of public finances in part induced a reassessment of potential output as a consequence of the crisis.
We argue that the joint fiscal stance is not a reasonable measure of fiscal policy in the euro area. This is the case because business cycle needs as well as fiscal sustainability are primarily relevant at the national level. As long as heterogeneity in the business cycle between Member States is large, while spillovers are low, it makes more sense to look at national fiscal stances. Additional fiscal stimulus in one country beyond its cyclical needs can be expected to generate welfare losses in that country, while effects on euro area-wide welfare depend on the size of total spillovers. Only sufficiently large spillovers would make it reasonable to discuss the euro area aggregate fiscal stance. However, even then, the composition of fiscal policies may be inappropriate, since additional spending may be called for in countries where it is not needed.

We discuss the following main points: a meaningful application of the concept of a euro area aggregate fiscal stance would require (1) that the aggregate fiscal stance is a reasonable measure of fiscal policy in the euro area, (2) spillovers of national fiscal policies on economic activity of other countries that are large enough to justify systematically intervening in national fiscal policies, (3) and that implementation is possible and democratically legitimate. In Section 2, we evaluate how the fiscal stance is measured and evaluated, and we discuss problems of measurement and aggregation. In Section 3 we review the current fiscal framework and current efforts to implement an appropriate aggregate fiscal stance. In particular, we discuss whether and under what circumstances it is useful to push countries with fiscally sound positions to engage in fiscal expansion to target euro area aggregates. In Section 4, we discuss how an aggregate fiscal stance (as a policy objective) would achieve (or not achieve) democratic legitimacy. Section 5 covers other potential ways to address perceived weaknesses in the current coordination efforts of euro area fiscal policies.

Figure 1: Euro area fiscal stance and output gap, 2005-2015.

Source: IMF, World Economic Outlook, 2016. We use IMF data since EU Commission estimates (Economic and Financial Affairs) for the structural balance are available only from 2010 onwards.
2. MEASURING AND EVALUATING THE FISCAL STANCE

2.1 Measurement: How is the fiscal stance defined and calculated?

The fiscal stance answers by and large the question whether current fiscal policy positively or negatively affects economic activity. Looking at the effects on economic activity, the fiscal stance can be measured as the change in the structural budget balance, where a decrease in the structural budget balance is expected to be expansionary, while an increase is expected to be contractionary. The structural budget balance is used instead of the total budget balance because the latter measures an accounting quantity rather than an economic policy instrument. The total budget balance is not an instrument for discretionary stabilization because it contains several elements that are not amenable to policy, at least in the short run. These main elements are the cyclical portion of the budget balance, interest payments, and one-offs. The budget balance has a cyclical portion because tax revenues are highly procyclical, while government consumption and gross investment tend to be acyclical, and social transfer payments (especially unemployment insurance payments) are countercyclical. Therefore, during recessions, the budget balance deteriorates (due to a fall in revenues and an increase in expenditures), even though this reflects neither short-term changes in policy nor long-term changes in fiscal sustainability (since the cyclical component disappears after the output gap returns to zero). Furthermore, interest payments and one-offs are not the result of current policy, but instead are the result of past debt levels and (in the case of most one-offs) accounting decisions which do not reflect the current operations of the government.

In order to remove the effects of output fluctuations on the budget balance, the European Commission performs a cyclical adjustment procedure. This involves two steps: first, developing a measure of the business cycle, and then removing the influence of the business cycle from the budget balance. The business cycle is measured by decomposing GDP into potential GDP and the output gap, following a production function approach as documented by Havik et al. (2014). This approach involves calculating statistical trends in productivity, labor input, etc., and then seeing how current output deviates from its implied trend (which is treated as representing potential GDP). On this basis, the cyclical component of the budget balance is calculated by applying semi-elasticities of the budget on the measured output gap as documented by Mourre et al. (2014). Semi-elasticities are estimated by a disaggregated approach for certain revenues and expenditures, which are then re-aggregated. The procedure does not adjust with respect to interest payments, since interest payments typically do not fluctuate strongly from year to year, except for extreme situations. The resulting concept of the fiscal stance is thus based on the structural budget balance and not the structural primary budget balance.

In addition to the cyclical adjustment, so-called one-offs are subtracted. One-off measures have a transitory effect on the budget balance and do not change the fiscal position permanently. Examples of one-offs include extra revenues that occur in just one year and cannot be expected to be repeated, such as revenues from auctions of mobile phone licenses. An important one-off in recent years was government spending for bank rescue packages. Such spending was substantial in some countries, to the point that they had an indirect effect on the structural budget balance, because these one-offs have led to sharply higher debt levels, and higher debt levels have resulted in higher interest payments. An important element in the definition of one-offs is that they are not at the discretion of governments; the EU Commission does generally not regard discretionary policies that decrease the budget balance as one-offs. Otherwise, this would give room for policymakers to engage in persistent discretionary, expansionary policies without this showing up in the structural budget balance. The structural budget

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3 The focus on the structural budget balance was introduced into the European fiscal framework with the 2005 reform of the Stability and Growth Pact.
4 It should be noted, however, that the extent of automatic stabilization over the cycle (achieved through the fiscal system) is at the choice of the government and may vary from country to country.
5 At least for the euro area as a whole, one may also argue that interest payments are also a component of government spending that increases the disposable income of private households and enterprises. From this perspective it can make sense to include interest payments in the definition of the fiscal stance, if these interest payments are then spent rather than saved.
balance itself is a typical measure for the fiscal position and plays an important role for the surveillance of fiscal policy in the EU. The components of the total budget balance are shown for a selected set of countries for 2015 in Figure 2; the structural budget balance is defined as the sum of the structural primary balance and interest payments (add blue and grey bars).

**Figure 2:** Composition of the budget balance in selected countries, 2015.

![Chart showing composition of budget balance in selected countries](chart.png)

Source: European Commission 2016, authors’ calculations.

However, there are technical and conceptual problems related to estimating and evaluating the structural budget balance, and in making policy based on that balance. First, it is difficult to measure the current position of the business cycle. It is common knowledge that output gap estimates sometimes experience substantial revisions; recent experiences for EU countries are documented by Kempkes (2014). However, to judge the fiscal position, some measure for the business cycle is needed to disentangle short-run fluctuations from medium- to long-run developments. Otherwise, short-run fluctuations will tend to dominate the measurement of fiscal policy. Secondly, raw data get revised on a regular basis. The issue of revisions can be seen by looking at Table 1, which shows the total balance and cyclically adjusted balance for the euro area for 2005 through 2009, as measured in spring 2016, in autumn 2009, and in spring 2008. While revisions to the total budget have been small for actual data, cyclically adjusted figures have been revised substantially and continuously. In particular, the estimates for the cyclically adjusted balance in 2005 through 2007 were reduced substantially from spring 2008 to autumn 2009 and afterwards, reflecting the reassessment of potential output after the Great Recession that led to a substantial upward revision of the estimate for the output gap for the years before the crisis.⁷

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⁶ The huge revisions to the forecast values for 2008 and 2009 reflect the impact of the surprise recession in those years.

⁷ It is worth noting that measurement problems of potential output (and potential growth) affect almost all concepts for fiscal surveillance as these usually rely on the idea of potential output or, similarly, medium run to long run projections.
Another conceptual problem is that cyclical adjustment, by design, wipes out the effects of automatic stabilizers, which can lead to different judgments about the behaviour of fiscal policy over the cycle. For example, one country may systematically and predictably adjust its tax code during a recession to stimulate the economy, while another country may have a progressive tax code that automatically adjusts. Abstracting from the problem in the former case of getting the timing right, the effects of both setups on the economy should be expected to be very similar. However, in one case, the fall in tax rates during a recession would show up as a change in the structural balance, while in the other case, it would not. As a result, the cyclical adjustment process may not automatically deliver a true cyclical adjustment from the perspective of a person who has rational expectations about the way that fiscal policymakers behave.

2.2 Evaluating the fiscal stance: Business cycle stabilisation and debt sustainability

While the fiscal stance is measured purely against cyclical considerations, the evaluation of its appropriateness has to take into account the issue of sustainability of public finances and involves making normative judgments about how to balance the effects of fiscal policy on economic activity (business cycle stabilization) against the effects on debt sustainability. This is one major source of tension. With respect to judging appropriateness in terms of cyclical stabilisation, a common view is that automatic stabilizers constitute a desirable, predictable counter-cyclical response to normal shocks, while additional discretionary measures are a weak stabilisation tool due to inherent problems to get their timing and size right (ECB 2016: 73). Therefore, only exceptional circumstances and deep swings of the cycle may require additional discretionary measures. With respect to debt sustainability, Boeing-Reicher (2016) shows that if the structural total balance is bounded, then this is sufficient to keep the public debt from exploding over the long run. However, the EU cares about more than keeping the debt from exploding; it also wants debt levels to drop below the 60 per cent threshold contained within the Stability and Growth Pact. In order to keep track of debt levels in the long term, the EU Commission monitors an indicator called S1. This indicator is based on debt projections, and it gives the structural primary balance needed to reach a debt level of 60 per cent relative to GDP in 2030. Therefore, since public debt-GDP ratios are above 90 per cent in the euro area on average, considerations on debt sustainability would require respective countries to run more restrictive fiscal policies compared to a situation where debt levels were still in line with the Stability and Growth Pact’s requirement of less than 60 per cent. The indicator S1 also explicitly accounts for the fiscal pressures exerted by an aging population in the debt projections. Details about the calculation of S1 can be found in European Commission (2016a, Annex A2). It is also shown how the figures for S1 are highly sensitive to long-run projections for economic activity – a problem that all debt sustainability analyses face.

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8 In this context, we would like to stress that according to the EU fiscal rules, the 60 per cent debt-to-GDP ratio is not a target but an upper limit of tolerable debt.
9 See Wyplosz (2011) and Plödt and Reicher (2014) for other examples where this matters.
It might be unrealistic to expect countries to target specific paths for their debt-GDP ratios, since this can actually destabilize output and debt levels, as shown by Boeing-Reicher (2016). More generally, this can run afoul of the tradeoff between business cycle stabilisation and debt sustainability. In the specific case of the indicator S1, it is not clear whether macroeconomic repercussions are taken into account, or how this tradeoff should be expected to be made. Instead, we argue that it might make sense to allow for a time-varying deficit target that varies with both the output gap and the level of debt, following Plödt and Reicher (2015), such that automatic stabilizers and policy mechanisms are allowed to operate in the short run while ensuring a strong degree of debt stabilization in the long run. This is a modified version of the fiscal reaction function of Boeing-Reicher (2016), Plödt and Reicher (2015), and Snower et al. (2011). Further work could help to explore the effects of different calibrations – our own internal simulations suggest that a “structural debt brake” rule of this type might strike a good balance.

2.3 How is aggregation done and is the procedure appropriate?

Generally, the structural budget balance (as well as the primary budget balance) is measured in euros, thus making aggregation easy. This holds for the fiscal stance, too, as it is measured as the change in the structural budget balance. Likewise, it is possible to come up with a business cycle position for the euro area as a whole; the European Commission regularly produces euro area output gap estimates, which have the same benefits and drawbacks as country-level output gap estimates.

**Figure 3:** Output gap estimates in selected euro area countries, 1999-2015.

![Output Gap Estimates in Selected Euro Area Countries](image)


But, business cycle fluctuations across Member States are far from perfectly correlated, thus making aggregation and assessment of cyclical needs for the euro area as a whole problematic. To see this, Figure 3 shows how the output gaps of the original euro area countries have varied since the introduction of the EMU. For the most part, these output gaps exhibit a positive correlation with each other, but this correlation is far from perfect. More precisely, the timing of cyclical up- and downturns is fairly similar across countries, but the amplitude differs significantly. The ex-post
evaluation shows rather small variations in many euro area countries, but larger variations in Spain, Ireland, Greece, and also Finland. Arriving at an aggregate fiscal stance (analogous to the ECB’s aggregate monetary stance) implies abstracting from the fiscal conditions and business cycle conditions in individual countries. Consequently important information is lost when looking at euro area aggregates. Moreover, the example of some of the countries mentioned above shows that the very focus on the fiscal stance may be misleading as it distracts from the problems that are at the root of the country-specific developments. These are predominantly at the micro level and need structural reform rather than macroeconomic demand management.

Additionally, the other main criterion, debt sustainability, is not in the domain of euro area policymakers, but is instead in the domain of the member countries. Debt levels and structural deficits too are far from perfectly correlated. This imperfect correlation matters – if a country runs too high a deficit and endangers its own debt sustainability, this “mistake” cannot be counterbalanced by a higher surplus in another member country, since this does nothing to alleviate the deficit country’s loss in creditworthiness. As argued by the ECB (2016: 78), the aggregate fiscal stance “can only be deemed appropriate if it safeguards the sustainability needs of all euro area countries.” Counterbalancing would only work if the euro area as a whole would bear each member country’s default risk, e.g. via a euro bond mechanism or some other risk-sharing mechanism. This is also recognized by the EU Commission. In its recent assessment, the EU Commission concludes that the fiscal stance in the euro area for 2016 is consistent with moderate stabilization and is less restrictive than that implied by sustainability needs (European Commission 2015b: 10). Furthermore, the EU commission regularly includes cyclically adjusted data for the euro area and for the EU as a whole; these data currently indicate (for 2015) a small cyclically-adjusted deficit for the euro area as a whole (see Figure 2).

Altogether, we find that the joint fiscal stance is a concept of limited relevance. Business cycle stabilization needs as well as debt sustainability considerations are first of all measured and relevant at the national level. Ensuring debt sustainability is a national responsibility and, so far, only national authorities have the means to conduct fiscal policies.
3. IMPLEMENTATION BY MEANS OF FISCAL COORDINATION

3.1 The current fiscal framework

The current set of fiscal rules and surveillance mechanisms constitutes a legal framework in which national fiscal policies are coordinated, however weakly. Governments are to some extent disciplined to comply with established rules in their budgetary plans by way of peer pressure and by the threat of possible sanctions. For instance, draft budgets need approval by the European Commission, and Member States that deviate from established fiscal rules are obliged to commit to a reasonable path of adjustment. However, the current debate on the aggregate fiscal stance demonstrates that the outcomes of this process are controversial. Moreover, the willingness or ability to comply with the existing set of rules is weak among many Member States, as demonstrated by a large number of countries recently violating the fiscal rules.

If all countries had sound public finances, the current set of fiscal rules would likely result in a countercyclical (i.e. business-cycle stabilizing) aggregate fiscal stance. Under the rules of the fiscal compact and the current interpretation of the European Commission (2015c), each country with sufficient fiscal space is free to conduct discretionary counter-cyclical demand smoothing on its own. This way, the resulting joint fiscal stance would be counter-cyclical as long as countries run counter-cyclical policies “on average”. As Claeyts et al (2016) argue, the current set of fiscal rules actually does not prevent Member States from this type of behaviour. Indeed, wide-ranging flexibility clauses enable the European Commission to interpret the rules with discretion.

However, some countries are restricted in their ability to react countercyclically in response to economic downturns due to debt sustainability considerations enshrined in the fiscal rules. In these cases, “sound public finances” present a constraint, and these constraints may require countries facing a large, protracted crisis to tighten their fiscal stance. This constraint operates asymmetrically in practice, since fiscal restrictions become binding mainly in the course of economic downturns, and due to the fact that ensuring debt sustainability is a one-sided issue. This asymmetry implies that binding fiscal restrictions in a subset of member countries can push the aggregate of country-level fiscal stances toward a too tight, potentially even procyclical policy, in comparison with a world where sound public finances are not a constraint. In this context, the ongoing debate on an appropriate aggregate fiscal stance is about the possibility of overcoming this asymmetry by encouraging additional coordinated spending in countries where fiscal restrictions do not bind. However, even if this would be successful, in a situation where the aggregate euro area fiscal position is not in compliance with the medium-term fiscal goals (of a structural deficit not higher than 0.5 per cent and the debt-to-GDP ratio below 60 per cent), the appropriate fiscal stance would have to be more restrictive than purely cyclical considerations would suggest (see ECB 2016).

Even when fiscal coordination might be desirable, fiscal coordination is difficult to achieve. The EU and the euro area itself have had difficulties in enforcing fiscal rules. Additionally targeting a euro-area-wide fiscal stance is even more difficult. The situation may be uniquely difficult because a fiscal entity on euro area level would try to steer the aggregate fiscal stance, while that entity would have little direct budgetary power. In most federal systems (like the USA or Germany), a large proportion of the general government budget is steered by the federal government directly, and the federal government has the sovereign right to issue new debt. Even in countries with rather high expenditure shares for regional governments, coordination between regions and the central government is typically not designed to steer the fiscal stance (Kirkegaard 2015). In fact, attempts to do this have not worked well; in Spain, for instance, the central government has tried to impose deficit targets for the autonomous regions, but the regions have not met these targets (Romero 2016). In Germany, the “debt brake” will be binding for all states from 2020 onwards; however, so far, there is no strong coordinating mechanism. While it is complicated enough to maintain debt sustainability and prudent fiscal policy in a federal system, there is little evidence for macroeconomic stabilization policies that have been conducted jointly by federal states. Instead, stimulus packages are rolled out by central governments. To this extent, coordination to target the joint fiscal stance in the euro area would move the euro area into uncharted territory, since the euro area is not a federal state.
3.2 Using fiscal space at the country level to target euro area aggregates

In the EU Commission’s current approach to fiscal coordination, the Commission asks countries with sound debt positions to provide extra fiscal stimulus. Currently, this is the case with Germany (European Commission 2016b). The idea of the EU Commission is that additional stimulus from Germany can generate positive demand spillovers for the other euro area (or EU) Member States, and this can allow the fiscal policies of the other Member States to be tighter without damaging the fragile recovery in the euro area. This extra stimulus should improve – in the current case, loosen – the joint fiscal stance and help those countries that cannot afford a more expansionary fiscal stance.

However, using fiscal space in one country to address euro area aggregates could destabilize the euro area on disaggregated level. A country with fiscal space that at the same time operates at normal capacity utilization levels may be asked to increase expenditures (i.e. Germany). For that country, however, such a policy of additional stimulus beyond its own business cycle needs may generate welfare losses. This would be because that country is asked to engage in (from its perspective undesirable) pro-cyclical fiscal policies, which might push its economy into a state of “overheating”. Meanwhile, the benefits of these policies are assumed to accrue to other countries, and the degree to which these policies accrue depends on the size of cross-border spillovers. So, even if the joint fiscal stance resulting from this procedure appears appropriate for the euro area as a whole, it can be destabilizing at the individual country level. This is the case because additional fiscal stimulus mainly takes effect in the economy where the money is actually spent. Such a policy (of spending money where it is not needed) would generate more divergence in cyclical fluctuations between Member States. Additional cyclical divergence, in turn, would make it even more difficult for the European Central Bank to conduct monetary policy that fits the different needs of member state economies.

Using available fiscal space in a country when it is not needed may compromise that country’s fiscal sustainability and makes it difficult for that country to engage in fiscal expansion during a possible future crisis. An inappropriately expansive fiscal stance in a country enjoying fiscal space could not only push its economy into overheating, it also jeopardizes fiscal space that might be needed to counter a potential future economic slump. The magnitude of fiscal resources sufficient for a smooth adjustment during crises can be large, which was demonstrated by the cases of Spain and Ireland in recent years, where favourable public debt ratios (well below 60 per cent of GDP) and government balances in substantial surplus were not enough to cushion the blow of the Great Recession. It may thus be preferable to keep the powder dry in those countries that enjoy fiscal space, especially since using this fiscal space to excessively stimulate the economy (from the country’s perspective) would also increase the probability of a crisis by contributing to a build-up of imbalances that sooner or later would have to be corrected. Excessive stimulus that triggers a protracted boom thus risks setting the seed for a future crisis.

Because of these tradeoffs at the country level, implementing a desirable aggregate fiscal policy stance under the current framework is not workable. Attempts to coordinate the fiscal stance in this manner run into problems with the incentives faced by individual countries, and overcoming these problems would require a tough enforcement mechanism. In a top-down approach, a centralized fiscal authority could be empowered to make the decision on the aggregate fiscal policy stance. Afterwards, the centralized decision would be translated to a temporary caps and floors for the national fiscal policy stances in each country (Benassy-Quéré 2015). This essentially would imply that the amount of public spending (or taxes) would be determined at the euro area level, while the decisions on the actual compositions of fiscal policies would remain at the national level. This approach leaves unanswered a major question: How would the centralized fiscal authority push through its optimal set of national fiscal policies? Without a means of enforcement at the central level, such an approach is likely to remain a paper tiger. More likely, the centralized fiscal authority would rely on moral persuasion and cajoling, which would not provide the desired results, in turn because not all national governments would automatically share centralized fiscal institution’s view on the optimal spending levels for their country. Therefore, enforcement measures would become necessary,
for instance, sanctioning countries via an “Excessive Surplus Procedure”. Apparently, such a fiscal framework is very unlikely to be implemented, because national budgetary autonomy would be substantially undermined. Consequently, as Darvas and Leandro (2015) put it, they “see no political possibility of countries agreeing to a binding process which may force them to have deficits larger than what their domestic preferences deem appropriate.”

### 3.3 The size of spillovers: Does spending in one country help other countries?

Enforcement measures aside, whether or not additional spending (or tax cuts) in one country would help other countries depends crucially on the size of spillovers. There are different channels along which spillovers can work: in particular the trade channel and the monetary policy channel. The standard argument for trade spillovers is that if (say) Germany were to increase public investment, then this would stimulate the German economy, and in particular, this would stimulate the demand for imports. These imports would come from Germany’s trading partners, which include other European countries. An increase in imports from other European countries would stimulate output and employment in those countries, thus putting less pressure on those countries to engage in expansionary policies in the face of a fiscal and economic crisis. Clearly, the magnitude of such spillovers depends on the trade linkages of the country that is expected to run expansionary fiscal policies – whether the import share is rather 30 per cent of GDP (as in France), 40 per cent (Germany) or even 100 per cent (Ireland). Additionally, the size of spillovers also depends on the extent to which these goods and services are mainly imported from other euro area countries or from countries outside the monetary union. Moreover, spillovers include the reaction of monetary policy, which affects all euro area members equally. In fact, if trade spillovers are low, then stimulus in Germany may hypothetically even damage others due to the reaction of joint monetary policy (higher interest rates / less quantitative easing). In an extreme case, Germany would enter a fiscally induced boom, while recovery in Spain or Italy would be suppressed by tighter monetary policy.

The effective size of spillovers depends crucially on monetary policy reactions. In the country report for Germany in 2015, the EU Commission reported that an increase in public investment in Germany by 1 percentage point in terms of German GDP would result in limited spillover effects on economic activity in the rest of the euro area (below 0.03 per cent in all years; see also Kollmann et al., 2014). Calculations are based on the QUEST model. In calculations for the most recent country report of 2016, spillovers reach ¼ per cent for the rest of the euro area, which is almost 9 times as high as the estimated spillover effect of the previous years’ country report. Crucially, the reaction of monetary policy in this simulation was switched off, and so these simulations represent the effects of the trade channel. The importance of the reaction of monetary policy is also documented by Elekdag and Muir (2014). According to their model, a boost in German government investment can have negative effects on other members of the euro area in case that monetary policy reacts strongly. If, however, monetary policy does not react in response to the German fiscal stimulus, then spillovers could be sizeable. Sizeable spillovers are also found by In’t Veld (2013) and Blanchard et al. (2015), when monetary policy does not react. Altogether, the theoretical evidence on spillovers seems to be mixed, as is the empirical evidence.

Spillovers also depend on the composition of public spending and tax collection. For example, a country with fiscal space might on the one hand increase public investment spending, which might involve considerable demand spillovers. Even so, these spillovers might vary across categories of public investment or public consumption – hiring teachers might have different effects than building a bridge or repairing a pothole. With respect to other fiscal measures, spillovers could even be negative – the government might cut taxes for companies that produce tradable goods (“beggar-thy-neighbor”) instead of raising investment, which would also stimulate the economy but produce very limited or even negative net impact on demand in other euro area Member States. Therefore, dependent on the composition of public expenditure and revenues, more expansionary fiscal policies would not necessarily have the intended effects. The size of spillovers may also depend on the cyclical position the country is in when public investment is increased. In a situation of low capacity utilization, a given amount of fiscal spending may translate into increases of volumes rather than price
increases, relative to a situation when capacity utilization is high (crowding out). Any attempt to mandate and enforce the national fiscal stance in a top-down approach would therefore run into the problems of heterogeneity with respect to (highly uncertain) multipliers and spillovers. Further attempts to mandate the composition of public spending would involve even further interference in the national budgetary autonomy, and this interference may violate the principle of subsidiarity, a main guiding principle of the European Union, which requires delegating decisions to the lowest possible level.

**Overall, effects on euro area-wide welfare depend on the size of total spillovers.** Only if spillovers were sufficiently large, discussing the euro area aggregate fiscal stance as a policy target would make sense. An assessment of overall welfare effects for the euro area as a whole requires a comparison of possible welfare losses in one set of countries and welfare gains in other countries. Even if this assessment suggested that welfare gains in some countries outweigh welfare losses elsewhere, this would not make such a policy desirable from an economic point of view. The allocation of scarce fiscal resources would not be efficient and optimal, since additional spending may be called for in countries where it is not needed. This, in turn, could generate output losses in the longer run.

### 3.4 Should fiscal policy target external imbalances?

The issue of spillovers is closely related to the issue of external (current account) imbalances; in fact, the debate on an aggregate fiscal stance might also reflect the desire to use fiscal policy to correct these imbalances. In particular, demands for fiscal stimulus in certain countries seem to be intended to counteract trade surpluses, particularly those of Germany and the Netherlands. According to this logic, fiscal stimulus in the surplus countries in expected to fuel domestic demand, thereby increasing imports, and increasing wage inflation, thereby realigning real exchange rates (e.g. OECD 2016: 18). Even without significant spillovers in terms of short-run economic activity, more expansionary policies in surplus countries could alleviate required adjustment processes for distressed countries through a relative gain in price competitiveness of these countries. However, this approach is problematic.

**Fiscal policy would be overburdened with the responsibility to counteract trade imbalances.** First, this expands the scope of targets for fiscal policy (for one set of instruments). Fiscal policy would then have to balance not only business cycle stabilisation against debt sustainability, but also to consider the target of counterbalancing trade accounts. Secondly, these targets do not always (or often) coincide with each other as they appear to do currently. In general, fiscal space and external surpluses do not always coincide. In a different setting, this approach of “using available fiscal space” might in fact trigger real exchange rate misalignments instead of counteracting them. For example, Spain and Ireland in the pre-crisis years had not only favourable public finances, but also booming economies and growing external deficits. The situation for Germany before 2005 was the reverse; the German economy was in fact rather distressed. Using the available fiscal space in Spain and Ireland to create hypothetical spillovers for the distressed German economy would have fuelled divergence in terms of unit labour costs and trade balances, thus aggravating the imbalances that helped contribute to the subsequent recession. This demonstrates that using fiscal space on country level to target euro area aggregates should not be a universal approach. Finally, this line of argument obscures the debate about what fiscal policy should be and should not be expected to accomplish. While it should be discussed openly whether or not current account imbalances are problematic, and whether there are reasonable policy options to tackle this set of problems, these concerns should not be made the basis for changes in the euro area fiscal framework.

### 3.5 Interim conclusion: The current approach to fiscal coordination has its limits

**Based on the above considerations, we conclude that it is problematic for macroeconomic stabilization policies to target euro area aggregates.** Additional spending in one country may help others, but only in a narrowly defined environment, where (1) trade spillovers are large; (2) monetary policy does not react substantially to fiscally induced increases in economic activity; and (3) monetary
policy is ineffective at stabilizing euro area output. More realistically, the proposed mechanisms can destabilize output at the country level, particularly since business cycles and fiscal conditions across euro area countries are insufficiently synchronized. This lack of synchronization implies that targeting an aggregate involves abstracting from important information at a country level. As a result, even with considerable positive spillovers, proposals for individual countries to bear the burden of an aggregate euro area fiscal stance can be harmful for those countries, since such a proposal would require those countries to put up with less fiscal space and more volatile business cycles. We conclude that the current approach to fiscal coordination is not workable.
4. DEMOCRATIC LEGITIMACY AND THE AGGREGATE FISCAL STANCE

In the course of the euro crisis, fiscal coordination in the euro area has been further centralized with a shift of authority to the EU Commission, the European Council and the Council. This process was, however, not accompanied by increased political accountability for these institutions (Alcidi et al. 2014; Majone 2014; Scharpf 2015). In this context, the Five Presidents Report stresses that further integration would need to “go hand in hand with greater democratic accountability, legitimacy and institutional strengthening” (Juncker et al. 2015: 17). Against this background, we ask whether and how an aggregate fiscal stance (as a policy objective) could be guaranteed democratic legitimacy.

What is democratic legitimacy and how can it be assessed? The term legitimacy refers to the social acceptance of polities or policies, and is usually assessed in two dimensions (Scharpf 2003): first, a polity or policy needs to solve the common problems of the governed (“government for the people”, or output legitimacy). Put simply, an institution and its policies must cater for its citizens’ needs. Second, in order to democratically legitimate, it must also be responsive to the political preferences of the governed (“government by the people” or input legitimacy). Such responsiveness can be attained by including citizens in political processes, such as public debates, competition for political office, and via “political institutions that ensure the electoral accountability of governors to the governed.” (Scharpf 2015: 20). For a euro area fiscal stance to be legitimate, it would thus need both to a) provide for an effective solution for some of the common problems of the citizens of the euro area (output legitimacy) and b) to be determined in a way that accurately responds to the preferences of those governed (input legitimacy).

In case that the assessment of an aggregate fiscal stance for the euro area was translated into policy recommendations significantly constraining national fiscal policy-making, this would increase concerns about legitimacy. As a rule of thumb in the EU, legitimacy concerns are the greater, (1) the more EU-level decisions constrain national policy-making competences, (2) the more they violate the interests of (some of) those affected, and (3) the less they are accompanied with effective tools to hold the EU-level decision makers accountable (Alcidi et al. 2014; Scharpf 2003). With regard to the euro area fiscal stance, concerns about legitimacy would thus be the greater, the more fiscal coordination would restrict national budgetary autonomy, violate the interests of some euro area members, and be enforced by a centralized fiscal authority that is not subject to democratic checks and balances. In this vein, the current fiscal coordination framework has been strongly criticized for accelerating a “democratic default” (Majone 2014) by increasing the discretionary budgetary powers of the European Commission to the detriment of directly elected national parliaments and the European parliament, despite the fact that formal budgetary autonomy still rests with the Member States. The introduction of “reverse qualified majority voting” has also weakened the provision of input legitimacy through national representatives in the Council (Scharpf 2015: 39).

The potential of legitimising a euro area fiscal stance by output-related efficiency gains (output legitimacy) seems questionable. As business cycle dynamics are mainly national, and spillovers are uncertain, targeting the euro area aggregate rather than a national fiscal stance may create welfare losses for individual countries, or even make the attainment of a relatively undisputed common good (price stability or debt sustainability) more difficult. Targeting such a policy objective is thus likely to be politically controversial in a number of euro area member countries and is likely difficult to justify as representing a euro area wide common good. Consequently, the euro area fiscal stance, as a policy objective, is unlikely to receive its legitimacy from efficiency considerations. In addition, the aggregate fiscal stance in the euro area currently remains the sum of national fiscal stances and happens to be appropriate only by coincidence. Targeting the euro area fiscal stance would therefore also depend on a stronger enforcement authority and a possible shift of fiscal competencies towards the euro area level, which would require changes to the treaty of the European Union. In addition, if decisions made at this level can inflict sensitive welfare losses for individual euro area members, social acceptance of these decisions rests on whether euro area citizens perceive the issuing authority
to be accountable and responsive to their preferences (input legitimacy), so that citizens would tolerate temporary welfare losses in order to attain a euro area wide political objective.

**Assessing and determining an appropriate aggregate fiscal stance would require a process that is transparent and responsive to euro area wide political preferences; which is unlikely to be achieved in the current fiscal framework.** So far, the Commission assesses the euro area fiscal stance, discusses this assessment with the Eurogroup, and makes it publicly available (European Parliament and Council of the European Union 2013: Art.7). The European Parliament can invite the President of the Commission or the Eurogroup to discuss their assessment in the framework of the Economic Dialogue (European Parliament and Council of the European Union 2013: Art.15). Given that the determination of an appropriate fiscal stance involves balancing various objectives (European Central Bank 2016a), and eschews a solely technical assessment and decision, it is crucial to involve democratically legitimated institutions that can represent the preferences of and that are accountable to euro area citizens. In this vein, processes such as the Economic Dialogues and greater inter-parliamentary cooperation between the EP and various national parliaments have previously provided parliaments with resources to better control governments and to foster “deliberative bridges between citizens and the EU” (Jančić 2016). Yet, they represent rather soft forms of parliamentary control and may be ill-suited to legitimize decisions that have the potential to impact national budgeting decisions. In addition, the Eurogroup may indirectly legitimize the determination of an appropriate fiscal stance as it includes representatives of elected national governments. In the past, however, it has itself called for the Commission to increase the transparency of the overall fiscal surveillance framework (European Central Bank 2016b).

**There are various ways in which the European Parliament’s involvement, for instance, could be improved with regard to assessing an appropriate aggregate fiscal stance.** Whether this would generate more acceptance for closer fiscal policy coordination, however, remains doubtful. First, if the Economic Dialogues were to be better timed and the Commission were to explain how EP views are taken into account, this would make sure that EP views are accurately represented in executive decisions (Alcidi *et al.* 2014). This is also true with regard to the aggregate fiscal stance. Secondly, the EP should more efficiently monitor the Commission’s work in this regard, and this would require clarifying the standards used to assess an appropriate aggregate fiscal stance. Previous assessments of these standards have rather been “a value judgement [by the European Commission] than the result of rigorous analysis” (Darvas and Leandro 2015: 11). The transparency of this process may be increased by the newly established Advisory European Fiscal Board (EFB) (European Parliament 2015). The EFB is supposed to advise the Commission on the aggregate fiscal stance and, jointly with national fiscal boards, should independently and critically review the implementation of the EU’s fiscal framework. In order to do so, however, the EFB and national fiscal boards would need to operate transparently and fully independently from the European Commission and national governments. Currently, in this regard the set-up of the EFB and its reporting procedures have been criticized, e.g. for not clarifying whether the EFB can comment on the Commission’s decisions in real time (European Central Bank 2015b; O’Reilly 2016). Likewise, the independence, power, and involvement of national fiscal councils differs substantially among euro area members (Angerer and Donatelli 2016; European Central Bank 2014). Even if such increases in transparency and enforcement of the independence of national fiscal boards would be accomplished, however, it is doubtful whether the EP’s involvement would generate more acceptance for policies that have the potential to affect euro area Member States unevenly. After all, elections to the European Parliament only qualify as “second order elections”, and EU citizens rarely vote for concrete party programs, but rather along pro-European versus Eurosceptic lines (Alcidi *et al.* 2014). For a euro area fiscal stance, more (output- and input-related) democratic legitimacy is thus rather unlikely to be achieved without a substantial revision to the current fiscal and institutional framework of the EU.
5. WHAT ELSE CAN BE DONE?

We argued that targeting an aggregate fiscal stance is likely to destabilize business cycles and endanger fiscal sustainability for individual euro area countries. Given these concerns, we ask, can we suggest (partial) solutions that help to alleviate some of the perceived deficiencies of the current fiscal framework, in which highly indebted countries may be forced to engage in procyclical fiscal tightening? To this end we discuss the potential of a number of policy tools or mechanisms to produce a more favourable outcome in terms of macroeconomic stabilization.

5.1 Relaxing fiscal rules

A new set of fiscal rules could more strongly incentivise counter-cyclical fiscal policy while still encouraging fiscal sustainability. For example, it has been suggested to temporarily exclude incremental investment and incremental unemployment expenditures from the measure for the fiscal deficit (e.g. Benassy-Quéré 2016). These expenditures would be booked into a separate adjustment account – and thus not affect the Maastricht deficit – in bad economic times and gradually transferred into the normal budget when the cycle had turned to the better. This approach would allow countries to engage in more fiscal expansion in a recession, without compromising the established fiscal rules. Alternatively, the excessive deficit procedure could be based on structural deficits and not total deficits. This would be another way in which current rules could be adjusted in a simple way in order to remove some possible sources of asymmetry. Clearly, both approaches have implementation issues, since, for example, countries with fiscal restrictions might be tempted to book as much public expenditure as possible as incremental investment if this did not affect the relevant deficit measure. Similarly, focussing on structural deficits would be accompanied by a substantial loss of clarity, because measurement of the structural deficit remains uncertain and susceptible to revisions. Overall, it is unclear how large the effects are likely to be given that current rules already entail a large degree of flexibility.

If fiscal rules were changed in order to loosen the current restrictions, debt sustainability would remain an issue. The reason behind the episode of pro-cyclical tightening in 2012 and 2013 was concern about debt sustainability, not current fiscal rules. The SGP has a general escape clause increasing fiscal flexibility, whenever an economic event outside the control of a Member State has a major impact of government finances, or in the case of a severe downturn on the euro area level, although this is possible only as long as fiscal sustainability is not endangered in the medium term. In addition, the EU Commission in practice often has tolerated temporary deviations from an adjustment path. As a result, during the episode of 2012 and 2013, it was not compliance with rules or pressure by the EU Commission that made countries engage in pro-cyclical fiscal tightening. Instead, the crisis started out as a financial crisis and a large recession but then subsequently evolved into a “sudden stop” and a sovereign debt crisis (Baldwin et al. 2015). If debt sustainability is at stake, fiscal priorities shift from business cycle stabilization towards consolidation, especially if there is increasing evidence that potential output of the economy has declined with a corresponding need for fiscal adjustment. This set of problems would remain if fiscal rules were relaxed.

5.2 A macroeconomic stabilisation function

A stabilization fund could be constructed to support countries once they were hit by severe asymmetric shocks (“rainy day fund”). Governments would be required to provide financial contributions to a centralized fiscal authority, which redirects these resources to those member countries hit by asymmetric shocks. To avoid permanent transfers in one direction, such a system would need to address only genuine cyclical risks, which is a problem when output gap estimates are highly uncertain. Therefore, the estimation of the output gap would become even more a contentious political issue than it currently is.
Spending decisions should be left on country level. A central fiscal authority could either be responsible to redirect funds to Member States, without being involved in the composition of spending, or it could be made responsible to actually carry out centralized decisions on public expenditures. For example, spending could take place in the field of public investment, by directing funds primarily to infrastructure projects in distressed countries, as the Five-Presidents-Report suggests the European Fund for Strategic Investments (EFSI) to become a vehicle for implementing a stabilisation function (Juncker et al. 2015: 15). In our view, spending should be left on national level for several reasons. First, moving spending decisions to the supranational level conflicts with the principle of subsidiarity as long as there is no efficiency gain involved by shifting competencies to a higher level. Second, centralized spending would call for an economic analysis of EMU-specific collective goods apart from providing “stabilization”. As argued above, while EU-wide collective goods may exist (and should then be reflected in the EU budget), EMU-specific public goods are rare, if they exist at all. Third, funding for long-run public investment projects as intended by the EFSI (Juncker plan) can hardly be switched on and off in a discretionary manner depending on the business cycle. Therefore, reasonable public investment projects with a considerable lead time and duration are not suitable for targeted fiscal stimulus aimed at macroeconomic stabilisation.

Fiscal policies of a centralized authority can conceptually be decomposed into the redistribution of available resources between countries (net transfers) and redistribution over time (net lending). A stabilization function could involve between-country smoothing of cyclical risks, since countries with a more positive output gap would then be required to transfer funds to countries with a more negative output gap (IMF 2013: 19f., De Grauwe and Ji 2016). This would ameliorate the effects of asymmetric macroeconomic shocks – an example of a transfer mechanism would be a common unemployment (re-) insurance scheme. However, a pure transfer system is problematic particularly once the euro area as a whole enters a recession. Then, funds would be channelled from countries in a mild recession to countries in a deep recession, pushing the former country deeper into recession. On aggregate, to deal with economic up- and downturns on euro area level, the fiscal authority would have to conduct inter-temporal smoothing. This in turn would require a joint debt instrument at the euro area level (i.e. euro bonds). Overall, a macroeconomic stabilisation function would certainly combine both net transfers and net lending.

Permanent contributions of Member States would allow for joint debt issuance without imposing full liability on national budgets. To this end, Member States would have to agree on transferring relatively small financial contributions from their national budgets, but they would have to commit to payments for a very long time span (Tabellini 2016, drawing mainly on Ubide 2015). Thereby, a limited transfer of fiscal sovereignty to a supranational institution could be accomplished, while the largest part of budgets would remain under the control of national parliaments. Based on a long-run inflow of revenue, the joint fiscal authority could issue and service debt, and use this debt to engage in area-wide fiscal stabilization policy (inter-temporal smoothing). Backing the limited amount of jointly issued debt with full liability of national budgets is not necessarily required.10 Backing it explicitly with ECB guarantees would certainly reduce risk premia and financing costs (Corsetti et al. 2016), although it is clearly not a recognized central bank objective to provide fiscal authorities with favourable financing conditions. To initially ensure liquidity of the new debt instrument, Tabellini (2016) proposes to issue bonds amounting to 10 per cent of GDP at the start, the receipts of which were simply used to retire equal amounts of circulating national debt, and to limit the maximum amount of circulating euro bonds to 25 per cent of GDP. Such a debt instrument would not impose joint liability on the major part of accumulated national debt. Moreover, current crisis mechanisms could be replaced by the joint budget: Once a fiscal capacity with substantial resources was to be introduced on euro area level, it could take on the role currently attributed to the ESM (Tabellini 2016).

Net transfers could help to partially loosen fiscal restrictions for countries in crisis and to improve the alignment of cyclical patterns between Member States. First, financial transfers

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10Tabellini (2016) and Ubide (2015) suggest that in order to create perfectly default-free assets with lowest possible risk premia, governments need to agree on the possibility of additional payments in the case of extreme events. Moreover, they argue that national debt should be subordinated to “stability bonds”.

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would likely reduce some of the fiscal restrictions countries can face when they are hit by a deep recession. Still, the aggregate fiscal stance would not necessarily achieve a desirable level, since there is still the issue of fiscal sustainability at the country level – for example, overall fiscal expenditure could even be reduced in a euro-area-wide recession, if a country without fiscal space were required to transfer money to a country deeper in recession. Secondly, net transfers could improve the alignment of cyclical patterns between Member States. Countries with a relatively more positive output gap would be required to transfer funds to countries with a more negative output gap. This way, ups EWNS as well as downturns are both dampened, so that business cycles are better synchronized. Currently, the alignment of business cycles between Member States mainly depends on trade integration and the common monetary policy. Trade integration generates positive demand spillovers, while common monetary policy has caused business cycles to diverge: Higher economic activity in one country induces tighter monetary policy, thus negatively affecting economic activity in other countries. Since booming economies often exhibit higher wage and price increases, divergence is amplified by implicitly imposing lower real interest rates in boom countries. Recent efforts to promote a capital market union could further contribute to strengthening spillovers by inducing higher cross-border capital income flows (both profits and losses). A possible introduction of a transfer mechanism between countries could in principle constitute another force that supports alignment of business cycles, which would allow monetary policy to better fit the needs of all euro area Member States.

**However, a joint stabilisation fund would likely be accompanied by moral hazard problems and would reduce both market forces and political pressure to overcome structural causes of crises.** Unfortunately, it is difficult to make sure that transfers actually tackle genuine risks without producing permanent cross-border transfers in one direction. In particular, the blurry notion of “macroeconomic shocks” conceals the different nature of these shocks. Macroeconomic shocks can be more or less symmetric to all countries (e.g. oil price shocks), as well as asymmetric so that the shock hits only a subset of countries. Asymmetric shocks, in turn, can be due to “bad luck” or the result of “bad policies”. As it is difficult to design a regular stabilisation mechanism that can accurately discriminate between these two types of shocks, moral hazard problems may arise. That is, countries might be tempted to engage in unsustainable policies or to take irresponsible risks, for example in order to avoid unpleasant consequences of necessary reforms. Moreover, asymmetric shocks that are actually caused by “bad luck” can be either cyclical or structural, the latter of which implies that structural adjustment is required. In structural crises, a transfer mechanism has detrimental side effects. While net inflows of transferred funds alleviate matters for the distressed country, they also reduce the political pressure to conduct appropriate structural reforms that might address the fundamental causes of the problems. Transfers also weaken market forces that help to overcome imbalances – for example, a required internal devaluation would be suppressed if transfer payments keep the wage level higher than overall productivity would allow for.\(^{11}\) Therefore, a “risk-sharing” mechanism can perpetuate structural problems.\(^{12}\) Given that certain macroeconomic imbalances actually trigger financial support for affected countries, and macroeconomic imbalances do not disappear without painful reforms and adjustment processes, financial support for these countries is doomed to be permanent – although proponents of a joint stabilization function claim to avoid this (e.g. Juncker et al, 2015: 15).

**Availability of fiscal resources for macroeconomic stabilization policies on euro area level may also damage incentives in the fiscal surveillance framework.** On the one hand, the desire of

\(^{11}\) For example, Pissarides (2016) argues that fiscal transfers are required as a corrective mechanism to substitute for exchange rate flexibility, since internal devaluation is perceived as too costly and labour migration is not politically feasible. In other words, whenever a country is hit by an asymmetric shock, so that productivity is not in line with the real wage level any more, the country will receive fiscal transfers in order to avoid painful adjustment processes.

\(^{12}\)This problematic side effect also applies to highly expansionary monetary policies of the ECB, which effectively reduces public financing costs and thereby eliminates much of the pressure for governments to engage in far-reaching structural reforms. Nevertheless, this is not meant to deny that in certain situations, smoothing (and probably slowdown) of macroeconomic adjustment processes can be required due to social considerations, concerns on political stability, or in order to prevent systemic risks to materialize.
Member States to access funds of the stabilization function in times of crisis would provide the joint fiscal authority with leverage to enforce compliance with fiscal rules and thereby strengthen fiscal surveillance. On the other hand, the desire to be able to conduct counter-cyclical fiscal policies on national level is probably a major incentive to seek for fiscal space. If a joint budget were implemented that eliminates the need for national policymakers to cushion big macroeconomic shocks themselves, incentives to reduce high debt levels could be severely damaged. Overall, intrinsic motivation to reduce debt levels would to some extent be replaced by extrinsic motivation to comply with rules in order to maintain access to joint fiscal resources.

**Significant cross-border transfers as well as joint debt instruments are likely to be politically contested.** In existing transfer unions such as Germany (federal level vs. state level), by far the largest part of redistribution between regions is “hidden” in social security contributions and taxes. Yet there are also direct redistributive payments between state-level budgets, which are of minor importance (~0.3 per cent of GDP), but which cause disagreement between state-level governments on a regular basis. So even in a single country with a common spoken language and a political union there is dissent on “minor” direct transfers between regions, which is, however, mediated with the help of a full-fledged democratic process. The euro area, however, lacks such processes and fiscal risk-sharing was explicitly ruled out by law from the start (“no-bail-out” clause). A transfer system of significant magnitude is likely to be politically highly contested; particularly in countries that likely end up in a net payments position. Similarly, introducing joint debt instruments even on a small scale will face strong objections. The mere existence of euro bonds would be suspected as paving the way for the further mutualisation of accumulated national public debts and of undermining national budgetary autonomy. Introducing a limited role for joint debt instruments would possibly raise demands for an increase of the issuance of joint debt, for example to handle the problem of “legacy debt” once monetary policy becomes tighter. Some commentators explicitly recommend “small steps”, only because the final aim of a full fiscal union appears not to be currently attainable (e.g. Bofinger 2016, De Grauwe and Ji 2016). Therefore, any limited role for a joint debt instrument is likely to face strong objections even if it is not intended to mutualize accumulated national debt. Overall, the creation of a joint budget and joint fiscal stabilisation policies represent far-reaching institutional changes that would require a consensus among all Member States that advantages of a joint stabilisation function outweigh possible disadvantages.

5.3 Fiscal union: The way forward?

The extent of fiscal integration, risk-sharing mechanisms, and also legacy-sharing could in principle be scaled up deliberately. A centralized fiscal authority could be allowed to issue joint debt, thereby shifting funds over time (intertemporal smoothing) and redistributing available fiscal resources between Member States (between-country smoothing). Moreover, fiscal spending decisions could also be partly carried out at central level, if reasonable collective goods for the euro area could be identified. Additional steps might concern introducing euro area taxes for the joint budget (instead of member state contributions), joint debt instruments (to remove differences in credit ratings and refinancing costs), debt mutualisation (to remove country-specific restrictions caused by high debt levels, i.e. “legacy sharing”), harmonized institutions and regulation (to harmonize macroeconomic adjustment processes), a joint treasury, and a euro area finance minister. The extent of such further steps of integration could in principle be scaled up deliberately, ranging up to a full fiscal union.

**There is disagreement whether the monetary union should actually evolve in the direction of a fiscal union.** Some proposals argue that further integrative steps towards a fiscal and political union

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13 Zuleeg (2015) suggests that a centralized fiscal authority might link availability of fiscal spending to proper implementation of country-specific recommendations (via “contractual agreements”), so that the fiscal authority would basically use its spending power as an instrument to pressure Member States into complying with a centralized reform agenda.

14 For example, progressive income taxes as well as social security contributions are generated over-proportionately in the industrial centers of Southern Germany, where unemployment is very low, incomes are high, and people are relatively young. In contrast, rural areas in Eastern Germany exhibit lower incomes, higher unemployment rates, and many pensioners, who on average cause higher health costs. There is a similar pattern across U.S. states.
are desirable and even necessary for the survival of the monetary union (e.g. Juncker et al. 2015, de Grauwe and Ji 2016, Bofinger 2016). In a fiscal and political union that encourages euro area wide preference formation on fiscal-policy-making, an increasingly powerful fiscal authority could in principle be able to increase the effectiveness of fiscal policy coordination, while – if designed accordingly – being constrained by democratically elected institutions on the national and European level. In addition, any decision about the establishment of a central fiscal authority (e.g. to administer a joint macroeconomic stabilisation function) would require a transfer of competencies. This, in return, required changes to the treaties of the European Union that need to be ratified by all Member States and would hence be democratically legitimate. Against the background of the rise of Eurosceptic parties, however, such further and far-reaching European integration currently seems to be a rather distant prospect.

**If a fiscal union is unattainable, strengthening resilience of the monetary union becomes paramount.** In this vein, other commentators argue that further fiscal integration is not necessarily required, but instead that the monetary union and the financial system need to be made more resilient, so that fiscal failure in one country does not harm the monetary union as a whole, and that the euro area should credibly re-establish the no-bail-out principle (Baldwin et al. 2016, Feld et al. 2016, Weidmann 2016). The latter approach does not necessarily involve or require substantial further steps towards stronger fiscal and political integration. If a fiscal union is unattainable, strengthening resilience of the monetary union becomes paramount, especially when taking into account that support for European integration has previously been predominantly based on efficiency considerations (Scharpf 2015).
6. CONCLUSIONS

Altogether, we find that the joint fiscal stance is not a useful concept, because business cycle stabilization needs as well as debt sustainability considerations are first of all measured and relevant at the national level. Debt sustainability is a national responsibility and, so far, only national authorities have the means to conduct fiscal policies.

Proposals for implementing a euro area fiscal stance are highly questionable as long as this requires countries to run more pro-cyclical fiscal policies. Such a proposal would also run into problems with incentives, since increasing public spending in one country beyond its cyclical needs would generate welfare losses for that country, because that country would experience less fiscal space and more volatile business cycles. What is left is the issue of spillovers: Additional spending in one country would help other countries under specific conditions, where (1) trade spillovers are high, and (2) there is no (or only a small) reaction of monetary policy to a fiscally-induced increase in economic activity. Moreover, (3) additional spending appears reasonable mainly in an environment where monetary policy does not successfully stabilize the output gap for the euro area as a whole. However, even when these conditions are satisfied, we argue that such a policy would still destabilize the euro area at disaggregated level and induce more cyclical divergence across countries.

While a transfer mechanism (to address cyclical risk-sharing) can potentially improve the alignment of business cycles between Member States and alleviate fiscal restrictions to some extent, there are risks of moral hazard and persistent one-sided transfers. Given that the benefits of such proposals for aggregate business cycle stabilization are highly uncertain, and given that the consequences of such proposals are likely to shape the lives of citizens in the euro area, it is crucial to consider the democratic legitimacy of such proposals. In a fiscal framework that gives more responsibilities to the euro area level, assessing and determining an appropriate aggregate fiscal stance would require a process that is transparent and responsive to euro area wide political preferences.
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Contact: egov@ep.europa.eu