Is There an Alternative to the Fiscal Compact for Conducting Fiscal Policy in the Euro Area?*

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This paper suggests an alternative framework for achieving fiscal discipline in the Euro Area. It is argued that national fiscal policies should focus on a long-term objective, such as a public debt-to-GDP ratio, and the common monetary policy should focus on a short-term objective, such as price and output stability. The result is a self-stabilising set-up where the enforcement problem has largely been resolved.

1. Introduction

It is widely believed that members of a monetary union should have their fiscal policies restricted by rules to prevent unsustainable debt developments.[1] Otherwise, the argument goes, a country allowing its debt-to-GDP ratio to grow continuously will create negative spillover effects. There are two dimensions to this position: First, with access to borrowing in the union-wide capital market, a country with excess deficits will drive the union interest rate upwards. This may force other member countries to follow more restrictive fiscal policies to keep their public debt on a sustainable path. Second, the common central bank may come under pressure to ease the stance of monetary policy, thereby potentially undermining the independence of the central bank and creating an inflationary pressure.

Both of these spillover arguments motivate the existence of a control mechanism to keep budget deficits, or debts, below a certain threshold. However, it is not uncontroversial to argue in favour of explicit fiscal rules. For two reasons: First, financial markets may play an important role in preventing governments from pursuing overly expansionary fiscal policies. The point is that a risk premium will be attached to government debt of a country in fiscal trouble, leaving the interest rate in a country with sound public finances unaffected, and hence there would be no spillovers.[2] However, whether that actually happens or not depends on whether the markets price the financial or default risks to the monetary union itself; or whether they price the risk to individual countries. If it is the former, then spillover effects are present, rules or no rules. Second, fiscal rules are typically ineffective since experience with such rules show that they are difficult, if not impossible, to enforce.[3] Either way, fiscal rules are likely to be problematic.

In reality, market pressure is typically complemented by explicit fiscal rules, but it is still an unresolved question what the ideal mix between market pressure and fiscal rules is or what those rules should be. In the European Union (EU), fiscal rules have been in place for several years. The Maastricht Treaty imposed numerical limits on the fiscal debt and deficits of those joining the Euro Area (EA). Those limits became permanent with the Sta-

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bility and Growth Pact (SGP) in 1997. The most recent development involves the fiscal compact (FC) which was agreed in 2012. This is a balanced budget rule, extended by an automatically triggered correction mechanism at the national level and a strengthening of the automaticity of the excessive deficit procedure within the SGP if the deficit criterion is breached by a member of the EA.

In this paper we offer a critical assessment of the past and existing fiscal set-up in the EA, and we consider a new framework for achieving fiscal discipline. From here the road map of the paper is as follows: We first provide a political economy examination of why the SGP has effectively failed. Next we review the recent changes to the fiscal framework in the EA, focusing on the design of the FC. Then we revisit the debate about the objectives of fiscal policy, whether fiscal rules should target debt or deficits, and how to co-ordinate fiscal and monetary policies. This is followed by an outline of how an excess debt protocol might be constructed to give enforceable form to such a regime. Finally, we argue that fiscal rules should be set in a forward-looking fashion to allow for the impact of projected demographic changes and other implicit liabilities.

2. The Failure of the Stability and Growth Pact

The SGP was adopted in 1997, prior to the creation of the euro, in order to ensure that fiscal discipline is maintained in the member states.[4] The Amsterdam Treaty which governs the working of the SGP defines a country to have an excessive fiscal deficit if *both* that country's deficit exceeds 3% of its GDP, *and* if the Council of Ministers judges it to have done so. This leaves open the possibility that the Council of Ministers will judge the deficit *not* to be beyond the 3% limit on the grounds that the excess is either excusable, or only temporary; or because the excess is measured incorrectly or has appeared for reasons beyond the accused government's control. In effect, the SGP has proved to be unenforceable in practice.

Two facts suggest why the SGP is difficult to enforce. First, deficits are to a large extent endogenous, as revenues and expenditures fall and rise around the cycle. Thus, slow or negative growth will typically make a given deficit *ratio* rise, even if the deficit itself has not changed. This gives plenty of scope for arguing that a deficit is temporary or unexpected and beyond the violating government's control. Second, when France and Germany had exceeded the 3% limit for two years, without accepting the sanctions or deficit reduction plans imposed upon them, their cases were referred to the European Court of Justice. However, the Court found in favour of Germany and France precisely because the Council of Ministers had not declared them to be in excess of the 3% limit. In effect, the credibility of the enforcement process was lost.

Since a necessary condition for enforcing the SGP is that the Council of Ministers declares a country to be in violation of the excessive deficit procedure, there clearly is a „sinners-sitting-in-judgement-of-sinners" problem here. This is so since the Council includes representatives of the violating government and unanimity is required in matters of taxation and fiscal policy. Even if unanimity is taken away, there is very little incentive for countries to vote to support an excessive deficit decision and sanctions. Indeed, it could be claimed that the SGP will fail almost by construction, as the only incentive to adhere to it is the risk of a new financial and debt crisis.

In fact, an accused government will have a natural incentive to veto such a decision or to try to promote a veto. Meanwhile other council members, whether they also have excessive deficits or not, have a strong incentive to provide a veto on the argument that „it will be our turn next, so a veto now will bring a veto in our favour next time". More worrying still are the possibilities that countries will form coalitions to vote against such decisions in support of one another. They will do so in their own perceived short term self-interest on the argument that some countries are too big to fail, or that it would be too dangerous to the rest of the community and to the voting country in particular, in terms of deflationary spill-overs, if the accused were forced to cut back its deficits sharply.

As France and Germany push for sanctions for EA members who break borrowing limits, both countries are among the worst offenders. Wyplosz (2012) has shown that, of the 12 original members of the single currency, 10 have run up budget deficits beyond the 3 per cent limit since 1999. From 1999-2011, Greece has broken the rules every year, Portugal in 10 of those years and Italy eight. Next is France (seven), followed by Germany (five). In contrast, Ireland, which had to be bailed out because of the state of its public finances, was outside the 3 per cent limit in four of those years. Spain, which like most EA countries is adopting tough austerity measures to put its public finances in order, also broke the rules in four of those years. Only Luxembourg and Finland were within the limit every year.

In sum, automatic sanctions for EA countries running deficits above 3 per cent are all very well in principle, but the procedures for addressing non-compliance have lacked automaticity. Only two countries have managed to consistently fulfil the criteria, and financial sanctions have never been imposed. The SGP has not succeeded in securing fiscal discipline, and it is far from clear whether any new sanctions will be enforced. It is difficult to see how this process will not again become mired in political wrangling between the EU and member states, especially if one of the larger core countries, say France, is in violation of the rules. It therefore seems unlikely that the SGP, even as currently constituted, would ever produce a judgement that a country was in violation of the excessive deficit rule and should be sanctioned, especially if it involves a large country.

3. Recent Revisions of the Fiscal Framework in the Euro Area

The recent changes of the economic governance framework in the EU/EA have taken place in several incremental stages. The starting point is the *European Semester*, agreed in June 2010 by the European Council, which is an instrument to ensure consistency between monetary, fiscal and structural policies. A few months later, in September 2010, the European Commission published their ideas of what would constitute an effective system of fiscal restraints to provide long term financial stability. These proposals specify a debt target of 60%; that countries with debt ratios exceeding 60% should show adequate progress to reaching that target, defined as eliminating 1/20th of the excess over 60% each year; and that each economy with a persistent excess debt ratio on this criterion should pay a fine of 0.2% of GDP each year. There was also a proposal that the growth in public spending should not exceed the growth in GDP. Moreover, these proposals added a „debt brake", meaning that current spending must be balanced across the cycle. However, the sanction or penalty to be imposed on those who fail to meet this condition, what definitions of current spending and cycle should be used, and how compliance with such a condition can be measured in real time, are all questions that remain unresolved. But they need to be resolved before they become constitutionally embedded.

The *Euro Plus Pact*, also referred to as the *Competitiveness Pact*, was agreed in March 2011. While mentioning a better coordination of economic policy as the main objective, the real focus was to improve competitiveness in order to obtain a higher degree of convergence. There were provisions that countries unable to improve their competitiveness, or correct persistent macroeconomic imbalances, will be fined 0.1% of GDP each year. However, what constitutes „persistent", or what criteria define „competitiveness", and which imbalances should be targeted, are matters that remained to be agreed. Popular suggestions are to increase the retirement age, or restrict wage increases to no more than productivity growth.

Under the term the *„six-pack"*, five regulations and one directive entered into force at the inter-governmental summit meeting in December 2011. It was decided *not* to create a pan-European treaty to implement the ideas set out in the Commission's September 2010 report, but to create instead an inter-governmental agreement in which the main ideas of the new enhanced SGP could be set.

In March 2012 the Heads of State or Government of all EU countries (with the exception of the UK and the Czech Republic) signed the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (TSCG), see European Council (2012). The most important component of the TSCG is the *fiscal compact* (FC), which states that the budgetary position of the general government shall be balanced or in surplus. The rule is respected if the annual structural balance of the general government is at its country-specific medium-term objective, defined as a maximum structural deficit of 0.5% of GDP at market prices.

If significant deviations from the medium-term objective or the adjustment path towards it are observed, a correction mechanism shall be triggered automatically. The mechanism shall include the obligation to implement measures to correct the deviations over a defined period of time. These rules shall take effect in the national law of the EA member state at the latest one year after the entry into force of the FC through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes.

The EA members may temporarily deviate from their medium-term objective or the adjustment path towards it only in exceptional circumstances, namely if the ratio of government debt-to-GDP at market prices is significantly below 60%, and where the risks to the long-term sustainability of public finances are low. In such situations, the lower limit of the medium-term objective can reach a structural deficit of at most 1.0% of GDP at market prices. Otherwise, when the ratio of their general government debt-to-GDP ratio exceeds the 60% reference value, the member shall reduce it at an average rate of one twentieth per year as a benchmark. If the Court of Justice of the European Union finds that the country concerned has not complied with its judgment, it may impose on it a penalty payment capped at 0.1% of its GDP.

Two other conditions have been added. First, all member governments have agreed to allow their budget plans and performance to be inspected and commented on by Commission officials. So the Commission may begin to act a little like the Stability Council discussed below. Second, the voting on whether sanctions should be applied to those who breach this FC has been changed. Before, a qualified majority of countries had to vote to impose a fine on any country deemed to have violated the SGP's 3% deficit limit, otherwise no fine. Now, the fine would be imposed automatically, and a qualified majority has to vote to get a fine lifted. Fines are therefore far from automatic since blocking coalitions are relatively easy to construct.

While the sanctions process is somewhat stronger than before, the fiscal compact is likely to be difficult to implement and enforce. This is due to a legal aspect which is often neglected by economists. The point is that the UK and the Czech Republic decided not to sign the TSCG. Since two EU members were not willing to commit to the TSCG, it takes the form of an intergovernmental treaty outside the EU legal framework, and as such it does not need to respect the EU Treaties. Indeed, the UK made it very clear that they would not accept the TSCG to become part of EU law. Therefore, the treaty is based on ordinary international law rather than EU law.

With this weaker legal status of the FC compared to the SGP it may well become even less enforceable than the failed SGP. As is well-known, EU law (regulations, directives and decisions) take precedence over national law and are binding on national authorities. For example, it is only within the EU legal framework that (a) the EU Commission is allowed to submit cases for the Court of Justice of the European Union and (b) the relevant enforceability mechanisms apply, such as the legal apparatus which makes it possible to levy fines etc. By contrast, if the anchor for the FC is ordinary international law, it is up to the individual states to take each other to court, and this is unlikely to happen very often for the reasons identified in Section 2. It should be noted that the intention is to incorporate the substance of the TSGE into the EU Treaties within at most five years following its entry into force, and it is hoped that it will be applied and interpreted in conformity with EU law even before that.

The bottom line is that the fiscal compact is long on good intentions but short on substance (Gros, 2012). However, there is a potentially important addition to the compact, namely that only EA countries following the compact will be eligible to receive support from the permanent bail-out fund, the European Stability Mechanism (ESM). This may prove an effective enforcement channel but it clearly remains to be seen how powerful it is in practice.

4. An Outline of an Alternative Macroeconomic Policy Framework in the Euro Area

In this section we outline a framework for the conduct of fiscal policy, discuss whether fiscal policy should be stated in terms of debt or deficit targets, and finally we explain how fiscal and monetary policies could be better co-ordinated.

4.1. Short-term vs. long-term orientation of fiscal policy

The role of fiscal policy has traditionally been twofold: first, to serve as an instrument for macroeconomic stabilisation purposes (demand management) in the short term and, second, to achieve certain political objectives in the medium-to-long term, such as (a) the size of the government sector, (b) the allocation of resources across different public activities and (c) the distribution of wealth and income through the tax and transfer system. More recently, with most countries suffering from public debt problems, the main objective of fiscal policy seems to have shifted towards keeping public debt on a sustainable path. In any case, fiscal discipline has become a major concern.

We believe that fiscal policy is not easily reversible, or easily used for stabilisation, if consistency across time and different policies is to be maintained. Moreover, depending on the details of the budgetary process, the implementation lag may be quite long for changes in instruments of fiscal policy, and this lack of flexibility may undermine the usefulness of fiscal policy for stabilisation purposes.

Admittedly, in the real world, and certainly in a European context, there is a caveat to the premise that fiscal policy has a long-term orientation. In fact, although the European fiscal rules were founded on long-term targets, they were not respected, as discussed extensively in section 2. Similarly, while one could concur that fiscal policy is not suitable for stabilization, the experience from the recent crisis, with widespread use of stimulus packages etc., seems to suggest the opposite.

However, these facts do not rule out that a fiscal framework based on a long-term orientation is the appropriate design for the future, i.e. after the disruptions of the financial crisis. And again, while focusing on long term targets we recognize that fiscal policy could play a role as a stabilization device, as long as the longer term objectives would not be jeopardized for the sake of short-term objectives. Specifically, if the common monetary policy is not stabilizing enough at the individual country level, the fiscal stabilisation objective is permitted only if debt sustainability is not compromised.

4.2. Debt vs. deficit targets

Against that background, we proceed on the assumption that fiscal policy is better conducted in terms of long-term rather than short-term objectives. This naturally brings us to a discussion of whether fiscal authorities should target the public debt (a stock) or the public deficit (a flow). We have argued elsewhere that debt targets are superior to deficit targets, both for theoretical and practical reasons (see, e.g., Hughes Hallett and Jensen, 2012).[5] Here we briefly revisit this discussion.

We start by offering a technical argument why a stock target is more appropriate than a flow target. The reason is that fiscal deficits, and hence public debt, are endogenous and subject to random shocks, whether external shocks, policy errors or temporary indiscipline. Any fiscal control regime must therefore designate a „safe zone" around the preferred target value within which the debt ratio can fluctuate freely; and specify a self-stabilising control mechanism to ensure that the debt ratio automatically returns to its target following a shock.

The implication of a „safe zone" is that any government that goes beyond it to higher levels of debt will have to be rescued. Many rules can satisfy those requirements. But an element common to all of them is that, in order to control a target variable so as to ensure that it eventually converges on its designated target value, the decision rule for the policy instrument must follow a difference equation of at least the same order as that governing the behaviour of the target, and one degree higher if full convergence is to be possible (Salmon, 1982). A deficit rule cannot satisfy those conditions, unless there are no dynamics in the system, but a debt rule (driven by the accumulation of past deficits) automatically does so. In technical language, we move from proportional to integral control rules.

Turning next to some more practical aspects, the first point to make is that debt targets are helpful because they focus on the ultimate risk: unsustainable public finances. An important question is whether hard or soft targets should be chosen. We prefer soft targets (a band, or a debt ceiling) since, compared to a setting with hard targets, decision making is less likely to become disabled by arguments over the precise definition and measurement of the target, or the arbitrary nature of a numerical limit. In addition, soft targets introduce flexibility into policy making, so that the pro-cyclicality of hard targets is reduced, along with the tendency of rigid targets to block reforms whenever the latter have short run costs. Soft targets can also accommodate the positive effects of a deficit, and allow different national priorities, although simplicity and fairness suggest uniform limits might be imposed in the long run. Moreover, a soft target version allows policymakers to trade off good years against bad. In effect, because the target is a stock not a flow, this produces a cyclically adjusted fiscal rule without the extra difficulty of having to actually calculate the cyclically adjusted deficit accurately.

Finally, since debt is a stock and therefore more persistent, a debt rule gives policy makers a greater incentive to obey the rules: first, to preserve freedom of manoeuvre in the future and, second, to save at the top of the cycle and therefore remain „within target" in the future.

4.3. Co-ordination of fiscal and monetary policy

Fiscal policies need to be co-ordinated, not only among themselves to avoid threats of instability and adverse spillovers on others, but also with monetary policy to ensure consistency and commitment to inflation goals and financial discipline. It is important that fiscal policy be handled this way so that it does not undermine monetary discipline, and does not trigger an overreaction by the monetary authorities when governments are attempting to stabilise employment or reach their objectives.

As we have argued repeatedly, fiscal policy lends itself naturally to longer term objectives. This provides an element of (Stackelberg) leadership, in the sense of fiscal authorities „going first". The leadership role derives from the difference in timing: fiscal policy has long-term targets and monetary policy short-term targets. In effect, this is an intertemporal assignment, where fiscal policies directed at long-term objectives are set first, and then followed by, or combined with, an independent monetary policy directed at short-run demand management objectives. That framework creates a basis for *rule-based* co-ordination between policymakers without the need for explicit negotiations, and where each policy would operate according to comparative advantage.

Finally, since debt targets imply a degree of persistence, especially in countries with higher levels of public debt, they can be used to pre-commit fiscal policies to a path which is consistent with the expected stance of the independent monetary policy. Hence they are well suited to achieve the twin goals of sustainable public finances and limited spillovers on others. Moreover, because a debt target is more persistent, it facilitates the creation of credibility and commitments for the future. From here we get the fiscal pre-commitment we need; but only if monetary policy follows (with a shorter horizon) to provide the threat of punishment to any deviant fiscal policy making.

5. Debt Targets in Practice

The problem with any fiscal control rule is whether it can withstand the pressure to undermine its enforceability, as the EA experience with the SGP process amply illustrates. With this critical dimension in mind, we propose the following enforcement mechanism, based on the governance principles outlined in the previous section:

A. The debt targeting system should be set up for each government as a target value and an upper boundary or ceiling (both expressed as a percentage of GDP);
B. The space between the target and upper boundary should be divided into three equal ranges;
C. The debt target values may be specific to each country, at least in the transition from today's high debt ratios to more reasonable values for a long term framework.

But they are more likely to reach and follow a common value thereafter.

By way of illustration, if the debt target was set as a 45% debt-to-GDP ratio, and the ceiling at 60% in normal times, the excessive debt protocol range could be divided into three: from 45% to 50%; from 50% to 55%; and from 55% to 60%.[6]

The *first* range would be the range of normal fluctuation and would require no immediate action or comment (a debt ratio being a structural indicator, is less volatile and slower moving than a deficit).

If the level of debt entered the *second* range, the government would be placed on a watch list and be subject to comments and advice from an independent Fiscal Policy Commission (FPC).[7] Any financial assistance from the FPC or other governments, any liquidity provision to domestic firms or banks by the central bank, or comfort statements from the FPC to reassure the markets, would become conditional on policy improvements being undertaken and subject to joint oversight.

If that government's level of debt entered the *third* debt range, this would trigger public warnings and specific policy recommendations to remain in place until the 55% ratio or less is regained. At this point, any assistance, loans, or bail-out guarantees would become strictly conditional on those recommendations being implemented and carried out to the FPC's satisfaction.

Finally, if the government's debt-to-GDP ratio rose above 60%, all bail-out guarantees would be suspended and any new or refinanced debt would be priced according to market forces with an explicit *no bail-out* provision attached.

The principle threat to domestic policymakers is that this step will be known in advance. Moreover, any further European or IMF support would only be offered if the government is able to accept the „assistance“ of Euro Area or European Commission officials in running government spending and taxation until the 60% limit or better was regained. In other words, the national fiscal authorities would be placed in administration.

Any loans or assistance invoked under the excessive debt protocol would be channelled through the EA authorities (or the European Commission). To pay for that, the EA authorities could use its own funds plus a levy imposed of 0.25% of GDP say for each percentage point that any *deficit* (symmetrically for any participant) had exceeded the 3% limit in the period in which public debt was in one of the upper two excessive debt ranges. This levy would be lifted only in quarters in which growth was recorded as negative. Those conditions would be agreed and made public before the regime started, and each government's progress in relation to them would be assessed and discussed in public by the FPC. The point of this fund would be to provide some risk sharing properties, IMF style, between the EA governments.

Apart from a mild fiscal penalty designed to slow down the expansion of excessive deficits in the debt conditionality ranges, the real sanction in this protocol is that the possibility of any loan, bail-out or other help is strictly conditional – and known to be so. Once the public debt-GDP ratio goes beyond the 60% barrier, any further assistance is withdrawn and the national government will be abandoned to the mercy of the markets.

Since this fact will be well-known in advance, and that any breaches come with two zones of warning, it should act as a break on imprudent debt expansions (except in severe recessions) and should guard against the dilemma of moral hazard. In fact, given the warnings and the threat of outside control, any government that nonetheless transgressed the 60% debt-to-GDP limit would likely be subject to a severe political backlash and incur escalating borrowing costs. Note also that the penalties in this scheme are ex ante: designed to withhold what a government would like to have (fiscal freedom, guarantees, lower borrowing costs), rather than to remove something which they already have (resources for a fine).

Finally, in view of the fact that most EA countries are well above the 60% limit, the political relevance of our proposal might in the current situation appear doubtful. However, the fact that many countries have debt ratios above 60% is not really relevant. Rather, what we present is a medium-to-long term, or post-crisis, proposal. So we assume that some of the current proposals to mutualize and control debts will be adopted. That implies a stagewise return to 60%, exactly in accord with the new fiscal compact of 2012.[8]

6. Further Perspectives on Debt: Accounting for Implicit Liabilities

If a debt targeting rule is chosen, the question arises: what public debt level, or debt-to-GDP ratio, should be targeted? One approach would be to draw on the empirical research which has established a link between public debt and economic growth. For example, in the oft-cited study by Reinhart and Rogoff (2009) it is found that debt-to-GDP ratios above 90% tend to hamper economic growth. Bringing debt ratios below 90% would most likely be desirable from the perspective of economic growth, and such studies would hence offer a useful empirical basis for deriving the level of public debt that maximises economic growth rates.

A more sophisticated theoretical approach is given in Aschauer (2000) where the optimal level of public debt is expressed in terms of the public-to-private capital ratio. This will allow us to determine and calculate the best level of public debt for any specific economy and sample period. Such a rule does of course imply some kind of golden rule or „debt brake“ in the long run since, across the cycle, current government spending has to be financed by current revenues rather than borrowing. In steady state, the debt ratio will become constant, as confirmed in empirical work by Aizenman et al. (2007). If maintained, such a rule would imply sufficient capital cover in the economy as a whole for the public borrowing, which is just a matter of good banking practice.

As discussed by Auerbach (2009), the search for an optimal level of public debt involves other complicated trade-offs. For example, how should concerns about intergenerational equity be balanced against economic performance (inflation, investment, growth etc.) and long term fiscal sustainability? In fact, bringing debt ratios below 90% may be desirable from the perspectives of both long-term economic growth and sustainability of public finances, as discussed above, but the fiscal restraint involved might be thought to place an unfair burden on current generations.

The problem of choosing a target for public debt also involves the question about whether or not to account for implicit liabilities. Typically, the government liabilities entering the calculation of government debt only include explicit liabilities. However, if we think of these liabilities as requiring future revenues in order to avoid default, using an explicit debt criterion only by itself can be highly misleading. If implicit liabilities are ignored, it means failure to account for the budgetary impact of future liabilities originating from, notably, ageing populations, despite the fact that future revenues will be needed to cover the benefits that have been promised to existing workers and beneficiaries. This is the case for extending the existing debt targeting proposals to include predictable demographic changes, see Bokan, Hughes Hallett and Jensen (2012).

Several papers, including Kotlikoff (2006) and Davig et al. (2010), have emphasised the fiscal „overhang“ posed by the uncovered expected financial liabilities associated with public pension schemes and likely health and social support costs in most OECD economies. A recent paper by IMF (2009) has put this problem into dramatic form by showing that the financial stress caused by the great financial crash of 2007-10 was probably only about 10% of that likely to be caused by future age related spending in economies with a shrinking labour force. Against that, if fiscal sustainability is now the objective, it makes sense to search for fiscal rules capable of ensuring the sustainability of public finances *given* ageing populations, shrinking labour forces and greater implicit liabilities.

In fact, the EAs fiscal compact fails to account for those serious concerns. Therefore, we find that balanced budget rules, key to the fiscal compact, are not appropriate. Instead, more sophisticated fiscal rules are needed which allow for the implicit liabilities that are generated by projected changes in the age-structure of the population. The implication is that a government facing a demograhic change, or the need to adjust to more social spending, will have to adjust their fiscal plans to accommodate those changes. Therefore, forward-looking rules are likely to call for even more severe austerity measures than those already made necessary to resolve the sovereign debt crisis in the EA.

7. Concluding remarks

This paper has provided a critical assessment of the fiscal set-up in the Euro Area, including the fiscal compact that was introduced recently. Based on serious enforceability problems associated with past fiscal arrangements in Europe, we have proposed an alternative macroeconomic framework for achieving fiscal discipline. The key idea is an intertemporal assignment where national fiscal policies focus on long-term objectives and a common monetary policy on short-term objectives.

A natural way to pre-commit fiscal policy in a form that can be combined with independent monetary policies, but without any explicit negotiations that might compromise monetary independence, is to make fiscal policy „lead“ in the sense of being the first to decide and for a longer period of commitment. This idea can be implemented by giving the fiscal authorities an explicit debt target to provide the pre-commitment mechanism to a long-term objective and slow moving target variable. We have further argued that the debt target should be set in a forward-looking fashion to account for implicit liabilities, such as the discounted budgetary impact of changing demographics in addition to conventional debt measures.

That framework creates a basis for *rule-based* coordination between policymakers without the need for explicit negotiations, and the result is a self-stabilising set-up where the enforcement problem has largely been resolved. Once the monetary authority knows the (credible) long-run path of fiscal policy, it is free to choose a monetary policy that fits best in terms of achieving their objectives. Should fiscal policies deviate from their chosen path, monetary policies can quickly counteract to cut out any unwanted consequences. This threat would normally be enough to persuade fiscal policymakers to stick with their announced path.

Notes

1. There is a large academic literature on the implications for fiscal policy of monetary unification in Europe, see, e.g., Hughes Hallett, Hutchison and Jensen (1999).
2. Recent studies on European interest rate spreads (e.g., Mink and De Haan, 2012) find evidence of contagion, in particular across southern European countries.
3. Based on data collected for the American states, von Hagen (1991) found that explicit fiscal rules had only little impact on budget deficits.
4. Recent studies evaluating the SGP include Buti, Eijffinger and Franco (2003), European Central Bank (2005), Fischer, Jonung and Larch (2006), Hallerberg, Strauch and von Hagen (2007) and Schuknecht, Moutot, Rother and Stark (2011).
5. In Denmark, for example, a policy of public debt targeting is widely regarded to have been very successful for a decade or so, see Andersen, Jensen and Pedersen (2008).
6. Recent work by the European Central Bank (Checherita, Hughes Hallett and Rother, 2012) has shown how to calculate optimal debt targets from first principles based on intertemporal decision making. Applying this to the OECD and the EA countries, respectively, they obtain optimal debt ratios of 67% for OECD countries and 50% for EA members, both reported as averages. So, a target of 50% and a ceiling of 60% make sense for the EA. At this stage, numbers have not been found for individual countries, which is an obvious task for future research.
7. On the role of and experiences with fiscal policy councils, see Calmfors and Wren-Lewis (2011).
8. In fact, a report by the President of the European Council (Van Rompuy, 2012), prepared for the European Summit on 26 June 2012, appears to have endorsed the idea of debt limits and desirable debt levels individually by country. However, the wording in the report (prepared in close cooperation between the Presidents of the Commission, the Eurogroup and the European Central Bank) is a bit vague and no position is taken as to what the reference values should be in practice.

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