United or Divided We Stand? Perspectives on the EU's Challenges

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To Centralise or Decentralise? Implications of German and US fiscal performance for EMU

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ABSTRACT

Since the 2010 sovereign debt crisis, debates on fiscal discipline in the EU have centered on the need to centralise further economic governance under EMU. Reforms to the Stability and Growth Pact (SGP), the basis for EMU's supranational governance framework, have sought to strengthen centralised mechanisms of fiscal surveillance and enforcement. Is this the correct approach?

The paper poses two related questions. 1) Has increased centralization of EMU's governance framework succeeded in instilling fiscal discipline among Member States? 2) If not, under what conditions could fiscal discipline be achieved?

The paper argues that the Stability and Growth Pact (SGP) has failed because it is incompatible with budgetary sovereignty prescribed by the Maastricht Treaty. It also argues that the specific rules envisioned in the Pact have consistently failed to find an appropriate balance between rules and discretion. Using fiscal data from the US and Germany, the paper argues that fiscal discipline can best be achieved through the strengthening of national instead of supranational fiscal institutions. However, this is contingent upon a firm re-commitment to the Maastricht Treaty's 'no-bailout principle' and the transferal of financial sector risk from the national to the supranational level.

1. Introduction

Which aspects of the European policy landscape should be centralised and which should remain decentralized has long been a subject of interest for scholars of European integration. Advocates of 'more Europe' have argued that further centralizing fiscal competences is a necessary act of self-preservation for Member States using the euro - particularly in light of the punishing economic crisis which has vexed European policymakers since 2010. The crisis has resulted in a flurry of regulatory activity seeking to plug perceived gaps in Economic and Monetary Union's (EMU) governance structure.

The general outcome of these reforms has been a 'doubling down on existing policies and to strengthen supranational enforcement mechanisms to ensure that Member States credibly commit to fiscal discipline; a principle long identified as an absolute requirement for the viability of EMU. Is a further layer of external conditionality on the fiscal policies of member the answer the EU's problems? The paper seeks to answer this question with reference to themes raised in the twin literatures of fiscal federalism and multilevel governance.

This question is particularly relevant because the Stability and Growth Pact (SGP), the fiscal framework in place since 1997 has consistently failed to achieve the desired result. The paper argues that the SGP institutionalised centralised mechanisms of control, despite the fact that EMU lacked a 'fiscal center' by design. In this regard, the policy was doomed to fail from the start. Indeed, at no point since the establishment of the euro in 1999 has the SGP achieved its stated aims of prohibiting deficits of over 3% of GDP and national debts higher than 60% of GDP.

The crisis has laid bare the weaknesses of EMU's governance framework. The length and intensity of the crisis is in many ways a reflection of these weaknesses. The root of these weaknesses can be found in the policy framework that emerged following the ratification of the Maastricht Treaty in 1991. The Treaty establishes a clear separation between the monetary and fiscal spheres. The conduct of monetary policy was to be transferred to the European level, while fiscal policies were to remain a national competence. The implication of this arrangement is a clear centralization of monetary power and a clear *de*centralization of fiscal power.

Using fiscal data from Germany and the United States, the paper argues that the EU's economic governance framework has failed because it prescribes a 'supranational' solution to what has been clearly established as a national problem in EMU's founding texts: the problem of fiscal indiscipline.

The paper begins with a brief discussion of theoretical principles, an overview of the literature and an explanation of the research design and selection of the cases. This is followed by a presentation of the empirical data and an analysis of its implications for EMU. The analysis sets the stage for a discussion of fiscal dynamics under EMU – and why fiscal discipline assumes a unique importance within the context of a heterogeneous monetary union. The paper then presents a detailed analysis of EMU's economic governance framework and the reforms enacted after the onset of the sovereign debt crisis in 2010. Concluding remarks follow.

Fiscal Federalism and Multilevel Governance – An Overview

The literature on fiscal federalism is not directly related to conventional understandings of the concept of federalism. Rather, it is concerned with the inter-relationship between different levels of government in a fiscal sense (Oates 1999). It examines interactions between levels of government responsible for providing public goods and services and those responsible for collecting the revenues to fund them. In other words, fiscal federalism 'broadly considers the vertical structure of the public sector, fiscal policy institutions and their interdependence' (Virkola 2014: 4). These considerations are common to all countries in which policy-making is decentralized to any degree.

A central question posed by the literature is, which functions of government should be subject to centralised control and which should be decentralized? The theory lays out a general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions (Musgrave 1959, Oates 1972, 1999, 2006). The literature emphasises four main economic components of federal systems.

First, expenditure responsibilities must be assigned. The conventional starting point is that local governments hold more detailed information on the preferences of their citizens than higher levels of government (Oates 1972, 1999, 2006, Baskaran 2010). As such, they are typically expected to provide many 'basic' public goods and services such as sanitation, refuse removal and so on. According to the conventional view, policies concerning macroeconomic stabilization and redistribution should be left primarily for a higher level of government. Higher levels of government serve national interests. They are less likely to adequately deal with decentralized policy fields due to free riding or competition among jurisdictions (Geys and Konrad 2010). In addition, policies that induce significant spillover effects to other jurisdictions could justify assigning particular tasks to the central government

Second, there is the question of how to finance public goods and services. In federal arrangements, the level of government responsible for the provision of a particular good or service is typically expected to be responsible for its funding as well as collecting the necessary revenue. The provider bears the costs related to provision, which induces efficiency incentives that also serve to limit moral hazard (Brennan and Buchanan 1980, Weingast 1995). Tax instruments in federal systems are ideally assigned so that each level of government can realistically collect sufficient tax revenues. However, different levels of government are only rarely self-sufficient in terms of financing their operations in practice.

Third, appropriate instruments to redistribute fiscal resources and close 'fiscal gaps' (the disparity between incomes and expenditures) - over time and across jurisdictions - must be established. Most federal systems employ 'vertical' transfers from different levels of government to each other, and 'horizontal' transfers within the same level of government. The differences between revenues and expenditures are referred to as *vertical* and *horizontal fiscal imbalances* (Broadway 2005). Borrowing and different types of transfers such as conditional and unconditional grants are alternative instruments to stabilize imbalances between revenues and government expenditures over time.

Fourth, strategies must be adopted to cap excessive spending and borrowing at each level of government. (Oates 2006, Geys and Konrad 1010) Fiscal rules and governance practices regarding budget deficits and borrowing are also necessary to avoid fiscal free riding and limit moral hazard. In many respects, the allocation of responsibilities and instruments to different levels of governments is never clear-cut. Government responsibilities are frequently shared between federal and state governments or their actions are coordinated.

2.1 Literature Review

The question of how fiscal decentralization is related to debt accumulation is not well explored in the empirical literature, and there is no consensus on the issue. Marlow (1988) finds that fiscal decentralization is negatively related to total government size in the United States. In a study of 32 developed and developing countries, Jin and Zou (2002) conclude that that fiscal decentralization could pertain to either the expenditure or revenue side of the budget, and that effects might vary according to the side of the budget considered. Their research makes the rather general conclusion that fiscal decentralization as a concept encompasses both revenue and expenditure and that revenue decentralization and vertical fiscal imbalances between subnational expenditure and revenue autonomy should be treated as independent representations of fiscal decentralization.

There are only a limited number of studies on the impact of fiscal decentralization on government indebtedness. This does not imply that researchers have not attempted to analyze the determinants of public debt in general, however. There is a large literature concerned with this issue. Traditional normative approaches do not explain the varying levels of indebtedness between countries from an economic perspective. Alesina and Perotti (1995) sought to explain the phenomena from a political economy perspective, exploring ideological differences in the borrowing policies of governments. Neck and Getzner (2001) conducted a case study on the politico-economic determinants of public debt growth in Austria, while Seitz (2000) examined the determinants of subnational deficits in Germany. Both studies found that economic factors are generally more relevant than ideological variables.

The effects of government fragmentation (in parliamentary systems) or divided government (in presidential systems) on fiscal outcomes have also been studied. The theoretical expectation is that the common pool problem is more severe when governments consist of many coalition partners (parliamentary systems) or when different parties control the presidency and legislature (presidential systems). Volkerink and de Haan (2001) found that some forms of fragmented government lead to larger deficits. However, Elgie and McMenamin (2008) found that their results could not be generally replicated when a different sample was used.

The effect of fiscal institutions on public borrowing has also been analyzed. Feld and Kirchgässner (2001) argued that direct-democratic institutions like budget referendums constrain politicians who operate within the general framework of a representative democracy. Their analysis of Swiss municipalities found that direct democratic institutions lead to lower public indebtedness. Kiewiet and Szakaly (1996) reached the same conclusion on their study on the effects of constitutional limitations on borrowing within the US context.

A related literature studies the impact of budget procedures on debt accumulation. Numerical as well as procedural rules have been analyzed. Examples of numerical rules are the balanced budget requirements in US states or the Maastricht criteria upper limits for public debt and/or deficits. Procedural rules, on the other hand, relate to the stringency of the procedures that govern the various stages at which the budget is formulated. Cabasés, et al. (2007) examine the effectiveness of borrowing restrictions with data on Spanish, finding that they imposed some discipline on the borrowing policies of local governments.

Lagona and Padovano (2007) criticize the methodology with which the impact of budget rules is usually analyzed. They argue that the application of indices to measure the stringency of rules implies the need for arbitrary classifications. Instead, they propose a nonlinear principal component analysis approach. However, their results, too, indicate that more-stringent rules lead to larger fiscal balances and smaller budget sizes.

Using data on US states, Bohn and Inman (1996) found that budget rules affect fiscal outcomes. De Mello (2000) focuses on the effect of fiscal decentralization on the deficit of federal and subnational governments separately. He finds that subnational tax autonomy generally leads to an *increase* in subnational deficits. This implies that decentralization might aggravate soft budget constraints and coordination failures.

Fornasari et al.'s (2000) study of 32 developing and industrialised countries found that expenditure decentralization contributes to a larger government sector, but that subnational deficits are unrelated to the fiscal balance of the central government. However, they found that once a revenue measure of decentralization is used, decentralization turns out to be negatively related to central government budget deficits. The study also found that that expenditure decentralization increases central government deficits. Freitag and Vatter (2008), on the other hand, found more decentralized cantons in Switzerland tend to have smaller deficits in times of economic crisis. However, they did not observe significant differences between centralized and decentralized cantons under better economic conditions.

2. Research Design and Case Selection

In order to understand how these dynamics unfold in the European context, the paper examines economic governance arrangements in the Germany and the United States. The cases are relevant because the EU's economic governance framework draws heavily on German federal arrangements. While the *Länder* officially enjoy a large degree of *de jure* autonomy, they are nevertheless subject to considerable influence from the center. This influence extends from decisions on taxes, to mandates on spending standards, to the redeployment of funds to areas in need (Broadway 2004).

German fiscal rules can be best described as soft - there is no centrally imposed or effective no-bailout rule. The implicit guarantee that the Länder will be bailed out where needed has created strong incentives for deficit spending. As a result, the level of indebtedness at the Länder level in Germany is markedly higher than that of US states. Because of the strong influence exerted from the center regarding finances, two *Länder* struggling to balance their budgets, Bremen and Saarland, successfully argued in the 80s and early 90s at the German Constitutional Court that the federal government was obliged to provide financial assistance after they were denied bailouts.[1] In this regard, the German fiscal framework embodies 'common pool problems because of the way federal and state finances become interrelated' (Feld and Baskaran 2008).

If the German case is an example of a *centralised* fiscal framework, the United States case is an example of a strongly *decentralized* approach to economic governance. It should be emphasised that while economic governance in Germany and the United States is organised along very different lines, public spending is of the same order of magnitude: 44.5% of GDP in Germany and 38.8% in the US in 2013 - in 2013 the most recently available data (OECD 2015). The breakdown across levels of governments is shown in the table below. According to the OECD classification, social security is non-existent in the US while it represents

[1] For discussions on subnational bailouts in German, see Seitz (2000) and Pisauro (2001).

almost half of public spending in Germany. However, if added to the government share of spending, Germany can be considered somewhat more centralized (61% of all expenditures) than the US (51.9%) in 2014 but the orders of magnitude are nevertheless comparable and are reasonably consistent over time.[2]

Table 1.1: Total percentage distribution of expenses across levels of government 2014

	Central govt	State govt	Local govt	Social security
USA	51,9	48,1	0	0
GER	18,20	22,70	16,30	42,80

Source: OECD National Accounts Statistics database 2015

A key difference is that states are fiscally sovereign[3], each with a parliament in charge of deciding state spending and taxes. They are also fully responsible for raising the taxes needed to carry out spending. The separation between the federal and state levels is reinforced through a firm no bailout principle combined with self-imposed rules embedded into state constitutions that restrict the accumulation of debt. While the German system has not proved particularly successful, the US approach, in place since the 1840s[4], has consistently resulted in lower subnational debt levels. Moreover, the largest state debt is 19.6%, while the corresponding figure for the Länder is 66%.[5]

Economic governance under EMU mirrors the German experience. The Stability and Growth Pact (SGP) has consistently failed to stand up to legal challenges. When it was put in abeyance in 2004 following the French and German refusals to abide by its terms, the Commission took all member governments to the European Court. This is the exact opposite of the US case, where the no-bailout clause has been established not by legal obligation but by precedent. It is notably ironic that while the Maastricht Framework for EMU explicitly established a decentralized framework for economic governance, the chosen fiscal policy instrument for the euro area, the SGP, has sought to impose ex-post centralised mechanisms of fiscal control over Member States. It should therefore come as no surprise that it has failed in its stated aims.

3.1 Analysis

In the United States, the approach to fiscal policy and deficits is primarily market-based. State level fiscal policy is constrained by balanced budget rules that have been self-imposed by most states (Henning and Kessler 2012). The rules are not always formal nor do they necessarily encompass all state-level spending. Fiscal discipline is enforced by the federal government via a firm, albeit unofficial, 'no-bailout' rule, which prohibits federal government intervention in individual states in the case of excessive deficits and debt.[6] The rule has proved effective and credible inasmuch it has left markets to discipline state government borrowing since the unofficial rule was adopted in the 1840s (Bayoumi et al. 1995, Bohn and Inman 1996 and Schuknecht et al. 2009). Tables 1 and 2 show the differing roles at the central and subnational levels. Tables 1.1 and 1.2 clearly show a far stronger role for the federal government in Germany than in the US.

[2] The German welfare system is administered by independent, state-owned funds under federal supervision (Streeck 2005).
[3] For a direct comparison of differences in tax autonomy, see table 4.3.
[4] For an in-depth discussion of the history of fiscal federalism in the United States, see Henning and Kessler (2012).
[5] See following section for details.
[6] The US 'no-bailout rule' is technically a norm rather than a rule, as it is referred to neither in the US constitution nor in any provision of federal law. Following independence from the United Kingdom in 1776, the possibility of a federal bailout of states was a reasonable expectation. The practice ended in the 1840s, when eight states plus Florida, then a territory, were refused bailouts and defaulted.

Table 1.1 Consolidated government expenditure as percentage of GDP 1995-2014 – Germany

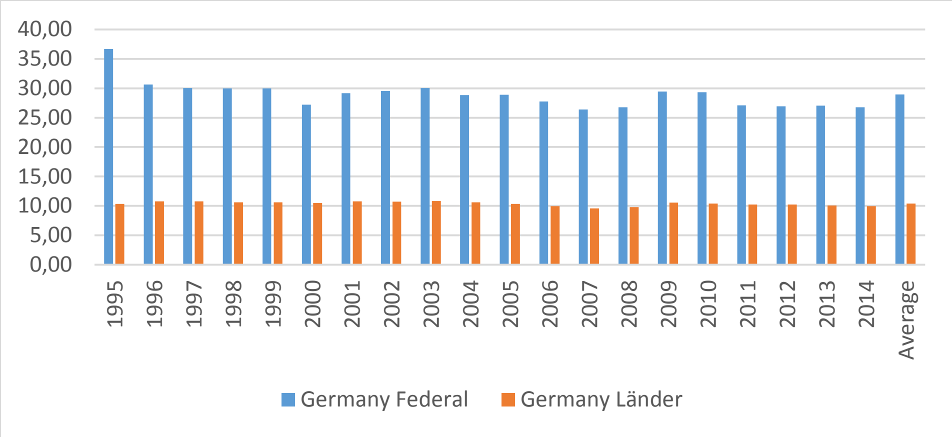
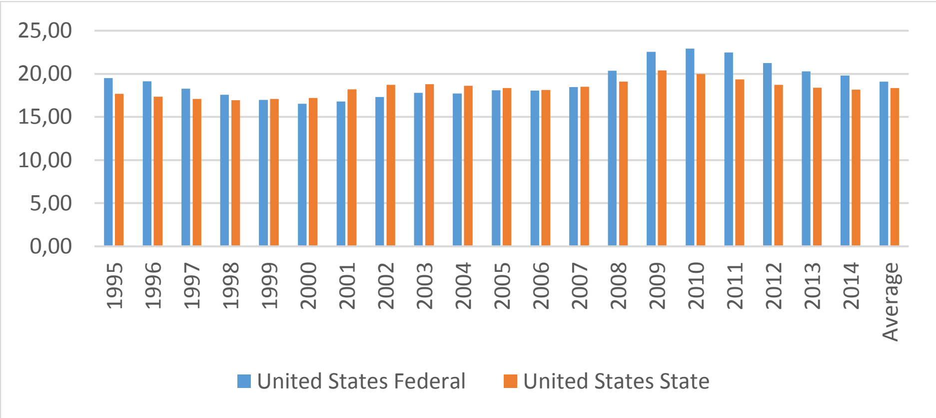


Table 1.2 Consolidated government expenditure as percentage of GDP 1995-2014 – United States



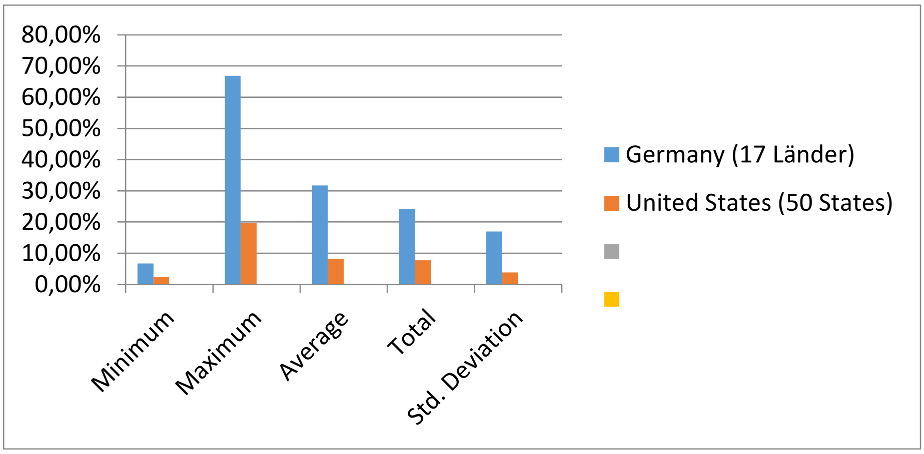
Source: OECD National Accounts Database (2015)

Tables 2.1 and 2.2 illustrate the effects of a clear separation between governance levels. The largest state debt (Massachusetts) is 19.6% of state GDP. Total US state indebtedness (7.7%) is a third of the German ratio (24.2%). Importantly, some German Länder have reached debt levels that do not meet SGP criteria for sustainability: this is the case of Berlin (66.9%) and Bremen (66.1%); the last one having already defaulted once as noted above.

Table 2.1: Debt to GDP comparison – Germany and the US (2014).

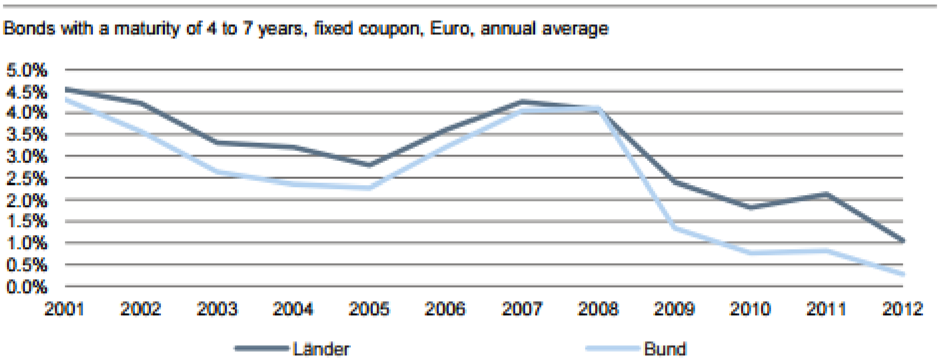
	Germany (17 Länder)	United States (50 States)
Minimum	6.70%	2.30%
Maximum	66.90%	19.60%
Average	31.70%	8.30%
Total	24.20%	7.70%
Std. Deviation	17.00%	3.90%

Table 2.2 - Debt to GDP comparison – Germany and the US (2015).



Sources: German Federal Statistics Office and US Bureau of Economic Analysis

Figure 1. Federal and Lander Bond Yield Curves 2001-2012



Source: Deutsche Bank 2012

Interestingly, interest rate spreads on state-level borrowing have not historically reflect a concern over fiscal deficits, indicating an implicit trust that Länder would benefit from additional fiscal transfers from the federal government or that they would be bailed out in the event of excessive debts (Schuknecht et al. 2009, Heppke-Falk and Wolff 2008).[7]

Table 3.1 Total liabilities as percentage of GDP 1995-2014 – Germany

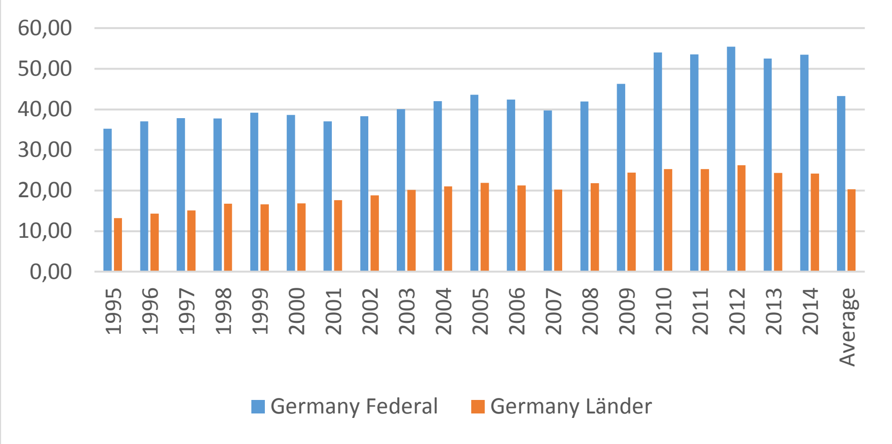
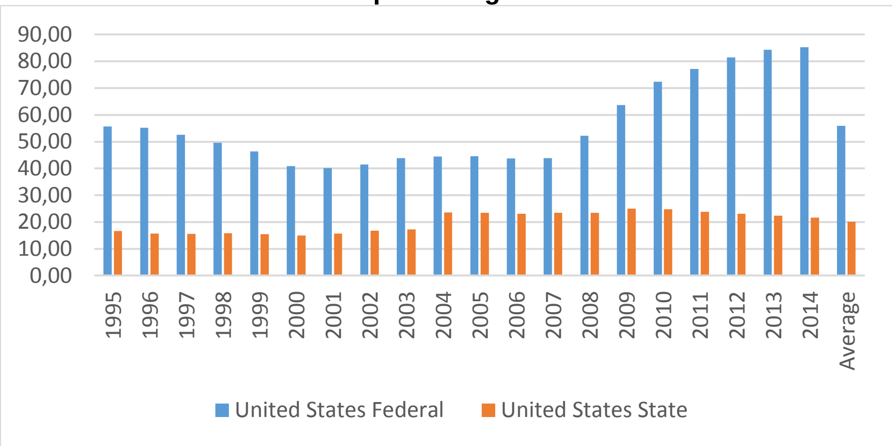


Table 3.2 Total liabilities as percentage of GDP 1995-2014 – United States



Source: OECD Fiscal Federalism Database 2015

As tables 3.1 and 3.2 indicate, the US approach has resulted in substantially lower debt at the state level over time, both as an average and on a per case basis. A credible (albeit informal) no-bailout principle in the United States has led to a situation where states have independently developed the necessary rules to prevent being placed in a situation when they would be forced to seek assistance from the federal government. The states also enjoy full autonomy in matters of taxation. This is considered a key determinant of the preservation of the no-bailout principle (Henning and Kessler 2012, Wyplosz 2012, Virkola 2014), and by extension, fiscal stability as a whole.

This can be contrasted to the German case. In practice, the federal in Germany government exercises legislative power, whereas revenue responsibilities are typically split. Even though the Länder are, in principle, independent, their autonomy is limited de facto regarding both expenditures and revenues. The Länder typically only participate in tax legislation via the Bundesrat and even then only on revenue volume. While they have a right of veto, they are largely denied participation in making quantitatively significant, autonomous decisions on the volume of taxation. Seventy percent taxes in Germany are *joint taxes* comprised primarily of income tax and value-added tax (VAT) (See figures 4.1, 4.2 and 4.3). Income tax and

[7] As figure 1 demonstrates, this trend parallels that of the Eurozone in the lead-up to the sovereign debt crisis.

VAT are initially assigned (vertically) in the framework of a system of 'shared apportionment'. These are partly redistributed (horizontally) via separate processes (OECD 2013).

The share of purely Länder taxes is only 3%; add to this 8% for municipal taxes, which the Federal government and the Länder also partly share via trade tax apportionment. These numbers reflect the narrow scope for autonomous decisions on revenue volume that can be taken by the Länder, even though the Federal government and the Länder as a whole generate roughly equal volumes of tax revenue (Deutsche Bank Research 2011). In the US, the federal government also collects the largest share of taxes.

Table 4.1 Tax revenue as percentage of total general government revenue 1995-2014 – Germany

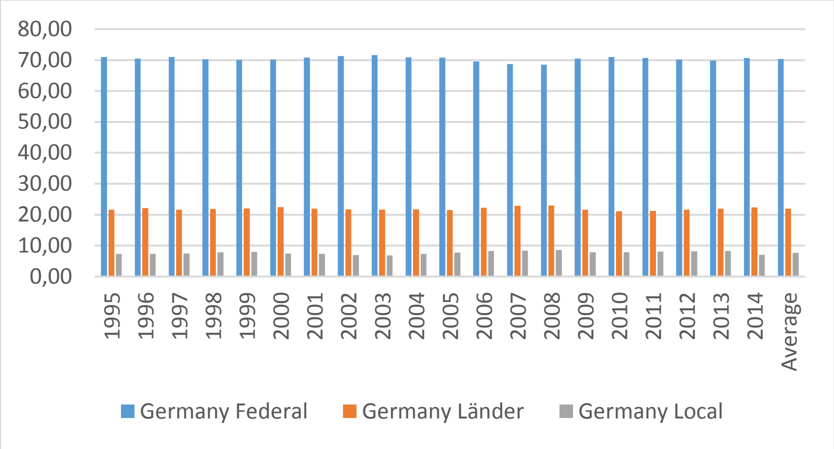
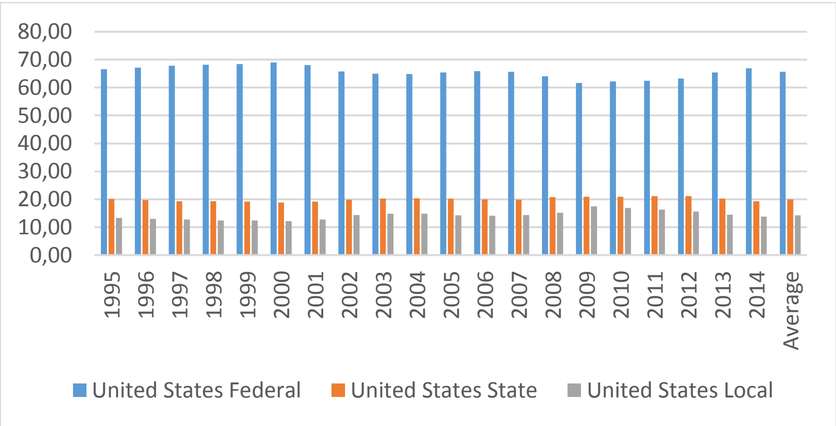


Table 4.2 Tax revenue as percentage of total general government revenue 1995-2014 – United States



OECD fiscal federalism database 2015

Table 4.3: Taxing power of sub-central governments, 2011

	Sub-central tax revenue	As % of sub-central tax revenues											
	As % of total tax revenue	Discretion on rates and reliefs		Discretion on rates		Discretion reliefs	Tax sharing arrangements				Rates and reliefs set by CG	Other	Total
		Full	Restricted	Full	Restricted			Revenue split set with SCG consent	Revenue split set by CG, pluriannual	Revenue split set by CG, annual			
		(a1)	(a2)	(b1)	(b2)	(c)		(d2)	(d3)	(d4)	(e)	(f)	
United States	**36,8**												
States	20,9	100,0	-	-	-	-	-	-	-	-	-	-	100
Local [2]	15,9	-	-	-	-	-	-	-	-	-	-	100	100
Germany	**29,3**												
Länder	21,3	-	-	3,1	-	-	-	93,6	-	-	-	3,3	100
Local	8,0	-	-	15,1	43,3	-	-	40,5	-	-	-	1,1	100

Source: OECD Fiscal Decentralization Database (2012)

3.2 Fiscal Rules

The data implies that a decentralized approach to fiscal policy is more likely to achieve fiscal discipline. However, in 2009, Germany wrote into its constitution a new rule aims to address the shortcomings of the current fiscal framework. The so-called 'debt brake' was introduced at the federal level in 2015 and be fully implemented at the *Länder* level in 2020. The old rule required a stable allocation of public sector resources over the course of the business cycle. The new system combines rules and discretion in a new way by emphasizing a cyclically adjusted budget (Deutsche Bundesbank 2011), thereby encouraging countercyclical spending instead of the old approach, which encouraged procyclical spending.[8]

The result that fiscal discipline at sub-central level is stronger in the US than in Germany obviously needs to be further explained. The paper suggests that decentralization backed by a credible no-bailout principle is a possible explanation for both the success of the US economic governance, and the failure of the German. This is congruent with the literature and with the empirical evidence, but other explanations should also be

[8]Procyclical fiscal policies maintain a stable allocation of public sector resources over the course of the business cycle. This means that during booms, governments tend to spend higher than necessary, and lower than required during recessions. Conversely, countercyclical fiscal policies seek to 'cool down' the economy when it is in an upswing, and stimulate the economy when it is in a downturn (Alesina and Tabellisi 2005).

excluded. The idea that fiscal rules at the state level are better structured in the US than in Germany is another possible explanation.

Up until the constitutional change adopted in 2009, Germany operated at both the federal and state level a golden rule that limited the deficit to financing productive public spending. The problem with this approach is that it is highly difficult to identify ex ante public spending that will 'pay for itself' through additional growth. As a result, the rule is open to manipulation. In the US, each state has its own rules. One state – Vermont - has no rule.[9]

However, most state rules are quite old, and do not allow for cyclical adjustment in the same way as the German (and now EU) debt brake. In this regard, US rules are quite similar to the old German golden rule. If German state fiscal discipline improves in the 2020s, we will be able to conclude that this was the main difference between the US and German performances so far. If that does not happen, the US no-bailout will remain the most plausible interpretation of its superior performance (Oates 2006; Henning and Kessler 2012).

This is of direct relevance to EMU because the debt brake has also been incorporated into the euro area's governance framework as part of the reforms introduced in 2012 via the Fiscal Compact.[10] While the SGP relies on centralized enforcement mechanisms, the Fiscal Compact operates on a decentralized basis. A notable innovation of the Compact is the requirement member states incorporate into national legislative frameworks the obligation to maintain cyclically adjusted budgets. The constitutionalization of the debt brake theoretically makes it more difficult to circumvent, since member states will be obliged to respect internal obligations instead of those imposed upon them by supranational authorities.

The logic of this approach is twofold. 1. It assumes that, even though there exists potential for loopholes to be exploited, established democracies cannot tolerate in perpetuity deviations from their laws. 2. It allows member states to adapt the Compact's rules in a manner that reflects their own specific institutions and political contexts (Gros 2012). In this regard, the Fiscal Compact does not represent a further loss of sovereignty; rather, it represents an important step to a more decentralized form of fiscal discipline.

From this perspective, the constitutionalization of EU debt rules under the Fiscal Compact is a positive development. However, while the Fiscal Compact shares the same basic principles as the SGP, it does not replace them. Instead, it operates alongside them – which could potentially undermine both the older and newer rules by creating unnecessary layers of complexity between them. The continued existence of the both Stability and Growth Pact and the Fiscal Compact preserves the conflict faced by member states between their EU obligations and national sovereignty and increases the likelihood that neither will be effective.

4. Fiscal Discipline in a Heterogeneous Monetary Union

This section discusses fiscal discipline in the EMU context. It specifically explains why effective economic governance is so important in a heterogeneous monetary union, and why the sovereign debt crisis that erupted in 2010 had such a profound effect on EMU institutions and EU Member States using the euro.

[9] For an in depth discussion of US state fiscal rules, see National Association of State Budget Officers, Budget Stability: A Policy Framework for States (1995).

[10] A notable problem with the SGP's framing of the 3% ceiling was that it was interpreted as a target instead of a ceiling. This encouraged procyclical spending. The debt brake reverses this practice.

Before proceeding to the primary focus of this discussion, it is useful to outline first the institutional basis for the framework.

4.1 Economic Governance: Theory and Practice

Much like Germany, the EU has relied heavily on a centralised approach to fiscal governance. Member States are obliged to obey fiscal rules imposed by the (supranational) center. Such an arrangement, which section three showed to be not particularly effective, clashes with the institutional logic of EMU. The Maastricht Treaty is intentionally asymmetric. It provides for strong centralised control of monetary policy, with fiscal matters remaining the preserve of the Member States. In other words, there is no 'fiscal center' to EMUS institutions under the Maastricht Framework. The chosen fiscal instrument under EMU, the Stability and Growth Pact, runs counter to this logic. The SGP was introduced in 1997 and revised twice in 2005 and 2012.[11]

While specific details of the Pact have changed over time, the primary objective, to instill fiscal discipline in Member States through the prohibition of deficits of over 3% of GDP and a national debt lower than 60% of GDP, has remained in place. The Pact seeks to a balance the need for a strong rules-based system while providing sufficient space to allow states to pursue their own fiscal strategies.

It has historically struggled to balance the need for rules with that of the need for discretion amid a weak system of incentives to abide by the agreed rules. Moreover, market reactions to budget deficits in the euro area countries were deemed inadequate to serve as market-based constraints in national fiscal policy (de Grauwe and Yi 2013); implying that the no-bailout rule laid out in the Maastricht Treaty was not credible. It should come as no surprise that the SGP has proved ineffective on many occasions since its adoption in 1997.

The SGP's shortcomings have long been analyzed.[12] It was intended to combine a rule for deficit and debt levels with an escape clause. The rule – the 3% deficit limit – proved difficult to enforce from a technical standpoint because it did not consider intertemporal constraints: if GDP is expanding, servicing debt can simply be delayed by more borrowing.[13] As such, 3% limit became a target instead of a ceiling. From a political standpoint, it was vulnerable to political interference.

The escape clause (Article 126.2 TFEU) allowed Member States to avoid sanctions when deficits were deemed by the Commission to be 'exceptional and temporary and the ratio remains close to the reference value.' Wyplosz (2015) and Wyplosz and Eichengreen (1998) suggest the kind of recession required was too restrictive, resulting in a narrow application of the rule without the necessary flexibility: An economic downturn was only qualified as 'severe' when annual real GDP had fallen by at least 2%. A fall of less than 2% could also be considered exceptional in light of further supporting evidence regarding the abruptness of the downturn or the accumulated loss of output relative to past trends.

In order to address the perceived lack of discretion, the SGP was reformed in 2004 largely because of political pressure exerted by France and Germany. Both countries were struggling to emerge from persistent recessions. Both were unable to meet the Pact's terms and unwilling to enter the Excessive

[11] While specific details of the Pact have changed over time, the primary objective, to instill fiscal discipline through the prohibition of deficits of over 3% of GDP and a national debt of lower than 60% of GDP, has remained in place.

[12] See for example, Eichengreen and Wyplosz (1998), Collignon (2000), Buti and Van Noord (2004), Eichengreen (2005), Scharpf (2012) and Eichengreen (2005).

[13] This is known as the 'transversality condition' or the 'no-Ponzi game. For a general discussion of this concept, see Escolano (2010). For a discussion of the concept as it applies to EMU, see Jonung (2010), Larch et al (2009) and Afonso (2000).

Deficit Procedure, the SGP's 'corrective arm'. The principal aim of this reform was to introduce more flexibility (mainly by shifting to cyclically adjusted figures), which saw the emergence of the opposite problem: too much discretion.

When the sovereign debt crisis erupted in 2010, policymakers reacted by again strengthening the rule. The Pact was reformed in 2012, in effect a reversion to its original conditions. In essence, the reform afforded the Commission more powers to decide how to adjust the rule. The problem with this approach is that it immerses the Commission in national budgetary processes and structural reform programmes, both of which are highly political. Despite the preponderance of new, tougher budgetary requirements, France,[14] Italy,[15] Spain and the Netherlands[16]have all failed to meet deficit requirements, have all been given extra time to bring their deficits in line, and none of the 'automatic' sanctions envisioned by the reforms have come into effect. Two-year extensions were proposed by the Commission and adopted by the Council in all cases.[17]

4.2 Crisis Causes

There is by no means a scientific consensus on the causes of the EU's sovereign debt crisis. Mongelli and Walters (2009) and Scharpf (2011) argued that the crisis was caused by divergences in demand linked to the convergence of nominal interest rates. This made credit looser for countries who entered the monetary union with relatively higher inflation, and tighter for countries with initially lower inflation.

Chen et al (2013) argued that the crisis was caused by trade asymmetries, while Lane and Peels (2012) have argued that excessive optimism in the peripheral countries during the boom years had a measurable effect on demand. De Grauwe (2011) has argued that the sovereign debt crisis hit the euro area - and only the euro area - because public debts are essentially issued in a 'foreign' currency.[18] Countries using the euro have no control over their currency. There is no capacity at the national level to perform the monetary tasks typically associated with central banking.

As Table 5 indicates, the common factor linking euro countries together is debt: every country affected by the crisis had, for one reason or another, an unsustainable debt burden leading up to the beginning of the crisis in 2010. Member States hardest hit by the sovereign debt crisis either entered 2008 with an initial debt level of 100% of GDP or greater, or had an increase in the debt-to-GDP ratio of 25% after 2008.[19]

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[14] http://www.consilium.europa.eu/en/press/press-releases/2015/03/150310-france-gets-two-more-years-to-correct-government-deficit/. Accessed 05.05.2015.

[15] http://intereconomics.eu/archive/year/2015/1/the-stability-and-growth-pact-and-balanced-budget-fiscal-stimulus-evidence-from-germany-and-italy/. Accessed 05.05.2015.
http://www.bloomberg.com/news/articles/2014-02-25/eu-says-spain-budget-deficit-to-widen-in-2015-without-more-cuts. Accessed 05.05.2015.

[16] http://ec.europa.eu/economy_finance/eu/forecasts/2014_winter/nl_en.pdf. Accessed 05.05.2015.

[17] For an overview of these decisions excluding Italy, see http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm. Accessed 13.11.2015. For an explanation of the Italian exclusion, see http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2015-02-27_it_126-3_en.pdf. Accessed 13.11.2015.

[18] The euro can be considered a foreign currency because it is not controlled by any of the countries using it. Rather, it is controlled by the ECB.

[19] The European experience suggests that Reinhardt and Rogoff's controversial (2009) study, which found that countries with debt ratios over 90% have trouble generating economic growth, is correct in the context of the initial phases of the sovereign debt crisis. Whether they hold true in other contexts is not under examination here.

Table 5: General Government Debt as a Percentage of GDP, 2008–2011

	2008	2009	2010	2011
Austria	63,8	69,2	71,8	72,3
Belgium	92,7	99,8	99,5	101,9
Cyprus	48,9	58,5	61,5	71,6
Estonia	4,5	7,2	6,7	6
Finland	33,9	43,5	48,4	48,6
France	75,5	87,2	90,6	96,2
Germany	66,7	74,2	83	81,2
Greece	113	129,4	145	165,3
Ireland	48,2	68,7	95,7	109,8
Italy	105,7	116	118,6	120,1
Luxembourg	13,7	14,8	14,8	18,2
Malta	62,3	68,1	69,4	72
Netherlands	63	65,6	68,6	70,6
Portugal	74	86,9	98,3	112,3
Slovakia	279	35,3	41,1	47,3
Slovenia	21,9	33,5	38,8	47,6
Spain	35,4	48,6	54,7	60,7
Total	**56**	**65,2**	**71,2**	**76,3**

Source: World Bank Public Sector Debt Database (2013).

High debt levels in the euro area are not a recent phenomenon. Greece and Portugal have historically struggled to balance their budgets. Both countries have remained in deficit every year since at least 1990 (OECD 2015). Figure 5 also shows that Ireland and Spain were more successful in taming their budgets over the past twenty-five years. Indeed, while the financial sectors of both countries expanded significantly in the pre-crisis period, the Irish and Spanish governments were models of fiscal probity. Their woes only truly began when they were forced to guarantee the deposits of failing banks when housing bubbles burst after the 2008 financial collapse. This was followed by a significant expansion of public debt in both cases.

4.3 The Diabolic Loop

Why was the sovereign debt crisis limited to countries in the euro area? After all, the United Kingdom and United States faced a similar banking crisis after 2008. In both cases, this was followed by a massive expansion of government balance sheets. Yet neither country faced a faced a sovereign debt crisis. This is because in a typical 'stand-alone' monetary union, sovereigns can issue debt in their own currencies, and national financial institutions such as banks have recourse to the central bank in an emergency. The markets expected the Fed and Bank of England not to allow important financial institutions to fail, thus ensuring that the effects of the crisis would be comparatively small.

A central bank empowered to act as lender of last resort means that cash is always available to pay out investors and by extension pacify markets. The implicit support of central banks is not without consequence, however. It raises the question of moral hazard and the issue of whether government profligacy will be forgiven through the monetary financing of debt. This has potential implications for inflation, to say nothing of the possibility of losses suffered by the central bank.

Leading up to the crisis, the sole function of the European Central Bank (ECB) was to safeguard price stability.[20] As such, banks operating in the euro area could not expect any assistance from the ECB in the event of a crisis. Instead, when the crisis hit, banks were forced turn to Member States, which were obliged to act as lenders of last resort.[21] However, states using the euro are constrained by finite resources because they cannot issue their own debt. Under such an arrangement, there can be no meaningful guarantees that investors will be paid out in the event of a serious, system-wide emergency. A monetary union where the central bank does not act as lender of last resort is therefore far more vulnerable to bank runs and contagion.

Fiscal discipline assumes a far greater importance within the context of the Economic and Monetary Union (EMU) because a financial crisis has a greater likelihood of leading to a loss of budgetary control (Wyplosz 2012).[22] The implication is that financial stability in a heterogeneous monetary union must be closely linked to fiscal stability. This, presumably, is why the Maastricht Treaty – and indeed the 1989 Delors Report on which it was in large part based - identified fiscal discipline as an absolute requirement. The problem of how to achieve is one that continues to bedevil policymakers, however.

The absence of a viable lender of last resort in the euro area suggested that either specific measures were needed to prevent the likelihood of a widespread financial collapse occurring, or that there should be a fund in place to be accessed quickly in the event of an emergency. On the eve of the crisis, there was neither. Indeed, the possibility that unchecked financial sector expansion could lead to systemic crises and banking failures - followed by a loss of market access and potential default for sovereigns - had not even been contemplated by the framers of the Maastricht Treaty (Mongelli et al 2015, Vines 2015, Scharpf 2011).

Likewise, Article 125 expressly forbade the establishment of an emergency lending facility at the supranational level for the euro countries. This contradiction speaks directly to the core problem confronting the euro area: a dysfunctional relationship between countries using the euro, banks, and the European Central Bank.

4.2 The Moral Hazard Paradox

Much attention has been paid under EMU to the problem of moral hazard because costs, including financial losses, are shared among all Member States. For this reason, the Maastricht Treaty sought to ensure that states would have no recourse to the ECB.[23] Thus, no incentive would be provided for a country to run up its debt with the expectation that it would eventually be taken up by others. National crises, according to the Treaty, are to be resolved at the national level.[24]

Article 125 suggests that moral hazard considerations should always trump the need for emergency assistance. This was notably evident between 2010 and 2011, where initial supranational responses to the crisis took the form of intergovernmental lending and nominal bond purchases by the ECB (ECB: 2010, 2011). Unsurprisingly, given the priority of placing moral hazard considerations over providing emergency

[20] Article 2 of the Statute of the ECB.

[21] The problem was memorably described in 2008 up by Mervyn King, then the Governor of the Bank of England, who stated that 'global bank are international in life, but national in death'.

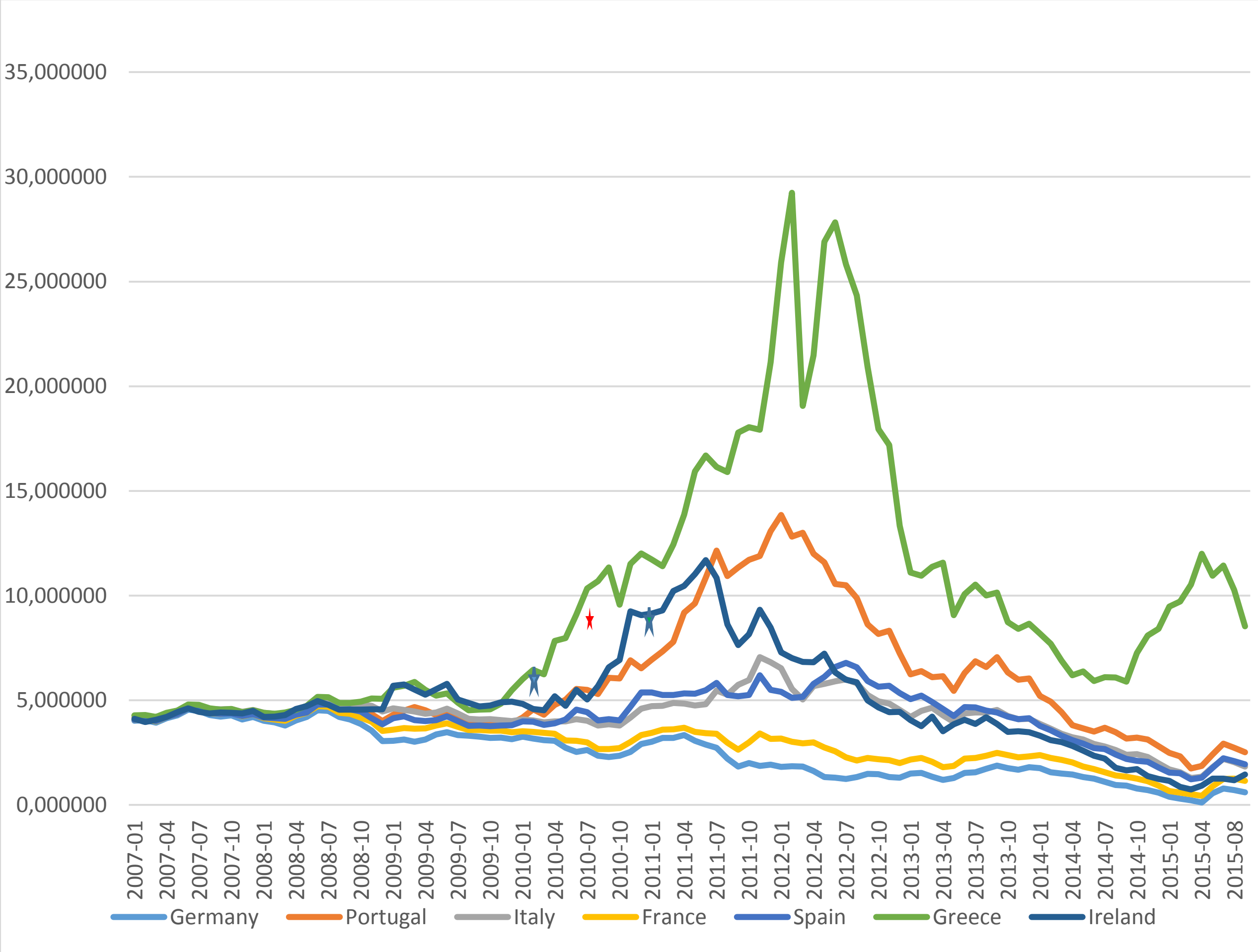
[22] Eichengreen (2007) has noted that euro countries occupy a similar position in this regard to developing countries that issue debt in foreign currencies. Both are 'in an unstable position in the event that financial markets come to expect, rightly or wrongly, that a debt might not be serviced' (Wyplosz 2015: 4).

[23] Article 123 TFEU established that there would be no monetary financing of debt.

[24] Article 125 TFEU established that public debts were to remain the responsibility of the sovereign.

assistance, markets continued to panic even after emergency assistance was granted to Greece in May 2010, Ireland in November 2010, and finally Portugal in May 2011.

Figure 2: Long Term Interest Rates 2007-2015



Source: OECD (2015), Long-term interest rates (indicator). doi: 10.1787/662d712c-en (Accessed on 15 November 2015).

Despite these interventions, spreads of long-term interest rates, a key indicator of financial health,[25] continued to rise (see Figure 2). The programs were perceived as neither effective solutions nor preventing possible contagion in the rest of the euro area. It is clear that markets understood that such programmes were no substitute for the infinite resources of a central bank empowered to act as lender of last resort.

The above section sought to explain why the crisis in the euro area was fundamentally different from those experienced in other industrialised countries. More specifically, it examined the precise reasons why achieving fiscal discipline was so important in the European context. The following section builds on this discussion by critically examining the reforms to EMU's economic governance framework.

5. To Bail Out or Not to Bail Out

5.1. The European Financial Stability Facility and the European Stability Mechanism (ESM)

[25] Long-term interest rates are a key the determinants of the economic environment. For example, favourable long-term rates encourage investment in new equipment, whereas high interest rates discourage it. Long-term investment is a major source of economic growth (OECD Library 2012).

The European Financial Stability Fund (EFSF) was initially intended as a temporary instrument, or special purpose vehicle,[26] to address crippling debt levels in a number of member states. The EFSF has since been institutionalized as a permanent feature of the policy landscape. While its use is subject to strict conditions, its permanent institutionalisation, the European Stability Mechanism (ESM) is problematic for two reasons. 1. Its limited capital base of 700 billion euros will likely prove insufficient in the event of future asymmetric shocks hitting multiple member states in the euro area.[27] 2. The introduction of a permanent mechanism to provide financial assistance to member states by definition undermines the no-bailout principle so clearly established in the Maastricht Treaty. As it stands, the ESM represents yet another institutional inconsistency within the EMU framework.

Advocates of the ESM (for example, Allard et al 2013) argue that EMU needs a fiscal buffer to act as an insurance mechanism at the supranational level because it can mitigate the effects of systemic shocks and prevent the credit crunches. The argument is that the mechanism would provide an ex ante framework for enforcing fiscal discipline and temporary transfers, hence ensuring that systemic shocks can be contained. The ESM operates under strict conditionality, thereby ensuring further centralization and further steps towards eventual fiscal union.

There are two problems with this argument: While a fiscal union would provide degree of stability in the euro area, it runs counter to the logic of the Maastricht framework. Moreover, such an arrangement would eventually require a treaty renegotiation, which is politically unfeasible in the current climate. A second objection is that the degree of cyclical stabilization such a system provides are, relative to an empowered central bank, comparatively small. Once again, the US provides a useful illustration of this point. A recent study by Poghosyan et al. (2015) finds that stabilizers budgetary stabilizers originating from the federal budget accounted for 5-10% of total stimulus after 2008, with the rest being comprised of state-level stabilizers and Fed interventions in the banking system.

Moreover, a system of fiscal transfers is once again at odds with institutional logic of the Maastricht Treaty. This means that some countries would likely emerge as net beneficiaries while other would be net contributors. As countercyclical transfers are hard to design, the success of such policies can only be determined in the long run – which by definition extends beyond the electoral cycle (Giavazzi and Wyplosz 2015).[28]

Finally, there is the perennial question of moral hazard: fiscal transfers would invariably encourage fiscally undisciplined countries to borrow equally in good times as in bad (Alt et al 2012). The evidence presented in this paper suggests that a strictly enforced no-bailout principle and a fully independent bank empowered to act as lender of last resort to the EU banking sector as a whole is more likely to have a stabilizing effect on spending and financial stability in a crisis. A fiscal rule that aims at stabilizing or reducing the public debt in the long run is the natural complement to this principle.

5.2 Banking Union

Perhaps the most promising development since the beginning of the crisis is the establishment of a European Banking Union in 2013. The push for a banking union stems from the realisation that the financial

[26] The EFSF was established in 2010 and was initially set to expire in 2012.
[27] Moreover, the fund pales in comparison to the infinite resources of a central bank acting as lender of last resort.
[28] Ironically, Greece did not turn to the ESM in the summer of 2015 when their financial system once again teetered on the brink of collapse – a situation that surely called for ESM intervention.

safety net for the euro area is incomplete. The establishment of a banking union is of particular relevance to discussions of fiscal discipline. Its significance lies in its potential to reduce sovereign risk.

As mentioned previously, the key distinction between countries using the euro and stand-alone monetary unions is the ability to issue debt, or 'print money' in the event of a crisis. In such arrangements, financial institutions have recourse to the central bank. As has been previously argued, this was not possible in the euro area, where banks until recently were compelled to turn to states, themselves captives of the Eurosystem, as a lender of last resort.

Such an arrangement constitutes a serious threat to the fiscal wellbeing of member-states. The existence of a banking union recognises this fact and transfers much of this risk to the ECB. This renders the possibility of another financial collapse considerably less likely. The Banking Union as it stands, however, is incomplete. While it has established a common supervisory mechanism to supervise banks in euro area and a common mechanism to resolve insolvent banks, it does not have a common deposit insurance mechanism (which has been in place in the US since 1933). As such, the 'doom-loop' between banks and sovereigns remains intact.

The importance of common deposit insurance cannot be overstated. Gros and Schoenmaker (2014) provide an interesting comparison between Ireland and Nevada (two economies of similar size) in the aftermath of the 2008 crises that illustrate the point. Both 'countries' suffered a banking crisis. The Irish bank rescue directly led to a fiscal crisis - a stark illustration of the diabolic loop between banks and governments. In contrast, banks in Nevada were resolved at the federal level via the Federal Deposit Insurance Corporation (FDIC) without affecting the state finances. The study found that the US Banking Union

> 'provided Nevada with a 'shock' absorber of about 10% of GDP, not in the form of loans, but in the form of an (ex-post) transfer because losses [of approximately 4 billion] were borne at the federal level. … If a similar system had existed in Europe, the fate of Ireland (and that of Spain) might have been different. The 'diabolic loop' between banking debt and sovereign debt would not have been set in motion.' (2013: 6-7)

So far, the EU Banking Union remains incomplete. Only the functions of the ECB have been clarified. The ECB is now the direct supervisor of large cross-border banks, as well as the lender of last resort for the euro area banking system. Because the banking union only empowers the ECB to lend to solvent banks, insolvent banks will continue to pose a threat to fiscal stability in the euro area. Until the mechanisms for dealing with insolvent banks – namely resolution and deposit insurance – are reformed and fully transferred to the supranational level, vulnerabilities in the Euro area will persist.

Conclusions

The challenges of maintaining fiscal discipline in systems combining central, sub-national and local authorities have been written about extensively (Wildasin 1999, Rodden et al. 2003). The task is to ensure that no one level of government is able to take advantage of another by requesting financial support for its activities.[29] These challenges have proved particularly vexing in the Euro area. The area economies are highly interconnected. This means that severe economic shocks in one country can have potentially systemic implications. Because countries using the euro do not have control over their own monetary policy, the maintenance of fiscal discipline is key to ensuring systemic stability. With the benefit of hindsight, it is clear that the envisioned governance framework was woefully underequipped to deal with this task.

[29] This too applies to the central government, which can seek assistance from the central bank via debt monetization.

Empirical data from Germany and the United States suggests that for fiscal discipline to be achieved in the euro area there needs to be a clear devolution of fiscal policies to the national level and a full transfer of financial risk to the supranational level. This view is consistent with the evidence presented in this paper. This is not only preferable and more likely to be effective; it is also in line with the institutional logic for EMU established by the Maastricht Treaty. Such an arrangement would also likely mitigate the effects of economic governance framework in place since 1997.

The SGP is fundamentally incompatible with the principle of budgetary sovereignty. The failure of the framework to enforce fiscal discipline reflects problems associated with transferring management of fiscal policy to supranational authorities when the responsibility for the fiscal policy has been legally enshrined as the responsibility of Member States Yet under the Treaty. Member States face two contradictory obligations: one to their citizens who entrust their parliaments with the authority to vote on budgets, and another to their EU partners, who have the right to issue binding budget recommendations. Even if the tensions between rules and discretion described in this paper were resolved, this contradiction remains.

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