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Searching under the lamp-post: the evolution of fiscal surveillance

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Abstract:
Why is the Euro area economy laboring under the burden of fiscal austerity? Critics argue that an ideological bias towards austerity has been institutionalized in the EU's fiscal rules. We examine this claim by contrasting a 'disciplinarian' account of fiscal surveillance with a welfare-maximising approach and using this to review how fiscal surveillance by the European Commission has been practiced since the financial crisis. While we find that Eurostat's practices bear some marks of disciplinarianism, particularly in bringing the fiscal consequences of reckless behavior by banks into the beam of the fiscal surveillance lamp, the Commission's welfare maximising orientation is reflected in its efforts to identify and partition out financial, macroeconomic and budgetary contributions to fiscal outturns and thereby avoid an excessively disciplinarian orientation. Its efforts are impeded by a lack of supranational institutions to resolve bank failures and conduct countercyclical policy. These institutional deficits, rather than an entrenched ideological standpoint, explain the persistence of austerity.

Introduction

For some years now, commentators have been discussing the failure of the Stability and Growth Pact (SGP) and how to reform it. A systematic analysis of '101 proposals to reform' conducted in 2006 identified a fundamental disagreement between two groups of economists: those who sought to specify a welfare-maximising path for fiscal policy in the light of macroeconomic objectives, and those who adopted the disciplinarian perspective[1] that governments' incentives created a tendency to fiscal profligacy that needed to be reined in (Fischer et al 2006). At that time, it seemed that the welfare-maximisers had won the day. The SGP was revised in ways which expanded the scope for exemptions in applying the deficit and debt limits specified in the Maastricht Treaty. There was more emphasis on medium-term outturns, leaving space for demand management in the short run. There were also more possibilities to differentiate between countries in evaluating their fiscal positions: those with lower debt would not be called to account so readily for deficits. Disciplinarians were also disappointed that there were few

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[1] Fischer et al (2006) refer to the disciplinarian perspective as 'political economy', using the term to dignify political analysis as done by neoclassical economists. This is not a usage we are inclined to perpetuate.

institutional changes: the Council retained the final vote over measures, which they claimed was like ‘asking turkeys to vote on the menu for Christmas’.

One explanation for the outcome of the 2005 reforms was that, at that time, there was much more concern about growth than debt in the euro area (EA) (Fischer et al 2006: 25). Another was that fiscal surveillance had to adjust to the lack of carrots and sticks, since the carrot of euro membership had been consumed. Attention shifted to embedding the statistical and analytical practices of good fiscal governance by strengthening the networks of the regulatory state (Schelkle 2009). The financial crisis was a shock to this settlement. Debt sustainability, which had been embraced by welfare-maximizers as a medium-term target that would shift the focus from year-on-year budget outturns, became an immediate imperative. Growth is evidently a concern and disagreements over the appropriate strategy of crisis management are virulent, but the climate seemed to shift decisively in the disciplinarian direction.

Reforms to fiscal surveillance in 2010-11 introduced several of the institutional measures that disciplinarians advocated, as we describe in section 2 below. Critics argued that Europe was laboring under an ‘austerity delusion’ (Blyth 2013): an ideology that holds that macroeconomic problems always have their origins in a lack of fiscal discipline. Krugman (2013) writes of a ‘Rehn of Terror’, perversely flattering the former Vice President and Commissioner for Economic and Financial Affairs and the Euro for his role in the excessive enforcement of budgetary retrenchment in the Southern periphery. In focusing on fiscal discipline after a crisis caused by banks, the Commission seems like the drunk who looks for his lost keys under the lamp-post, not because he can be sure that they are there but because “that’s where the light is”.

We show in this chapter that, despite the reforms, fiscal surveillance has continued to disappoint disciplinarians. Our explanation centers on the self-understanding of the EU as a regulatory polity that is charged with promoting good economic governance in member states (Mabbett and Schelkle 2009, Genschel and Jachtenfuchs 2013). To this end, the European Commission is set up as a non-elected body, and as a trustee with discretionary powers rather than an agency of the member states (Majone 2001). This fits neither the intergovernmentalist nor the supranationalist script (see Caporaso and Rhodes in this volume). The Commission enforces the commitments that elected governments have signed up to, but only to the extent that these commitments do not obviously harm economies and are in line with the economic consensus of the day. However, it has proved impossible to implement a welfare-maximising fiscal policy in response to the financial crisis, given the EA’s current institutional arrangements. The impact of bank rescues on government finances, combined with the ineffectiveness of monetary policy in achieving macroeconomic stabilization, have produced persistent deficits in many countries. These would not prevent countercyclical fiscal expansion if they could readily be financed, but several states have fallen hostage to bond market crises. These crises have been the proximate cause of austerity, not fiscal rules.

Ideally, the fiscal surveillance process would isolate the effects of governments’ budgetary decision-making from the effects of the EA’s fragile monetary and financial system. In practice, fiscal accounting for the financial crisis works in the opposite way, drawing in rather than separating out these wider developments. The explanation is that governments are suspected of a proclivity to hide their claims on resources in places where the fiscal surveillance lamp-post does not shine. The response of statisticians has been to establish a comprehensive definition of 'general government' which extends beyond the ambit of budgets to take in all manner of 'non-market' entities. Actions that originate with market actors but have fiscal consequences can then also come under the purview of fiscal surveillance. Because outturns are always seen through the lens of government behavior, a disciplinarian orientation is embedded in accounting practices, even though the judgments made by the Commission when it evaluates these outturns reflect a welfare-maximising orientation.

Our discussion falls into four main sections. In the next, we provide a brief account of the reforms to fiscal governance that have taken place in the radically changed political environment created by the crisis, which has divided the union into guarantor and program countries. We highlight the uneasy relationship between Germany and the Commission, focusing on developments in fiscal surveillance 'proper' – the set of rules governing all members of the EA – which are distinct from the emergence of fiscal conditionality in other forms, such as the Macroeconomic Adjustment Programs (MAPs) imposed on borrower countries and the conditions that the ECB has tried to impose in return for bond market support (see Henning, this volume).

In section 3, we examine how the statistical process of measuring the fiscal stance has been affected by bank bailouts and recapitalizations that have strong and uneven effects. Eurostat strives to apply internationally agreed standards consistently. We show, however, that accounting conventions of deficit and debt measurement tend to produce harsher assessments in weaker economies.

Section 4 considers the implications of the ineffectiveness of monetary policy since the financial crisis. The regime established by the SGP assumed that the primary task of macroeconomic stabilization would fall to monetary policy. The persistence of economic stagnation since the crisis has led technical and political disagreements to emerge around the cyclical adjustment of fiscal indicators.

Section 5 turns to the puzzle of why, despite these known problems with searching under the fiscal surveillance lamppost, macroeconomic regulation in the EA retains such a strong fiscal focus. Our explanation is that, even though moral hazard on the part of banks is known to have been the driver of the crisis, there remains the mutual suspicion that this might provide cover for fiscal irresponsibility on the part of governments. We argue that attempts to partition out the financial, monetary and budgetary contributions to fiscal outturns are impeded by a lack of supranational resources and capacities.

We conclude that, while the European institutions do not labor under an ideological austerity delusion, fiscal surveillance remains the main mechanism for dealing with spillovers between member states' policies. In that sense, the Euro area is trapped under the lamp-post.

2 Searching under the lamp-post

Before we outline the reforms that created the impression of an obsession with counterproductive fiscal restraint, it is worth recalling how they came about. There were at least two phases to the EU's crisis management: a first phase of Keynesian stimulus and a second phase when the emphasis shifted to fiscal discipline. In the second phase, not only did the macroeconomic orientation shift, but also institutional conflict emerged: specifically, measures were marked by German concern that the Commission lacked a sufficiently disciplinarian orientation.

When the financial crisis broke, the fiscal surveillance process generated assessments that were tolerant and forgiving of the straits in which member states found themselves. Similar leniency in applying the rules in a crisis could be seen in other areas, such as state aid (Schelkle 2012). The immediate effect of the financial crisis was to create a short-lived Keynesian turn in fiscal policy in Europe. Member states undertook stimulus programs which were endorsed and given a European label in the form of the European Economic Recovery Plan (EERP). These programs, combined with sharp falls in GDP, took almost all member states across the threshold for deficits.

An escape clause in the Pact provides that, in a deep recession, defined as a fall of GDP of more than 1.5%, Excessive Deficit Procedures (EDPs) can be suspended. However, the clause was not invoked: the Council decided to start EDPs against the vast majority of member states. The opening of an EDP forces a government to inform its peers in the Council in detail about its budgetary plans. In other words, given the number of 'delinquents', EDPs created a venue for policy coordination in the absence of alternative venues. Member states were not very hard on each other: the Council agreed in October 2009 on a general extension of the time for correction of excessive deficits, whereby consolidation should begin in 2011 in most member states.

Two examples can illustrate the tenor of assessments at this time. Reviewing the situation in France in November 2009, the Council was informed that the deficit target of 5.6% of GDP was likely to be missed because of a greater than expected decline in GDP. The deficit was likely to reach 8.3% of GDP. Furthermore, the 'minimum average structural effort' (leaving out the effects of the GDP outturn) fell short of requirements, but this had 'to be seen in the context of the still somewhat fragile economy'. Overall, the Commission recommended and the Council agreed that 'taking into account the particular circumstances of the economic crisis and the EERP, the French authorities can be considered to have taken effective action' (CEU 2009a). Similarly, Italy's huge deficit in 2009 was determined to 'have resulted from an appropriate response to the EERP and the free play of automatic stabilisers' (CEU 2009b). Italy's 'appropriate response' consisted of hardly any stimulus, in line with its precarious fiscal situation, but the 'free play' of in-built stabilizers meant that the Berlusconi government refrained also from pro-cyclical retrenchment (Schelkle 2012).

This phase, whereby discretionary counter-cyclical policy was endorsed in the surveillance process, was brought to an end by the emerging sovereign debt crisis in Greece, and its contagious effects. It became clear that the no-bailout clause could not be enforced without risking a second Lehman moment. Furthermore, the ECB was in effect drawn into monetary financing of government deficits, through its operations in secondary bond markets. These developments created pressure for a revitalization of fiscal surveillance. Both Germany, as the principal guarantor of bailout funds, and the ECB, with a hawkish reputation to defend, pressed for stronger arrangements for fiscal control.

Importantly, stronger controls did not have to come through the established surveillance process. Instead, there were opportunities to impose austerity in the loan agreements made with member states that had to call on the IMF and the EU for assistance. Loan agreements were not bound by the norms of symmetry and common agreement that were foundational for the fiscal surveillance process. Under IMF rules, the key criterion for a loan agreement was that the borrowing country should adopt a program that would enable it to repay. This program could prescribe a country-specific adjustment path and could impose requirements which lenders themselves did not comply with.

There were also attempts to embed austerity in other ways. German initiatives show an ambivalent attitude towards the EU-led process. On the one hand, promoting collective self-restraint through the Council might veil the exercise of power by creditors and mitigate anti-German sentiment (a forlorn hope, as it turned out). On the other hand, Union institutions could provide venues for challenging austerity and manoeuvring Germany into larger contributions to collective resources. This is a plausible interpretation of Chancellor Merkel's resistance to creating a new permanent competence for the Commission in the form of a bailout fund (Barber 2010). Germany has also become critical of the Commission's leniency in its assessments of countries with excessive deficits that are not subject to conditionality under a loan agreement, notably France, Spain and Italy (Spiegel and Carnegy 2014, Spiegel 2014).

Germany's disaffection with the rigor of enforcement of fiscal surveillance by the Commission and Council was reflected in its initiative to create an intergovernmental Fiscal Compact (Chang 2013: 264). This intergovernmental treaty, outside the EU's legal framework, is modeled on legal changes, among them a 'debt brake' (Schuldenbremse) in the German constitution, passed in 2009 under the Grand Coalition. The emphasis of the Compact is on the incorporation of fiscal restraints into domestic law. National parliaments are required to legislate on balanced budget rules and debt limits; failure to do so can be challenged in courts. Moreover, a member state who does not sign the Compact is not eligible for assistance from the permanent bailout fund, the European Stability Mechanism (ESM). Twenty-five of the then 27 member states signed the Compact; only the Czech Republic and the UK stayed out.

Table 1: Major reforms of fiscal surveillance – 'Fiscal Compact'

Applicability	Major provisions	Major innovation
Contracting parties (25 as of 22 July 2013)	Balanced Budget Rule analogous to the MTO; Automatic correction mechanism for debt significantly moving away from the 60% debt ratio	Fiscal rules written into domestic law; access to ESM is conditional on signing up

At the same time, the task force of Council President Van Rompuy, made up largely of the finance ministers of the Euro area members, was at work preparing proposals to strengthen the Commission-led process. The 'Six Pack' of five Regulations and one Directive was passed in 2011. Among its innovations was reverse qualified majority voting, which would make it harder for the Council to reject Commission recommendations. Of course this assumed that the principal obstacle to fiscal restraint through Community pressure was the Council, and that the Commission would make recommendations for compliance with fiscal rules that some states would find unappetizing. This reform is in line with the disciplinarian critique of the original Pact, which saw the principal problem of fiscal governance in the enforcement of restraint by 'turkeys'. Reverse majority voting appeared to strengthen the delegation of decisions to the Commission: a majority is now required to reject a recommendation of the Commission to open an EDP.

The Six Pack introduced four substantive innovations that helped to establish the impression that fiscal surveillance was being tightened. First, sanctions now attach to excessive debt as well as deficits. Penalties can be levied on a debt-to-GDP ratio above 60% (even if the deficit is not excessive) if it is not reduced by at least 0.5% over three years. Second, there is an intensified emphasis on the 'medium term objective' (MTO) of achieving a fiscal position 'close to balance or in surplus'. The MTO is fulfilled if the structural deficit does not exceed 1% (or 0.5% for those above the debt threshold). Third, more checks on data validity have been introduced. Eurostat has obtained extended rights to visit member states and inspect primary source data; if fraud is detected, the government can be fined. Furthermore, the assumptions underlying GDP forecasts must be verified and assessed by national fiscal councils, and agreed with the Commission. Table 2 gives an overview.

Table 2: Major reforms of fiscal surveillance – 'Six Pack'

Applicability	**Major provisions**	**Major innovation**
All MS of the EU but sanctions only for EA countries	*SGP preventive arm*: -definition of country-specific MTOs in terms of structural balances -annual evaluation of MTO, expenditure rule and debt -evaluation of adjustment to MTO with possibility of financial sanction	Precise MTOs; Expenditure rule; financial sanction in the form of an interest-bearing deposit
All MS of the EU but sanctions only for EA countries	*SGP corrective arm*: -surveillance of deficit (3%) and debt (60%) ratios to GDP -financial sanctions (non-interest bearing deposit or fine) - reverse majority voting on Commission proposals	Excessive Deficit Procedure includes 'excessive' debt above 60%; decision rule of reverse majority
All MS	*National fiscal frameworks*: Mandatory minimum requirements re numerical fiscal rules, medium-term fiscal frameworks, independent fiscal councils etc	GDP forecasts to be confirmed by independent national councils and agreed with the Commission
All MS	*Statistical governance*: Minimum standards for independent authorities; independent auditing of data by Eurostat; financial sanctions for statistical fraud	More formal powers for Eurostat backed by sanctions

Abbreviations: MS=Member States; EA=Euro Area
Sources: Regulations (EU) 1173-1177/2011, Directive 2011/85/EU, available at URL: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm

Heightened attention to debt levels has been interpreted as a toughening of fiscal surveillance, because it means that many countries will be required to exercise fiscal restraint for long periods, instead of coming under scrutiny only intermittently for breaching the deficit limit. But it is possible to read the shift of emphasis from 'correction' to 'prevention' differently. The Commission retains considerable discretion to push deadlines for corrective action into the future.

Commission officials drew the lesson from the standoff with member states in 2003 and again from the sovereign debt crisis of 2010 that the preventive arm of the Pact needed to be strengthened, in order to create more fiscal space for countercyclical policy. Larch et al (2010: 4), writing as Commission insiders (but of course in personal capacity), argue that the shift to a medium-term orientation is desirable because countries failed to restrain spending in the pre-crisis years and their fiscal positions were therefore too vulnerable to a downturn. This is an argument that goes against the imposition of austerity measures when economies are weak, but retains a role for fiscal surveillance in cautioning and reining in governments in good times.

The ‘Two Pack’ of regulations extends the monitoring of budgets over a medium-term horizon, with an additional emphasis on structural reforms. It also codifies the *ad hoc* arrangements adopted in loan agreements. These have been country-specific; the Two Pack establishes generic procedures. It sets out that countries in financial difficulties or receiving support from the ESM will be subject to inspection of their budget plans and regular mission visits to the country, unless the ESM is specifically tied to bank recapitalization in which case supranational banking supervision will operate (see section 5 below and Epstein and Rhodes in this volume). It specifies the general parameters of loan conditions in so-called Macroeconomic Adjustment Programmes (MAPs), and provides that these replace regular fiscal surveillance processes as long as they are in force. By contrast with the symmetry of other measures, the Two Pack is explicit in distinguishing between those countries receiving emergency support and others. Table 3 summarizes its main provisions.

Table 3: Major reforms of fiscal surveillance – ‘Two Pack’

Applicability	**Major provisions**	**Major innovation**
EA-MS with or without excessive deficits or debt	Gradually closer monitoring of draft budget plans with 3yr horizon; ‘economic partnership programmes’ for structural reforms for those with excessive deficits	Not only the balance but the composition of budgets under surveillance
EA-MS experiencing fiscal difficulties	Bi-annual MAPs with close monitoring of draft budget plans; Financial supervision where ESM assistance provided directly to banks	As above; ECB and Financial Supervisory Authorities involved

Abbreviations: MS=Member States; EA=Euro Area
Sources: Regulation (EU) No 473/2013, Regulation (EU) No 472/2013

All these measures appear to secure the role of the Commission in preparing assessments and making recommendations. However, it is far from clear that the Commission will always use these powers to recommend fiscal consolidation measures, because of the dilemmas that arise in the statistical accounting for government interventions in an unprecedented financial crisis and a deep recession. We take up these issues in turn below. First, the surveillance process is intended to regulate governments’ budgetary decision-making, but, for reasons we explain in the next section, it also brings under its purview the fiscal consequences of reckless behavior by market actors such as banks. Furthermore, when we trace through exactly how bank bailouts affect the fiscal accounts, we find that the effects on fiscal indicators create incentives for governments to avoid restructuring and recapitalizing their banking systems. Hence, if the Commission insisted on rigorous compliance with fiscal rules, this could have the perverse consequence that banking problems are hidden rather than resolved.

Second, the long-standing problem of how to avoid pro-cyclical adjustment through cyclical adjustment, and what size of cyclical margin should be allowed, has acquired a new dimension. Settled practice assigned the primary task of overall macroeconomic stabilisation in the EA to monetary policy, leaving national fiscal policies the subsidiary role of addressing idiosyncratic shocks. However, the financial crisis has rendered monetary policy ineffective: low interest rates and liquidity creation have amounted to 'pushing on a string' and economies have not been stabilized around a stable trend for GDP. As we explain in section 4 below, it is difficult, in determining the right fiscal stance, to know how to take into account the magnification of the cyclical problem that has occurred as a result of the ineffectiveness of monetary policy.

3 Accounting for the financial crisis

The measurement of the Maastricht fiscal indicators is the job of Eurostat; the task of preparing macroeconomic projections and interpreting and evaluating the data falls to DG EcFin. The determination of deficits and debts is the subject of voluminous rules, covering issues such as the scope of general government and the classification of transactions as spending or lending. It has become clear in the aftermath of the crisis that some of these rules are inconvenient and others are unsuited to the conditions of deleveraging in depressed economic conditions. In this section, we show that the norm of comprehensiveness in fiscal accounting brings into the purview of fiscal surveillance developments that have no connection to budgetary decision-making. Furthermore, to maintain the appearance of neutrality and impartial judgment in assessing government activities, Eurostat refers to market valuations, but this is a questionable procedure when markets themselves have failed, and can induce pro-cyclical assessments of the fiscal stance, to the detriment of states in a weak fiscal position.

Eurostat's accounting for the debts and deficits of general government is dependent on the judgments of statisticians, who are guided by the extensive technical apparatus of the European System of Accounts (ESA). Notwithstanding some practical differences, ESA produces a similar picture of public finances to the IMF's Government Finance Statistics (GFS). In particular, both establish a norm of comprehensiveness, whereby 'general government' is defined according to its substantive activities of non-marketised production and redistribution, rather than relying on legal or budgetary conventions. The comprehensive measure of general government means that central government, which is the signatory to the SGP, has to develop fiscal policy institutions which will regulate other parts of government, such as local governments and social security funds. This was an intended consequence of the definition. Not necessarily intended was that market entities which cease to be viable and are rescued by government are also part of 'general government'. In particular, the interventions undertaken to support the banking system since 2008 were not part of any country's regular budget process, but under ESA some (but not all) of these interventions affect general government debt and deficit measures for the purposes of the SGP.

Comprehensiveness is considered good practice in the international fiscal policy community, as it ensures that priorities for the use of fiscal resources can be properly established and implemented. Nonetheless, there are valid choices to be made about which debt and deficit measures to focus on, depending on a country's economic structure and political priorities. For example, since the Thatcher era, the focal point for successive British governments has been the public sector borrowing requirement, where the ‘public sector’ is defined more broadly than ‘general government’ under ESA. The public sector includes publicly-owned trading entities: the Thatcher government had reform and privatization of these companies in its sights, whereas the EU has pursued a policy of neutrality on the merits of public versus private ownership of economic entities. It focuses on whether a company, private or public, depends on trading income or public funding.

As governments have taken on losses arising from the financial crisis, the norm of comprehensiveness has been tested and restated. One of the measures in the Six Pack (Directive 2011/85/EU, Chapter VI) requires member states to ensure ‘the comprehensive scope of budgetary frameworks’, including the identification of ‘all general government bodies and funds which do not form part of the regular budgets’. Among the targets for this edict are ‘bad banks’ in public ownership, created to achieve the orderly resolution of impaired assets while encouraging normal banking activity to resume. Statisticians have to decide whether state-owned banks are primarily trading entities, in which case they are part of the ‘public sector’ but not ‘general government’ and so do not count towards the deficit under fiscal surveillance. They also have to determine whether financial support given by governments to banks has been matched by the acquisition of assets of equal value, in which case it is a ‘financial transaction’ which does not raise the fiscal deficit. If financial support is unlikely to be recovered, it is a ‘capital transfer’ which counts as government spending.

In making these judgments, statisticians turn to the norm of reliance on market judgments. This norm reflects a widespread shift in accounting practice away from historic cost accounting towards ‘marking to market’, where the market is seen as providing objective valuations. For example, when a government purchases shares on an active market, ‘any excess of the price paid by the government over the prevailing market price is recorded as a capital transfer’ (Eurostat 2012b: 1). Alternatively, the expected rate of return can be compared with ‘a sufficient’ rate of return – if the expected return on the now-publicly-owned assets is lower than the sufficient return for a commercial investor, the difference is deemed to be a capital transfer. The presence of private co-investors is taken to indicate an adequate return, ‘since it is assumed that the private investors are seeking a return’ (Eurostat 2012b: 2).

This approach has some affinities with the methodology used by DG Competition to calculate the ‘state aid’ element in government intervention: specifically with the so-called ‘private market investor principle’ (Hancher et al 2012). But it is applied there in a microeconomic setting where the intervention can be scrutinized in isolation. Applying market valuations in an unstable macroeconomic situation introduces systematic biases towards deficit-increasing classifications in weak economies. Negative ‘animal spirits’ drive down asset prices and drive up risk premia, thus raising the rate of return that private co-investors would consider sufficient (Goodhart 2010).

One consequence is that Eurostat’s classification decisions sometimes appear to take a harsh view of the fiscal position of weak economies on the European periphery, while leniently evaluating stronger economies. For example, much of the Irish government's bailout expenditure has been classified as capital transfer, reflecting the poor recovery prospects of several of the large institutions. The effect was to increase the Irish deficit by 20.2% of GDP in 2010 and about 26% cumulatively (Eurostat 2012a: 4, 8). By contrast, much of the financial support to banks provided by Germany and the Netherlands has been classified as 'financial transactions'. In the Netherlands, bailouts cost some 14.6% of GDP but, by end-2012, 10% had been recovered, validating the statistical classification. Not so for Germany however: while only 1.4% of the German bailout expenditure of 12.8% of GDP was classified as capital transfer, recovery through asset sales in Germany has been low so far, at only 2.0% of GDP (IMF 2013: 14, Table 5).

Such differential treatment can create the impression of political bias, in this case in favor of Germany. But statisticians adhere to market valuation exactly because it gives them independence from direct political interference. The classification reflects the judgment of 'the markets' in an environment in which Germany's economic performance is much stronger than that of Ireland. The classification is not necessarily wrong in its implicit prediction about whether bailout expenditure will be recovered. But it works to the detriment of weaker economies and reinforces pro-cyclical market pressures, leading to austerity.

A similar process, of letting market valuations rule statistical classifications, is at work in determining how entities brought into public ownership should be classified. The Maastricht indicators refer to the deficit and gross debt of 'general government'. Trading entities owned by the government are part of the 'public sector' but not part of 'general government'; the latter is defined as undertaking non-market production and allocation. This raises the question of what constitutes sufficient autonomy and commercial viability to make an operation a trading entity. Trading at a loss temporarily does not jeopardize trading entity status, but once an entity becomes mainly dependent on government funding, it is reclassified into 'general government'.

Surveillance operations in several countries have produced some striking reclassifications. Eurostat reclassified several Greek public enterprises which led to an increase in government debt by 7.8% of GDP in 2009 (Irwin 2012: 11). Eurostat argued that the magnitude of their losses meant that they should be accounted for as non-market producers and hence as part of general government. Portugal also experienced a considerable rise in gross public debt because of the reclassification of public enterprises. The adverse economic environment meant that these enterprises became mainly dependent on government funding, and hence they were counted as debt-increasing parts of general government. While justifiable in each case on narrow statistical grounds, these decisions create a bias against weak economies and create the impression that their administrations cannot be trusted, while what happened is that their economies deteriorated.

4 Fiscal surveillance in a depression

The technical method for avoiding pro-cyclical austerity is cyclical adjustment. While the original Pact specified an unadjusted 3% threshold, the Commission and the Council moved to monitoring a 'structural' measure of the deficit with Stage III of EMU (Savage 2005: 176-177). The move to cyclical adjustment was then seen as necessary because it was not possible to maintain compliance with rules when the regulatory target was not fully under the control of the regulatee.

Commentators in the 2000s noted that fiscal tightening could worsen a recession, and therefore potentially be counterproductive for meeting fiscal targets. However, this was not seen as a fatal flaw in the SGP by 'welfare maximisers'. The prevailing economic policy paradigm assumed that monetary policy could ensure that the economy of the Euro area would, in aggregate, track a stable GDP path (Schelkle and Hassel 2012). Fiscal policy was only necessary to address idiosyncratic shocks in individual member states. The Commission's economists always had doubts about governments' political capacities to implement stabilizing fiscal policies, and promoted an analysis in which countercyclical fiscal policy would rely on 'automatic stabilizers' rather than discretionary measures (Buti et al 2003; cf Mabbett and Schelkle 2007). Their analysis showed that the 3% deficit criterion, once cyclically adjusted, provided a sufficient margin for the automatic stabilizers to operate.

The obvious difficulty presented by the financial crisis is that monetary policy is not effective at stabilizing or stimulating GDP. Furthermore, in this situation of a 'liquidity trap', fiscal policy may be very effective through a Keynesian multiplier mechanism. This effectiveness works both ways: IMF research suggested a strong negative response of economies to fiscal consolidation in times of deep recession (Blanchard and Leigh 2013). This research, showing that in times of economic depression fiscal policy can be powerful while monetary policy amounts to 'pushing on a string', generated a heated controversy about the wisdom of adhering to fiscal rules in Europe.

Critics of the IMF's view rely on a different theory of the relationship between the fiscal stance and economic outturns: the theory of 'growth friendly fiscal consolidation', also known as non-Keynesian effects of fiscal consolidation (Giavazzi and Pagano 1990; Blyth 2013: 57-58, 131-2). It is hard to know whether advocates really believed this theory, or whether they were more concerned about the implications of the multiplier theory for mediating fiscal relationships in the Euro area. Certainly the intervention in the debate of the then Commissioner for the Euro, Olli Rehn, focused on the implications for fiscal governance. Faced with discussion among finance ministers of the possibility that fiscal multipliers were so large that austerity could worsen deficits, Rehn sent an open letter in an attempt to close off 'a debate that has not been helpful.' (Rehn 2013a) He argued that 'the confidence that we have painstakingly built up in numerous late-night meetings' was eroded by airing the possibility of fiscal stimulus. Plans for Eurobonds and ECB interventions were no substitute for a 'stability culture'.

Rehn insisted on the inadmissibility of the discussion of fiscal multipliers, as this would undermine the case for fiscal restraint and control. However, his officials faced a different problem. They have to assess member states' forecasts of GDP and evaluate their consistency with fiscal plans. It cannot be ruled out that fiscal policy affects GDP; if this is ignored, then forecasts will be incorrect. The 'Codes of Conduct' – the guides to preparing surveillance reports – prepared by Rehn's officials suggest that they were not convinced that fiscal multiplier effects can be discounted. The guide for all member states (in and out of the euro area) simply states that assumptions on real GDP growth should be underpinned by an indication of the expected demand contributions to growth (CEC 2012: 14). The code for euro area states, revised in 2013, is more explicit. It asks reporting countries to specify the assumptions on which their GDP estimates are based, including 'the estimated impact on economic growth of the aggregated budgetary measures envisaged in the [draft budget plan]' (CEC 2013: 3). This estimate is also itemised in the report's first table on macroeconomic prospects.

The possible endogeneity of GDP with respect to fiscal policy provides a good reason for officials to keep their eyes firmly on the medium term as facilitated by the Six Pack reform. It also suggests that policy recommendations to adopt structural reforms to promote growth are less likely to have perverse effects than recommendations to raise taxes or cut expenditure. And this is exactly what we find in the Commission's assessments. Member states are repeatedly urged to adopt 'growth friendly structural measures' drawn from a limited and familiar menu: pension reform, improvements to public administration, changes to wage-setting institutions, and measures to liberalize the services sector and network industries.

The Commission itself is under surveillance for the accuracy of its assessments, and its approach to structural adjustment has been subject to some criticism.[2] In a deep and prolonged depression, there are inevitably doubts about whether economies will return to their previous levels of productive capacity. The Commission has been criticized for its estimates in the current downturn. It uses a production function methodology to estimate potential GDP and output gaps (D'Auria et al 2010). This requires it to determine the available productive inputs, converted by the production function into an estimate of potential output. Controversially, the Commission's estimates of potential employment track actual employment rather closely for some countries. Spain, Portugal and Ireland are all estimated as having experienced strong and sharp increases in the level of structural unemployment in recent years.[3] This has the effect of raising the Commission's estimates of the structural deficit and the adjustment effort required to restore fiscal balance. This controversy also highlights that fiscal austerity may not be the best way to reach structural targets: measures to enhance labor market flexibility or deregulate the service sector could be adopted instead, and the Commission's recommendations have taken on precisely this tenor.

[2] See the review in a blog by the Bruegel Institute: http://www.bruegel.org/nc/blog/detail/article/1176-blogs-review-the-structural-balance-controversy/ as well as the campaign for different measurement of structural balances by Zsolt Darvas from Bruegel: http://www.bruegel.org/nc/blog/detail/article/1170-mind-the-gap-and-the-way-structural-budget-balances-are-calculated/
[3] See http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp_455_en.pdf in Graph 1.

5 Trapped under the lamp-post

One way of summarizing the previous two sections is that fiscal surveillance, created to keep national fiscal policies from spilling over into the conduct of the common monetary policy, has been encroached on and encumbered by the fiscal fallout of the crisis. Government books show the impact of a deep recession and impaired banking systems, neither of which could be tackled decisively by the ECB, though not for want of trying (see Henning in this volume). The fiscal surveillance process seems to still hold fiscal authorities to account for calamities that are outside their control.

In this section we ask what it would take to separate monetary, financial and fiscal policy so that fiscal surveillance could focus on fiscal policy. An argument for removing the spillovers from distressed banks has been cogently advanced by Wyplosz (2013). Drawing on a comparison of EA fiscal governance with fiscal rules in US states, Wyplosz notes that the monetary functions of EA members present difficulties in designing and implementing a fiscal rule. In the US, the federal authorities have the resources and authority to bail out and resolve banks; thus banking problems do not find their way onto state budgets. The creation of a banking union with a European-wide resolution fund is therefore of central importance, because 'bailouts of financial institutions have historically been the main reason why governments lost control of their public debts.' (Wyplosz 2013: 33)

Most commentators agree on the necessity for a joint bank resolution fund, accompanied by the strengthening of supranational regulation under the auspices of the ECB. However, there are different views of the 'legacy' problem of accounting for the financial crisis. Under existing accounting rules, 'defeasance structures' or 'bad banks' are part of general government. Eurostat issued guidance in 2009 to the effect that 'Government-owned special purpose entities, which have as their purpose to conduct specific government policies (for example with regard to defeasance or recapitalisation) with no autonomy of decision, are to be classified in the general government sector' (Eurostat 2009: 5). This meant that their debt would become part of general government debt, and any ongoing deficits of those entities would add to the government deficit. An implication of this decision is that governments which lack fiscal room for manoeuvre should avoid creating defeasance structures, and instead leave impaired assets inside the originating banks to be gradually worked out. But this is widely thought to be a counterproductive strategy that leads to a 'Japan scenario': it hides problems and postpones a return to normal operations in the banking system.

It might be thought that all the EU authorities would share an interest in avoiding the Japan scenario and supporting ways to enable member states to recapitalize banks without breaching the fiscal rules. From the ECB's point of view, one implication of putting off recapitalization is that banks are left to rebuild their balance sheets by taking cheap loans from the ECB and earning a margin from on-lending. The more banks rely on this process, the larger the gap between the ECB's policy rate and bank lending rates has to be, and the longer this gap will have to persist, impairing the transmission of low policy interest rates onto lending conditions.

However, the Commission and the ECB have not seen eye-to-eye on the desirability of establishing separate bank resolution mechanisms. Their different positions crystallized around a proposal by Spain to use an ESM loan to recapitalize its banks (Blackstone and House 2012). The Spanish government sought to avoid the political embarrassment of a lending program, with the imposition of conditionality and loss of sovereignty that would imply. Instead, it proposed, in the context of proposals for a banking union, that the ESM should undertake a lending program to Spanish banks that did not go via the accounts of the Spanish government. Loans to recapitalize banks could be made via supranational institutions and accounted for separately to the main assessment of government debt.

The ECB argued against this proposal. It recognised the problem that Spain could put off resolving the problems of its banking sector, and that this would mean that Spanish banks would draw heavily on ECB resources. Its preferred solution was that the Council should have enhanced powers to compel a member state to receive assistance (ECB 2012: 3). Having been compelled to take out a loan to fix its banking system, a state would be required to prepare a MAP. Contrary to the argument that fiscal and banking problems should be separated out, it argued that, because of the ‘close relationship between fiscal sustainability and financial sector instability’, government debt sustainability should be (re)assessed if a member state received a loan to recapitalize financial institutions (ECB 2012: 5-6).

It is possible to identify some reasons for the ECB’s insistence on ‘inseparability’. One reason is that governments have got around the prohibition on direct ECB sovereign lending by selling bonds to their own banks, which have in turn converted them into cash at the ECB’s discount window. Bank and sovereign finances in several countries have become very closely linked (De Grauwe 2011). While some accounts of this ‘doom loop’ see it as originating with government rescues of banks, it is also possible for the process to be fed by large budget deficits originating in poor fiscal conduct, such as low rates of tax collection. It can also be argued that fiscal responsibility and regulatory conduct are linked: thus Wyplosz (while supportive of separating monetary from fiscal regulation) raises (but does not answer) the question of whether ‘the authorities in Ireland and Spain .. [would] have allowed the housing market bubbles had they known for sure that the eventual costs would be borne entirely by their taxpayers’ (Wyplosz 2013: fn 21). More generally, governments have proved resistant to complete independence for financial regulators, and critics argue that they do not have clean hands when it comes to resolving the problems that deficient regulation has caused (Quintyn et al 2007).

While the ECB has insisted on the links between fiscal and financial sector governance, the Commission has taken the opposite approach. It seeks to distinguish financial from fiscal (mis-)conduct, notably by making it clear that bank recapitalizations will not produce adverse verdicts under existing surveillance processes. In a letter to finance ministers in October 2013, Olli Rehn spelled out how capital injections would affect Member States’ standing in relation to the debt and deficit criteria in the Pact. There is no way to exclude these interventions from the statistical measures of debt and deficits, but they can be ‘taken into account as a relevant factor’ in DG Ecfin’s assessment of compliance. The aim of the letter was to establish, or at least to assert, ‘that the EU fiscal rules provide no disincentive’ to publicly financed bank recapitalizations (Rehn 2013b).

Epstein and Rhodes (in this volume) offer some partial support for the ECB’s position, arguing that EU states have tried to retain domestic control over their banking sectors, to ensure that their government bonds are readily taken up and/or to pursue other public policy purposes such as promoting lending to SMEs. This in turn made them willing to bail out their banks when it might have been better to wind some down: ‘states have taken on the enormous fiscal burden of bailing out their own banks, in large measure to keep domestic banks domestic’ (Epstein and Rhodes, p.9). This points to moral hazard if states are let off the hook of paying for bank recapitalization: they will not have fiscal incentives to ensure proper regulation in the future.

However, even if political fingers can be found in banking pies, banking and fiscal problems have to be separated if fiscal rules are to be enforceable. The approach embraced by the Commission is to establish a supranational system of banking supervision to regulate access to supranational resources for bank resolution. Ultimately, this should achieve a genuine separation of fiscal (or, more precisely, budgetary) policy from monetary policy, preventing both the distortion of monetary policy for budgetary purposes and the imposition of financial sector losses on government budgets. A number of steps have been taken in this direction, as Epstein and Rhodes document. A key barrier is that supranational bank resolution means pooling financial resources and allowing quasi-fiscal transfers. These transfers can only be separated from national budgets by the creation of supranational funds, and the ESM is a first step.

Addressing the budgetary consequences of banking crises would go a long way to reducing the pressure for austerity on EA governments. It is not the only step required, however. More capacity to implement a countercyclical fiscal policy across the EA is evidently needed. This is ignored by advocates of ‘decentralized’ enforcement of fiscal rules, whereby voters insist on fiscal discipline, spurred on by the judgments of bond markets (Wyplosz 2013, Kelemen and Teo 2014). Kelemen and Teo examine why and how US states comply with their fiscal rules (most have self-imposed budget balance conditions) and find that the bond markets impose effective sanctions. Delinquent states are quickly punished: governments that bring forward non-compliant budgets find themselves faced with a lower rating and higher spreads, and are pushed into revising their plans. But US states and EA states differ in a number of important respects, not least that, in the former, the Federal Reserve looks after financial stability and the federal government can implement a countercyclical policy.

The IMF has advocated fiscal expansion on the part of those EA member states that can afford it: in other words, those not subject to bond market attacks. In our view, it would be better to establish a debt instrument to insure member states against bond market attacks, which could also regulate access to the common resource of low-interest public finance for EA members (Mabbett and Schelkle 2010, CAE 2013: point 6). Given the periodic failure of monetary policy, it would be desirable to be able to determine a countercyclical fiscal stance for the EA as a whole, and to be able to finance a fiscal expansion if needed, regardless of the verdicts of the bond markets (Dullien and Schwarzer 2009).

In summary, fiscal surveillance in the EA would have more chance of operating effectively if it had a narrower remit. But the remit can only be narrowed if new supranational institutions are built. Removing the fiscal costs of bank bailouts from member states' budgets calls for a supranational resolution fund. Protecting member states against contagious bond market attacks calls for a joint liability Eurobond, as does countercyclical macroeconomic management in the face of monetary doldrums. So long as the EA does not have these institutions, the fiscal surveillance process struggles: a puny Atlas with the whole burden of macroeconomic regulation on its shoulders.

6 Conclusion

The evolution of fiscal surveillance has a less straightforward trajectory than either disciplinarians or their critics generally care to notice or admit. Our analysis suggests that the propensity to look for everything under the fiscal surveillance lamppost is due to the institutional structure: the norms governing accounting for crisis, the responsibility of governments for 'their' banks, and the assignment of the task of overall macroeconomic stabilization to monetary policy.

We have tried to show that, while the dice in fiscal surveillance are at times loaded against economies in recession, this is a product of the rules and methods used by Eurostat and DG EcFin, rather than being the result of an austerity delusion. On the contrary, at the enforcement stage, DG Ecfin has been rather lenient with the member states that have not met their budget targets, and has provoked a public stand-off with major guarantor countries such as Germany and Finland (Spiegel and Carnegy 2014, Spiegel 2014). France, Italy and Spain were seen as getting overly favorable treatment.

The difficulties facing the Commission are illustrated by the two faces of the former Commissioner for the Euro, Ollie Rehn: apparently the disciplinarian in finding a discussion about fiscal multipliers 'not helpful', but signalling clearly that the Commission will take a lenient view of the fiscal costs of bank recapitalization. We find Rehn's position explicable, if not entirely consistent. The potential effect of the fiscal stance on the macroeconomic outturn is a long-standing problem in fiscal surveillance, and the Commission has established a limited concession to it, holding that the 3% threshold provides enough fiscal space given that the indicator is cyclically adjusted. This may not really be so in the current liquidity trap, but the Commission was reluctant to give way, especially as the countries most likely to seize on any extra fiscal space were those with the largest macroeconomic imbalances and the weakest fiscal positions. Bank bailouts, by contrast, are an issue that has faced the Commission only since the financial crisis, and there Rehn could find that discretion is the better part of valor without undermining a long-standing compromise or showing excessive partiality to the interests of a few countries.

While Rehn has to look for political solutions acceptable to the member states, we have provided evidence in this chapter that the approach taken by Eurostat and DG EcFin is fundamentally technocratic. Governance by experts means varying the implementation of established rules and procedures in the light of the evolving consensus among peers. The Commission has no reason to apply a rule mechanically if it can see a better alternative. It may take the view that governments are failing to adopt optimal fiscal policies, but that will not lead it to enforce a rule if the result would be a third-best outcome. However, it is not open to the Commission to propose replacing the focal points of the general government deficit and gross debt with more robust measures. The best it can do is to point out the issues in its evaluations and spread the light by adding more rules and indicators, as it has done through the Macroeconomic Imbalance Procedure (see Marzinotti in this volume). The Commission is stuck with the fiscal surveillance lamppost, but it is too sentient to believe that it will find the key there.

Our account suggests that reforms to fiscal surveillance that have attracted a lot of attention are actually unlikely to be important. In particular, we expect reverse majority voting to make little difference. Reverse voting matters according to the disciplinarian analysis that the problem of fiscal surveillance is self-enforcement by 'turkeys'. There is no room in this analysis to doubt whether an expert body would be in favor of upholding the fiscal rules. We have argued that there are, and should be, such doubts. They arise because fiscal surveillance is implicated in solving the joint monetary, financial and fiscal problems of the EA. Comparisons of the EA with the USA, such as that offered by Kelemen and Teo (2014), fail to pay sufficient attention to the much wider macroeconomic and financial roles of EA governments. The logic of fiscal rules is that governments should be like orderly households, living within their means. The larger the role of the government, the less viable is this view, and the more likely is it that a disciplinarian stance is so welfare-reducing as to be untenable.

We have suggested that the monetary and financial roles of EA governments could be curtailed, but only if those roles were transferred to supranational institutions. A banking union and a minimum of fiscal integration in the form of a joint debt instrument would help to distinguish between government and market failure, moral hazard and genuine insurance cases, fiscal causes and fiscal consequences of a crisis. As long as these policies are not in place, fiscal surveillance remains the main game in town, despite its evident limitations.

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