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FISCAL POLIC Y COORDINATION IN EUROPE

ECON

EN

2010

EUROPEAN PARLIAMENT

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

FISCAL POLICY COORDINATION IN EUROPE

NOTE

Abstract

A fundamental overhaul of EU economic governance is needed. The most important reform is a strengthening of national fiscal frameworks, including the establishment of independent fiscal watchdogs in Member States that do not yet have such institutions. At the European level, a permanent crisis resolution mechanism should be integrated with both broader macroeconomic surveillance and the sanction system. An independent European fiscal council could, based on macroeconomic risk considerations, decide in advance appropriate haircuts in the event of future sovereign debt restructuring.

IP/A/ECON/NT/2010-10 September 2010

PE 440.292 EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs

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LINGUISTIC VERSIONS

Original: [EN]

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To contact the Policy Department or to subscribe to its monthly newsletter please write to: to: poldep-esc@europarl.europa.eu

Manuscript completed in September 2010.

This document is available on the Internet at:
http://www.europarl.europa.eu/activities/committees/studies.do?language=EN

DISCLAIMER

[1] The author is grateful for comments from Laura Hartman and Lars Jonung.

Content

Executive Summary

The Commission has proposed a number of reforms of EU economic governance. They include strengthening of the EU fiscal rules, broader macroeconomic surveillance, better connect between the policy processes at the European level and the national level, and strengthening of national fiscal frameworks. Reforms proposed in all these areas are desirable. But as fiscal policy is a national prerogative, the most important reforms would concern national fiscal frameworks. Such reforms should include (i) well-defined fiscal objectives; (ii) ex-ante guidelines for the use of fiscal policy as a stabilisation tool; (iii) commitments to transparency; and (iv) stronger incentives to adhere to national targets.

The incentives for fiscal discipline can be strengthened by setting up *fiscal watchdogs* (fiscal policy councils), as has been done in some countries. These institutions should be truly independent from Governments with a clear separation of tasks from Ministries of Finance. They could be given narrow tasks of only fiscal monitoring or broader tasks, involving also evaluations of employment and growth policies, depending on the specific traditions and institutional environment of the country. The Commission and the Ecofin Council could help boost the standing of such watchdogs by regularly asking their views when evaluating Stability and Convergence Programmes.

One could also conceive of an independent fiscal policy council at the European level. It could be used for evaluating that national fiscal frameworks meet certain minimum standards. It could also engage in broader macroeconomic surveillance, which must be more judgemental than pure fiscal surveillance and which therefore is exposed to even larger risks of political interference.

The main risk with current reform initiatives is that they will merely represent tinkering with the present rules and will therefore result in a complex and non-transparent system which does not command enough legitimacy. Instead, there should be a fundamental overhaul of EU economic governance to address the "new facts on the ground" established by the financial emergency measures to deal with the sovereign debt crisis. Such a reform should integrate a permanent financial crisis resolution mechanism with the systems of sanctions and macroeconomic surveillance.

A permanent crisis resolution mechanism should allow for the possibility of orderly restructuring of government debt where lenders might have to take a haircut on their claims. The size of haircuts in the event of restructuring could be determined in advance by an independent European fiscal council on the basis of macroeconomic surveillance. The council could be explicitly instructed to take pre-emptive action and signal risks to financial markets through differentiation of the size of potential future haircuts with the aim of inducing *early* market reactions. Fines and other financial sanctions should be transformed into insurance fees going into a crisis resolution fund, which would boost their legitimacy. Measures should also be taken to increase the probability that the sanctions are used (the insurance fees paid). This could involve loss of voting power in the Excessive Deficit Procedure for all countries deemed to have excessive deficits and/or larger automaticity of enforcement steps (a requirement of a qualified majority to stop further steps rather than such a requirement to take them).

1. Introduction

The sovereign debt crises in the euro area have created an awareness of the need for reform of EU economic governance. Preliminary proposals have been made by both the Commission and the van Rompuy Task Force and have been endorsed by the European Council.[2] Inputs have been provided by both the ECB and Member State Governments.[3] There is also a vivid ongoing public debate.

EU economic governance is obviously in shambles. This was clear already before the onset of the economic crisis, as there were earlier frequent violations of the fiscal rules. The Stability and Growth Pact (SGP) was also weakened significantly in 2005. But the emergency measures to deal with the acute sovereign debt crises signal a complete wreckage of the system. The ad-hoc creation of the European Financial Stability Mechanism means in effect a cancellation of the no-bail-out clause. The ECB's purchases of debt of crisis-ridden governments amount to de-facto financing of their deficits. Although probably unavoidable in the situation that arose, the emergency measures imply serious moral-hazard problems and a further weakening of early market signals, the main remaining disciplining force after the loosening of the SGP.

There has emerged a consensus on the causes of the current public debt crisis.[4] These include:

- A failure in several countries to observe the fiscal rules. The violations range from outright fraud in Greece to budget deficits that in good times stayed too close to the three-per-cent-of-GDP ceiling and insufficient reduction of government debt in others like Italy, Portugal and France.
- Severe macroeconomic imbalances, involving excessive credit creation, real estate price bubbles, overexpansion of the construction sector, and strong real exchange rate appreciations in especially Ireland and Spain. Although these countries entered the recession with fiscal surpluses and low government debt, the scope for deterioration of the fiscal position turned out to be huge.
- Lax bank regulation with too small capital buffers which forced governments to transform private debt into public debt when the financial crisis struck - Ireland and the UK are prime examples.

There has also developed a fair amount of consensus on appropriate governance reforms. The ingredients can be summarised as follows:

1. Strengthening of EU fiscal rules.
2. More comprehensive macroeconomic surveillance.
3. Addressing the disconnect between the policy processes at the European level and the national level.
4. Strengthening of national fiscal frameworks.

A pertinent question is whether the various reform avenues are complements or substitutes. In view of the severity of the fiscal problems, there is a strong case for viewing them as complements, that is to make reforms in all four areas. But the most important reform is probably the establishment of strong fiscal frameworks at the national level, as fiscal policy is still – and will for the foreseeable future remain – a national prerogative.

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[2] See European Commission (2010a, 2010b), van Rompuy (2010a, 2010b) and the European Council (2010).
[3] See ECB (2010) and, for example, Swedish Ministry of Finance (2010) and European economic governance (2010).
[4] See the references in footnotes 2 and 3 as well as Baldwin and Gros (2010).

Sections 2-5 discuss the four sets of reforms listed above. This discussion mainly comments on proposals advanced in the ongoing EU policy process. Section 6 analyses the role that independent fiscal institutions could play. Section 7 focuses on the need for a permanent crisis resolution mechanism and how that could be coordinated with the SGP as well as with broader macroeconomic surveillance. Section 8 concludes. My discussion is relevant mainly for the Member States which have adopted the euro, although parts of it apply also to Member States which have not.

2. Strengthening the Fiscal Rules

At the national level, experiences with the EU fiscal rules have been characterised by frequent breaches of the deficit ceiling as well as by significant deviations from the medium-term fiscal objectives, resulting in insufficient reductions of debt levels in good times. At the European level, there has been a reluctance to follow stipulated procedures in general and to apply sanctions in particular. In 2005 a major loosening of the SGP was undertaken with the aim of accommodating French and German violations of it.[5]

The reluctance in the Ecofin Council to make full use of the enforcement mechanisms in the SGP has several causes: a general bias to avoid political conflicts, collusion among Member States simultaneously breaching the rules, “strategic awareness” among current non-violators that lenient treatment of violators likely increases the chances of lenient treatment for the own country if it were to breach the rules in the future, and insufficient legitimacy for sanctions (possibly because of their harshness).

The Commission has proposed reforms along several lines:

- Faster progress towards the medium-term fiscal objectives for high-debt Member States (*preventive* arm of the SGP).
- Greater emphasis on the debt criterion, such that Member States with debts in excess of 60 per cent of GDP not meeting a well-defined benchmark for debt reduction should be subject to the Excessive Deficit Procedure even if they comply with the deficit ceiling (*corrective* arm of the SGP).
- A wider set of sanctions against violators of the rules which should set in already at an early stage. This broader range of sanctions could include interest-bearing deposits and reductions in payments from the EU budget. Such sanctions would be used not only in the Pact’s corrective arm, but also in its preventive arm.

The proposed changes are reasonable. But some comments are warranted.

Earlier and more gradual sanctions would likely increase the probability that the sanctions are used. But a potential problem with the proposed widening of the sanction possibilities is that they are complex and involve many systems, including different parts of the EU budget. This is the consequence of the ambition to make reforms without Treaty revisions. A simpler and more transparent system would have benefits from a legitimacy point of view. A feature of the current sanction system that one should do away with is its *front-loading*: if non-interest-bearing deposits and fines are used, they will be larger in the first year they apply than later (because there is a fixed component – in addition to a variable component – in the first year which disappears in later years).[6] This front-loading works as a disincentive to use the sanctions because once applied they immediately become very harsh.

[5] See Calmfors (2005).

[6] As long as excessive deficits are below seven per cent of GDP, the deposit/fine is larger in the first year (which is the only one when payment of a fixed amount of 0.2 per cent of GDP is required) than in subsequent years (when only payment of the variable amount of 0.1 per cent of GDP for each percentage point’s excess of the deficit above three per cent of GDP is required). See Calmfors (2005).

An important element in the weakening of the SGP in 2005 was the introduction of possibilities to extend the deadlines for correcting an excessive deficit. These changes make it possible to prolong the time after identification of an excessive deficit before non-interest-bearing deposits and fines have to be paid from three and five years, respectively, up to seven and nine years, respectively.[7] Decisions on this are to be based on a consideration of "other relevant factors" which include factors deemed important "in the opinion of the Member State concerned". These factors are exemplified with rubber formulations that open up for arbitrary interpretations.[8] It is noteworthy that the recent Commission communications on stronger EU economic governance do not address this issue.[9] It would send a strong message that future enforcement is to be more rules-based if one did away with the possibilities to extend deadlines based on arbitrary criteria.

Reforms ought also to involve the decision-making procedures in the Ecofin Council, as the earlier lax enforcement has been due to an unwillingness to use the instruments available. Two possibilities immediately suggest themselves. A first one is to deprive Member States with excessive deficits of their voting rights in the Excessive Deficit Procedures against other Member States. This would make it impossible for Member States with excessive deficits to form coalitions that block further enforcement steps, as happened in the past. A more radical approach is to revert to the original German proposals on the SGP from the 1990s, according to which sanctions would be automatic unless there is a qualified majority against them (instead of as today requiring a qualified majority in favour). Both these reforms would require Treaty changes. An additional possibility would be for the European Parliament to take on the role of regularly evaluating the performance of the Ecofin Council (as well as the Commission) in the SGP processes.[10]

3. Broader Macroeconomic Surveillance

The Commission has also proposed that macroeconomic surveillance should be broadened. The idea is to set up a mechanism modelled on the SGP, thus including both a preventive arm with the aim of identifying macroeconomic imbalances and a corrective arm to enforce the elimination of such imbalances. The preventive arm would include an *alert mechanism* based on a *scoreboard* of indicators. These could include the current account balance, the net foreign asset position, the real exchange rate, private debt and asset prices. The corrective arm would include an *Excessive Imbalances Procedure*, where non-compliance with Council recommendations would trigger intensified surveillance and be "an aggravating factor in the fiscal assessment under the Stability and Growth Pact".[11]

The need for broader macroeconomic surveillance is obvious. The Commission's proposals are a late, but welcome, recognition of the gravity of the asymmetric-shocks problem emphasised in the research on optimal currency areas. It has been a futile hope that a common currency would automatically lead to such convergence that serious asymmetric shocks would disappear. On the contrary, past developments, especially in Ireland and Spain, illustrate clearly how unsustainable booms in individual economies can sow the seeds of macroeconomic deteriorations that quickly turn perceived sustainable public finances into unsustainable ones.

[7] See Calmfors (2005).
[8] The factors include "budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State" (Council Regulation 1056/2005).
[9] European Commission (2010a, 2010b).
[10] This way of holding both the Council and the Commission accountable has been proposed by Hallerberg (2010), who notes that the Council routinely weakens the text of recommendations the Commission proposes under SGP
[11] European Commission (2010b).

A few words or warning are, however, warranted. Evaluations of the fiscal risks arising from macroeconomic imbalances will always be of a judgemental character. These evaluations cannot be based on precise numerical values in the same way as evaluations of compliance with the fiscal rules. Hence, it is not advisable to set up a financial sanctions system linked to "excessive imbalances" as suggested by the ECB.[12] One should also avoid that broader macroeconomic surveillance introduces a larger discretionary element into the Excessive Deficit Procedure, as the main problem with it has been too much discretion.

4. Addressing the Disconnect between the European and the National Level

An easily identifiable problem with EU fiscal surveillance is the disconnect to the fiscal policy debate at the national level. In ordinary times, EU concerns do not seem to influence the fiscal policy discussion much in most Member States. Stability and Convergence Programmes appear more as an ex-post account of policy than as an integrated part of the domestic policy formation process.

The Commission's proposal of a *European Semester* is designed to address this problem by devising an annual cycle where (i) the Commission and the European Council provide strategic guidance; (ii) this guidance is taken into account when Member States formulate their Stability (Convergence) Programmes and National Reform Programmes; (iii) the Council issues country-specific guidance on the basis of these programmes; and (iv) Member States finalise their national budgets in the last step of this process.

A European Semester would increase interaction between the European level and the national level. An important point is the need of a highly *visible* domestic arena where the European and national levels can meet. Such an arena could be created if EU-level orientations for national policy were to be presented – by, for example, the President of the Eurogroup, the Chair of the Ecofin Council or the Commissioner for Economic and Financial Affairs – in national Parliaments and subjected to open hearings there in a way such that these presentations become important events in the national policy discussion.

5. Stronger National Fiscal Frameworks

European macroeconomic surveillance can – and should – be improved. But as economic policy is still mainly decided nationally, stronger national fiscal policy institutions are of paramount importance. Without them, efforts at the European level are likely to fail, as in the past. For this reason, the most important Commission proposals are the ones on strengthening national fiscal frameworks. It is desirable to set minimum standards for such national frameworks at the European level and monitor that the standards are respected. There is much to suggest that common rules on the design of institutions are more easily accepted than decisions on actual policies (an obvious example is the requirement of independence of central banks, which applies also to the Member States which have not adopted the euro).

National fiscal frameworks should have four main ingredients:[13]

- *Well-defined fiscal objectives*. They should include a multi-year objective for the fiscal balance or the development of government debt and preferably also expenditure ceilings, the motivation being that deficit problems usually originate on the expenditure side.

[12] ECB (2010).
[13] This reasoning has been elaborated in SOU 2002:16 and Calmfors (2003, 2005).

- *Ex-ante guidelines* for how fiscal policy should be used as a stabilisation tool. They should specify to what extent fiscal policy to stabilise the business cycle should rely on the automatic stabilisers and to what extent on discretionary action. To shorten decision lags in acute situations, it may be desirable also to specify in advance which fiscal instruments are to be used. Such guidelines are particularly important in booms, as it may be particularly difficult then to reach political agreement on appropriate measures.
- *Commitments to transparency* to guarantee adequate statistical reporting as well as to prevent that creative accounting and one-off transactions are used to mask deficits. An obligation for governments to indicate clearly in advance which fiscal measures are undertaken for temporary stabilisation purposes and which are undertaken for other reasons would also be helpful.
- *Incentives to avoid deviations from policy objectives*. A recently much discussed method is to build in countervailing powers in the decision-making process through the establishment of independent fiscal watchdogs. This is discussed in the next section.

6. Independent Fiscal Institutions[14]

Several countries have recently set up independent fiscal watchdogs (fiscal policy councils is the label used in the academic literature). Sweden (2007), Canada (2008), Hungary (2008), Slovenia (2009) and the UK (2010) are examples. Similar institutions existed already before in the Netherlands, Denmark, the US, Belgium and Austria. The exact tasks vary but could include:

- The provision of “objective” macroeconomic forecasts on which government budget proposals are to be based.
- Costing of various government policy initiatives.
- Ex-ante evaluation of whether fiscal policy is likely to meet its medium-term targets.
- Ex-post evaluation of whether fiscal policy has met its targets.
- Analysis of the long-run sustainability of fiscal policy.
- Normative recommendations on fiscal policy.

A fiscal watchdog can help to increase public awareness of the future costs of current deficits and to offset tendencies to overoptimism and overconfidence by highlighting historical examples and providing analysis of the sensitivity of budget calculations to various risks. By increasing fiscal transparency, a watchdog makes governments more accountable to the electorate. Independent monitoring could be seen as a complement to fiscal rules: it is likely to increase the reputation cost of deviating from them. At the same time, elaborate monitoring by an independent institution could allow the rules to be more flexible, permitting more contingencies: such monitoring makes it less necessary for a government to earn credibility through mechanical application of simple and more easily observed rules.

[14] This section builds mainly on Calmfors (2010a, 2010b).

Member States that do not have independent fiscal watchdogs would be well advised to establish such institutions.[15] In this context, a number of considerations are important:

- The watchdogs must be truly independent of the political sphere. This could be achieved through long and non-renewable terms of office for council members, a long-term budget, and a clear separation from the Ministry of Finance with own staff and no obligations (rather a prohibition) to provide in-house input to the Ministry.[16]
- The majority of council members should be academics, since they are mainly active in another arena than the political one (where the reputation cost of being seen to be politically biased is huge) and not dependent on it for their careers. The inclusion also of ex-politicians, preferably earlier Ministers of Finance, with their political careers behind them could contribute to the public standing of a watchdog.[17]
- In the long term, fiscal watchdogs can gain credibility only through building a reputation for unbiased, high-quality analysis. But to get a head start it is important that governments show that they take them seriously. To the extent that governments are criticised they may have a strong incentive to downplay the views of the watchdogs. One way of boosting their credibility would be for the Commission and/or the Ecofin Council to regularly ask the views of the national fiscal watchdogs when evaluating Stability and Convergence Programmes.
- Since both historical traditions and institutional set-ups vary among countries, the precise tasks of independent fiscal institutions should be adapted to the circumstances of each country: there is no unique optimal model. Among existing institutions, the remits vary from very broad macroeconomic ones (including analysis of employment and other structural policies in the Netherlands, Denmark and Sweden) to more narrow fiscal ones (as in, for example, Hungary and the UK).[18]

There have also been proposals to set up an independent fiscal council at the European level.[19] One idea would be to let such an institution monitor that national fiscal frameworks meet certain minimum standards. In addition, a European fiscal council might have a role to play in broader macroeconomic surveillance (possibly with an input from national councils). Such surveillance must be of a judgemental character and is therefore exposed to larger risks of political interference than pure fiscal surveillance, which can be more rules-based. If such an independent European watchdog were to be set up, it should be placed outside the Commission to avoid all suspicions of undue interference from it.

7. A Permanent Crisis Resolution Mechanism

The need to handle the sovereign debt crisis has created an untenable situation. On the one hand, there is the no-bail-out clause in the Treaty. On the other hand, the ad-hoc establishment of the European Financial Stability Facility is a clear breach of the clause. The initial mistake behind the no-bail-out clause (125(1) TFEU) was the belief that if a euro country were threatened by default, it would be alone. In such a situation the no-bail-out clause was credible. But in a situation with widespread financial distress and sovereign debt problems, it is not. A default in an individual country could then cause systemic financial collapse.

[15] See Fatás and Mihov (2010), Lane (2010) and Wyplosz (2010) for recent proposals. See also, for example, Calmfors (2003, 2005).
[16] The recent debate on the newly established Office for Budget Responsibility in the UK illustrates the dangers of insufficient separation from the Ministry of Finance (Calmfors 2010c).
[17] For example, the Swedish Fiscal Policy Council is made up of two ex-politicians in addition to six academics (Calmfors 2010a, 2010b).
[18] In Sweden, the remit of the Fiscal Policy Council even includes examination of the clarity of the Government's budget proposals and of the motivations given for policy initiatives. The Council thus acts also as a "debate watchdog" with the aim of raising the quality of the economic policy discussion (Calmfors 2010a, 2010b).
[19] See, for example, ECB (2010) and Burda and Gerlach (2010).

Since sovereign debt crises are obviously possible in the euro area, there is a need for a permanent crisis resolution mechanism. It should balance moral-hazard risks against risks of systemic financial collapse. To this end, it should allow the possibility of orderly restructuring of debt. At the same time, there would be a great advantage from the legitimacy point of view if the mechanism could be integrated with the macroeconomic surveillance at the European level and the sanction procedures.

The creation of a crisis resolution mechanism in the form of a European Monetary Fund has been proposed by Gros and Mayer (2010).[20] According to the proposal, a defaulting country could apply for a swap of its debt against claims on the fund, which would then acquire the claims on the country from lenders. The swap would be made with a *haircut*. This means that lenders take losses, at the same time as there is an upper limit to the losses such that the risk of systemic collapse is reduced. The debt exchange would be allowed only under strict conditionality regarding fiscal consolidation in the defaulting country.

Such a permanent crisis facility could be linked to surveillance in two ways.

1. SGP fines – and other new forms of financial sanctions as discussed in Section 2 – could go into the fund. This would address the legitimacy problem of the current sanction system, where it is not clear why other Member States would be allowed to fine, and thus aggravate the deficits, of those that already have severe fiscal problems. One should expect it to be much easier to get public acceptance for fines that can be regarded as *insurance fees*, the potential use of which would be more visible. Setting up such an insurance-based system, where financial sanctions are explicitly linked to risk considerations, would represent a complete overhaul of the current sanctions system and require a Treaty change.

2. Broader macroeconomic surveillance could be used to determine the amount of risk that lenders would have to take on. More explicitly, the size of haircuts on a Member State's debt in the event of restructuring could be decided in advance based on judgements on macroeconomic imbalances. These judgements could preferably be made by an independent European fiscal policy council of the type discussed in the previous section, as the temptations for political decision-makers to make other considerations than purely economic ones would be huge. The council could be explicitly instructed to act pre-emptively, that is to decide in advance appropriate haircuts on a Member State's sovereign debt (in the event of a future restructuring) on the basis of long-term fiscal risk evaluations. The aim would be to signal risks to financial markets at an early stage and this way try to induce early market reactions. This could be seen as an attempt to let surveillance and market discipline interact in a more healthy way than is the case now.

[20] See also Mayer (2010) and Persaud (2010a, 2010b). ECB (2010) raises similar ideas but in less concrete form.

8. Conclusion

The Commission has proposed a number of reforms of EU economic governance. They include strengthening of the EU fiscal rules, broader macroeconomic surveillance, better connect between the policy processes at the European level and the national level, and strengthening of national fiscal frameworks. Reforms in all these areas are desirable. But as fiscal policy is a national prerogative, the most important reforms would concern national fiscal frameworks.

The incentives for fiscal discipline can be strengthened by setting up *fiscal watchdogs* (fiscal policy councils), as has been done in some countries. If such institutions are to be effective, they must be truly independent from Governments with a clear separation of tasks from Ministries of Finance. They could be given tasks of only fiscal monitoring or broader tasks involving also evaluations of employment and growth developments depending on the specific traditions, the institutional environment and the economic problems of the country. The Commission and the Ecofin Council could boost the standing of such watchdogs by regularly asking their views when evaluating Stability and Convergence Programmes.

One could also conceive of an independent fiscal policy council at the European level. It could be used for monitoring that national fiscal frameworks meet certain minimum standards. It could also be engaged in broader macroeconomic surveillance, which must be more judgemental than pure fiscal surveillance and which therefore is exposed to even larger risk of political interference.

The main risk with current reform initiatives is that they will merely represent tinkering with the present rules and will therefore result in a complex and non-transparent system. Instead, there should be a fundamental overhaul of EU economic governance to address the “new facts on the ground” established by the financial rescue measures to deal with the sovereign debt crisis. Such a reform should integrate a permanent financial crisis resolution mechanism with the systems of sanctions and macroeconomic surveillance.

A permanent crisis resolution mechanism should allow for the possibility of orderly restructuring of government debt where private lenders might have to take a haircut on their claims. The size of haircuts in the event of restructuring could be determined in advance by an independent European fiscal council on the basis of macroeconomic surveillance. The council could be explicitly instructed to take pre-emptive action and signal risks to financial markets through differentiation of the size of potential future haircuts with the aim of inducing *early* market reactions. Fines and other financial sanctions should be transformed into insurance fees going into a crisis resolution fund, which would boost their legitimacy. Measures should also be taken to increase the probability that the sanctions are used (the insurance fees paid). This could involve loss of voting power in the Excessive Deficit Procedure for all countries deemed to have excessive deficits and/or larger automaticity of enforcement steps (a requirement of a qualified majority to stop further steps rather than such a requirement to take them).

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