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FISCAL RULES: TIMING IS EVERYTHING

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THE ISSUE The strengthening of the European Union's fiscal rules with the approval of the so-called 'six-pack', and the parallel worsening of economic conditions in Europe, re-opened the debate about the relationship between fiscal discipline and growth. Influential voices have argued against the EU's perceived obsession with fiscal discipline, which risks being self-defeating in bad times. However, EU fiscal rules are not as rigid as commonly thought, but represent a sophisticated system of surveillance and *ex-post* control that provides sufficient room for manoeuvre under exceptional circumstances.

POLICY CHALLENGE

The EU fiscal framework has come under attack more because of the timing of the application of the new rules than for substantive reasons. The framework entered into force when most euro-area countries were under the Excessive Deficit Procedure. Linked to this is the fact that the six-pack suggests that the new surveillance procedure enters into force after EU countries have corrected nominal fiscal deficits. We argue that: a) fiscal surveillance should be prioritised over enforcement of sanctions for excessive deficits; b) it is inconsistent to allow for exceptional circumstances, while not recognising up-front the role of surveillance; c) there is scope to decide that slow growth at member state level and EU levels acts as a constraint on fiscal consolidation: it should be done *ex ante* in a way that allows governments to use the Commission's forecasts in their Stability Programmes, and must be decided by the Commission and not by the Council.

Time inconsistency in the application of the new SGP rules

	2012 →	2013 →	2014 onwards
Potential sanctions under Preventive Arm	Estonia, Finland, Luxembourg	Belgium, Cyprus, Estonia, Finland, Germany, Luxembourg	All countries
Potential sanctions under Corrective Arm	Austria, Belgium, Cyprus, France, Germany, Greece, Ireland, Italy, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain	Austria, France, Greece, Ireland, Italy, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain	All countries

Source: Bruegel.

THE TIGHTENING OF EUROPEAN UNION FISCAL RULES through the Fiscal Compact, which was signed in March 2012, and through the so-called six-pack regulations that entered into force in December 2011, comes at a time of worsening economic conditions in Europe. This unfortunate timing has re-opened the debate about the relationship between fiscal discipline and growth, and has provoked a wave of criticism from governments and academics about the EU's perceived obsession with fiscal discipline, and the potential in bad times for this to be self-defeating[1].

It is certainly the case that the new, tougher rules on excessive deficits have been introduced at a time of exceptional circumstances, which will severely test the new system. When the new rules entered into force, 14 of the 17 euro-area countries (ie all except Estonia, Finland and Luxembourg) were under the Excessive Deficit Procedure (EDP) and were committed to bringing their deficits to below 3 percent of GDP by 2012 (Belgium and Cyprus) or 2013 (12 others)[2]. Yet EDP countries face low or even negative growth prospects especially for 2012, as acknowledged by the Commission[3]. Thus, they could face sanctions for excessive deficits, whether in 2013 or a year later as recently decided for Spain, even before the EU is able to use its new surveillance tools to monitor structural fiscal positions.

But the debate about timing should not be allowed to detract from a measured analysis of the new framework. In fact, the EU fiscal rules are well designed, offer an often-underestimated flexibility, and are a useful contribution to the functioning of European monetary union. It would be a shame if the credibility of the rules were to be undermined because of the timing of their introduction.

Policymakers need to take this into account. In the current economic situation – with slow growth and high unemployment in many euro-area countries – it is important that the room for manoeuvre provided by the Treaties and the new six-pa ck is fully exploited, possibly with some minor corrections to the process. For the first test of the new rules to be negotiated successfully, timing is everything.

For a smoother transition from the old to the new regime, we suggest a simple rule that will allow a 'smart' application of the six-pack provisions without undermining them. We start in the next section by outlining the main features of the new fiscal framework. In the third section, we discuss the size of the required correction, the relevance of arguments about its potentially self-defeating nature, and the notion of 'exceptional circumstances'. We conclude in the final section with suggestions to ameliorate the risks that might arise because of the timing of the first application of the rules.

THE NEW RULES EXPLAINED

The Fiscal Compact (a part of the Treaty on Stability, Coordination and Governance – TSCG) will be an important addition to the EU's fiscal architecture. It will enter into force when at least 12 euro-area countries have ratified it, which could happen in early 2013. In the meantime the EU fiscal rules are laid down in the six-pack, the set of six regulations that entered into force on 13 December 2011, and which form the backbone of the Fiscal Compact. Both the six-pack and the Fiscal Compact aim to strengthen fiscal surveillance and improve enforcement by granting the European Commission powers to impose sanctions on countries that have failed to make sufficient progress towards more sustainable (structural) fiscal positions and/or to correct excessive deficits. The six-pack introduces rules both in the preventive and the corrective arms of the Stability and Growth Pact (SGP).

On 23 November 2011, the Commission made two additional regulatory proposals, known as the two-pack, which introduce enhanced monitoring of euro-area countries that risk non-compliance with the deficit criterion, and more clearly-defined surveillance and monitoring of countries receiving financial assistance.

The preventive arm

The preventive arm of the SGP invites member states to achieve a balanced budget in the medium term. The 'balanced budget' provision has been there since the very first version of the Stability Pact, but deviations have never been sanctioned. Under the six-pack provisions, they will be.

The structural balance

The preventive arm of the SGP is concerned with surveillance and early detection and correction of unbalanced fiscal positions. As deficit levels may be affected by unfavourable growth conditions, rather than signalling discre-

1. See, for example, the Vox Debate 'Has austerity gone too far?', available at http://www.voxeu.org/debates/has-austerity-gone-too-far.

2. Exceptions are made for countries under programme (ie Greece, Ireland and Portugal), whose commitments are defined in their respective adjustment programmes.

3. European Commission (2012b).

tionary measures that are excessively expansionary, the fiscal aggregate that is used for the surveillance exercise is the so-called medium-term budgetary objective (MTO), which is a country's cyclically adjusted (or structural) budgetary position net of one-off and temporary measures. This aggregate is typically assessed over the medium-term (ie about three years, the typical time horizon of Stability and Convergence Programmes)[4]. The reference value for the MTO is a structural balance but, in reality, each country has the freedom to pick its own MTO following a commonly agreed measurement methodology, provided the target does not exceed a deficit of 1 percent of GDP[5].

MTOs have always been central to the exercise of fiscal surveillance under the SGP. The original text of 1997 already called on EU countries to adhere to *"the medium-term objective of budgetary positions of close to balance or surplus"*[6]. The 2005 Stability Pact reform introduced the concept of country-specific MTOs, for which each member country can identify its own target provided this guarantees an appropriate safety margin with respect to the 3 percent target. Table 1 sets out the MTOs and sanctions contained in the SGP and six-pack[7].

Deviations from MTOs are allowed. They are accepted if a country has implemented structural reforms (eg pension reform) that may be costly in the short-term but contribute to debt sustainability. Deviations are also allowed if they result from *"an unusual event outside the control of the Member State concerned… or in case of severe economic downturn for the euro area or the Union as a whole"*[8]. This is a further novelty from the six-pack, namely the appreciation of aggregate circumstances, on top of country-specific exceptional circumstances. The provision addresses the problem of possible negative growth spirals when all countries reduce public consumption in bad aggregate conditions[9].

The transition from the old to the new regime

At present, the new preventive-arm regime only applies to euro-area countries that are not under EDP (ie Estonia, Finland, and Luxembourg). It will only apply to the other countries after they have corrected their excessive deficits and formally exited the EDP. This implies that, for most countries, the new regime and the ensuing sanctions on medium-term commitments will be enforced from 2014, by which time it will presumably be strengthened by the Fiscal Compact (Table 2 on the next page).

Box 1 describes the main features of the TSCG Treaty, of which the Fiscal Compact is a part, and the extent to which it adds to the six-pack rules. The Fiscal Compact recognises the importance of the structural balance, above and beyond deficit levels. However, the commitment of the contracting parties to include a debt brake rule either in their constitutions or via a similarly binding regulation, risks making the system more rigid at home than what it really is at EU level, at least in some countries.

The corrective arm

The new provisions on the Stability Pact's corrective arm foresee sanctions not only for excessive deficits but also for excessive debts (Table 3 on page 4). The provisions also strengthen enforce-

Table 1: The changing definition of the medium-term objective

	Medium-term objective	Adjustment effort	Sanctioning system
First SGP (1997)	Close to balance or surplus	No minimum adjustment effort	No sanctions
Revised SGP (2005)	Country-specific medium-term budgetary objective (MTO) < - 1% of GDP	Minimum annual adjustment in the structural balance of 0.5% of GDP	No sanctions
Six Pack (2011)	Country-specific medium-term budgetary objective (MTO) < - 1% of GDP	Minimum annual adjustment in the structural balance of at least 0.5% of GDP or > 0.5% of GDP in high-debt countries	Sanctions (ie interest-bearing deposit of 0.2% of GDP) in case of lack of effective action on deviation of structural balance from target that is at least 0.5% of GDP in one year or deviations from minimum annual adjustment effort (7-8 months after initial warning from the Commission)

Source: Bruegel.

4. Stability and Convergence Programmes are medium-term fiscal plans which euro-area countries and countries that are preparing for accession respectively need to submit to the EU in the Spring every year in the framework of the SGP provisions.

5. The Fiscal Compact revises the lower limit to 0.5 percent of GDP, and adds that a MTO of minus 1 percent of GDP may only be allowed in countries whose public debt is significantly below 60 percent of GDP.

6. European Council (1997).

7. The six-pack imposes also an expenditure benchmark. Sanctions may thus be imposed also on deviation of actual expenditure from the benchmark but here the excess over the benchmark is not quantified. The final decision on sanctions is taken by the European Commission and may only reversed by the Council (2011a).

8. See Regulation 1466/97.

9. European Commission (2012a).

BOX 1: THE TSCG TREATY

The TSCG is an intergovernmental treaty, signed by 25 of the 27 EU countries. It needs to be ratified by national parliaments and may be subject to referendum in some member states[10]. The length of ratification processes hinges on the timing of the application of the treaty provisions, but in all likelihood the TSCG will enter into force in early 2013. The Fiscal Compact builds on the six-pack and repeatedly refers to it, but is different in three main respects:

- The TSCG Treaty is an intergovernmental treaty, whereas the six-pack is based on the Lisbon treaty and therefore respects the Community method. Under the Community method, the European Commission is at the centre of the legislative process. The TSCG puts member governments at the centre of the decision-making process. Even if Article 7 of the TSCG invites governments to support the European Commission's recommendations, the Council remains the final decision-maker.
- The Fiscal Compact is an instrument to guarantee debt sustainability rather than to fight excessive deficits. The TSCG Treaty text mainly addresses the question of MTOs with a threshold that is lower than envisaged in the six-pack[11]. To reinforce the balanced-budget objective, the Fiscal Compact further requires that a rule be introduced in national legislation that is as binding as a constitutional rule would be.
- Failure to transpose the balanced-budget rule into national legislation gives any EU member state a right to refer to the EU Court of Justice (ECJ) for an opinion. A fine may be applied if a country fails to respond to an ECJ request.
- The Fiscal Compact further strengthens the role of the European Commission vis-à-vis the Council, as it states that all Commission proposals and recommendations may be considered as automatically applied unless the Council rejects them by qualified majority at every stage of the EDP[12].

Table 2: Time inconsistency in the application of the new SGP rules

	2012 →	2013 →	2014 onwards
Potential sanctions under Preventive Arm	Estonia, Finland, Luxembourg	Belgium, Cyprus, Estonia, Finland, Germany, Luxembourg	All countries
Potential sanctions under Corrective Arm	Austria, Belgium, Cyprus, France, Germany, Greece, Ireland, Italy, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain	Austria, France, Greece, Ireland, Italy, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain	All countries

Source: Bruegel.

Table 3: The corrective arm of the SGP

Initial legal act	Scope of document	Follow-up by Commission	Follow-up by Council
Council decision	Establishing existence excessive deficit (EDP) (QMV, except MS)	Within 20 days, the Commission shall recommend non-interest-bearing deposit (mainly in the presence of interest-bearing deposit)	• Council may reject Commission recommendation (RQMV) • Council may amend Commission recommendation (QMV)
Council recommendation	Recommending corrective action and timeline (at least 0.5% of GDP of cyclically adjusted balance per annum or above in high-debt countries)		
Council decision	Establishing no effective action taken (QMV, except MS)	Within 20 days, the Commission shall recommend a fine	• Council may reject Commission recommendation (RQMV) • Council may amend Commission recommendation (QMV)

Source: Bruegel.

10. Ireland held a referendum on 31 May 2012, voting in favour of ratification.

11. See footnote 7.

12. Article 7 of the TSCG treaty states: "[The Contracting Parties whose currency is the euro commit to supporting the proposals or recommendations submitted by the European Commission where it considers that a Member State of the European Union whose currency is the euro is in breach of the deficit criterion in the framework of an excessive deficit procedure. This obligation shall not apply where it is established among the Contracting Parties whose currency is the euro that a qualified majority of them]is opposed to the decision proposed or recommended".

ment. In fact, the new excessive deficit procedure imposes sanctions quite early on in the process and is overall quicker than before. From a procedural perspective, it is significant that the final decision on sanctions now takes the form of a Commission recommendation, which is dealt with by reversed qualified majority voting (RQMV) in the Council, meaning the Council is not required to confirm the recommendation, but can block it.

DEFICIT REDUCTION IN BAD TIMES

As we have discussed, much of the debate on the undesirability of synchronised fiscal contraction in the EU relates to the need for most euro-area countries to adjust their deficits at a time of slow growth. Some countries will need to implement additional deficit reduction measures to meet their deficit targets by the agreed deadline.

In November 2011, the European Commission forecast that six euro-area countries would be unable to meet the deficit target by the deadline laid down in the latest EDP recommendation, unless extraordinary fiscal measures were introduced. These countries were Belgium, Cyprus, France, Slovenia, Slovakia and Spain. Belgium and Cyprus, whose deadline is end-2012, immediately approved austerity measures in December 2011.

On 2 March 2012 the Spanish government said it would not be able to meet the 2012 deadline[13]. Spain's unorthodox unilateral announcement was followed by a compromise decision taken by the Eurogroup, whereby Spain's 2012 target was set at 5.3 percent of GDP compared to the 5.8 percent initially announced by the government, provided the country remained committed to a deficit lower than 3 percent of GDP in 2013. Moreover, the Commission announced on 30 May that it is prepared to grant Spain a one-year extension to the deadline in the light of poor growth condition in the framework of the presentation of the country-specific recommendations which the Commission publishes every year under the European Semester process[14]. On 20 July, the Council approved the one-year extension at the same summit in which Spain was granted EU financial assistance to recapitalise its banking system.

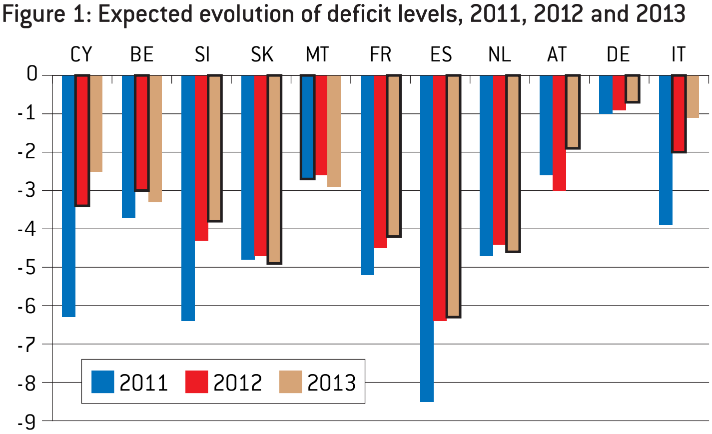
The size of the correction

The Commission's May 2012 forecasts provide a good indication of which countries are under pressure to meet the EDP's targets by the agreed deadline and may risk sanctions, unless they implement extraordinary fiscal packages or obtain deadline extensions. Figure 1 provides a snapshot of nominal deficits in the euro-area countries currently under EDP excluding programme countries. Columns outlined in black indicate each country's original deadline[15]. The countries off track are those for which the Commission had signalled problems back in November 2011, ie mainly Slovenia, Slovakia, France and Spain, but also Cyprus and the Netherlands.

Our figures are rather conservative as they do not account for worse-than-expected fiscal outcomes for 2012. Nevertheless, the size of the correction over 2012-13 is in some cases significant. To see this, we distinguish between corrective measures that have already been envisaged in the April 2012 Stability Programmes, which we classify as 'planned', and the extraordinary measures that are not planned but deemed necessary to comply with the agreed deadline; these are classified as 'extra' and are calculated as the gap between the deficit forecast by the Commission and the 3 percent of GDP level in the target year[16].

Figure 2 on the next page shows the cumulative size of the planned correction in euro-area countries and the extra effort needed. The average planned consolidation effort across the relevant 11 euro-area countries is about 2.75 percent of GDP, calculated as the difference in the deficit at the end

Figure 1: Expected evolution of deficit levels, 2011, 2012 and 2013



Source: European Commission's Spring Economic Forecast, 2012.

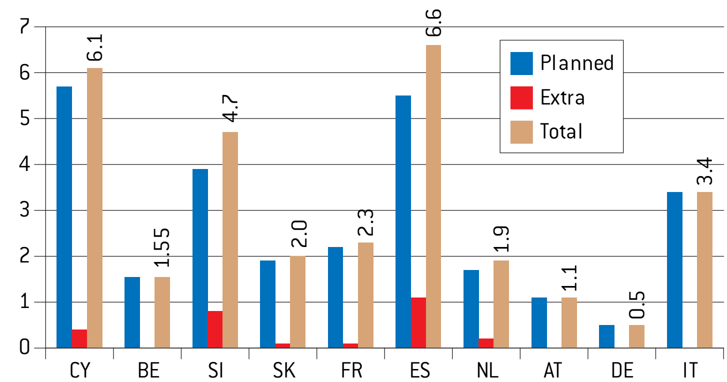
13. 'Spain defies EU over deficit rules', *Financial Times*, 2 March 2012.

14. Under the European Semester, EU member states must submit by 30 April every year their Stability or Convergence Programmes and their National Reform Programmes. The Commission assesses the documents and provides country-specific recommendations. The Council adopts the country-specific recommendations based on the Commission proposal.

15. Only Spain was granted an extension up to 2014.

16. For all countries for which the deadline for correction is 2013 the distance from the 3%-target is simply the difference between the 2012 deficit in the Stability Programme and the level in the Commission's Spring Forecast, as the Commission's forecast for 2013 includes fiscal measures not yet approved. In other words, we assume very optimistically that the correction in the following year will lead to exactly the same result that has been forecast by the government in the latest Stability Programme.

Figure 2: Cumulative size of deficit reduction 2012-13, % of GDP



Source: Bruegel based on National Stability Programmes and Commission's Spring Economic Forecast, 2012.

of 2013 compared with the level in 2011, implying an annual nominal fiscal cut-back of close to 1.4 percent of GDP. It is not desirable to retrench in extremely slow growth periods but the figure is probably not dramatic either. But the extra effort necessary to meet the targets in some countries and its likely impact on neighbours, which is not normally quantified by EU institutions, are more worrying. Spain, Slovenia, Cyprus, Slovakia, France, Spain and the Netherlands need to introduce additional measures above those already planned in their 2012 Stability Programmes, leaving the total (planned plus extra, where necessary) and cumulated consolidation effort in 2012 and 2013 at an impressive 6.6 percent of GDP in Spain[17], 6.1 percent in Cyprus, 4.7 percent in Slovenia, and at a more moderate 2.3 percent in France, 2 percent in Slovakia, and 1.9 percent in the Netherlands.

Exceptional circumstances

The size of the fiscal correction in 2012 and 2013 is considerable, especially for some countries, and raises concern about extreme austerity in the euro-area countries with excessive deficits. While the exact size of fiscal multipliers remains the subject of debate, it is now generally accepted that deficit reductions depress economic growth rather than produce so-called non-Keynesian expansionary effects, at least under the conditions prevailing in the peripheral euro-area countries[18].

Growth forecasts are already disappointing without accounting for the recessionary impact of additional fiscal retrenchment. Table 4 provides the latest available data for real GDP growth in 2012 and 2013. A crucial element is the GDP forecast for 2012, as this is the year in which a large part of the adjustment is supposed to take place in order to allow timely deficit correction by 2012 (Belgium and Cyprus) and by 2013 (all others but Spain). Negative growth is expected in 2012 in Cyprus, Spain, Italy, the Netherlands and Slovenia. These discouraging figures partly explain why the adjustment in these countries' nominal deficits needs to be so significant to compensate for dismal business-cycle conditions.

Table 4: Real GDP growth forecasts

	New forecast		Previous forecast	
	2012	2013	2012	2013
AT	0.8	1.7	0.9	-0.2
BE	0	1.2	0.9	-0.3
CY	-0.8	0.3	0	-1.5
DE	0.7	1.7	0.8	0.2
ES	-1.8	-0.3	0.7	-1.7
FR	0.5	1.3	0.6	-0.1
IT	-1.4	0.4	0.1	-0.3
MT	1.2	1.9	1.3	-0.1
NL	-0.9	0.7	0.5	-0.6
SI	-1.4	0.7	1	-0.8
SK	1.8	2.9	1.1	0

Source: European Commission Economic Forecast, May 2012

Most interestingly, both the original SGP and its revised form under the six-pack allow for exceptional and temporary excessive deficits when the economic downturn is especially severe both in each country and across the Union. This is one clear example of the SGP's flexibility. The texts of the regulation define a severe economic downturn as *"negative annual GDP volume growth rate or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential"*. A severe economic downturn may be either country-specific or EU-wide. Exceptional circumstances give rise to the following adjustments: i) the Commission and the Council may decide not to initiate an EDP, ii) the target may be set for a much later period[19], iii) the Commission and the Council may agree to allow a one-year extension of the deadline for correction. We argue that the EU should make full use of the reference in the new rules to the overall EU economic situation. We further suggest that the one-year extension is granted as early as possible, ideally before member states submit Stability Programmes to the EU, and under some other conditions. We will address these issues in the next section.

17. This is now spread over three years instead of two.

18. See for example IMF (2010), which calculates that a fiscal consolidation equal to 1 percent of GDP typically reduces GDP by about 0.5 percent. A key point of the research on non-Keynesian effects builds on the role of expectations. The idea is that fiscal adjustment may generate economic growth if rational economic agents also expect their own government to be virtuous in the future (leaving fiscal pressure unchanged) and would in turn continue to consume and invest even under austerity. Yet, the possibility of continuing consumption and investment even at times of diminishing aggregate demand is a function of the availability of credit (or of the absence of credit constraints), which is a condition that is not fully satisfied at present.

19. For example, the current EDP was launched for most countries in 2009 and dismal growth conditions plus the crisis explain why the deadline for correction was set so much in advance, an early indication of the 'intelligent' flexibility of the fiscal framework.

POLICY IMPLICATIONS

Some of the apparent weaknesses in the EU's new fiscal governance framework underestimate the flexibility of the framework and do not relate to substance but concern the timing of the application of the new rules. Euro area fiscal governance should address this timing issue, which arises because:

- The enforcement of final sanctions on excessive deficits precedes the exercise of surveillance of underlying fiscal positions, a problem related to transition times from the old to the new regime.
- Exceptional circumstances apply in the current low-growth environment, but it is important that the EU uses fully its provision on the general economic situation, and that the one-year extension in the correction of the deficit is decided in a timely manner.

Policy recommendations

The fiscal framework is not too stringent, and may be successfully applied in the current context. Minor adjustments can improve its consistency and efficacy.

Exceptional circumstances: Deficits above 3 percent of GDP should be considered acceptable in euro-area countries given the EU's poor growth prospects, especially for 2012. This should be conditional: the EU should bring forward the provision under which euro-area members are sanctioned in all cases in which the annual adjustment effort in their structural balance is lower than 0.5 percent of GDP. In the following years, when the general situation improves, deficits of greater than 3 percent should be allowed in all euro-area countries that face negative growth in 2012-13, or particularly low growth relative to potential, again provided they stick to a minimum yearly adjustment of the cyclically adjusted balance.

Surveillance: Following on from the previous recommendation, the EU should apply the principles of fiscal surveillance to countries already under EDP and not just those that are not. This means countries may be punished for deviations from their medium-term positions or insufficient progress, as envisaged under the SGP's new corrective arm. Looking at actual data, a recommendation for corrective action under our terms may only be addressed to Malta and Slovakia, which are far from the close-to-balance position and are not taking sufficient measures (Table 5)[20]. Our recommendation is more stringent compared to the EU fiscal framework, in which poor growth exempts euro-area countries from preventive and not just corrective arm obligations.

Table 5: The size of structural balance correction (% of GDP)

	Forecasted average adjustment, effort in 2011-13 (per year)	Size of deviation from target, required adjustment (per year)	Level (2013)
AT	0.40	0.10	-1.8
BE	0.45	0.05	-2.6
CY	2.15	0	-1.7
DE	0.35	0.15	-0.3
ES	1.05	0	-4.8
FR	0.60	0	-2.9
IT	1.50	0	0.1
MT	-0.25	0.75	-3.1
NL	0.50	0	-2.5
SI	1.55	0	-1.9
SK	0.05	0.45	-4.6

Source: Bruegel.

The general economic environment: Deviations from the deficit target should be allowed as early as possible. Ideally, the decision to grant an extra year to countries that are already under an EDP should be taken in time for euro-area countries to design a corresponding new fiscal strategy in the Stability Programmes that they must submit every year by 30 April in the framework of the European Semester, or at least before they finalise budget negotiations for the relevant year. We thus suggest that, in the light of the general economic situation in the euro area, a one-year extension is granted already in 2012 to all EU countries.

Ex-ante exceptional circumstances: As Stability Programme forecasts need to be compared with the most recent Commission forecast[21], it is desirable, post-2012, that the Commission brings forward the publication of the Spring Economic Forecast by at least one month to allow countries to take it into account in the drafting of their Stability Programmes. This procedural change would also improve cross-country comparability of fiscal policy, and facilitate the European Semester[22]. If this is not possible, it would be desirable to postpone submission of Stability Programmes until mid May, con trary to proposals contained in the two pack, now under negotiation, under which euro-area countries shall submit fiscal plans earlier than 30 April (and national draft budgets by 15 October).

Credibility: The recognition of the existence of very low EU growth follows from the application of the six-pack rules and should not be considered a threat to the new surveillance and enforcement frame-

20. Much smaller adjustments may be also necessary in Germany, Austria and Belgium, even if the former are in fact relatively close to a balanced budget.

21. See Regulation 1466/97.

22. See also Hallerberg, Marzinotto, and Wolff, 'An assessment of the European Semester', Bruegel, forthcoming.

work. It should however be a non-political process. At present, the one-year extension is granted if the Council backs the Commission recommendation by a qualified majority. But there is no reason for not also having RQMV at this stage, meaning the Council is not asked to confirm a Commission's proposal but can only block it. RQMV would more visibly leave the decision in the Commission's hands, strengthening the perception of markets that the procedural change has a technical and not a political motivation. The rules laid down in the TSCG Treaty may support this, as we explain below.

The role of the Fiscal Compact: There are two important aspects of the Fiscal Compact that make it desirable for economic policy coordination. First, while aligned with the surveillance mechanism envisaged in the six-pack, it emphasises the structural-balance rule, thus reinforcing the idea that underlying budgetary positions are more important than nominal deficits. Second, it advocates the application of RQMV at every stage of the EDP, possibly also where the six-pack does not provide for it. Its successful ratification will thus allow RQMV to be used in all cases in which an extension is allowed for deficit reduction, without a formal revision of the six-pack. There is however a drawback in the Treaty that relates to the obligation for each of the contracting parties to adopt a quasi-constitutional debt brake rule. The risk is that national fiscal policy becomes too restrictive, at least in some countries, undermining the flexibility that the fiscal framework enjoys at the EU level.

The new EU fiscal framework has been designed to strengthen surveillance and sanctioning in the case of severe deviations from the reference value, whether the deviation concerns nominal deficits, structural balances or debts. However, the timing of the new rules is unhelpful. First, sanctions do not apply for structural balances until excessive deficits are corrected. Second, the new rules enter into force in a recession when most euro-area countries are under EDP. The first problem can be dealt with by extending the new preventive arm to countries that are under EDP. The second problem can already be dealt with in the existing rules. A one-year extension to the deadline for deficit correction may be granted in case of negative growth in the EU, or in specific countries. For 2012, given the general economic situation, the one-year extension should be granted to all countries before they finalise their budgets for 2013. Thereafter, it is only important that the decision is taken earlier than normal, ideally at the beginning of April, and that it is mostly in the hands of the Commission, as are other steps in the EDP.

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