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Interpreting the Stability and Growth Pact

special briefing

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Making Best Use of Existing Flexibility Within the Rules

By Alessandro Leipold

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'The European Union needs bold steps to foster growth… This also requires making best use of the flexibility that is built into the existing stability and growth pact rules.'
European Council Conclusions, 26-27 June 2014

Against the background of increasingly gloomy growth prospects, intractably high unemployment and a pending deflationary spiral, the enduring European debate on stability and growth has taken on a new sense of urgency, as well as possibly a new dimension.[1] Expectations run high, particularly regarding a potential all-institutions agreement – the celebrated "grand bargain" – in which all players central to the economic policy axis contribute to the structural, fiscal and monetary policy mix needed to lift Europe's flailing economy (for more on what commitments an effective grand bargain might entail, see the appendix on page 10).[2] Barring a swift move to such comprehensive action, some commentators even anticipate that the euro crisis could come roaring back.[3]

A new tool in the kit: 'flexibility within the rules'

The main components of a desirable structural, fiscal and monetary mix are well-trodden ground, and – important as they are – will not be rehearsed in this special briefing.[4] We will focus instead on comparatively uncharted territory, i.e., the new commitment within the halls of European Union policymaking to make the "best use of the flexibility that is built into the existing stability and growth pact rules."[5] Such language has now fully entered the official policy discourse.[6] But its implications and practical application remain disturbingly undefined. Very few voters

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1
The author would like to thank Paul Hofheinz and Ann Mettler of the Lisbon Council for their comments on an early draft of this special briefing. Any remaining errors of fact or judgment are the author's sole responsibility.

2
Mario Draghi, president of the European Central Bank, recently criticized the phrase "grand bargain" in this context for implying a give-and-take parleying that risked muddling respective institutional responsibilities. While we are sympathetic to this critique, the term has firmly entered the public debate and is used here as useful shorthand for a mutually beneficial set of common policies. Mario Draghi, "Introductory Statement to the Press Conference (with Q&A)," *ECB Press Conference*, 04 September 2014.

3
In a cover story, *The Economist* ominously warned "the euro may yet be doomed." See The Economist, "That Sinking Feeling (Again)," The Economist, 30 August 2014.

'The October European Council should commit to apply the flexibility envisaged under the pact fully and amply in exchange for enacted reform.'

or citizens have any idea what this "greater flexibility within the rules" would entail – and they're not the only ones, judging from recent comments from several senior policymakers.[7] Given all the talk, what then is the actual scope for fiscal flexibility within the current stability and growth pact rules?[8] And how can one make the "best use" of it, as pledged by the European Council?

In approaching the issue of fiscal flexibility, there is a need to clear the air of some common misconceptions, and to establish clear principles as guideposts. In this special briefing, we will propose four "guiding principles" for interpreting the pact in a more flexible way (see the box on page 9 for a summary). We will also offer a three-point programme on how these principles could best be implemented (see the box below).

Encouraging growth within existing rules: A three-point programme

1. **Apply the "exceptional circumstances" clause:** The 07 October 2014 European Council should officially declare the euro area to be in a situation of "exceptional circumstances" as regards the implementation of the stability and growth pact, thereby providing the European Commission with leeway to apply the related flexibility, lifting uncertainty regarding European Council approval. Member states could thus elaborate their stability programmes and final 2015 budgets with certainty and in full awareness of the available latitude.

2. **Enforce the "structural reforms" clause:** Given the obstacles to structural reforms, and their criticality in the euro area, the stability and growth pact must act as an incentive to their implementation. The October European Council should commit to applying the flexibility envisaged under the pact fully and amply in exchange for enacted reforms. It should furthermore launch a coordinated structural reform plan at euro area level, starting with a joint reduction in the tax wedge. The resulting fiscal cost of such a pro-growth measure should be accommodated under this stability and growth pact clause.

3. **Expand the "investment" clause:** The stability and growth pact must set the right incentives to avoid the further depletion of capital. The incoming European Commission should revisit the July 2013 specification of the investment clause, extending potential eligibility to all countries and adopting the European Parliament's call to exclude, permanently and unconditionally, all national co-funding of EU-supported investments (including projects under European Commission President-elect Juncker's investment plan) from the fiscal indicators used under the stability and growth pact.

4 See, *inter alia*, European Commission, *A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate* (Brussels: European Commission, 2012) and Thomas Mayer, *Europe's Unfinished Currency: The Political Economics of the Euro* (New York: Anthem Press, 2012).

5 European Council, Conclusions of the European Council, 26-27 June 2014, EUCO 79/14.

6 See, *inter alia*, "The existing flexibility within the rules could be used to better address the weak recovery and to make room for the costs of needed structural reforms." – *Mario Draghi, president of the European Central Bank, Speech at Annual Central Bank Symposium in Jackson Hole, 22 August 2014*; "All the flexibility we need to overcome the problems is contained in the current stability pact. That's our joint understanding." – *Angela Merkel, chancellor of Germany, 18 June 2014*; "The only problem that some countries have is that they have to stick to the rules." – *Wolfgang Schäuble, German finance minister, 18 June 2014*; "Anyone who does reforms should get more room to use the flexibility that is in the treaties." – *Sandro Gozi, undersecretary of state for Europe, Matteo Renzi government, 09 May 2014.*

7 Notions of flexibility within the pact have been around for a while but largely devoid of practical content.

‘Expectations run high, particularly regarding a potential all-institutions agreement, the celebrated “grand bargain.”’

Making ‘best use’ of the scope for fiscal flexibility ‘within’ the rules

Specifically, we see four guiding principles in interpreting flexibility within the stability and growth pact: 1) flexibility should promote a “smart” pact, and not be confused with laxity; 2) it should strengthen the economic underpinnings of the existing pact; 3) it requires simple rules; and 4) it is best administered by an independent enforcer. A major first hurdle that needs to be overcome lies in the frightful complexity of EU fiscal rules.[9] “The rules are so complicated that you can’t see the woods for all the trees,” says Austrian Finance Minister Michael Spindelegger, adding “what’s critical is whether we need so many rules and complicated calculations on top of that.”[10] Such complexity is in turn rooted in the rules’ history, with the original pact embodied in the Maastricht Treaty being modified on several occasions, most notably in 2005 (in response to the 2003 breach by France and Germany) and in 2011-13 (via the “six-pack,” “two-pack” and fiscal compact legislation). The specification of flexibility should in no way add to such complexity. On the contrary, it should be guided by a laser-like focus on what is economically relevant, downplaying redundant or ill-designed rules.[11] A sound adage for all fiscal rules is a crisp, “keep it simple.”

In line with this axiom, policymakers seeking to exercise flexibility within the pact should focus on the three “flexibility clauses” that are the most economically relevant, and whose intelligent use would most strengthen the pact’s economic underpinnings. We propose a three-point plan, focusing on existing clauses within the pact (see the box on page 2). The three clauses in question concern: 1) exceptional circumstances, 2) structural reforms and 3) public investment.

Three necessary steps for greater pro-growth impact

1) Apply the “exceptional circumstances” clause

The stability and growth pact provides an escape clause from its rules in the case of “exceptional circumstances.”[12] These are defined as either “an unusual event outside the control of the member state concerned which has a major impact on the financial position of the general government” or “periods of severe economic downturn for the euro area or the EU as a whole.” When such circumstances prevail, the pact’s “corrective arm” and its related excessive deficit procedure would not be triggered even if the 3% of gross domestic product deficit limit (originally enshrined in the 1992 Maastricht Treaty) was being breached, provided the breach is considered to be “only exceptional and temporary and the ratio remains close to the reference value.”[13] In 2011, the “six-pack” extended the exceptional circumstances clause also to countries where the “corrective arm” and the excessive deficit procedure had already been triggered (due to an earlier breach of the 3% limit). The revision allowed these

Thus, for example, the conclusions of the European Council of March 2013 stressed “the necessity of differentiated growth-friendly fiscal consolidation,” supported “short-term targeted measures to boost growth” and recalled “the possibilities offered by the EU’s existing fiscal framework to balance productive investment needs with fiscal discipline objectives.” European Council, *Conclusions of the European Council*, 14 March 2013, EUCO 23/13.

8
The gap between declarations and actions is a dispiriting European ritual. It is high time to bridge this void. There are two key opportunities to do so in the immediate future: the informal council of the European Union on economic and financial affairs (EcFin) meeting in Milan on 13 September and the special “Jobs and Growth” European Council in early October. These meetings should give substance to the notion of “flexibility-within-the-rules,” thus allowing an agreed – and consequently politically palatable – application in individual country’s budget plans, starting importantly with the update of Italy’s stability programme. See Alessandro Leipold, “Jackson Hole, Draghi and the Governments’ Turn,” *Il Sole 24 Ore*, 26 August 2014. In his new political priorities, European Commission President-elect Jean-Claude Juncker added his own voice to the call to make “the best possible use of the flexibility that is built into the existing rules,” and announced his intention “to issue concrete guidance on this as part of my ambitious jobs, growth and investment package.” Jean-Claude Juncker, *A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, Political Guidelines for the Next European Commission*, 15 July 2014.

'Very few voters or citizens have any idea what this "greater flexibility within the rules" would entail.'

countries to depart temporarily from the adjustment path toward their medium-term budgetary objective, provided that "fiscal sustainability in the medium term" would not be endangered.

The rules also provide a more detailed specification of exceptional circumstances, defined as "a 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." The data starkly indicate that these conditions are amply met. While the situation has improved since 2009 (when all except one EU country – Poland – recorded a negative growth rate), 11 countries were still in recession in 2013. Strikingly, growth in Italy has been negative in 11 of the last 12 quarters, i.e., almost uninterruptedly for three years. Indeed, *all* countries have experienced "a protracted period of very low growth," to the point that "the accumulated loss of output" condition applies to the entire EU and, even more markedly, to the eurozone as a whole: by the European Commission's own calculations, euro area GDP is still a remarkable four percentage points below its pre-crisis level.[14]

This grave situation is now further compounded by a series of geopolitical headwinds, most notably the situation in Ukraine and the spill-over effects of western sanctions on Russia. In an already bleak situation, the risks to future growth are clearly tilted to the downside. This constellation surely lives up to "exceptional circumstances."

- ***Recommendation:*** *The 07 October 2014 European Council should officially declare the euro area to be in a situation of "exceptional circumstances" as regards the implementation of the stability and growth pact, thereby providing the European Commission with leeway to apply the related flexibility and lifting any uncertainty regarding European Council approval. Member states could thus elaborate their stability programmes and final 2015 budgets with certainty and in full awareness of the available latitude.*

2) Enforce the "structural reforms" clause

The 2005 reform of the stability and growth pact introduced a fairly open-ended list of "other relevant factors" to be taken into account in assessing the sustainability of a country's fiscal position.[15] Among such factors, the revision explicitly included structural reforms and their budgetary upfront costs. In the preventive arm (i.e., when the 3% limit is observed), the waivers allow temporary deviations from the country's proscribed adjustment path toward its medium-term objective – provided a safety margin vis-à-vis the 3% ceiling is maintained. In the corrective arm (for countries exceeding the 3% limit), structural reforms can slow the gradual buildup of pressures under the excessive deficit procedure (ultimately leading to pecuniary sanctions, never however applied). Here, too, there is a fairly strict proviso: the deficit must be

9 The European Commission's Vade Mecum on the rules runs to 115 pages; even the abbreviated version for laymen is 38 pages long. See, respectively, European Commission, "Vade Mecum on the Stability and Growth Pact," *Occasional Papers 151* (Brussels: European Commission, 2013), and Ibid., "Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact" in *Occasional Papers 150* (Brussels: European Commission, 2013).

10 Austrian Finance Minister Michael Spindelegger, quoted in Gabriele Steinhauser, "The EU's New Stability and Growth Spat," *The Wall Street Journal*, 20 June 2014.

11 For a fuller critique of the rules' complexity and related drawbacks, see International Monetary Fund, "Fiscal Governance in the Euro Area: Progresses and Challenges," *IMF Country Report No.14/199* (Washington, DC: IMF, 2014).

12 All quotations from the stability and growth pact rules are drawn from the pact's two main legislative documents, namely 1) Council Regulation 1466/97 as amended by Regulations 1055/2005 and 1175/2011, and 2) Council Regulation 1467/97 as amended by Regulations 1056/2005 and 1177/2011.

13 The stability and growth pact contains two arms – the preventive arm and the corrective arm. The preventive arm applies to countries observing both of the pact's main rules: 1) maintaining a deficit within 3% of GDP and 2) keeping public debt at under 60% of GDP, or at least diminishing sufficiently towards that goal.

‘A major first hurdle that needs to be overcome lies in the frightful complexity of EU fiscal rules.’

expected to return to the medium-term budgetary objective within the three-year period covered by the stability programme.

Furthermore, only “major structural reforms” accompanied by a “comprehensive and detailed assessment of their quantitative effects on the budget position” may qualify for consideration. In practice, therefore, flexibility is limited only to adopted reforms, beyond the “promise stage,” placing a particular onus on the requesting states (in current circumstances, notably France and Italy). The reforms must also be judged to “have direct long-term positive budgetary effects, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances.” In this regard, specific reference is made to “pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar.” This provision was applied in 2013 to Latvia.[16]

While the budgetary costs of passing to a fully-funded pension system are manifest, other structural reforms may also have short-term fiscal costs, in terms for example of compensation schemes to offset redistributive effects – or, put more bluntly, to compensate the expected losers of structural reforms (an oft-mentioned case in point being taxi drivers, who would stand to lose their status from liberalisation toward new competitors such as Uber – hence the choice, in many European countries, to maintain existing restrictions).[17] Furthermore, many reforms (in particular of the labour market) can have a short-term negative effect on output, especially during a recession. Thus, notes the OECD, “Some reforms can be temporarily detrimental in ‘bad’ times… For instance, the pay-off from unemployment benefit and job protection reforms appears to be less when the economy is depressed.”[18]

There is thus a trade-off between consolidation and structural reforms, with the upfront costs making it more difficult to simultaneously reform and consolidate. The issue is indeed a well-known one in political economy: that of “short-term pain for long-term gain.” Thus, incentives in the form of flexibility under the pact are needed to overcome policymakers’ myopia. This is all the more the case in the eurozone – an area constrained by significant rigidities, and where structural reforms are thus of the essence.

Finally, ample literature has concluded that cross-country coordination of reforms produces larger and more evenly distributed positive effects than national efforts alone.[19] Importantly, senior policymakers recognise this. In a joint article in *The Wall Street Journal*, German Finance Minister Wolfgang Schäuble and his Italian counterpart Pier Carlo Padoan recently stressed that it is “urgently necessary to reinvigorate the momentum for structural reforms, *including by devising a joint European plan*”.[20] There is furthermore an obvious candidate for such joint action: the European Council’s country-specific recommendations of last June identified

It seeks to ensure that such observance is sustained in the medium term. The corrective arm applies to countries in breach of one or both of the two main rules, and is made operational by the excessive deficit procedure, a step-by-step process aimed at correcting such breaches. The distinction is important for the application of the pact’s flexibility clauses, with the leeway allowed varying between the two arms. At the extreme, as shall be discussed below, countries in the corrective arm are ineligible for consideration under the pact’s “investment clause.”

14
European Commission, *Quarterly Report on the Euro Area*, Volume 12 Issue 4, 2013.

15
Council Regulation 1056/2005 (Article 1, al. 1, par. 3) reads: “Furthermore, the Commission shall give due consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value…”

16
European Council, *Recommendation on the National Reform Programme 2013 of Latvia and Delivering a Council Opinion on the Convergence Programme of Latvia, 2012-2016*, 09 July 2013, 2013/C 217/12.

17
The most notable recent case being that of Germany; see Jeevan Vasagar, Duncan Robinson, Richard Waters and Tim Bradshaw, “Uber Hit with Nationwide Ban in Germany,” *Financial Times*, 02 September 2014.

18
OECD, *Economic Policy Reforms 2012: Going for Growth* (Paris: OECD, 2012).

'The European Council should officially declare the euro area to be in a situation of "exceptional circumstances."'

14 countries which should reduce their tax wedge, i.e., the difference between before-tax and after-tax wages, or address similar tax disincentives to employment.[21] Joint and simultaneous action by all would constitute a significant breakthrough in the EU's approach to structural reforms.

- ***Recommendation:*** *Given the obstacles to structural reforms, and their criticality in the euro area, the stability and growth pact must act as an incentive to their implementation. The October European Council should stress the payoff of reforms by committing to apply the flexibility envisaged under the pact fully and amply in exchange for enacted reforms. It should furthermore launch a coordinated structural reform plan at euro-area level, possibly starting with a joint reduction in the tax wedge. The resulting fiscal cost of such a pro-growth measure should be accommodated under the stability and growth pact's "structural reforms" flexibility clause.*

3. Expand the "investment" clause

The "investment clause" is the most recent modification of the pact. It followed the European Council's recognition, in June 2012 and again in March 2013, of the need to "balance the productive public investment needs with fiscal discipline objectives." The subsequent "two-pack" legislation accordingly provided for an investment allowance under the stability and growth pact, leaving the details to the European Commission. It did, however, specify that it should be limited to the pact's preventive arm, at a time when the great majority of countries were in its corrective one, i.e., subject to an excessive deficit procedure. Further details were spelled out in July 2013. Temporary deviations from the deficit path toward the medium-term budgetary objectives would be allowed, subject however to four confining conditions, all of which would need to be met: 1) that economic growth is negative or well below its potential; 2) that the deviation does not lead to a breach of the 3% deficit ceiling; 3) that the public debt rule is respected; and 4) that the deviation from the medium-term budgetary objectives derives from national expenditures on projects co-funded by the EU under its structural and cohesion policy, trans-European networks and connecting Europe facility.

The European Parliament was dissatisfied with these provisions and adopted a resolution in October 2013 requesting that all expenditure relating to the co-financing of European structural and investment funds projects be completely excluded from the calculation of the deficit for stability and growth pact purposes. Although this resolution was adopted by the European Parliament by a large majority (433 votes to 131), it has remained unheeded to date.[22]

See also Romain Bouis, Orsetta Causa, Lilas Demmou, Romain Duval and Aleksandra Zdzienick a, "The Short-Term Effects of Structural Reforms: An Empirical Analysis" *OECD Economics Department Working Papers*, No. 949, 26 March 2012.

19
See, for example, Luc Everaert and Werner Schule, "Structural Reforms in the Euro Area: Economic Impact and Role of Synchronization Across Markets and Countries," *IMF Working Paper* No. 06/137 (Washington, DC: IMF, 2006); Sandra Gomes, Pascal Jacquinot, Matthias Mohr, and Massimiliano Pisani, "Structural Reforms and Macroeconomic Performance in the Euro Area Countries: A Model-based Assessment," *European Central Bank Working Paper*, No. 1323 (Frankfurt: ECB, 2011); and Janos Varga and Jan in 't Veld, "The Growth Impact of Structural Reforms," *European Commission Quarterly Report on the Euro Area*, Vol.12/4, December 2013 (Brussels: European Commission, 2013).

20
Pier Carlo Padoan and Wolfgang Schäuble, "A Pro-Business, Pro-Growth Agenda for Europe," *The Wall Street Journal*, 26 June 2014. Such an approach has been strongly endorsed also by ECB President Draghi.

21
The burden of a high tax wedge (or other tax disincentives to work) was stressed most forcefully in the cases of Austria, Belgium, France, Germany, Hungary and Romania, but raised also for the Czech Republic, Italy (where note was taken of "limited" recent action, which needed to be monitored), Latvia, Lithuania, Luxembourg, the Netherlands, Slovakia and Spain. European Council, *European Council Endorses Country-Specific Recommendations*, June 2014.

‘There is a trade-off between consolidation and structural reform, with the upfront costs making it more difficult to simultaneously reform and consolidate.’

In addition, application of the clause has been strict. Thus, for example, Italy’s request to avail itself of its provisions in 2013 was rejected on the grounds that it was not compliant with the debt reduction path. Italy and Slovakia applied to use the investment clause in 2014, as did Bulgaria and Romania. While the latter two were accepted (given also the EU loan programme in Romania), Italy and Slovakia were rejected given that, based on the European Commission’s 2013 autumn forecast, they were not seen to fulfil the eligibility criteria (for Italy, again the failure to adhere to the envisaged debt-reduction path, and for Slovakia in light of the persistence of an excessive deficit).

The clause is thus characterized by stringent eligibility criteria, rigorously applied, on top of the *a priori* exclusion of all countries subject to an excessive deficit procedure – currently 11, but as many as 24 at the height of the crisis in 2011, when a public investment boost was arguably most needed. This situation has induced several analysts to conclude that the investment clause is virtually of no use. A recent Bruegel study puts it thus: “The provisions in the EU fiscal framework to support public investment are very weak. The recently inserted ‘investment clause’ is almost no help… We thus conclude that the EU’s fiscal framework is not really conducive to preserving public investment during economic slumps.”[23]

This in a setting where public investment has been the major victim of fiscal consolidation in the EU. Public investment outlays are notoriously the easiest to slash and the data paint a bleak picture. From 2007 to 2013, investment fell by 18% in the EU, compared to just 6% in the United States.[24] In southern Europe, investment has collapsed, and even in Germany it is projected to reach pre-crisis levels only this year. The situation cries out for correction, with a focus in particular on future-oriented investment.[25] President-elect Juncker’s announced plan for additional public and private investment of up to € 300 billion needs to be rapidly advanced by the new European Commission. But it will be hampered if the stability and growth pact’s provisions do not grant greater co-financing leeway. It would be foolhardy to sacrifice future growth for the sake of sophistic observance of ill-designed provisions.

- ***Recommendation:*** *The stability and growth pact must set the right incentives to avoid the further depletion of capital. The new European Commission should revisit the July 2013 specification of the investment clause, extending potential eligibility to all countries and adopting the European Parliament’s call to exclude, permanently and unconditionally, all national co-funding of EU-supported investments (including projects under President-elect Juncker’s investment plan) from the fiscal indicators used under the stability and growth pact. In such EU-wide schemes, the quality of the investment is ensured by the centre, and the scope for creative accounting games contained.*

22
Francesco Prota and Gianfranco Viesti, “Which European Investment Clause?” *Social Europe Journal*, 28 October 2013.

23
Francesca Barbiero and Zsolt Darvas, *In Sickness and in Health: Protecting and Supporting Public Investment in Europe* (Brussels: Bruegel, 2014).

24
World Bank DataBank. See also Jean Pisani-Ferry, “Can Investment Save Europe?” *Project Syndicate*, 30 July 2014.

25
For the importance of innovation-led growth, see Ann Mettler and Stian Westlake, *Reforming the European Commission: How Jean-Claude Juncker Can Deliver on Growth and Jobs* (Brussels: Lisbon Council, 2014).

> 'The October European Council should launch a coordinated structural reform plan at euro-area level, possibly starting with a joint reduction in the tax wedge.'

'The courage to make far-sighted decisions now.'

Clarifying what is meant by the new mantra on "fiscal-flexibility-within-the-rules" is of course only one of the many actions required to tackle Europe's range of problems. But it ranks high in its importance among the components of the necessary broader policy mix (as summarised in the "grand bargain" appendix). Steps along the lines advocated in this special briefing would serve to illuminate the (currently murky) policy debate, provide a more predictable framework for national policymakers and promote transparency for the citizenry.

As is known, the stability and growth pact is under heavy critical fire from many quarters. It needs to be safeguarded but, to do so, it must evolve. It has to be – and be perceived to be – supported by sound economic underpinnings. This does not imply changing the rules, but operating a shift in their interpretation to ensure that the key requirements for a successful fiscal framework are met: simplicity, transparency and sound underlying economic principles.

Failure to strengthen the pact's economic rationale would ultimately signify its demise. To survive, the stability and growth pact needs to be a genuine "pact," true to its derivation from the Latin *pactum*: viz., to make a bargain. Collins Dictionary defines a pact as "an agreement or compact between two or more parties for mutual advantage." To this end, the stability and growth pact has to fully embrace both its facets – stability *and* growth. In the awareness that the truly binding rules are actually set by financial markets, and that financial-market credibility is itself dependent on a sustainable balance between stability and growth.

In the face of the sharp deterioration in the eurozone's economic situation, failure to move in this direction, and continuing to speak of "flexibility" in vague and empty terms, would be gravely irresponsible. To paraphrase ECB President Draghi in his Jackson Hole speech, it would be a case of "doing nothing" – which is clearly much worse than "doing too little" and, of course, well removed from "doing too much."[26] We hope rather that EU leaders will heed the sense of urgency present in President-elect Juncker's "new start" agenda, and respond to the Schäuble-Padoan call in their joint op-ed: "Let's leave anxiety behind us and have the courage to make far-sighted decisions now."[27]

With reform of the pact off the political table, efforts to rebalance its interpretation between stability and growth – by teasing a bit more flexibility out of the contours in which it was written – need to reconcile boldness with realism, and desiderata with political feasibility, pushing the envelope as far as pragmatism will allow. The very confines of the subject matter – with its key qualification of *"within"* the existing rules – limits the degree of ambition. While many highly desirable proposals animate the European debate, they often tend to be of a "first-best" variety, implying a

26 In his speech, the ECB President warned that "the risks of 'doing too little'… outweigh those of 'doing too much.'" Mario Draghi, "Unemployment in the Euro Area," *Speech at Annual Central Bank Symposium in Jackson Hole*, 22 August 2014.

27 Padoan and Schäuble, op. cit.

‘In southern Europe, investment has collapsed, and even in Germany it is projected to reach pre-crisis levels only this year.’

significant *quantum* leap in policies. Such a leap might indeed be needed, and there are some examples in the history of the European project. But on the whole, as has been observed, “the project of European integration has been a process in which each step forward has been the step that was feasible at the time.”[28] We hold that the steps proposed in this special briefing are not only feasible but also – and above all – vital.

28 Wolfgang Schäuble and Karl Lamers, “More Integration is Still the Right Goal for Europe,” *Financial Times*, 31 August 2014.

Guiding principles
Flexibility should promote a “smart” pact. It should not be confused with laxity or with weaker implementation of the stability and growth pact. It does not imply changing the pact, but a shift in its interpretation so as to promote a smart, welfare-improving compact.
Flexibility should strengthen the economic underpinnings of the pact. It should leave sufficient room for macroeconomic stabilisation, allowing it in bad times and forcing it in good times. It should set the right incentives to avoid sharp cuts in public investment and the related depletion of capital. And it should encourage structural reforms. These elements are present in the pact but there is scope to apply them more fully and actively.
Flexibility needs simple rules. The web of European Unioin fiscal rules is notoriously complex, raising issues of redundancy, consistency and transparency. The implementation of flexibility should studiously avoid over-specifying rules and procedures, aggravating this situation.
Flexibility is best administered by an independent, non-political supranational enforcer. The obvious candidate with the expertise to independently judge the quality of fiscal policy is the European Commission (although it too undoubtedly internalises political constraints). In the 2011 reform of the stability and growth pact, the European Commission was seen to be the best guarantor of impartiality in enforcing the rules on wayward members. The same should apply in exercising flexibility.

Appendix: A grand bargain

PLAYER	ACTION
European Council/ Eurogroup	• Specify meaning of "flexibility within rules" and support its full use • Aim for an aggregate supportive fiscal stance in the euro area, using the European Semester's *ex ante* coordination • Work toward European Union-level coordination of structural reforms • Move rapidly on President-elect Juncker's investment plan, using scope under stability and growth pact rules • Revisit position on European Stability Mechanism direct bank recapitalisations as needed by stress test results • Complete single market (notably digital, energy and services)
European Commission	• Use European Commission discretion under the stability and growth pact to ensure growth-friendly consolidation • Rapidly adopt planned "jobs, growth and investment" package • Conduct review of "six-pack" and "two-pack" legislation (due by 14 December 2014) to ensure growth-friendly underpinnings • Cast annual growth survey and country-specific recommendations in terms of greater coordination (fiscal stances, structural reforms) • Conclude transatlantic trade and investment partnership with the US
European Central Bank	• Move to quantitative easing and other steps as needed • Resolutely ensure credibility of the asset quality review and stress tests
European Stability Mechanism	• Review European Stability Mechanism precautionary facilities, clarify their conditionality • Become an advocate of direct bank recapitalisations
Deficit countries	• Implement structural reforms • Proceed with growth-friendly adjustment, as allowed by the flexibility in the pact • Address private debt overhang and non-performing loans
Surplus countries	• Implement structural reforms • Use available fiscal space; raise public investment • Address private debt overhang and non-performing loans

Source: Lisbon Council

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