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e Camilla Mariotto

# Fiscal Governance of the European Union: Ideas, Integration Theories and Public Opinion

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SUMMARY

Camilla Mariotto

# Introduction

In its first 25 years, the Economic and Monetary Union has gone through several major reforms. Also, important new measures supporting countries in financial difficulties and overhauling bank regulations have been adopted. These rules have been subject of heated debates both within and beyond academia, especially since the outbreak of the sovereign debt crisis in 2009. This volume collects three contributions regarding the institutional design underpinning fiscal governance rules of the European Union.

In the first chapter, Franchino investigates the economic ideas which may have provided the theoretical foundations of fiscal rules. Two alternative economic approaches are thought to provide the theoretical background. For standard macroeconomic theories, these rules are designed to prevent negative cross-country externalities arising from expansionary fiscal policies that are adopted by authorities with short-term incentives to boost output at the expense of inflation. Cross-country externalities are at the core of a few models of strategic interaction between monetary and fiscal authorities in a monetary union. They show how fiscal authorities who prefer higher output and inflation than the central bank have incentives to establish fiscal rules in order to preserve the credibility of commitment to stable prices. On the other hand, macroeconomic theories based on rational expectations and Ricardian equivalence point out the diminished effectiveness of expansionary fiscal policies and would recommend looser oversight than the one in force. The first chapter finally highlights how these latter theories fail to explain how these rules have been designed and modified through the first 25 years of Economic and Monetary Union.

In this regard, the second chapter integrates the theoretical debate about European fiscal governance. Franchino and Mariotto investigate the competence distribution among and decision-making of EU institutions, deriving expectations from contrasting theories of intergovernmentalism and delegation. Considering the laws adopted between 1993 and 2013, three patterns of competence distribution are analyzed: pooling, which entails policy authority that is centred within the Council; delegation, which occurs when policy prerogatives are given to the Commission; and tightening, which imposes requirements and demands on countries and


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national authorities. Franchino and Mariotto find puzzling results in the initial design of fiscal governance and its 2005 reform, while they easily explain the Six and Two Packs as a vindication of liberal intergovernmentalism and delegation theory. The provisions of the initial fiscal governance framework are mostly oriented in favor of pooling instead of delegation, despite evidence of noncompliance. Clearly, the bargaining context (such as unanimity requirements) and arbitrariness of the rules made governments very cautions in delegating and tightening powers. Additionally, the 2005 reform of the Stability and Growth Pact and of the Excessive Deficit Procedure (EDP) granted significant flexibility to member states to the detriment of the Commission's delegating power. In this latter case, procedural hurdles as well as the threat of suspending sanctions against France and Germany forced the least reformist countries to accept looser rules and no delegation. Evidence from the latest reform do not appear to support expectations derived from new intergovernmentalism, while they seem to be more in line with established theories. This new wave of theorizing is characterized by greater reliance of the European Council and the Council, and highlights the reluctance to pool and delegate in highly salient or core state power such as economic governance. However, Franchino and Mariotto empirically show a clear move from pooling to delegation and a tightening of national obligations. This outcome has probably been facilitated by procedural rules (Council's qualified majority voting and parliamentary involvement), an existential threat of the Eurozone if negotiations were to fail, and intense conflict within the Council.

The third chapter draws from political economy theory of tax-and-transfer public insurance scheme as well as theories of party cues, identity and trust, to investigate public attitudes toward the fiscal union – an important possible new pillar of fiscal governance. Franchino, Segatti and Zucchini rely on evidence from a survey question and two conjoint analyses carried out in May 2014 and 2015 and embedded in the second and third online panel wave of the Italian National Election Survey, when negotiations on the second Greek bailout package and the 2014 European Parliament elections made headlines. Economic self-interest, partisan orientation and attitudes toward the European Union affect support of a fiscal union. As expected, high income and right-wing respondents with low trust, weak European identity and negative assessment of EU membership display greater opposition to the measure. However, high income respondents, likely net contributors of the policy but also supporters and beneficiaries of the common currency, display greater willingness to pay, especially in order to keep the euro. Unemployed and lower income participants are instead more than willing to leave the Eurozone if it does not deliver good economic performance. Franchino, Segatti and Zucchini conclude this chapter with a rather optimistic note: The political feasibility of a fiscal union seems to rest on the willingness to contribute by the core constituency supporting the euro.

This volume tries to enrich the important academic and public debate about fiscal governance and provides food for thought for possible reforms.

Fabio Franchino

# Economic ideas and fiscal governance

## Introduction

Between being regarded as a major or minor nuisance (Eichengreen and Wyplosz 1998), the rules governing fiscal policies in the European Union (EU) have turned out being a major one. A centrepiece of the economic and monetary union, these rules are now subject to heated debates beyond the confined borders of academia. Indeed, they even became campaign issues at the European Parliament elections of May 2014. The Five Star Movement in Italy, the Syriza party in Greece and the Podemos party in Spain have harshly criticised the rules, while several national parties associated with the European People's Party have, instead, been staunch supporters of them.

This chapter investigates the economic ideas and models which may have provided the theoretical foundations to these rules. It explains how the cross-country distributive effects on the composition of output caused by expansionary fiscal policies offer the rationale for these rules, as suggested by the application of three standard macroeconomic models to a monetary union. It also demonstrates how claims that their development is the result of increasingly influential variants of macroeconomic theory – based on rational expectations and the Ricardian equivalence proposition – are unconvincing. Had these extensions gained influence, we should see *looser* rather than *tighter* rules over time.

The next section offers an overview of these rules, with particular emphasis on the legal provisions that constrain or empower the three key institutions involved in fiscal governance – the Council, the European Commission and the authorities of member states. We illustrate how such policy, despite remaining primarily Council-centred, clearly displays a strengthening of the Commission and a tightening of national budgetary controls over the past twenty years. Explaining these developments in detail is beyond the scope of this chapter.

In the next section, we move to the ideational basis of the policy. We are not interested here in tracing the presence of different economic ideas in official documents or in assessing if policy makers follow a coherent set of ideas in their decisions. This is unlikely to be the case anyhow. Several policy makers have argued for stricter rules *and* expansionary fiscal consoli-


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dation, despite the inherent contradiction. We instead evaluate which models and ideas about the workings of the macroeconomy would recommend such rules. We argue that standard models work better than more recent theoretical variants.

Finally, even though some economic ideas seem to matter more than others, institutionally sparse models of fiscal-monetary interactions in a monetary union are poorly suited to account for the development of EU fiscal governance over time. Recommendations based on them need to be taken with caution since they omit the highly institutionalized bargaining processes that shape both the design and implementation of fiscal governance. The chapter concludes highlighting the uncertainties facing policy-makers and arbitrariness of some decisions.

## The development of fiscal governance rules in the European Union

### *The initial design*

The linchpin of the EU fiscal governance rules is the protocol on the excessive deficit procedure (EDP) of the Treaty of Maastricht, according to which the ratio of the planned or actual government deficit to GDP should not exceed 3 percent and the ratio of government debt to GDP should not exceed 60 percent. The former threshold appears to have been chosen because it was the average ratio of public investment to GDP for the 1974-91 period, while the latter threshold represented the average ratio for 1991 (Buiter *et al.*, 1993: 62-63). The key institution in charge of implementing these rules is the Council – this institution establishes both the presence of and the sanctions associated with an excessive deficit. These initial rules primarily consisted of provisions constraining national administrations and empowering the Council. No significant prerogatives were conferred upon the Commission.

The three implementing regulations adopted between November 1993 and July 1997 altered this set-up in two ways. On the one hand, the EDP regulation and the preventive regulation of the Growth and Stability Pact (GSP) imposed further demands on member states, which are best exemplified by annual stability or convergence programmes (the former with the medium-term objective of a close-to-balance or surplus budget). On the other hand, the corrective regulation of the pact almost solely narrowed down the Council's powers by establishing deadlines and criteria (e.g. the annual real decline in GDP had to be at least 2 percent to avoid EDP).

### *The 2005 reform*

Heipertz and Verdun (2010: 113-173) narrate the initial implementation of these measures in detail. Suffice it to say that compliance has been patchy in this context because of well-known decision-making pathologies associated with Council-centred policies (see also Larch, Van den Noord and Jonung, 2010). Ministers reluctantly sanction one another's actions and, when push comes to shove, large countries have a greater capacity to form coalitions that support their views because their vote carries more weight. Indeed, Portugal and the Netherlands reined in their excessive deficits in 2002 and 2004, but Germany and France managed to form a coalition that blocked the procedure and pushed, instead, for reform when they found themselves in a similar position in 2003. After a legal challenge that upheld the Council's prerogative to hold the procedure in abeyance, the new measures adopted in June 2005 were not unidirectional.

On the one hand, the new preventive regulation clearly granted greater flexibility to the member states. The regulation referred to *country-specific*, medium-term budgetary objectives that could diverge from a close-to-balance or surplus position (although the deficit could not exceed 1 percent of GDP). These objectives had to be revised every four years or after major structural reforms. The Council's prerogative remained unaltered, aside from clarifying the criteria for decision-making[1] and extending the time for examining the national budgetary objectives. On the other hand, the new corrective regulation was a mixed bag. The definition of "severe economic downturn" was loosened, giving the Council greater discretion to grant exceptions. Deadlines were extended and decisions could be revised to account for unexpected events. Other provisions narrowed the Council's room to maneuver. Its decisions had to require a minimum yearly improvement in the budget balance of 0.5 percent of GDP and deadlines could not be extended by more than one year.

The most significant change was actually the new EDP regulation of November 2005. After the Greek incident in September 2004,[2] the measure included several new demands on the member states with regard to the quality of statistical data. It covered issues concerning national statistical authorities, principles of impartiality and professionalism, publication of data, methodologies and assistance to Commission inspections. More notably, it contained the first significant delegation of executive powers to the Commission (subject to traditional procedural constraints). This institution now sets formats for data quality assessments, adopts guidelines for data collection, decides on the correct implementation of accounting rules, may express reservations on the quality of national data and may decide to amend such data (see also Schelkle, 2009).

[1] The most notable are a) whether states pursue annual adjustments of the budget balance of 0.5 percent of GDP, especially during periods of high economic growth, and b) if major structural reforms are implemented.

[2] Eurostat revised upwards the Greek deficit by between 2 and 3 percentage points of GDP for the years 2000 to 2003 and the 2003 debt-GDP ratio by more than 7 percentage points (European Commission, 2010:12-13; Eurostat, 2004). In December 2004, the Commission initiated an infringement procedure against Greece for failing to comply with the EDP regulation. The procedure was closed in 2007.

*Six-pact measures and the fiscal compact*

After a minor tweaking in the Treaty of Lisbon,[3] the rules were overhauled in the midst of the sovereign-debt crisis that engulfed the eurozone countries beginning in early 2009. From our perspective, the key events were the repeated misreporting of fiscal data by the Greek authorities. Under the surface of an implementation record on a par with Germany[4] were Eurostat's repeated reservations on the quality of Greek data.[5] The alarming revisions of the 2009 deficit from 7 percent to, ultimately, almost 16 percent of GDP triggered a downgrade to junk status of Greece's credit rating, a pan-European capital flight to safety, bailout measures and a major reform that began in July 2010 and ended in January 2013 with the entry into force of the Fiscal Compact.[6]

These new rules remain centred on the Council. Indeed, this institution adopts preventive recommendations, establishes the existence of excessive macroeconomic imbalances, approves corrective plans, establishes noncompliance and sets sanctions. The main difference, however, is that several prerogatives are now extensively shared with the Commission, especially with regard to the investigation and sanctioning of noncompliance. First, this institution now enjoys wider rule-setting prerogatives and access to information when conducting methodological investigations of national data. It can examine both medium-term budgetary trends and macroeconomic imbalances. In the new GSP enforcement regulation, it can investigate statistical misrepresentations and set rules on fines and investigations. Second, in the case of recurrent Council or national inaction, Commission proposals establishing noncompliance with medium-term budgetary objectives need a simple Council majority *to be rejected* (rather than a qualified majority to be approved). Other decisions only require the approval of a Council-blocking minority.[7]

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[3] The Treaty expressively stated the possibility for the Commission to address a warning to member states that adopted measures inconsistent with the broad economic guidelines. Moreover, with the repeal of the cooperation procedure, the Council now enjoys greater leeway as it only needs to consult the Parliament to set the definitions for the provisions prohibiting financing and bailing out of public authorities.

[4] After both countries' deficits were deemed excessive in 2003-2004, they were the only two states which, in 2005-2006, were subject of a Council notice for failing to act – the last step before imposing sanctions. Both countries were then deemed compliant by 2007.

[5] After carrying out several methodological visits and revising spending figures, the EU statistical office reported 'severe irregularities in the EDP notifications' and concluded that 'the problems are only partly of a methodological nature and would largely lie beyond the statistical sphere' (European Commission, 2010: 20). It continued observing that 'the existing governance framework for fiscal statistics [...] cannot prevent deliberate misreporting of data' (European Commission, 2010: 28).

[6] Due to space constraints, we leave aside the most recent Regulations 472 and 473 of 2013. These laws display similar features and trends of the earlier measures, see Mabbett and Schelkle (2014).

[7] For instance, sanctions for noncompliance with the GSP provisions, establishment of excessive macroeconomic imbalances and sanctions for noncompliance with corrective plans.

These Council and Commission prerogatives are now associated with greater parliamentary oversight, tighter rules on sanctioning and evaluating national programmes (with more emphasis on debt[8]) and several other procedural constraints.

This reform has significantly increased the demands on the national authorities. The first prominent example is the directive on national budgetary frameworks. This measure includes several obligations concerning the coverage, availability and planning of fiscal data. Member states are expected to include numerical fiscal rules in their annual budgets and medium-term frameworks that are consistent with the debt and deficit reference values, as well as the medium-term budgetary objectives. The second prominent example is the Fiscal Compact Treaty, where the key provision is the obligation to correct structural deficits that exceed 0.5 percent of GDP (with some flexibility for low-debt countries and exceptional circumstances). Non-complying countries must produce partnership programmes that list the reforms to be implemented. In addition, high-debt positions must be reduced at an average rate of one-twentieth per year. The Commission has a role in proposing the time frame for convergence and the common principles for corrective measures.

In conclusion, the past twenty years have clearly seen a stronger Commission and tighter controls over national budgets, despite a primarily Council-centred policy. However, what are the ideational bases for these rules? Which ideas and theories about the workings of the macroeconomy would recommend them? We move on to these questions in the next section.

## The economics of fiscal governance in a monetary union

### *Standard macroeconomic theory and the need for fiscal governance*

The economics of fiscal governance in a monetary union can be easily explained by standard macroeconomic theory, which is based on the relation between output, the interest rate and the exchange rate in the short run; output and the level of prices in the medium run; and capital, labour and technology in the long run.[9] Consider a set of countries with their own fiscal authority and a single monetary authority. Assume that output and

[8] For member states with a debt level exceeding 60 percent of GDP, the Council and the Commission must examine whether the annual improvement in the budget balance is higher than 0.5 percent of GDP. Moreover, a budgetary deviation from the medium-term objective is significant if it is at least 0.5 percent (or 0.25 percent over two years) of GDP. The revised GSP corrective arm sets for the Council an adjustment benchmark of the debt-to-GDP ratio. This ratio approaches satisfactorily the reference value if the differential with respect to the reference value has decreased at a rate of one twentieth per year, on average, over the past three years.

[9] That is, Keynesianism for the short run, monetarism or the classic approach for the medium run and Solow's growth model for the long run.

employment are at their natural medium-run levels. What happens if one fiscal authority decides to increase spending unexpectedly and permanently? Let us first take a union-wide perspective. In the short run, more spending increases output (and income) directly and the higher disposable income leads to higher consumption, which further increases output. Increased spending may also lead to more investment (and, again, higher output) if investment responds more to higher sales than to higher interest rates (for a given money supply, higher income increases the demand for money, leading to a higher interest rate).[10]

Higher economic activity lowers unemployment, putting upward pressure on the nominal wage and the level of prices. Output is now above its natural level and the price level exceeds expectations. Wage setters will therefore revise their expectations upwards, leading to an upward pressure on prices. For a given money supply, higher prices decrease the real money stock, leading to higher interest rates and lower output, until the natural level is reached again. In sum, the increase in spending raises the level of prices and changes the composition, but not the level, of output in the medium run, as investment is crowded out through the higher interest rates. In the longer run, lower investment leads to lower capital stock and output.

This dynamic changes if we consider a monetary authority with an inflation target at potential output.[11] Assume that both current inflation and the nominal interest rate are on target, prior to the spending initiative. Once the programme is announced, the central bank expects lower unemployment and above-target inflation. It will therefore increase the interest rate, which lowers economic activity and prevents excessive upward pressure on wages and prices until inflation is back on target and output is again at its natural level. In other words, the interest rate rises more rapidly, decelerating both economic expansion and price increases.

Spending also has important implications for trade. First, the programme may build-up trade imbalances within the union. Depending on the trade links and the propensity to import, it may increase imports in the spending country and, consequently, increase exports in the non-spending countries. Second, a higher interest rate will lead to an appreciation of the single currency and a union-wide decrease in net exports. This further changes the composition of output.

Let us now take the perspective of the countries participating in the union. Despite the long-run consequences on output and a non-accommodating central bank, the in-

[10] In other words, the size of these effects depends on the fiscal policy multiplier. Higher spending may have a particularly strong effect on output in the short run if the propensity to consume and the sensitivity of investment to sales and of money demand to interest rate are high, and, additionally, if the propensity to import, the sensitivity of investment to interest rate and of money demand to income are low.

[11] Such as the Taylor rule, whereby the central bank sets the nominal interest rate at time *t* as a function of the target nominal interest rate, the weighted differences between the rate at time *t* and the target rate of inflation, and between output at time *t* and potential output at medium run.

centives for spending are there. All it takes is a government that is ready to forsake higher inflation for higher growth and lower unemployment in the short run. The resulting combination of a contractionary monetary policy and an expansionary fiscal policy has cross-country distributive implications because the composition of output can change in important ways.

For non-spending countries, the specific consequences depend on a host of factors, such as the propensity to import (in the spending country), the sensitivity of net exports to currency appreciations and the sensitivity of investment to sales and the interest rate (in the non-spending countries). The trade balance may improve if the increase in exports to the spending country is higher than the decrease in net exports outside the union following the currency appreciation. Assuming higher net exports, even investment could increase if it responds more to sales than the interest rate. More importantly, things can turn out bad for the non-spending countries. The trade balance could worsen and the higher interest rate could lead to lower investment, lower capital accumulation and lower output in the long run. The profligacy of one fiscal authority could produce a recession and lower long-run growth in a fiscally responsible member country.[12]

*Short-run games of fiscal-monetary interactions in a monetary union*

These cross-country externalities are at the core of a few studies on the strategic interactions between a monetary authority and the fiscal authorities in a monetary union. Dixit and Lambertini (2001, 2003; see also Dixit, 2001) propose a model where the output of each country in a monetary union is also a (positive or negative) function of the fiscal policies of other countries. As discussed above, these fiscal policy spillovers operate directly through the demand or crowding-out effects, as well as indirectly through the real effects of unexpected inflation. The actors' utility is a weighted function of ideal levels of inflation and output, where the monetary authority is at least as conservative as the fiscal authorities.

Dixit and Lambertini (2001) assume that the fiscal authorities desire a higher than natural level of output and they investigate the implications for inflation and output under different regimes; that is, when fiscal and monetary authorities simultaneously decide,

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[12] One could read standard macroeconomic theory as an argument for small government. Indeed, a cut in public spending increases investment in the medium run, and output in the long run. Aside from whether all private investment is indeed beneficial to long run growth, note that spending on infrastructure, education or active labor market policies builds up physical and human capital and may as well lead to higher output in the long run without increasing prices. The theory is a cautionary tale about managing the business cycle rather than public spending *per se* (aside from the distortionary effects of taxation). It has policy implications for the composition, rather than the size, of spending. Long run growth would actually be better served if the return from public investment exceeds that from private investment and if public investment increases productivity of the private sector.

and when either fiscal or monetary authorities act first (i.e. monetary or fiscal leadership). They limit the analysis to a situation where a country's expansionary fiscal policy increases both the other countries' output and union-wide inflation. They show that the Nash equilibrium of a simultaneous game produces higher output and lower inflation than the ideal levels, with consequences for debt accumulation and higher interest rates. This expansionary fiscal policy and contractionary monetary policy mix worsens as the ideal positions of the authorities diverge.[13] Importantly, the commitment to a monetary policy rule is ineffective if the fiscal authorities are not subject to any constraint. Therefore, rules imposed on the fiscal authorities can preserve the credibility of commitment to a monetary rule that would be negated in the case of fiscal discretion (Dixit and Lambertini, 2001). In conclusion, this model demonstrates that even fiscal authorities who *unanimously* prefer higher output and inflation than the central bank have incentives to establish fiscal rules if they desire to preserve the credibility of commitment to a monetary rule.[14]

## Rational expectations, Ricardian equivalence and the lesser need for fiscal governance

According to Blyth (2013: 316-337), standard macroeconomic theory does not offer the ideational foundations to EU fiscal governance rules. He traces their origin to ordoliberalism, a school of economic thought originating in 1930s Germany that emphasized the regulatory role of the state. The primary objective was to ensure competitive markets and stable prices through politically independent authorities, rather than public spending. He writes

> Germany's focus on rules, obligations, a strong monetary authority, a weak parliament, and no spending to compensate for busts [is] the basic design of the EU […]. From the Maastricht convergence criteria to the Stability and Growth Pact to the proposed new fiscal treaty – it's all about the economic constitution – the rules, the ordo […] the most recent German innovation of a constitutional debt brake (*Schuldenbremse*) for all EU countries regardless of their business cycles or structural positions, coupled with a new rules-based fiscal treaty as the solution to the crisis, is simply an ever-tighter ordo by another name (Blyth, 2013: 330-332).

Fast forwarding fifty years of the history of economic thought, Blyth sees these ideas further developed in formal works on the impact of government alternations on budget

[13] Outcomes are somewhat improved upon under different regimes of either fiscal or monetary leadership.

[14] Fiscal rules would be unnecessary, or even counter-productive, only if monetary and fiscal authorities were to share the same ideal levels of output and inflation. In these unlikely circumstances, a credible monetary commitment or a conservative central bank would not be needed as well (Dixit, Lambertini, 2003).

deficits (Alesina and Tabellini, 1990; Persson and Svensson, 1989) and in empirical analyses of fiscal contractions during recessions (Alesina and Perotti, 1995; Alesina, Ardagna and Galí, 1998; Giavazzi and Pagano, 1990; Hellwig *et al.*, 1987). Following Lucas (1972), the central theme is the role of rational expectations in shaping macroeconomic dynamics. This important innovation to macroeconomic theory appears to have provided the theoretical basis for the limited fiscal response to the early 1990s recession in the United States. Hence, it is not far-fetched to say that it may have influenced European policy cycles during the negotiations of the Maastricht Treaty and in the following period. However, is fiscal governance more needed or less needed in a world of rational expectations?

Take the case discussed above of a fiscal authority in a monetary union deciding to increase spending, from the perspective of the spending country. What if consumers and firms fully anticipate the long-run consequences of this measure; that is, they anticipate lower output, a higher price level and a higher interest rate in the future? How would macroeconomic aggregates be affected? The short-run increase in output expected by the standard theory would be offset by two dynamics. Rational expectations have an impact on consumption through a wealth effect. After the announcement of the programme, consumers expect lower after-tax labour income in the future. If current consumption is affected by the present value of these income streams, a negative wealth effect kicks in and the growth of consumption is attenuated.[15] Similarly, firms revise their expectations of future sales (and profits) downwards, lowering present values and, consequently, the growth in investment. Higher expected real interest rates would lower current investment as well. These countervailing effects suggest a lower sensitivity of current output to an increase in spending and weaker incentives for governments to entertain this policy option – a *diminished* expansionary fiscal policy hypothesis. One important caveat is that a government may be tempted to front-load a multi-annual spending programme to maximise the positive effect of current consumption and investment on current output, and thereby minimise the negative effect of expectations.

Ricardian equivalence would suggest, however, that front-loading is not going to work. If consumers internalise the government's budget constraint, higher debt-financed current spending will result in higher taxes in the future and the increase in current disposable income will be equivalent to the decrease in the present value of after-tax labour income in the future. The net wealth effect will be zero and the timing of a spending programme will not affect consumption. Note that the current increase in private savings (i.e. consumers do not spend more as a result of higher current disposable income) offsets the current decrease in public saving, leaving investment, capital accumulation and long-run growth unchanged.

[15] Current consumption can also be influenced by other wealth effects. Lower expected future dividends may lower financial wealth for instance.

Now, the key question is: Would the full consideration of rational expectations, even up to the Ricardian equivalence proposition, call for tighter fiscal governance rules? First, we must distinguish between fiscal governance and fiscal policies. Blyth (2013) argues that recent European fiscal policies have been (mis)guided by a modern rational-expectations version of austerity thinking - the so-called expansionary fiscal contraction (or consolidation) hypothesis - where a reduction in spending during an economic contraction can increase consumption and output through changes in future expectations about taxes and government spending (Giavazzi and Pagano, 1990). European fiscal policies operate, of course, within EU fiscal governance rules, but an evaluation of these policies is beyond the scope of this paper. More relevant to our purposes, Blyth (2013: 332) argues that these same ideas have also shaped the design and development of EU fiscal governance towards an 'ever-tighter ordo'. The problem is, if these ideas have actually gained currency in European policy circles, we should see the opposite – a *loosening* of rules. The full consideration of rational expectations offers an even more cautionary tale about managing the business cycle. Spending has a much more attenuated effect on output, the interest rate and the exchange rate in full rational-expectation models than in standard macroeconomic theories – a *diminished* expansionary fiscal policy, indeed. This means that the incentives to spend are weaker and, for any amount of additional spending, the potential negative implications for non-spending countries are smaller. The need for fiscal governance is *lessened* and the rules should be *laxer* in a world of full rational expectations. Contra Blyth (2013), we should have seen a relaxation of the rules if these ideas had gained any traction over the years. For the most part, we do not. Therefore, the development of fiscal governance rules cannot be squared with a presumed ascendancy of full-blown rational-expectation macroeconomic theories; not least because, as Blyth discusses at length, empirical support for expansionary fiscal contraction (or diminished fiscal expansion for that matter) is quite flimsy, indeed.

The European debate on austerity tends to blame these rules for obliging states to undertake pro-cyclical measures (i.e. cut spending – fiscal consolidation – during recessions). This is an interesting question *per se* but, despite their interconnection, we should analytically distinguish between fiscal governance rules and actual national fiscal policies. Nor do we argue that policy makers use economic ideas and models coherently. Olli Rehn, the former commissioner for economic and monetary affairs, for instance both demanded tighter fiscal surveillance and, apparently, embraced expansionary fiscal contraction (Rehn, 2013; see also Mabbett and Schelkle, 2014). Ironically, if the macroeconomy worked according to the full-blown rational-expectation framework, these rules would not have been necessary in the first place. In other words, Rehn supported provisions whose existence refuted his understanding of the macroeconomy and the consequences of the fiscal measures he recommended.

*Games of fiscal-monetary interactions with budget constraints in a monetary union*

Indeed, games of fiscal-monetary interactions that explicitly take into account the intertemporal implications of government budget constraints do not unequivocally support the need for fiscal rules, at least as they are codified in EU law. Beetsma and Bovenberg (1998; see also Beetsma and Bovenberg, 1997a) propose a model where fiscal authorities set the tax rates, subject to a budget constraint, and act as Stackelberg leaders against the monetary authority with an inflation target at potential output. The utility of fiscal authorities is a weighted function of ideal levels of inflation, output and government spending, while the utility of the monetary authority is only a weighted function of ideal levels of inflation and output. The central bank is conservative if it attaches a larger weight to price stability than do fiscal authorities and society at large. The model demonstrates that the fiscal authorities have an incentive to strategically raise taxes and induce the monetary authority to raise inflation to protect employment (note that, initially, the incentives are for a fiscal contraction – monetary expansion policy mix). They do so because higher inflation relaxes the budget constraint by generating seigniorage revenues and lowering the real servicing costs of government debt. Higher taxes then lead to a spending bias and lower output. These incentives increase as fiscal authorities attach less importance to inflation than does the monetary authority and they diminish if the tax of a single authority has a lower impact on union-wide employment (e.g. in a larger union or for smaller countries) or the monetary authority assigns more importance to price stability than employment. Beetsma and Bovenberg (1998; see also van Aarle, Bovenberg and Raith, 1997) argue *against* coordination because, if the fiscal authorities can coordinate tax policy, then they are even more likely to prompt a reaction by the monetary authority.

The EU fiscal rules do not seem to be motivated by the short-run policy mix produced by this model. These scholars also focus on only one externality: that is, the role of *common* actual and expected inflation in relaxing the budget constraint for *each* fiscal authority. Other externalities in terms of the level and composition of output are ignored.[16]

In a related model, Beetsma and Bovenberg (1999; see also Beetsma and Bovenberg, 1997b; Beetsma and Uhlig, 1999) analyse the impact of a monetary union on public debt. If the monetary authority is not conservative, the fiscal authorities are likely to *reduce* the debt, especially in a union with few members. Again, this results in a fiscal contraction – monetary expansion policy mix.[17] On the other hand, debt accumulation occurs when

[16] The fiscal authorities that are more likely to engage in strategic tax setting are those that benefit more from lower servicing costs, attach less importance to inflation, and have a larger impact on union-wide employment (therefore inducing a reply from the monetary authority). This sets the ground for conflict between large, high-debt and inflation-accommodating countries and small, low-debt and inflation-averse countries – a scenario that is not unrealistic in Europe.

[17] Van Aarle, Bovenberg, and Raith (1997) reach a similar conclusion. If policy makers cannot commit to their announced strategies and fiscal authorities do not cooperate, a monetary union leads to lower

the monetary authority becomes more conservative, the fiscal authorities assign greater importance to the short than the long term (i.e. they are myopic) and the size of the union increases. This bias originates from the failure of each government to internalise the union-wide inflationary consequences of debt (Beetsma and Uhlig, 1999). Therefore, Beetsma and Bovenberg (1999) and Beetsma and Uhlig (1999) argue that the combination of a conservative central bank and myopic fiscal authorities explains the establishment of debt ceilings and sanctions for exceeding the deficit-output threshold.[18] Without these rules, debt and inflation would be suboptimally high for each government of the union. The fiscal needs of each country will explain their preferred level of rule tightness.

Consider, finally, the fiscal theory of the price level (e.g. Canzoneri, Cumby and Diba, 2001; Canzoneri and Diba, 2001). According to this theory, the price level is determined by the interaction of monetary and fiscal policies, with the actors subject to intertemporal budget constraints. If the fiscal authorities dominate the monetary authority in a union, Bergin (2000) demonstrates that the price level is jointly determined by the budget constraints of governments. Hence, an increase in a member country debt that is not backed by future tax increases leads to higher prices across the union via the augmented inflation expectations of Ricardian households. Therefore, governments with large debts have strong incentives to pursue this policy because the inflation tax on bond-holders could be large, even if seigniorage revenues are not. Note that solvency rules for countries would be sufficient, even though they are not necessary,[19] to maintain price stability. This condition 'is much less restrictive than the debt ceilings imposed in practice' (Bergin, 2000: 48).

These models do not provide a solid theoretical background for the adoption of fiscal rules in a monetary union and certainly not in the form adopted by the EU. Some models produce a policy mix that is not even addressed by these rules. Other models advise either against or for less fiscal policy cooperation. Still, other models along the lines of Dixit and Lambertini (2001) are more convincing. They show, for instance, how a conservative central bank interacting with fiscal authorities with short time horizons could indeed produce a combination of exceedingly high debt and inflation.

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inflation and deficit and quicker debt stabilization. Fiscal cooperation leads to higher inflation and deficit and slower debt stabilization.

[18] Levine and Brociner (1994) reach a similar conclusion, although through a different channel. Given a conservative central bank, governments have the incentive to improve their terms of trade inefficiently if they do not cooperate. Chari and Kehoe (2007) have instead recently shown that it is the inability of the monetary authority to commit to an inflation rate that lead to excessive debt and inflation in a monetary union. This implies that EU fiscal rules would be necessary if one believes that the European Central Bank cannot credibly commit to an inflation rate.

[19] Fiscal solvency is not necessary for each fiscal authority if responsible fiscal authorities bail out profligate ones (Bergin, 2000: 48-50).

In conclusion, however, these works do not provide a theoretical basis to argue that fiscal governance should be tighter than that recommended by the theories and models analyzed earlier.

## Conclusion: imperfect commitment, arbitrariness and fiscal governance

EU fiscal governance rules have been object of intense criticism, at least to the extent that they may have provided the regulatory framework within which certain economic ideas that legitimize austerity measures have been implemented. We have instead argued that these rules appear more aligned with policy recommendations that standard macroeconomic theories would produce.

Indeed, earlier critiques of these rules appear to echo a rational expectation approach. In a well-known contribution, Buiter, Corsetti and Roubini (1993) argued that the negative externalities highlighted by the standard theory are too small and the uncertainty of their direction is too large to warrant fiscal rules. Moreover, fiscal authorities would be discouraged to entertain these policies if they face a credible inflation-averse central bank; and, anyway, international financial markets can deter unsustainable policies by demanding higher sovereign risk premiums (see also Buiter, 2006; Eichengreen and Wyplosz, 1998; Buti, Eijffinger and Franco, 2003). Even if these markets turn out to be poor at assessing sovereign risk, a default is primarily a distributional issue that does not need supranational intervention or rules monitoring public deficits on a yearly basis. As long as a core set of provisions are credible,[20] they are sufficient to prevent both fiscal and monetized bailouts of profligate governments (Buiter *et al.*, 1993; Eichengreen and Wyplosz, 1998). Possible contagion effects could be prevented by limiting the exposure of systemically relevant financial institutions to sovereign risk (Buiter, 2006: 695).

These criticisms underestimate the uncertainties facing policy-makers. At the time of adoption of these rules, it was far from certain that interest rate spillovers would be small (see Bean's and Gerlach's comments to Eichengreen and Wyplosz, 1998) and the extent to which consequences would be purely distributive crucially depended on an untested European Central Bank. After analyzing the bank's appointment and voting procedures, Alesina and Grilli (1994) concluded that its board might not display a conservative bias, despite its mandate and formal independence.[21] With the prospect of countries with a history of

[20] Specifically, no-bail out, independence of the central bank, objective of price stability, prohibition to set up overdrafts and credit facilities for governments as well as direct purchases of treasury bonds. We leave aside here the debate on the most appropriate fiscal quantities to monitor.

[21] In case of uncertainty about a central bank's commitment to price stability, Chari and Kehoe (2007) show how uncontrolled fiscal authorities may not internalize the union-wide costs on increased inflation, leading to higher debt and inflation. They state that "the larger the debt the monetary authority inherits, the higher it wants to set the inflation rate and, without some mechanism to prevent that, the higher it

fiscal profligacy joining the monetary union on the one side and an untested central bank on the other, policy prescriptions based on standard macroeconomic theories would have advised adopting fiscal governance rules (see also Heipertz and Verdun, 2010).

Once established the need for fiscal governance, policy-makers may have opted for numerical targets because of their transparency and easiness to monitor and enforce, even though there are clearly no magic numbers that guarantee fiscal sustainability. Any value is ultimately arbitrary, but it has non-trivial distributive consequences because it implies country-specific adjustments between current and future public expenditures, and between public and private debt (Pasinetti, 1998). For Buiter, Corsetti and Roubini (1993), the Maastricht reference values were excessively tight and inflexible, leading to a contractionary bias and impeding the operation of automatic stabilizers (see also Eichengreen and Wyplosz, 1998; Pasinetti, 1998; Buti, Eijffinger and Franco, 2003).

The provisions were loosened in the 2005 reform apparently to address some of these issues, but the renewed emphasis on structurally balanced budgets has its problems too. Compared to clear-cut balanced budget rules, the concept of structural balance is more opaque and discretionary. It may not provide 'a focal point that enables investors to coordinate on when to punish governments for running excessive deficits' (Kelemen and Teo, 2014: 366). There is more to opacity actually; there is a risk of pro-cyclicality. A structural deficit is positively related to the non-accelerating wage rate of unemployment. Aside from the uncertainties in the estimation of this measure, episodes of high long-term unemployment could raise this rate, turning a cyclical deficit into a structural one and prompting corrective measures that could further increase unemployment.[22] Also, one must wonder whether financial markets prefer clear-cut balanced budgets that increase output volatility by constraining stabilization (and relying solely on the balanced budget multiplier) over more opaque and discretionary structurally balanced budgets that leave room for smoothing out the business cycle.

Also the early neglect of financial stability (Buiter, 1999) and the underestimation of default risk are understandable. Noncompliance in the EU is generally infrequent and temporary, with delayed and sometimes contained, cross-country consequences (e.g. Börzel, 2001; Zürn and Joerges, 2005; Treib, 2014). In the run up to the Eurozone sovereign debt crisis, noncompliance was repetitive and the contagious effects had immediate and very pernicious consequences. For instance, starting in 2010, the widening yields between Spanish and German government bonds were in stark contrast with the perfect past compliance record of Spain (its deficit was never deemed to be excessive until then)

sets the inflation rate. Thus, without monetary policy commitment, when one of the fiscal authorities issues more debt, the others are made worse off." (Chari and Kehoe, 2007, 2400)

[22] The European Commission routinely revises the methodology to calculate the output gap in order to address this risk.

and the rather tarnished record of Germany (one of only two countries that received a notice to take measures for deficit reduction, which represented the last step before adopting sanctions). As if this was not perverse enough, countries outside the Eurozone were spared, despite showing similar deteriorating trends in government finances (De Grauwe and Ji, 2013). The credibility problem of the no-bail out commitment, now effectively reneged, may not have been easily anticipated.

Some economic theories and ideas may have therefore shaped these rules more than others, but they nevertheless fall well short of explaining their design and development, let alone the distribution of competences among and the decision-making rules of EU institutions. This is because these institutions are abstracted away. These models' primary objectives are welfare analyses based on the utilities of societies, governments and central bank constituting a monetary union (e.g. Beetsma and Bovenberg, 1998, 1999; Beetsma and Uhlig, 1999). Although important, its empirical relevance is doubtful because policy outputs also result from the decision-making rules of and the distribution of competences among the EU institutions. These models cannot explain why the reforms have taken a particular path over the years. The omission of highly institutionalized bargaining processes that shape both design and implementation should invite caution in producing policy recommendations based on useful, yet very simple, depictions of the real world. To better understand policy design and output, they should be integrated with, now well-developed, theories of EU legislative negotiations, delegation and implementation. This should be a priority for future research agendas.

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## Abstract

This chapter assesses the ideational basis underpinning the fiscal governance rules of the European Union. These rules are designed to prevent the negative cross-country externalities arising from expansionary fiscal policies adopted by authorities with short-term incentives to boost output at the expense of inflation. This set-up is based on standard macroeconomic theory, while claims that these provisions have been heavily influenced over time by theories based on rational expectations, including even the Ricardian equivalence proposition, are unconvincing. This is because these extensions suggest a *diminished* effectiveness of expansionary fiscal policies and, consequently, would recommend *looser* fiscal oversight. Therefore, supporting stricter rules means that one must doubt the empirical validity of expansionary fiscal consolidation.

Some economic theories and ideas may have therefore shaped these rules more than others, but institutionally sparse models of fiscal-monetary interactions cannot account for the development of fiscal governance. They omit the highly institutionalized bargaining processes that shape both design and implementation. The chapter concludes highlighting the uncertainties facing policy-makers who set these rules sometimes arbitrarily, inviting caution when policy recommendations rely on useful, yet very simple, depictions of the real world.

Fabio Franchino
Camilla Mariotto

# Intergovernmentalisms and fiscal governance

## Contrasting intergovernmentalist theories

The flurry of measures that have been adopted in response to the sovereign debt crisis has rekindled a dormant theoretical debate on European integration. This new wave of theorizing, which falls under the general rubric of new intergovernmentalism, shares a common view that, after the adoption of the Maastricht Treaty, core intergovernmental forums of EU governance [the European Council and the Council] have become the main catalysts of further policy integration but not in the sense of the traditional community method which involves acts of competence transfers to supranational bodies (Fabbrini and Puetter, 2016: 481).

Because of the end of the permissive consensus and the associated crisis of political representation, post-Maastricht policy initiatives are characterized by greater reliance on the European Council and the Council, not only for agenda-setting and decision-making, but also for policy execution and implementation. Delegation of powers 'to traditional supranational institutions such as the Commission [...] has become increasingly discredited among member state governments' (Puetter, 2016: 604), *de novo* institutions are preferred and unanimous decision-making within intergovernmental institutions has acquired greater prominence. This reluctance to pool and delegate – "integration without supranationalisation" (Fabbrini and Puetter, 2016: 481) – is particularly relevant in highly salient or core state powers such as economic governance (Genschel and Jachtenfuchs, 2013; Fabbrini, 2016; Puetter, 2012; Bickerton *et al.*, 2015a; Bickerton *et al.*, 2015b; Puetter, 2014; Fabbrini, 2013; Fabbrini, 2015).

In this chapter, we subject these expectations to empirical corroboration by means of an analysis of the patterns of tightening, delegation and pooling of the fiscal governance rules of the European Union (EU) adopted between 1993 and 2013. By tightening, we mean the imposition of requirements and demands on countries and their authorities (we cover also provisions that loosen constraints or offer national authorities leeway). Pooling occurs where the Council takes decisions by majority voting and delegation when policy prerogatives are conferred upon the European Commission.

We contrast these expectations with those derived from liberal intergovernmentalism and other studies on delegation. In his theory, Moravcsik (1998: 73-77) discusses the *bargaining con-*


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*ditions* that lead to pooling and delegation, the *positions* that countries are likely to take on these issues, and the *type* of powers that are pooled or delegated. Pooling and delegation are primarily driven by the need to bolster the credibility of policy commitments when incomplete contracting and incentives to renege on prior agreements create problems of time consistency. They are expected in case of uncertainty about future decisions, when joint gains are high and distributional conflicts moderate. Opposition (support) is likely to be voiced by larger (smaller) countries that expect being either in a minority (majority) position or noncompliant (compliant).

Pooling clearly entails a smaller loss of control for countries than delegation. It is preferred when policies require additional measures, since it undermines unilateral obstruction to the adoption of secondary legislation. Delegation addresses concerns about domestic compliance and it is more likely in enforcement. *A higher risk of noncompliance therefore tilts the balance in favour of delegation*.[1]

Moving on to the daily routine of legislative politics, formal models as well rely on uncertainty and cross-country conflict, perhaps originating from negative externalities and noncompliance, as key drivers of delegation (Franchino, 2007; Franchino, 2005). The following factors also matter: status quo (or reversion point), positions of the agenda setter and the agent, voting rules, inter-institutional conflicts and nonstatutory control mechanisms. If a new bill requires unanimity, the adopted measure is likely to constrain national administrations only moderately, perhaps rely on some pooling and avoid delegation because unanimity empowers recalcitrant ministers who are biased in favour of the status quo, consisting of no tightening, pooling or delegation. If a qualified majority suffices, we should expect more tightening and delegation.[2] Once a measure is adopted, if conflict intensifies, frequently triggered by noncompliance, we should expect demands by compliant countries for further tightening, (perhaps) pooling, and delegation. These are more likely to turn into laws if amending necessitates only a qualified majority.

The outcome may also tilt in this direction if, first, the reversion point - what would happen if no measure were adopted - is costly for recalcitrant countries. And, second, when the European Parliament is involved (in the ordinary legislative procedure), in case

[1] For Moravcsik (1998: 73-77), delegation is also more likely in implementation, but it is not immediately clear what shapes the choice between pooling and delegation. The scope and extent of delegation should to be inversely related with specific powers nested within a set of larger unanimous decisions and limited direct democratic control.

[2] The most recalcitrant governments, who prefer ample national discretion, limited pooling and narrowly defined Commission's competences, are more likely to be overruled under qualified majority voting since the supranational executive, which initiates legislation, is likely to display a symmetrically opposite preference ordering. Divergence between the Commission and the Council's pivotal member(s) increases the risk of agency drift and should discourage delegation.

of disagreement between Council and Parliament and agreement between the latter and the Commission.[3]

Being part of a package of measures has less defined implications. On the one hand, the most demanding procedure, like unanimous voting, is likely to drive negotiations. On the other hand, linkages across issues may offer the possibility to move beyond a minimal compromise if recalcitrant and reformist countries (or institutions) attach different saliences to the issues they disagree on.

In this chapter, we conduct a systematic provision-by provision analysis of the patterns of tightening, pooling and delegation of fiscal governance rules. We therefore consider only provision-specific national and institutional preferences, especially when they differ across actors. We analyse the bargaining dynamics only with this purpose in mind. Thus, differently from Bressanelli and Chelotti (2016) and Dehousse (2016), who assess the influence of, respectively, the European Council and the Commission in the 2011 six-pack and 2013 two-pack reforms, we do not discuss bargaining success (we share however Dehousse's emphasis on credibility to explain institutional choice). We share features with the studies of Heipertz and Verdun (2010; 2005) who employ four theoretical approaches to explain the 1997 growth and stability pact (GSP) and its 2005 reform. Given our narrower focus, we produce detailed and easily comparable data on tightening, pooling and delegation and we draw further insights by extending the analysis to the latest reforms.

Our main result indicates that a bias against delegation appears to have motivated the initial design of fiscal governance and its 2005 reform. We argue that arbitrariness, uncertainty and procedural hurdles to tightening and delegation are likely to explain this outcome. On the other hand, liberal intergovernmentalism and delegation theory can easily explain the recent reform, when new intergovernmentalism, according to its proponents, should instead do most of the explaining.

Before moving on to the analysis, we explain first how we have measured our key variables in the next section.

## Coding provisions and preferences

### *Tightening, pooling and delegation*

We broadly follow the method developed by Epstein and O'Halloran (1999), and applied by Franchino (2007; 2004) and Thomson and Torenvlied (2011) to EU legislation. Each legal act, including the treaty chapter on economic policy and the protocol on excessive

[3] We discuss only briefly the role of the Parliament here. Parliamentarians should prefer more tightening and delegation because they face higher/lower costs of ex-post monitoring over national authorities/Commission than Council ministers (Franchino, 2007: 64-65, 285-286).

deficit procedure (EDP), is subdivided into major provisions. Each major provision is then coded as to whether it pools policy authority within the Council (or *Eurogroup* – a gathering comprising of Eurozone ministers only), delegate powers to the Commission, or gives member states some leeway in implementing the measures. Similarly, each major provision is then coded as to whether it sets constraints upon the institutions and makes demands on member states. Provisions have been coded independently first, and then disparities have been settled. Agreement between coders is substantial.[4] Coding instructions are available upon request.

This operationalization has two drawbacks. First, it does not capture some important qualitative differences. A provision that confers upon the Commission the power to determine noncompliance has the same weight as one that asks this institution to adopt data collection guidelines. Second, it does not capture small changes to existing provisions, such as when an amending law shortens existing time constraints or marginally modifies existing rules. These shortcomings are not serious enough to distort the broad picture but deserve attention in the empirical analysis.

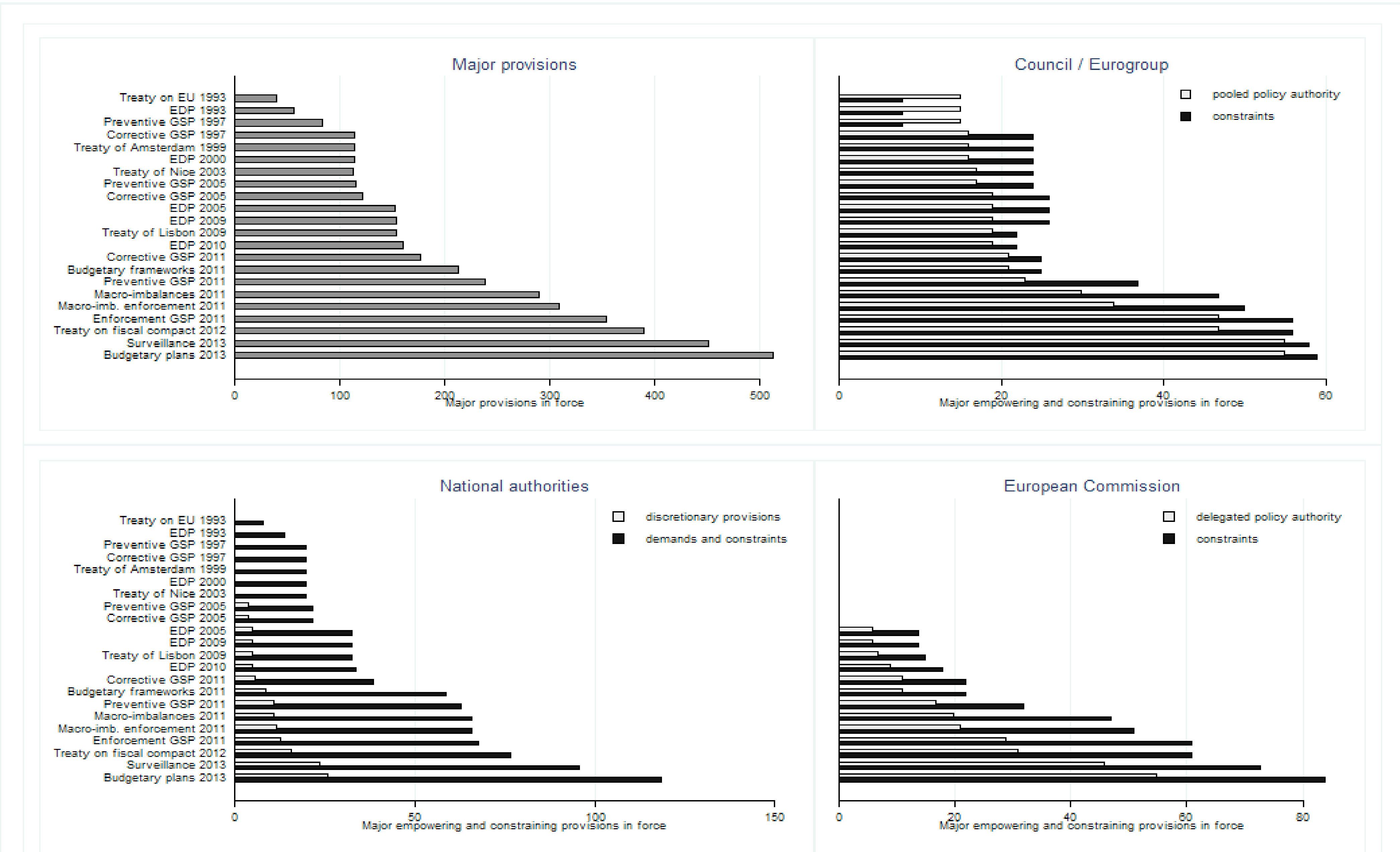
Figure 1 displays the number of major, empowering and constraining provisions in force after the adoption of each new law or treaty (we include, but do not discuss, the so-called fiscal compact treaty). Major provisions have increased from 155, when the 1997 GSP completed the initial framework, to 153 after the first 2005 reform. They then burgeoned to 514 (478 without the fiscal compact) at the end of the 2011-2013 major restructuring. Provisions that constraint or make demands on national administrations increased from 20 in 1997 to 33 in 2005. They now stand at 119. Initially no provisions loosened control or conferred some policy leeway. In the 2005 reform, five had these features. The total tally is now 25. For most of the period under study, about 19 provisions pooled powers within the Council; now 55 display these features. The trend is similar for constraints: 26 up until the 2005 reform, now 59. Instead, no provisions delegated powers to the Commission until the six included in the 2005 reform of the EDP. The totally tally is now a nontrivial amount: 55. The initial delegating provisions where associated with 14 constraining requirements. Now there are 84.

*Policy positions*

We have first identified for each measure the issues on which there was disagreement and then we located the positions of ministers and institutions. Since we cover a timespan of almost twenty years, we had to rely on several different sources. For inter-institutional conflicts, we compared the final act with the Commission's proposal, the parliamentary

[4] Cohen's kappa (a statistics of interrater agreement) is 0.89, meaning that the level of agreement is 89 percent greater than would be expected by chance. Data for the interrater agreement test are in Table A.

Figure 1: Major, empowering and constraining provisions in force




*Note*: Cumulative figures. EDP: Excessive Deficit Procedure, GSP: Growth and Stability Pact.

readings and the Council opinion.[5] We tracked and hand-coded all the amendments proposed throughout the legislative procedures and determined the contested dimensions and positions of the institutions.

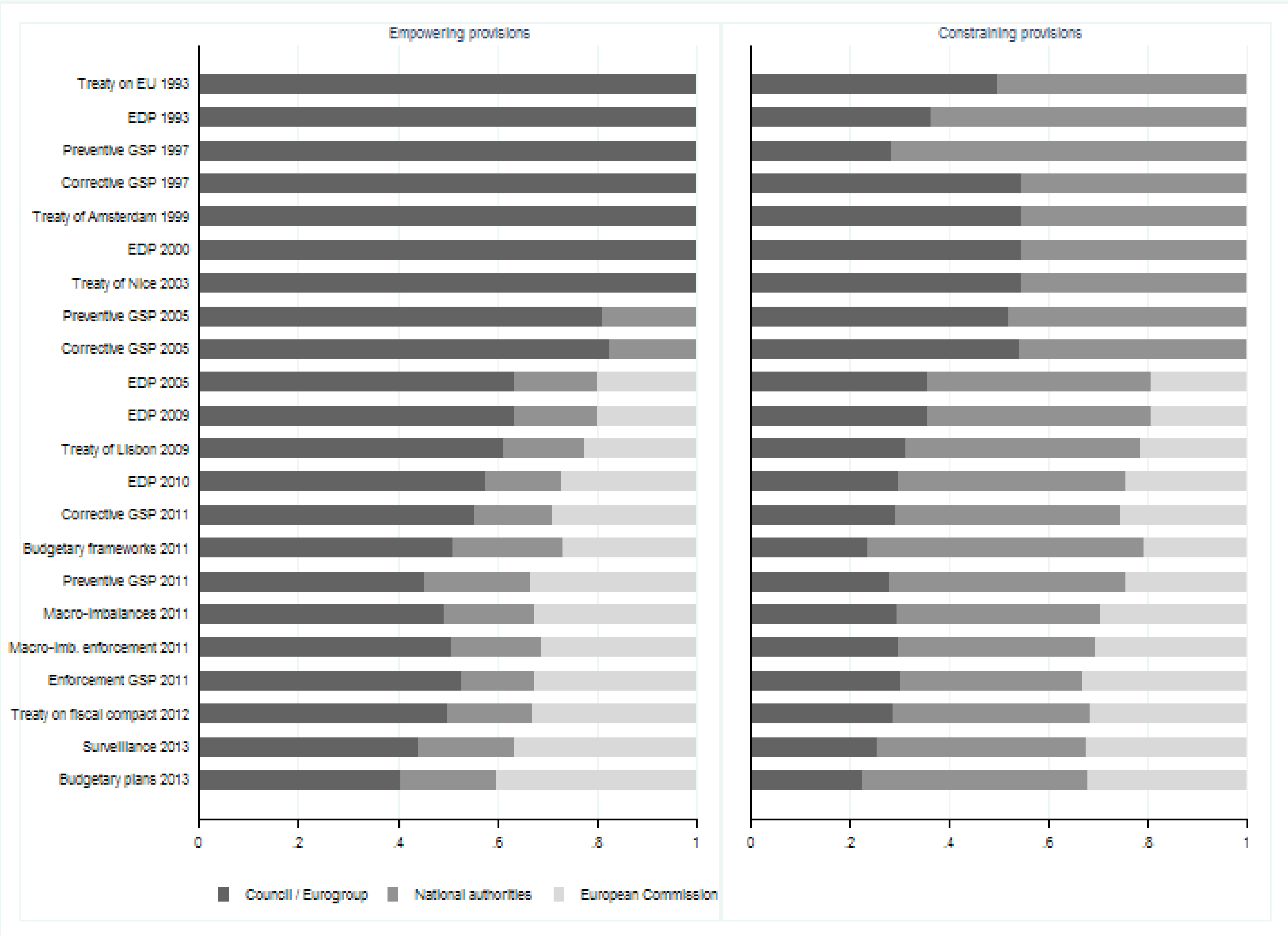
For member states' positions, we are interested in their initial stance on a given issue. We adopted several sources and strategies to identify and cross-validate them. First, the state of play issued by the Council Presidency during the negotiations is particularly informative and detailed since it highlights the key issues of disagreement. Unfortunately, this document offers mostly alternatives for compromise and rarely includes initial positions of ministers. Second, we examined 22 press releases, more than 90 transcribed speeches, given mostly during plenary debates, of parliamentarians, commissioners and Council presidents and more than 350 articles and reports of *Agence Europe* and other prominent European newspapers. Third, we used the Council public legislative records and the videos of Council legislative deliberations that were also made public. For our purposes, we have videos of Ecofin (economic and financial affairs) ministers debating the two-pack only. We hand coded the transcripts of these deliberations. Finally, we conducted interviews with expert witnesses affiliated with EU and national institutions: three representatives of the Parliament, three Commission officials from the Directorate General for Economic and Financial Affairs, and five officials affiliated with the permanent representations and the national finance ministries. Interviews were designed following the structure employed by Thomson (2011) and Thomson *et al.* (2006). We asked interviewees to identify the issues of disagreement and to locate the initial positions of the actors involved. Interviews provided useful information only for the 2005 and 2011-2013 reforms. Graphic illustrations of the full set of conflict dimensions and policy positions are available upon request. A systematic analysis of these issues and positions is beyond our scope.

## The initial fiscal governance framework: Why so much pooling?

Figure 2 displays the shares of empowering and constraining provisions in force by type of institution: national administrations, Council and Commission. By the time the initial fiscal governance framework was completed in 1997, only pooling has occurred. No provisions delegated powers to the Commission or granted some leeway to member states. Constraining provisions were equally shared between the Council and national authorities.

[5] The EDP regulations and the budgetary frameworks directive are adopted by a Council qualified majority after consulting the Parliament. The corrective GSP regulation requires a unanimous Council, in addition to parliamentary consultation; while the preventive GSP measure follows the cooperation procedure until the Treaty of Lisbon, then the ordinary legislative procedure. The remaining six-pack and two-pack measures are subject to the ordinary legislative procedure. Documents are available from the PreLex database.

Figure 2. Shares of empowering and constraining provisions in force by institutions




*Note*: Cumulative shares. EDP: Excessive Deficit Procedure; GSP: Growth and Stability Pact

Council prerogatives originate almost solely from the Treaty. This institution can preventively make public a recommendation sanctioning non-compliance if national measures are inconsistent with the broad economic guidelines. More importantly, it establishes the presence of and the sanctions for an excessive deficit; it sets the rules on multilateral surveillance, access to financial institutions, bailing out and application of the excessive deficit protocol. In the Treaty, these prerogatives are associated with timing and reporting constraints, and with requirements of cooperation with the Parliament; but the GSP corrective regulation circumscribes them more comprehensively. For instance, it clarifies the exceptional mitigating conditions for determining an excessive deficit and sets strict deadlines and detailed rules for setting sanctions.[6]

Some demands on member states are broad, such as those where they are required to coordinate and report on their economic policies and public finances (see especially the EDP 1993 regulation). Others are more specific, such as the well-known requirement to avoid an excessive government spending, defined in terms of ratios of deficit and debt to gross domestic product. Also, the GSP preventive arm requires Eurozone states to submit and make public annual stability programmes and non-Eurozone countries to submit convergence programmes, as part of multilateral surveillance.

*Explaining pooling*

These patterns represent more of a puzzle for liberal intergovernmentalism. The new theories at least expect limited delegation. Fiscal governance rules are designed to prevent negative externalities arising from combined contractionary monetary and expansionary fiscal policies which result when a fiscal authority in a monetary union has short-term incentives to boost output and employment at the expense of inflation.[7] Delegation should be preferred over pooling because noncompliance is a more pressing issue than completing the policy design, especially if the framework already contains detailed guidelines. Pooling can be ascribed to the need to clarify further the EDP, multilateral surveillance, access to financial institutions or bailout, but the complete absence of delegation betrays a puzzling lack of concern about compliance.

Several interrelated aspects can explain so much pooling. At the time of drafting, negative externalities were theoretical inferences from the application of standard macroeconomic theory to a monetary union. Some scholars downplayed their magnitude and emphasized their uncertain direction. Given no bail-out – they argued – national fiscal authorities would avoid excessive spending anyway *if* the central bank is credibly inflation-averse and *if* financial markets demand higher risk premia from profligate governments (Buiter *et al.*, 1993; Buiter, 2006; Eichengreen and Wyplosz,

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[6] Only in one provision the Council gives itself greater room of manoeuvre. It can supplement the deposit sanctioning an excessive deficit with other measures listed in the Treaty.

[7] In a monetary union of countries with independent fiscal policies and a common monetary authority with an inflation target at potential output, the reaction of the central bank to an unexpected and permanent increase in one country's public spending is to increase the interest rate. The resulting combination of contractionary monetary policy and expansionary fiscal policy may build-up trade imbalances within the union, appreciate the currency and decrease union-wide net exports. In the worst-case scenario, the trade balance could worsen for the non-spending countries and the higher interest rate could lead to lower investment, lower capital accumulation and lower output in the long run. The profligacy of one fiscal authority could therefore produce a recession and lower long-run growth in a fiscally responsible member country, at least in theory (see e.g. Dixit and Lambertini, 2001, 2003).

1998).[8] Uselessness aside, any given set of parameters is necessarily arbitrary[9] and may be excessively constraining since several combinations of debt and deficit values can be fiscally sustainable (Pasinetti, 1998). Buiter *et al.* (1993) explicitly argued that they should be disregarded.

These uncertainties may explain the choice for a Council-centred policy, but not convincingly. At the end of century, the no-bail out rules and the central monetary authority were obviously untested (the latter would become fully operational in 1998), while it became increasingly clear that countries with a history of fiscal profligacy, like Italy, may be joining the monetary union. Moreover, noncompliance was widespread. Figure 3 shows that, between 1994 and 1997, the Council opened an EDP for all probable early adopters of the single currency, except for Finland and Ireland.

The GSP initiative was put on the agenda by the German government under the implicit threat of a smaller Eurozone – a credible reversion point. Yet, delegation was not an issue. Negotiations centred on a) the exceptional and temporary circumstances under which a deficit would not be considered excessive, and b) the financial sanctions for noncompliant states.[10] The first was about Council's room of manoeuvre: the German and Dutch governments argued for specific thresholds[11] and proposed that automatic exemptions should apply only to countries experiencing an annual decline in real GDP of at least 2 percent. The Belgian, French and Italian governments preferred the status quo, thus leaving the Council free to determine country-specific exceptional circumstances. All these countries had an excessive deficit, but the risk of noncompliance plausibly explains the positions of Belgium and Italy which had the worst public finances (debt-to-GDP ratios averaging 135 percent and 118 percent respectively in 1992-6 – save Luxembourg, Germany had the lowest ratio of 34 percent) since the proposed reform would have make exemptions harder. France was however the second best performing country and in a significantly better shape than the Netherlands (a ratio of 55 percent compared to 70 percent).

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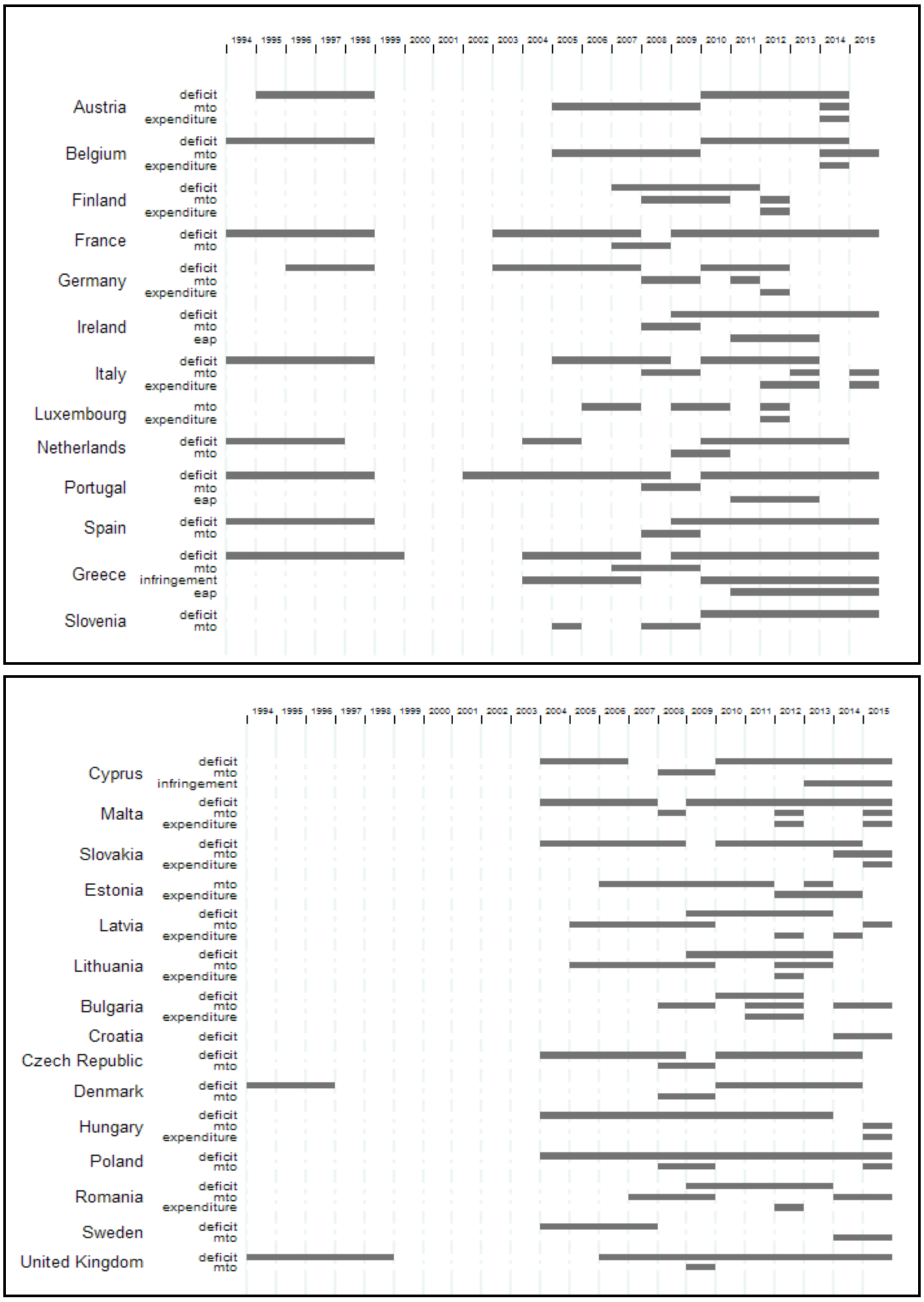
[8] No-bail out rules were deemed sufficient to deal also with the risk of fiscal default and with the pernicious financial contagion that such default would trigger (Buiter *et al.*, 1993). Several macroeconomic models employing rational-expectations and the Ricardian equivalence proposition question the need for fiscal rules in a monetary union (Beetsma and Bovenberg, 1997; Beetsma and Bovenberg, 1998; Bergin, 2000; Van Aarle *et al.*, 1997).

[9] The debt parameter is close to the 1991 average for EU countries and the deficit parameter is close to the share of general government fixed capital formation over GDP for the 1974-1989 period (Buiter *et al.*, 1993).

[10] The added references to growth after Lionel Jospin became the French Prime Minister in June 1997 were symbolic.

[11] Jürgen Stark, German Secretary of State at that time, argued that "precision is necessary when defining a serious recession" (Agence Europe, 1996). Germany, Denmark, Finland and Sweden also proposed to insert the words "the expectation is that the Council will respect the Commission's decision" (initially, Germany argued for an ancillary international treaty). They settled for the inclusion of the word "as a rule" in articles 2 and 11.

FIGURES 3A-3B. PERIODS OF NON-COMPLIANCE WITH EU FISCAL PROVISIONS




*Note*: Non-compliance with deficit reference value, medium-term objective (mto) and expenditure benchmark. Countries in excessive deficit do not have to comply with the GSP preventive arm. If a country has achieved its mto, it is exempt from complying with the expenditure benchmark. Infringement cases based on Eurostat reports. Countries under an Economic Adjustment Programme (eap – bailout package) need to comply with the Memorandum of Understanding and are not subject to GSP provisions. The Financial Adjustment Programme for Spain (2012-3) and the Balance of Payment Programmes for Hungary (2008-10), Latvia (2009-11) and Romania (2011-5) are excluded. Own calculation from EurLex database; Stability and Convergence Programmes; Country-specific Recommendations; Assessments of Commission Directorate General for Economic and Financial Affairs. Countries in order of euro adoption.

Key negotiations took place between the European Council summits in Dublin (December 1996) and Amsterdam (June 1997). The 2 percent threshold was included in article 2.2 of the GSP corrective arm, but the third comma stipulated that circumstances could be exceptional also for a contraction of less than 2 percent, *in light of further evidence*. It was a modest amendment then. A resolution of the Amsterdam summit further narrowed the Council's faculty to exempt noncompliant countries to cases when the reduction was more than 0.75 percent.[12] In sum, the most recalcitrant countries accepted to limit Council's powers only in case of mild recessions and this exception was not even included as a legal provision in the GSP.

The second contested topic was about tightening: specifically, the deposit to be made in case of an excessive deficit. The German government argued for the deposit fixed component of 0.25 percent of GDP, but it had to settle with the Commission proposal of 0.2 percent which was supported by the majority of member states.

Despite the risk of a smaller Eurozone, the GSP was a modest reform. The EDP regulation and the preventive measure, adopted under Council qualified majority voting, were marginal for our purposes. The corrective regulation clarified and tightened Treaty provisions but, despite poor compliance, the requirement of unanimity and uncertainties associated with the policy militated against delegation. The most recalcitrant countries, keen to preserve Council's prerogatives, only gave small concessions to the more reformist Germany.

## The 2005 reform: Why loosening despite noncompliance?

This reform introduces two small but significant changes. First, four provisions (19 percent of empowering provisions in force) grant member states greater flexibility. Most were inserted in the preventive GSP regulation. Article 2a of this measure replaces *country-specific* to common medium-term budgetary objectives (MTOs), which now *may* diverge from a close-to-balance or surplus position. The objectives can be revised every four years and in case of major structural reforms.[13] On the other hand, the EDP regulation adds several new demands about provision of statistical data, professionalism of national statistics officials and assistance to Commission's inspections. More than 45 percent of constraining provisions in force still relates to member states.

The second significant change concerns six provisions conferring policy prerogatives upon the Commission (amounting to 20 percent of empowering provisions in force) in the EDP regulation. The Commission sets the formats of the statistical information that

[12] This box model was suggested by Nigel Wicks, the chairman of the Monetary Committee which was composed of senior officials from the ministries of finance. 0.75 percent is halfway through the 0.5 percent proposed by France and the 1 percent proposed by Germany at the Dublin summit.

[13] The only notable constraint is that the medium-term deficit must be lower than 1 percent of GDP.

is required for quality assessment, adopts guidelines for data collection procedures, and decides on the correct implementation of accounting rules. Importantly, the supranational executive can object to the quality of reported data and amend them.[14]

Instead, the role of the Council is, on balance, unaltered. On the one hand, the definition of severe economic downturn – a key contested issue in 1997 – is loosened. Now even a protracted period of very low *growth* can be a mitigating factor to avoid the procedure (the 'box model' was dropped). Decisions can be revised if unexpected economic events significantly worsen government finances and the whole GSP assessment time frame is extended.[15] On the other hand, the preventive regulation clarifies the criteria for examining the path toward the MTOs;[16] while the corrective regulation specifies that the Council must request a minimum budgetary improvement of at least 0.5 percent of GDP a year from a non-complying state and deadline extensions cannot exceed one year.

*Explaining loosening*

Five Eurozone countries, including France and Germany, had an excessive deficit between 2000 and 2004 (see Figure 3). Yet, national obligations were loosened and no powers were delegated to the Commission in the GSP. Again, this seems to support the new variant of intergovernmentalism.

Concerns about uncertainty and arbitrariness may similarly explain, at least in part, the reluctance to delegate. Consider the redefined *cyclically-adjusted* and *country-specific* MTOs. A structural deficit is based on uncertain estimates of the output gap and the (non-accelerating wage) rate of unemployment. Determining the hysteresis of unemployment – whether episodes of high unemployment are structural – is far from uncontroversial. Yet, these estimates are crucial for separating the cyclical from the structural components of a deficit. Inaccuracies could prompt pro-cyclical corrective measures.[17] Notably, the Commission did not redefine the MTOs in its initial proposal, the Council did, with the cooperation of the Parliament.[18]

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[14] These powers are associated with standard reporting, consultation, publication and timing requirements, which make up 19 percent of constraining provisions.

[15] The corrective regulation clarifies the relevant factors, including pension reform, to be considered when evaluating budgetary positions. Perhaps with the exception of such reform, where net costs must be taken into account in linearly degressive terms over a five-year period, it is unclear whether this provision actually allows for greater discretion.

[16] The most notable are *a)* whether states pursue annual adjustments of the budget balance of half percent point of GDP, especially during periods of high economic growth, and *b)* if major structural reforms are implemented.

[17] The Commission constantly revises the methodology to calculate the MTO in order to address this risk.

[18] The Parliament also pushed for more frequent supranational review. The British government obtained that the MTOs apply only to Eurozone and Exchange Rate Mechanism II countries.

As far as loosening is concerned, the corrective regulation appears to run counter to the expectations of the formal delegation literature as well. Recall that this measure requires Council unanimity. By far the most controversial issue was the numerousness and specificity of additional mitigating factors for establishing an excessive deficit: a conflict like the one underpinning the first GSP negotiations, but with the German position crucially reversed. This time chancellor Gerhard Schröder argued for more leniency and proposed a long list of mitigating factors which was viewed favourably by France and Italy – noncompliance, or the risk thereof, clearly explains this coalition.

In March 2005, Luxembourgish Jean-Claude Juncker, presiding the Council, proposed a shorter list, which was criticized by both countries requesting the inclusion of specific spending categories (the three above plus the United Kingdom[19]) and those that considered it too long and insisted on the centrality of the reference values. The more recalcitrant Eurozone countries had clearly a history of better compliance (except for the Netherlands). After two weeks of negotiations, this list was abandoned in favour of a mostly fuzzy but still long enumeration of factors in article 2.3 and an invitation to a 'balanced overall assessment' (recall also the redefined *protracted low growth* as a mitigating factor).

Mitigation takes effect only if the deficit remains close to the reference value and its excess is temporary (an "overarching principle"), but these amendments undeniably expand Council discretion and dilute control over national authorities. Why did recalcitrant countries, despite their veto power, accept loosening and, especially given their smaller size, no delegation? Because the reversion point of these negotiations was the suspension of the EDP – clearly an unpleasant outcome for these fiscally responsible countries. In November 2003 France and Germany managed to assemble a minority[20] to block decisions establishing the insufficiency of their measures and demanding further action under the threat of sanctions (Heipertz and Verdun, 2010: 142-154). The Council also declared that the procedure was held in abeyance. This latter decision was successfully challenged by the Commission before the European Court of Justice in July 2004, but the Court upheld the Council's right to block decisions. It was clear that there was a minority blocking *any* new Commission's recommendation – de facto, an abeyance. The least reformist countries therefore had to accept a looser regime in exchange of the resumption of the procedure and more emphasis on preventive oversight.

On the other hand, the EDP regulation can be easily explained by liberal intergovernmentalism. In 2004, Eurostat revised upwards the Greek deficit by between 2 and 3 percentage points of GDP for the years 2000 to 2003 and the 2003 debt-GDP ratio by

[19] British support was obtained by assuring that the Commission would not be strengthened. The two lists proposed by Schröder and Juncker are available upon request. See Schure and Verdun (2008) for a study on country size and positions on tightening and delegation during these negotiations.

[20] It comprised of Ireland, Italy, Luxembourg and Portugal. Greece and Belgium supported the conclusions about abeyance.

more than 7 percentage points (European Commission, 2010: 12-13; Eurostat, 2004). In December 2004, the Commission initiated an infringement procedure against Greece for failing to comply with the regulation. In light of these events, the additional demands on national authorities with regard to statistical data and the expansion of Commission's competences are in line with expectations, also given qualified majority voting.

The most contentious issue concerned the powers of the Commission and the battle lines were as expected: the four largest countries (France, Germany, Italy and the United Kingdom) opposed the regularity of Commission's intrusive methodological inspections of national data as well as a first in-depth monitoring visit proposed by Luxembourgish Presidency. Indeed, article 8d narrowly defines the objectives of these visits and specifies that they should take place only in case of serious problems.[21]

## The six-pack and the two-pack: Back to old theories

This overhaul of fiscal governance was adopted in the midst of the sovereign debt crisis. The measures are essentially part of same package, even though they span over a period of three years. The number of major provisions has increased more than threefold and the main beneficiary is undoubtedly the Commission (see Figure 1). The share of empowering provisions that confer policy prerogatives to the supranational executive has increased from 23 to 40 percent and this shift has occurred primarily at the expense of the Council whose share has decreased from 61 to 40 percent (Figure 2). Provisions giving national authorities some leeway (21 in total, several are exemptions) have only marginally increased from 16 to 19 percent.

With more powers, Commission constraining provisions have correspondently increased from 21 to 32 percent, while the Council share has decreased from 31 to 23 percent. The proportion of demanding provisions for member states has not altered. 86 provisions impose obligations on national authorities;[22] 20 are listed in the budgetary frameworks directive, 42 in the two-pack measures.

Four measures significantly enhance the Commission's powers (all adopted with the ordinary legislative procedure). In the preventive GSP regulation, upon a Commission's proposal, the Council must decide on noncompliance if a state fails to redress a budgetary divergence from the MTO. If the Council fails to act, the Commission can resubmit the proposal which would be now adopted unless a simple majority in the Council rejects it. In other words, the threshold for taking noncompliance decisions lowers from qualified to simple majority, therefore strengthening the Commission. The supranational executive also sets out the framework

[21] There was also a second marginal divide about the deadline for making public a reservation on data quality, which is probably explained by national administrative efficiency.

[22] Including nine provisions in the fiscal compact which we do not discuss here.

for the information to be provided in the stability and convergence programmes, carries out surveillance missions in noncomplying states and may publicize the results of such missions.[23]

The second measure is a new enforcement regulation of the GSP. This law stipulates that the Council can impose sanctions on states that do not comply with budgetary obligations, manipulate statistics or fail to correct excessive deficits and deviations from MTOs. The role of Commission, as proposer, is reinforced because decisions require only a blocking minority in the Council for approval (so-called reverse qualified majority voting). The supranational executive also enjoys an array of investigative powers for establishing statistical misrepresentations and sets the rules concerning fines and investigations.

Finally, the Commission is significantly strengthened in the two-pack regulations (these measures apply to Eurozone countries only). The first law enhances its surveillance powers when the financial stability of a country is in peril or when a country receives financial assistance.[24] Moreover, post-surveillance decisions, proposed by the Commission, need only a blocking minority in the Council for adoption. In the second measure, the Commission sets the content of draft budgetary plans and debt issuance reports, and it is involved in their assessment. More importantly, it sets the reporting requirements for countries in EDP. It can request detailed information and independent audits of national accounts, and it issues recommendations in case of risk of non-compliance.

The six- and two-packs represent a clear move from pooling to delegation, but 36 new provisions still rely on the Council. Sanctioning remains centred on this institution in the GSP enforcement regulation, so does in the two regulations on macroeconomic imbalances. Here, the Council adopts preventive recommendations when imbalances emerge, establishes an excessive imbalance, approves corrective action plans, establishes non-compliance and sets sanctions. In the latter two cases, the Commission's role is enhanced because of the requirement of only a blocking minority for approval.[25] In the two-pack surveillance regulation, the Council recommends precautionary measures, approves macroeconomic adjustment programmes, establishes noncompliance, approve conditionality requirements, and takes post-surveillance decisions (here, with greater influence of the Commission, as we have seen). Among the usual constraints associated with pooling and delegation, two deserve mentioning. First, there are specific criteria for evaluating countries with a debt level exceeding 60 percent of GDP. Second, accountability to the Parliament has significantly increased through its involvement in the economic dialogue and its oversight of Commission delegated acts.

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[23] Enhanced surveillance is also provided for in the corrective GSP regulation, while the new EDP regulation formalizes the Commission's power to carry out methodological visits for assessing data quality. Only national experts who comply with rules set by the Commission can assist such visits.

[24] The Commission can request detailed financial information, require stress tests and assessments, and conduct review missions.

[25] The Commission can also carry out enhanced surveillance missions in states subject to an excessive imbalance procedure.

*Explaining the regulatory overhaul*

We first describe briefly the context of this reform. Fiscal gimmickry has been common across Europe (Alt *et al.*, 2014), but the significant revisions of the Greek government deficit in late 2009 raised serious concerns about data quality and led to opening an infringement procedure. This was the proximate cause of the sovereign debt crisis but the preceding financial crisis had already put public finances under serious strain. Since 2007 the Council established that the adjustment path towards the MTO of every single Eurozone country was inappropriate. Then, in 2010, every country, except for Luxemburg, run an excessive deficit, while Greece, Ireland and Portugal had to secure bailout loans (see Figure 3).

This clearly amounts to a policy failure and the reaction is in line with liberal intergovernmentalist expectations: a shift from pooling to delegation (especially with regard to noncompliance and sanctioning decisions) and a tightening of national obligations. As expected, this outcome has probably been facilitated by a) Council qualified majority voting (and parliamentary involvement), required for all but the corrective measure, and b) an existential threat of the Eurozone if negotiations were to fail (Schimmelfennig, 2015: 329).

We have identified 27 dividing lines. We discuss only a few selected ones. In the preventive regulation, the discussion centred on *a)* whether the adjustment path toward the MTO should differ for highly indebted countries and *b)* the assessment of deviations from such path. The Italian government argued against a differentiated assessment and, together with the Greek government, against sanctions for deviations. The new article 5.1 instead demands the Council and the Commission to examine whether the annual improvement of their structural budget is higher than 0.5 percent of GDP (the Finnish, Dutch and Luxembourgish governments pressed for an even more explicit requirement). Moreover, article 5.1 not only operationalizes the adjustment path in terms of an expenditure benchmark (differentiated on the achievement of the MTO), but the new article 6.2 also demands the Council to act within a month of a warning; and sanctions are envisioned.

In the corrective regulation, debates centred mostly on the debt criterion (article 2.1a). France, Italy and Greece expressed concerns about the benchmark for considering a satisfactory debt dynamics of highly indebted countries.[26] On the other hand, Slovenia and Slovakia tried to oppose the transitional provision stating that the debt criterion was fulfilled for three years for countries with an excessive deficit. Another highly dividing issue was, again, the numerousness and specificity of the mitigating factors for determining excessive deficit. The German government once again reversed its position and argued for fewer factors. The final provision did not change much.

[26] An average annual reduction of one twentieth of the difference between the actual debt-GDP ratio and 60 percent.

In the new GSP enforcement regulation, the key issues were about the stiffness of the sanctions. For instance, Finland, France and Germany toyed, unsuccessfully, with the idea of suspending voting rights, while the Council and the Parliament included sanctions for manipulating statistics.

In the macroeconomic imbalance procedure, Spain and Portugal argued for a symmetric assessment of the imbalances, while Germany defended asymmetry. Article 3.2 retains asymmetry but does not exclude structural reforms for countries with current account surpluses. The Parliament wanted stiffer sanctions and greater involvement in designing the scoreboard and the macroeconomic indicators.

During the negotiations on budgetary frameworks and plans, Spain raised concerns about the frequency of subnational fiscal data reporting and the features of national statistical offices. France, Germany and other smaller states unsuccessfully tried to limit the publicity of plans to countries with financial problems; while Ireland and Austria tried to postpone the annual deadline. In the two-pack budgetary surveillance regulation, the Parliament managed to keep Council qualified majority voting (that is, pooling) for approving macroeconomic adjustment programmes over the opposition of several ministers.

Finally, two important issues concerned the powers of the Commission. First, the possibility for this institution to adopt emergency measures (including Eurobonds) split the Council in two groups: Finland, Germany, the Netherlands, Slovenia and Sweden opposing, Belgium, France, Luxembourg and Spain supporting. In the enforcement GSP measure, they compromised on a provision demanding a report on the issue, later, in the budgetary plans regulation, on one establishing an expert group for studying its feasibility. Second, the extent of application of reverse qualified majority voting was debated during the negotiations of all three GSP measures and the macroeconomic imbalance procedure.

In sum, this very concise treatment indicates that governments clearly differed on several issues. Moreover, positions seem to mirror countries' compliance records, but more research is clearly necessary.

## Conclusion

The apex of the intergovernmental moment was reached between 2009 and mid-2012 (Fabbrini, 2013: 1010).

As far as this core state policy is concerned, our evidence indicates the opposite. Despite noncompliance, fiscal governance has been heavily Council-centred *until* 2011. The initial reluctance to delegate is actually a challenge for liberal intergovernmentalism. We suggest that the unavoidable arbitrariness of these rules and the uncertainties associated with its implementation most likely made ministers very cautious in delegating powers to the supranational executive, even in the face of noncompliance.

The bargaining context mattered as well. In the GSP negotiations, unanimity requirements (and parliamentary exclusion) empowered recalcitrant governments which were not keen on tightening and delegation. Faced an unappealing reversion point, they only accepted a moderate curbing of Council's discretion. In the 2005 reform, governments that opposed loosening and may have preferred delegation had to compromise since they faced the most unappealing reversion point. Nevertheless, some expected delegation occurred in the new EDP regulation.

Without neglecting the continuing relevance of the Council, the last reform appears a vindication for liberal intergovernmentalism and delegation theory. The empowerment of the Commission is therefore not paradoxical or unexpected (Bauer and Becker, 2014; Dehousse, 2016) nor did the Council rely on *de novo* bodies (Bickerton *et al.*, 2015a). New intergovernmentalist scholars acknowledge these new prerogatives without recognizing that they are explained by traditional theories (Fabbrini, 2016: 592; Fabbrini, 2013; Bickerton *et al.*, 2015b; Fabbrini and Puetter, 2016; Puetter, 2016). They also downplay their relevance. They argue for instance that "consensual decision-making within the Eurogroup speaks against the effectiveness of reverse qualified majority voting as an empowering device" (Fabbrini and Puetter, 2016: 491). Consensus is not what we find.

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## Abstract

This chapter assesses the ideational basis underpinning the fiscal governance rules of the European Union. These rules are designed to prevent the negative cross-country externalities arising from expansionary fiscal policies adopted by authorities with short-term incentives to boost output at the expense of inflation. This set-up is based on standard macroeconomic theory, while claims that these provisions have been heavily influenced over time by theories based on rational expectations, including even the Ricardian equivalence proposition, are unconvincing. This is because these extensions suggest a *diminished* effectiveness of expansionary fiscal policies and, consequently, would recommend *looser* fiscal oversight. Therefore, supporting stricter rules means that one must doubt the empirical validity of expansionary fiscal consolidation.

Some economic theories and ideas may have therefore shaped these rules more than others, but institutionally sparse models of fiscal-monetary interactions cannot account for the development of fiscal governance. They omit the highly institutionalized bargaining processes that shape both design and implementation. The chapter concludes highlighting the uncertainties facing policy-makers who set these rules sometimes arbitrarily, inviting caution when policy recommendations rely on useful, yet very simple, depictions of the real world.

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# Attitudes toward a fiscal union in the Eurozone

## Introduction

The sovereign debt crisis that began at the end of 2009, soon after the global financial crisis, and unfolded over the following five years has been the most prolonged and severe recession that European countries have experienced since the end of the Second World War. The crisis has hastened a flurry of measures, from the reform of fiscal governance rules, the establishment of support instruments for countries experiencing financial difficulties to an overhaul of bank regulation. If these measures have satisfactorily addressed the serious design flaws of the Eurozone and created the conditions for its political and economic sustainability remains to be seen, but the drama surrounding the negotiations in the first half of 2015 on the Greek government's bailout indicates otherwise. Indeed, given several recent official documents that call for the completion of Europe's economic and monetary union (European Commission, 2012; Juncker, Tusk, Draghi *et al.*, 2015; Juncker, Tusk and Draghi, 2015; Van Rompuy, 2012), European policymakers are well aware that these issues are far from settled.

The most recent report of June 2015 from the presidents of the European Commission, the European Council, the Eurogroup, the European Central Bank and the European Parliament calls for the creation of "a euro area-wide fiscal stabilisation function" and a "euro area treasury" (Juncker, Tusk, Draghi *et al.* 2015: 14, 18). A high-level group on own resources, established in February 2014, chaired by the former Italian Prime Minister Mario Monti and tasked with reviewing the system of funding the European Union (EU) budget, may lay the ground for future reforms.

These proposals are hardly new. The Werner Report (1970: 10-11, 17), the first detailed plan on monetary union, already discussed short-term budgetary policy and recognized the need of increasing fiscal capacity. The policy falls under the broad term of 'fiscal union' and consists in the centralization at the EU level of some taxation and spending that are sensitive to the economic cycle. A fiscal union would be designed, at least in theory, both to address business cycle fluctuations that are asynchronous across Eurozone countries and to counterbalance pro-cyclical country level fiscal policies.


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This chapter draws from political economy theories of tax-and-transfer public insurance schemes, as well as from theories of party cues, identity and trust, to test expectations about public attitudes toward a fiscal union. It relies on a survey question and two conjoint analyses carried out in May 2014 and 2015 and embedded in the second and third online panel wave of the Italian National Election Survey. Below we explain why Italy represents a good test base for this exercise.

Our surprising conclusion is that, despite the pathologies of EU decision making, there is some ground to be optimistic about the political feasibility of a fiscal union in the Eurozone, at least as far as public acceptability is concerned. As expected, high income right-wing individuals with low trust, weak European identity and negative assessment of EU membership are more likely to oppose such a measure. However, opposition from high income respondents is attenuated when made aware of all the policy implications. Its insurance features appear to temper the redistributive impact. These participants are actually willing to pay for a fiscal union, as long as tax rates are low. They oppose higher taxation, but significantly less than lower income groups.

This willingness to contribute by the core constituency which supports and benefits from European integration and the single currency speaks in favor of the political feasibility of a fiscal union. High income respondents are willing to accept a fiscal union in order to keep the euro, whereas lower income participants are much readier to ditch the currency if the monetary union fails to deliver good economic performance. Other factors, such as the impact on overall public spending, the institutional design and the spending destinations, affect the desirability of the policy in predictable ways. Low trustworthiness, especially of the Greek government, undermines the willingness to contribute.

In the next section we present the theories that should explain attitudes toward a fiscal union. Next, we subject them to a first empirical test using a survey question about support for the policy. We then introduce two conjoint analysis experiments. In the first one, the fiscal union is one of the measures of the economic policy programs respondents are invited to choose. The second experiment deals directly with the features of a fiscal union scheme. We then present the results and examine, in light of our expectations, the interactions between respondents' characteristics and conjoint analyses' attributes. We conclude fleshing out the key policy trade-offs underpinning the political feasibility of a fiscal union.

## Attitudes toward a fiscal union in the Eurozone

### *Economic self-interest: Redistributive and insurance perspectives*

We consider four sets of explanations. They are based on economic self-interest, party cues, identity and trust. The work of Meltzer and Richard (1981) on the size of government is probably the simplest and most commonly used model for deriving the attitudes toward a tax-and-transfer system like a fiscal union. In a set up where individuals contribute to such a system with a tax on their income and the tax revenue is equally divided among tax payers, above-average income earners are net contributors and prefer lower taxation and spending; whereas below-average income earners, being net beneficiaries, prefer higher taxation and spending.

The model offers three straightforward expectations: first, high income earners should oppose a fiscal union, whereas low income earners should support it. The negative relation between income and preferences for redistribution has been corroborated in several recent works (e.g. Alesina and La Ferrara, 2005; Corneo and Grüner, 2002). For our purposes, it could be argued that opposition from high income earners would soften if these individuals were to believe that Italy would always benefit from a fiscal union. We find this objection unfounded for two reasons. First, the relation between income and preferences for inter-regional redistribution does not seem to be conditioned by regional income (Balcells *et al.*, 2015). Second, whether Italy would systematically benefit is debatable since the Italian government has been a net contributor to the Eurozone bailout programs and the Italian media has made sure to alert the public about this credit position (see below the section on trust).

The other two expectations are equally straightforward: for a given benefit, employed individuals should prefer to contribute less (in other words, a lower tax rate) than more to a fiscal union, regardless of their income. Lastly, for a given tax rate, individuals should support spending in areas where they think they benefit the most (note that the model ignores benefit targeting). For instance, unemployed subjects should prefer spending on unemployment benefits over alternative destinations. Higher income respondents may prefer education spending because they either benefit directly as consumers or gain from its positive externalities (Alesina and Giuliano, 2011: 100). Due to space constraints, we will only briefly discuss how spending destinations shape attitudes.

An important alternative to the Meltzer and Richard's model sees the fiscal union as public insurance against the risk of asymmetric shocks (Barr, 1992; Luque *et al.*, 2014). From this perspective, assuming that insurance is a normal good, support for a fiscal union and willingness to contribute should increase with income. Four factors militate against these implications. First, since high income earners save a larger proportion of their income, they may prefer private insurance (or saving) to public insurance. Second, high income earners may display lower relative risk aversion. Third, risk may not be constant across income levels. Fourth, these expectations depend on how benefits are targeted since public insurance in advanced welfare states is normally offered on terms that are more favourable to low income earners. Moene and Wallerstein (2001; 2003) have produced a model that account for both redistribution and insurance. In the simpler version (Moene and Wallerstein, 2003: 491), the expected utility of individuals includes the formulation of Meltzer and Richard (1981) and a benefit accruing in case of unemployment. They show how higher earnings decrease demand for purely redistributive policies, increase demand for income-replacement policies and are unrelated to demand for universalistic policies (e.g. health). For a given tax rate, individuals should also prefer spending where they face higher relative risks. Low income earners may prefer more generous unemployment benefits relative to health insurance if they face a higher risk of unemployment relative to sickness, compared to higher income earners.

Lastly, country-level factors may also exert influence. After all, a fiscal union offers a public insurance against country-wide shocks resulting from negative interdependence, as in the recent crisis. So attitudes toward this policy could be shaped by both the income and the risk profile of the country of residence. Arguably, Italy is a particularly useful test case to evaluate attitudes toward a fiscal union because the Italian economy has been seriously affected by the crisis but it has been a net contributor to the bailout measures. From an insurance perspective, individuals in lower income member states, if facing higher country-wide risks, and individuals in higher income states, if facing lower risks, may be more willing to contribute - the former because of the higher country risk, the latter because of the higher country income.

*Party cues and partisan orientation*

Individuals may take cues about a fiscal union proposal from the stance that their preferred parties take on similar policies. According to the partisan model of economic policy (Hibbs, 1977), left-wing parties are more inclined to support government intervention in the economy and, more specifically, to expand total fiscal policy activity than right-wing parties because of the benefits accruing to their key constituencies of low-income earners, underemployed and unemployed individuals. The greater predisposition for these measures by left-wing parties could offer cues to individuals on the left to be more supportive of a fiscal union. After all, a fiscal union entails an increase in the fiscal capacity of the Eurozone. Similarly, individuals on the right may ground their views on the opposition that right-wing parties often display toward the expansion of domestic transfer programs.

Reinforcing this expectation are the cues that citizens infer from the more pro-EU stance of Italian left-wing parties (Conti and Memoli, 2014; Conti and Verzichelli, 2012) and the stronger internationalist orientation of left-wing compared to right-wing individuals (Noël and Thérien, 2008). In sum, left-wing individuals should be more willing to support and contribute to a fiscal union than right-wing individuals, and they should prefer spending on policies that benefit their constituency. Also, since a fiscal union requires both EU and national institutions for its implementation, left-wing individuals should prefer greater supranational involvement compared to right-wing individuals.

*Attitudes toward the European Union and European identity*

This brings us to the next set of explanations. Dalton and Eichenberg (1998: 256) and, more recently, Magalhães (2012) argue that public support for policy integration is greater in countries where support for the EU is higher and, in a detailed individual-level analysis, Gabel and Anderson (2002) find both left-right and European components to citizens' attitudes toward EU policies. Kuhn and Stoeckel (2014) have arrived at similar conclusions in the particular case of EU economic policy. These findings are relevant for two reasons. First, a fiscal union is clearly related to the single currency and the association between pro-EU views and support for the euro is particularly strong (e.g. Banducci *et al.*, 2003; Gabel, 2000; Hobolt and Wratil, 2015; Roth *et al.*, 2015). Second, Italian public opinion over the EU has become far more contested over the past years (Conti and Memoli, 2015; Quaglia, 2011) and it may therefore significantly shape policy preferences. In sum, individuals with positive attitudes about the EU should support to a greater extent a fiscal union and they should be more willing to contribute to it. They should also prefer greater involvement of supranational rather than national institutions.

*Trust and Trustworthiness*

Trust in political institutions and interpersonal trust have long been recognized as important foundations to good democratic performance (e.g. Putnam, 1993; Warren, 1999). Trust is encapsulated interest: we trust those whom we believe to have strong reasons to act in our interest and we place our trust correctly when the trusted person has a strong incentive to maintain a relationship with us (Hardin, 2004). Interdependence therefore provides the foundation on which to build trust. When it comes to government, it is more meaningful however to talk about trustworthiness (Hardin, 2004: 151-172). Indeed, European political elites adopt common policies expecting that each national administration will apply the new rules even if compliance is costly. To that effect, they have set up an elaborate system to monitor implementation and engender mutual trust.

The system is complex and public attitudes toward common policies are unlikely be affected by national compliance. The fiscal union may be an important exception however. The sovereign debt crisis was precipitated in late 2009 by the admission of the newly appointed Greek government that its authorities had again massively underreported the public deficit. In the following years, four countries needed assistance for refinancing their debts from other Eurozone countries, the European Central Bank and the International Monetary Fund. Between 2010 and 2014, successive Greek governments adopted several measures to counter its crisis and negotiated two bailout packages totaling €246 billion. In January 2015, the left-wing party Syriza won early elections in Greece, campaigning on an anti-austerity ticket. The swearing-in as Prime

Minister of its leader, Alexis Tsipras, was greeted in Italy with news on the front page of all major newspapers about the €43 billion the Italian government was exposed towards Greece.[1] In the first half of 2015, negotiations on the payment terms of the second bailout package made frequent headlines. A deal was reached in July after Tsipras took a dramatic, but eventually unsuccessfully, decision to hold a popular referendum in order to improve the terms of the bailout. In the heat of the negotiations, the Italian finance minister Pier Carlo Padoan stated that "the main obstacle to moving forward is lack of trust".[2] These dramatic events indicate that assessments of trustworthiness of political authorities - the national government, the European Union and the governments of other Eurozone countries - may shape attitudes toward a fiscal union. Trustworthiness of EU institutions for instance increases support for EU economic governance (Kuhn and Stoeckel, 2014).

## Public Support for a Fiscal Union

These expectations are first tested with a survey question which was included in the third wave of the population-based internet panel of the Italian National Election Survey (Vezzoni, 2014). The survey had 3,118 respondents and was fielded in May 2015 when negotiations on the second Greek bailout package made frequent headlines. By then, the Italian public has been exposed for quite some time to issues concerning fiscal policy in the Eurozone.

Participants are introduced to the concept of a fiscal union and they are asked for their support on a four-point scale from 'strongly against' to 'strongly for'. They are then further probed, pointing out its insurance purpose and possible distributive implications, and asked whether they would confirm their opinion (Supplementary Material (SM) for the question structure, wording and further analysis is available upon request).

### *Correlates of public support*

To account for economic self-interest, we use an indicator variable for employment status (inactive, unemployed, low and high income occupation) and a five-point self-assessment of family income. We also include a dummy variable if a respondent resides in a net contributing region. Partisan orientation is measured on a self-reported left-right scale ranging from 1 (left) to 11 (right). We use three variables for measuring

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[1] Cfr. "Grecia: Italia terzo creditore con 40 miliardi di prestiti", *La Repubblica*, 25-01-2015; "Debito, ecco quanti soldi deve la Grecia all'Italia", *Il Giornale*, 26-01-2015; "Quanto costa la Grecia al contribuente italiano", *Il Sole 24 Ore*, 28-01-2015.

[2] "Trust is the main obstacle to progress on Greece", *EUobserver*, 12-07-2015.

the attitudes toward the EU. In the first one, respondents assess whether EU membership is good, bad or neither. In the second, they report on a four-point scale how European they feel. As an alternative, the last measure asks subjects to answer, on a five-point scale, whether they feel more Italian or European. This variant assumes mutually exclusivity between the two identities. These measures capture the manifold combinations of meanings linked to national and European identity (Segatti and Westle, 2016). Finally, we include seven variables measuring trustworthiness of political institutions, trust in fellow Europeans, as well as interpersonal trust, and standard socio-demographic control variables. The SM includes additional information concerning the operationalization of these variables.

*Analysis*

Selected results are reported in Table 1 (see Table S1 in the SM for the full model). High income respondents oppose a fiscal union significantly more than both inactive and low income participants (models 1a-b).[3] After pointing out the implications of a fiscal union, the difference between high and low income subjects disappears and, at least in model 2a, they both oppose the scheme more than inactive subjects. These effects hover around 0.11 and 0.13 points of the four-point scale. Family income has no effect.

Partisan orientation and attitudes toward the European Union affect support substantively more than economic self-interest. As expected, left-wing participants are between 0.17 and 0.27 points more supportive than respondents at the other end of the ideological spectrum. Negative and positive assessment about EU membership separates participants by between 0.56 and 0.67 points; and a strong sense of European identity, either in absolute terms or relative to the national identity, has a similar large effect of between 0.31 and 0.59 points on support.

Most of the trust covariates do not correlate with support for a fiscal union but, notably, trustworthiness of the Greek government and (more weakly) interpersonal trust come into play after respondents are made aware of the implications of a fiscal union. In model 2a, support drops by 0.20 points among respondents with no trust, compared to those with high trust, in the Greek government. Low interpersonal trust has also a small but significant negative effect.

In sum, we have found support for most of the theories we discussed. Redistributive considerations also appear to dominate over insurance ones. However, among the respondents who switched their opinion after probing, high income earners were the most likely to move from opposition to support, while inactive and unemployed subjects were the least likely. We now examine our expectations in finer details with the use of the two conjoint analyses.

[3] The coefficients of high income respondents are -0.11 (se = 0.053) in model 1a and -0.16 (se = 0.054) in model 1b if low income participants is the reference category.

TABLE 1. SELECTED PREDICTORS OF SUPPORT FOR A FISCAL UNION

| | **Not probed (1a)** | **Not probed (1b)** | **Probed (2a)** | **Probed (2b)** |
|---|---|---|---|---|
| Employment: Unemployed | -0.0543 (0.0812) | -0.112 (0.0839) | -0.102 (0.0857) | -0.121 (0.0893) |
| Employment: Low income | -0.0650 (0.0472) | -0.0384 (0.0483) | -0.114** (0.0498) | -0.0801 (0.0513) |
| Employment: High income | -0.179*** (0.0548) | -0.194*** (0.0558) | -0.130** (0.0576) | -0.134** (0.0593) |
| Left-Right Partisanship | -0.0202*** (0.00721) | -0.0166** (0.00726) | -0.0266*** (0.00738) | -0.0253*** (0.00763) |
| EU Membership: Bad | -0.284*** (0.0646) | -0.286*** (0.0645) | -0.311*** (0.0643) | -0.318*** (0.0653) |
| EU Membership: Good | 0.313*** (0.0489) | 0.383*** (0.0493) | 0.250*** (0.0530) | 0.294*** (0.0532) |
| European Identity | 0.181*** (0.0298) | | 0.197*** (0.0318) | |
| Italian vs. European Identity | | 0.103*** (0.0228) | | 0.145*** (0.0252) |
| Trustworthiness: EU | 0.0204 (0.0316) | 0.0306 (0.0317) | -0.00130 (0.0351) | -0.00170 (0.0350) |
| Trustworthiness: Italian Government | 0.00774 (0.0265) | 0.0187 (0.0272) | 0.0379 (0.0281) | 0.0474 (0.0289) |
| Trustworthiness: Greek Government | 0.0298 (0.0304) | 0.0238 (0.0312) | 0.0680** (0.0321) | 0.0534 (0.0328) |
| Trustworthiness: German Government | 0.0270 (0.0303) | 0.0346 (0.0309) | 0.00452 (0.0329) | 0.0142 (0.0339) |
| N | 1,845 | 1,757 | 1,845 | 1,757 |
| R-squared | 0.270 | 0.261 | 0.246 | 0.229 |

*Notes*: See the full model in Table S1. OLS coefficients with robust standard errors in parentheses. ***p < 0.01, **p< 0.05, *p < 0.1. Reference categories: Employment: Inactive; EU Membership: Neither. Models 1a and 1b: original attitudes on fiscal union, models 2a and 2b: attitudes after pointing out insurance and distributive implications.

## Two Conjoint Analyses on Economic Policy and Fiscal Union

Conjoint analysis is an experimental method that allows isolating the aspects that influence a respondent's choice over an issue that is characterized by multiple features. It has been employed only very recently in political science (e.g. Hainmueller and Hopkins, 2015), but it is particularly useful in our context because a fiscal union is one component of the Eurozone mix of economic policies and because support is likely to depend on the specific features of the scheme.

We have designed two conjoint experiments. In the first one, respondents are asked, after an explanation of the exercise, to choose between pairs of economic policy programs, which consist of both policy measures and economic objectives. Expansion of EU fiscal capacity is one of the policy measures: a program can propose to keep the provision of social services and taxation as a national prerogative or to develop EU-wide welfare state provisions, either adding or replacing national policies (see Table S3 in the SM). This experiment was fielded in June 2014, right after the European Parliament elections when attention about these issues was high.

Programs include other two measures that are worth discussing briefly. The first captures the attitudes toward the common currency, offering the possibility of keeping or ditching the euro. The second proposes to keep, tighten or loosen the EU rules overseeing national fiscal policies. The single currency and the fiscal rules are peripheral to our investigation but they are obviously related to the discussion over a fiscal union. Leaving the monetary union or loosening fiscal oversight would make a fiscal union redundant. Moreover, these issues were center stage in the electoral campaign for the European Parliament.

The 3,026 participants come from the second wave of the population-based internet panel of the Italian National Election Survey, which included pre- and post-European Parliament election surveys. The experiment was included in the latter.

The second conjoint analysis deals directly with features of a fiscal union scheme. It was fielded in May 2015 and positioned after the survey question and the probing follow-up question discussed in the previous section. Participants were therefore aware of the purpose of a fiscal union; 2,656 individuals participated in both conjoint analyses.

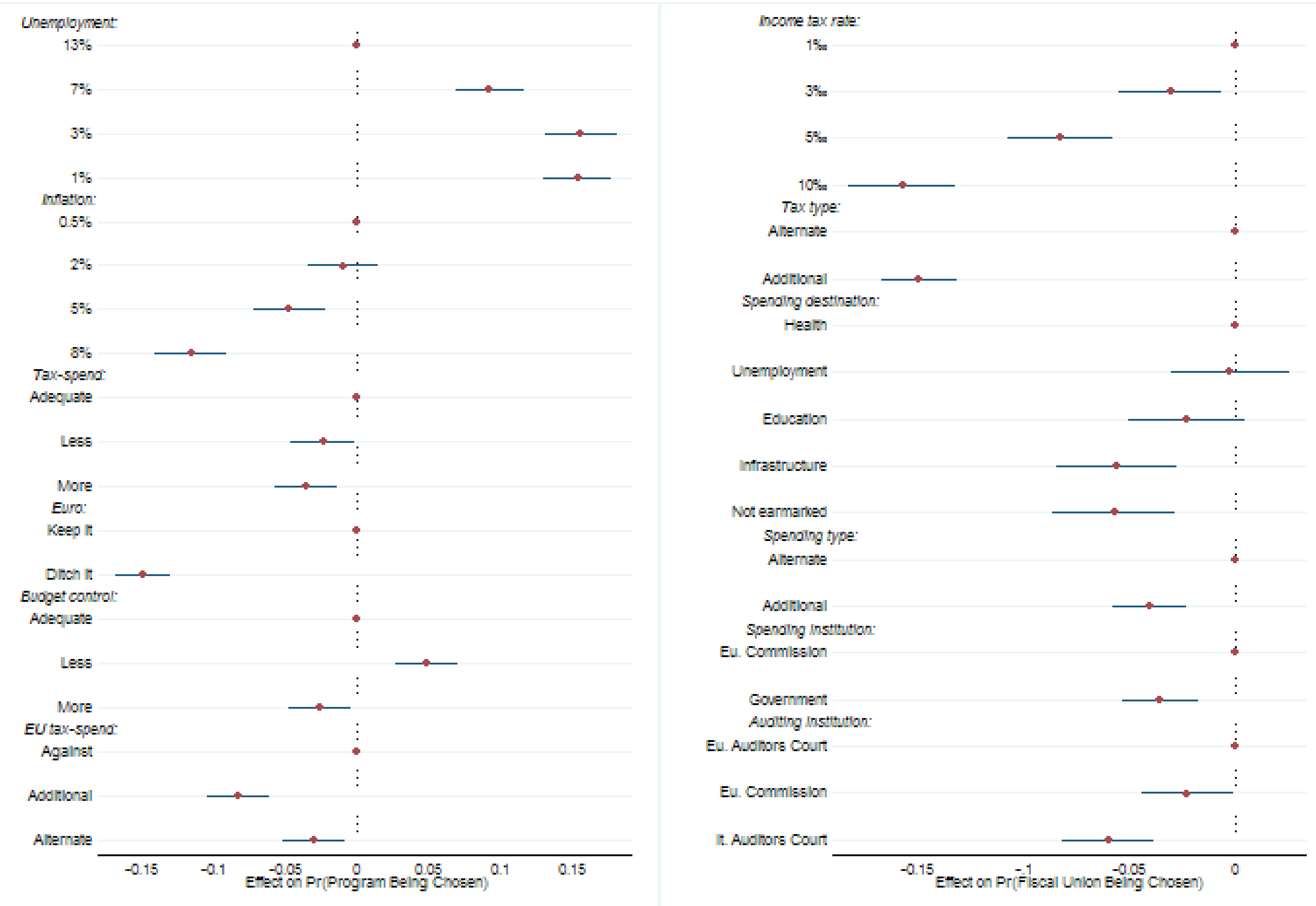
In the fiscal union conjoint analysis, each scheme is characterized by six attributes and each attribute takes between two and five values (see Table S4 in the SM). The first two features are the income tax rate and the nature of taxation, that is, whether the tax should be in addition to or replacing the current tax burden. The next two deal with the destination of the expenditure and whether it should add or replace current expenditure. The last two items include the institutions that should be responsible for spending and auditing.

The core of these experiments consists of two tasks where respondents are requested to choose between pairs of economic policy programs and fiscal unions. Table S5 illustrates an example of a choice task in the fiscal union conjoint experiment. Participants are first asked to choose between two schemes and then to rate them on a scale ranging from 'strongly against' to 'strongly for'. We employed the randomized variant of conjoint analysis recently proposed by Hainmueller, Hopkins and Yamamoto (2014) that does not require any assumption about choice probabilities. Attribute values are randomized across economic programs and fiscal union schemes. The orders of the attributes, as they appear in Tables S3 and S4, are randomized across respondents in order to minimize recency and primacy effects, without being cognitively too burdensome. Diagnostic tests for framing effects are reported in the SM.

## Economic policy priorities and the properties of a fiscal union

We present here the broad results from the two conjoint experiments. Figure 1 shows the average marginal component effects (AMCEs, see Hainmueller *et al.*, 2014) of each attribute value on the probability that participants choose a given economic policy program (left panel) and fiscal union scheme (right panel). In the left panel, the reference categories are the conditions at the time of the survey (13 percent unemployment rate, 0.5 percent inflation rate, no changes to taxation and spending and to budgetary oversight, euro as the national currency, no expansion of EU fiscal capacity).

Figure 1. Effects of attributes on the probability of an economic policy program and a fiscal union scheme being chosen




*Notes*: AMCEs from model 1 in Tables S6 and S7. Dots indicate point estimates, while lines the 95 percent confidence intervals. The reference categories are represented by dots with no confidence intervals.

Consider first our core attribute of interest at the bottom of the left panel in Figure 1. Economic policy programs that propose to expand EU fiscal capacity are opposed. Respondents want to keep these policies national. If a supranational policy is proposed in addition to the current national one, a program is 8.3 percentage points (se = 1.10) less likely to be preferred. If it replaces current policies, it is 3 percentage points (se = 1.10) less likely to be preferred. Additionality is also penalized over substitution (F-test p-value > 0.00).

These results must be read in context though. Respondents also consider the oversight the EU exercises over national budgets too intrusive,[4] but leaving the Eurozone is clearly the most heavily penalized attribute of any program. A policy with such a measure is 15 percentage points (se = 0.96) less likely to be preferred over one that keeps the common currency. This clearly overruns concerns about oversight and expansion of fiscal capacity.

The only other significant issue that is at par with the euro is the unemployment objective. The top half of the left panel in Figure 1 shows that programs tolerating higher inflation or proposing a change in domestic taxation and spending are opposed, but these effects are smaller compared to the large rewards for lower unemployment. They indeed rival the euro effect: a program that foresees no improvement over the 13 percent unemployment rate is as much penalized as one that advocates leaving the Eurozone (F-test p-value > 0.68).

The right hand panel of Figure 1 displays how features of a fiscal union affect the choice of a scheme. The reference categories are the most preferred ones: alternate tax rate of 1 per thousand, alternate spending on health, European Commission as the spending institution and European Court of Auditors as the auditing institution.

Tax rates and type exercise the largest substantive effects. Schemes with higher tax rates are less likely to be selected. A fiscal union with a 10 per thousand tax rate is 15.7 percentage points (se = 1.28) less likely to be preferred over a scheme proposing only a 1 per thousand rate. The effect is clearly monotonic. Furthermore, an additive scheme is 14.9 percentage points (se = 0.89) less likely to be chosen over an alternate one. These results corroborate the expectations of the Meltzer and Richard (1981) model.

Health, unemployment benefits and education spending are preferred to infrastructural spending or no earmarking, however an alternate spending scheme is 4 percentage points (se = 0.88) more likely to be chosen over an additive one. There is also a clear preference for the involvement of supranational organizations. A scheme where the European Commission is in charge of spending is 3.6 percentage points (se = 0.91) more likely to be preferred over one where national governments are involved. Scrutiny by the European Court of Auditors is 2.2 and 6 percentage points (se = 1.10 and 1.11) preferred over scrutiny by the Commission and the Italian Court of Auditors respectively. The Commission is preferred over the national court.

[4] Proposing looser control is 4.8 percentage points (se = 1.08) more likely to be preferred over keeping the status quo. Advocating tighter rules is 2.6 percentage points (se = 1.10) less likely to be preferred.

In sum, respondents are unwilling to pay for the scheme and economic self-interest appears to play quite a prominent role. The economic policy experiment reveals the strong attachment to the euro, but also its fragility if the Eurozone were unable to deliver an acceptable economic performance, especially in term of employment. We will go back to this point later but first we investigate, in finer details and in light of the theories discussed above, how individual traits explain attitudes toward the components of a fiscal union.

## Respondent characteristics, economic policies and the properties of a fiscal union

We examine here the interactions between each of the respondents' characteristics (economic self-interest, partisan orientation, attitudes toward the European Union and trust) and the attributes of the two conjoint analyses. We discuss only the significant results within the scope of our inquiry, but we will not cover spending destinations due to space constraints (results tend to be in line with expectations, see the SM for a fuller discussion). The full set of regressions is available in Tables S8-16 in the SM. Tables S17-18 include models with all the correlates to show that the results hold in expectation.

### *Employment status and economic benefits*

Figure 2 displays the estimated marginal effects derived from a model with interactions between employment status and attributes of economic policy programs (left panel) and of fiscal union schemes (right panel). We begin with the core attribute of interest in the left panel: high income subjects differ from other groups in their opposition to a fiscal union if the scheme replaces national programs (but not in case of an additive scheme). The conditional AMCE for the "alternate EU tax-spend" attribute in the high income subsamples is significantly larger than the AMCE in the low income (F test p > 0.036) and unemployed subsamples (F test p > 0.067). This is in line with Meltzer and Richard (1981) model.

Note also that the fight against unemployment is clearly a top priority for respondents in low income occupations,[5] reflecting higher perceived job insecurity and lower employability, at least compared to higher income occupations. This income group is also a stronger advocate of less intrusive budgetary oversight[6] and, together with unemployed subjects, a weaker supporter of the euro[7] than inactive and high income participants. These results are coherent

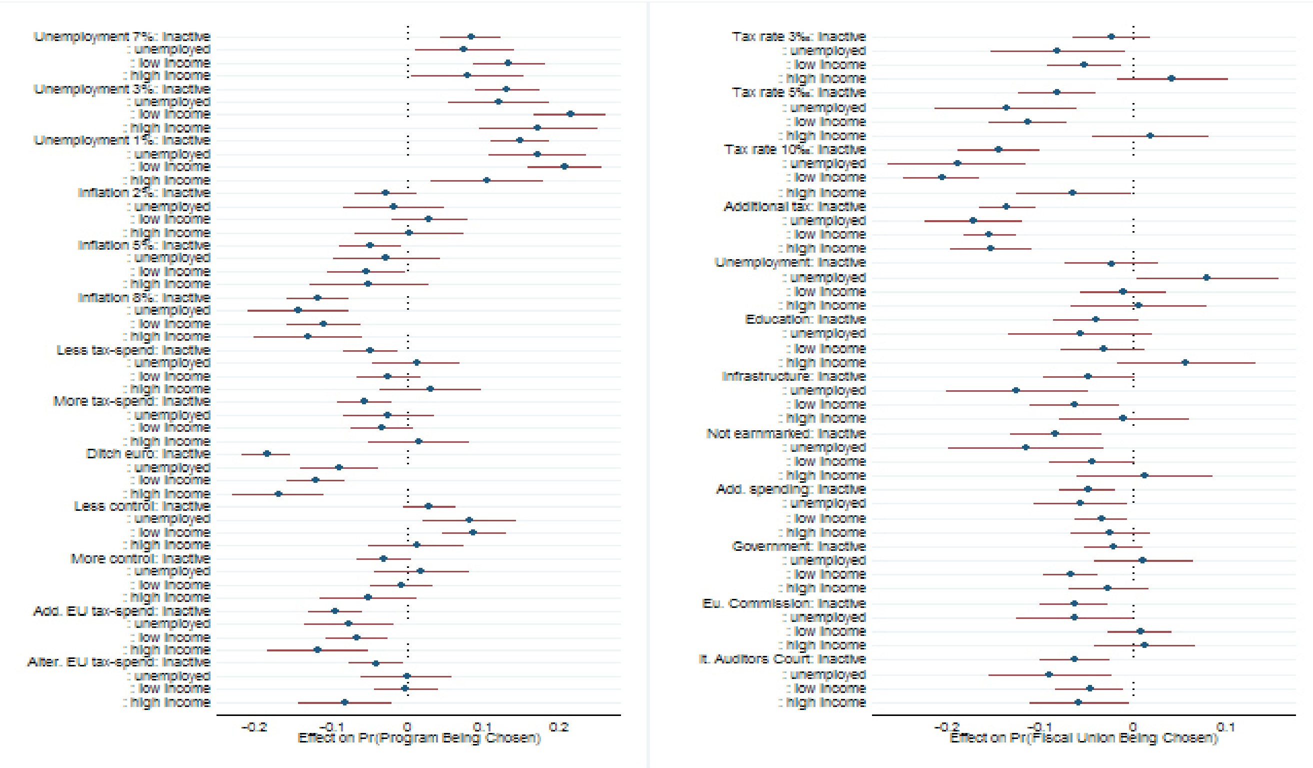
[5] They are 8.3 percentage points (se = 3.20) and 9.3 percentage points (se = 4.10) more likely to choose an economic program proposing 3 percent unemployment rate than, respectively, inactive and unemployed participants. They are 10.3 percentage points (se = 4.54) more likely to select an unemployment rate objective of 1 percent than participants in higher income occupations.

[6] Low income respondents are 5.9 percentage points (se = 2.76) and 7.5 percentage points (se = 3.83) more likely to prefer less oversight than inactive and high income participants.

[7] The conditional AMCEs for the "ditch euro" attribute in the unemployed and low income subsamples differ significantly from the AMCEs in the inactive subsample (p > 0.002 and p > 0.009, respectively), and in the unemployed subsample from the high income subsample (p > 0.043).

with the literature on attitudes towards the EU in general and the euro in particular (e.g. Banducci *et al.*, 2003; Gabel, 2000, 1998). We will go back to these findings below.

Figure 2. Effects of Program and Scheme Attributes on Probability of Being Selected by Employment Status



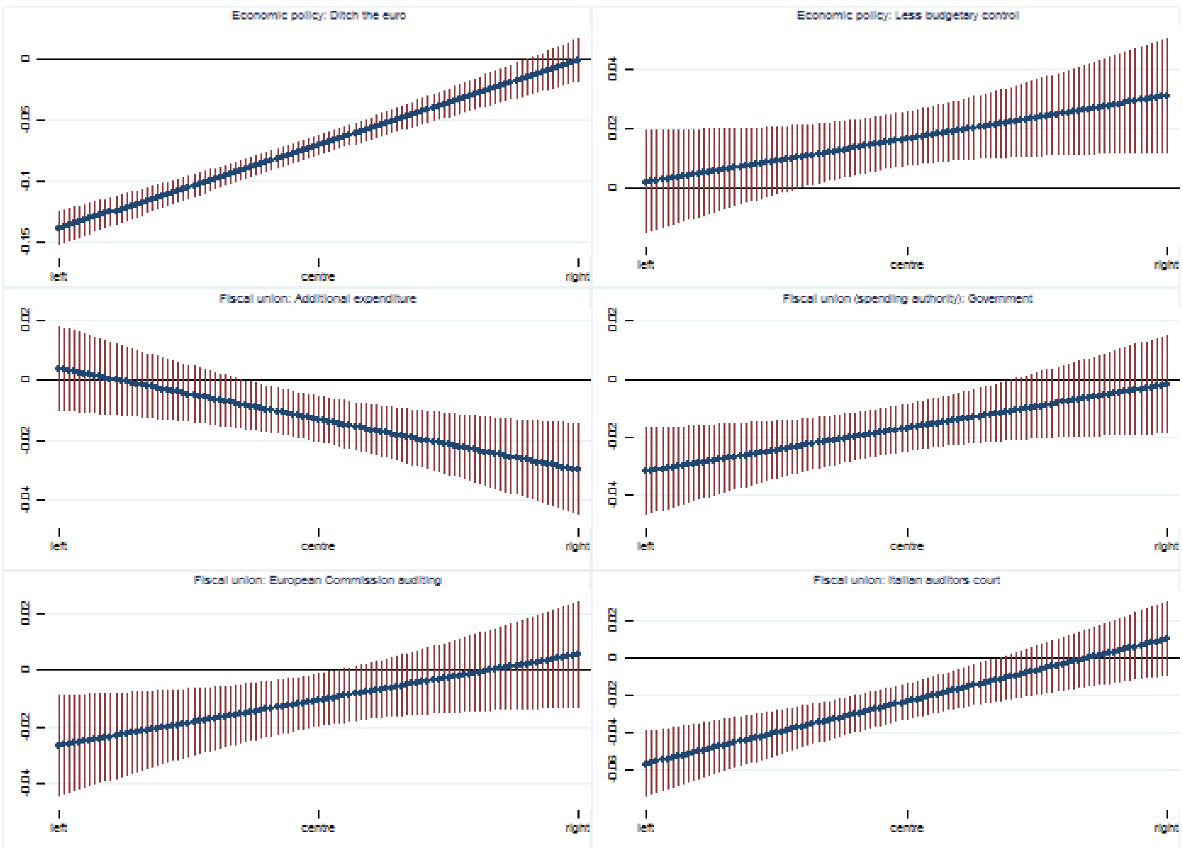

The right hand panel of Figure 2 offers further illuminating insights. Here, high income respondents behave differently. The effect of the tax rate is still monotonic but it is shifted rightward so the coefficients of the 3 per thousand and 5 per thousand tax rates are now positive, although they do not differ significantly from zero. In other words, these individuals are indifferent between schemes proposing a 1 per thousand, 3 per thousand or 5 per thousand tax rate. And they penalize a fiscal union with 10 per thousand rate significantly less than other participants.[8] In line with the insurance perspective, high income participants display greater willingness to pay. Let us clarify this finding. The analyses based on the survey question and the first conjoint experiment show that high income respondents oppose a fiscal union more than other groups. However their contribution, as long as it is low, is not a discriminating factor on which they base their choice between different schemes.

[8] The conditional AMCEs for this attribute in this subsample differ significantly from the AMCEs in the inactive (p > 0.038), unemployed (p > 0.012) and low income (p > 0.001) subsamples. Attitudes toward additionality of taxation and spending do not differ.

*Left-right Ideology*

Figure 3 displays selected marginal effects derived from models with interactions between self-reported left-right ideology and the features of economic policy programs (top row) and of fiscal union schemes (middle and bottom rows). Interestingly, ideology does not separate respondents in their attitudes toward EU taxation and spending.[9] There is also limited evidence that right-wing participants are less willing to contribute (they are only more likely to reject schemes with the highest tax rate, F-test p-value > 0.022). More in line with expectations, these respondents oppose schemes with additional spending (see left panel second row Figure 3).

FIGURE 3. EFFECTS OF SELECTED ATTRIBUTES ON PROBABILITY OF ECONOMIC PROGRAM OR FISCAL SCHEME BEING SELECTED BY IDEOLOGY




*Notes*: Clockwise from top left panel F-test p-values greater than: 0.000; 0.072; 0.035; 0.000; 0.043 and 0.009. The Commission is also preferred to the national court of auditors by left-wing subjects (F-test p-value > 0.033).

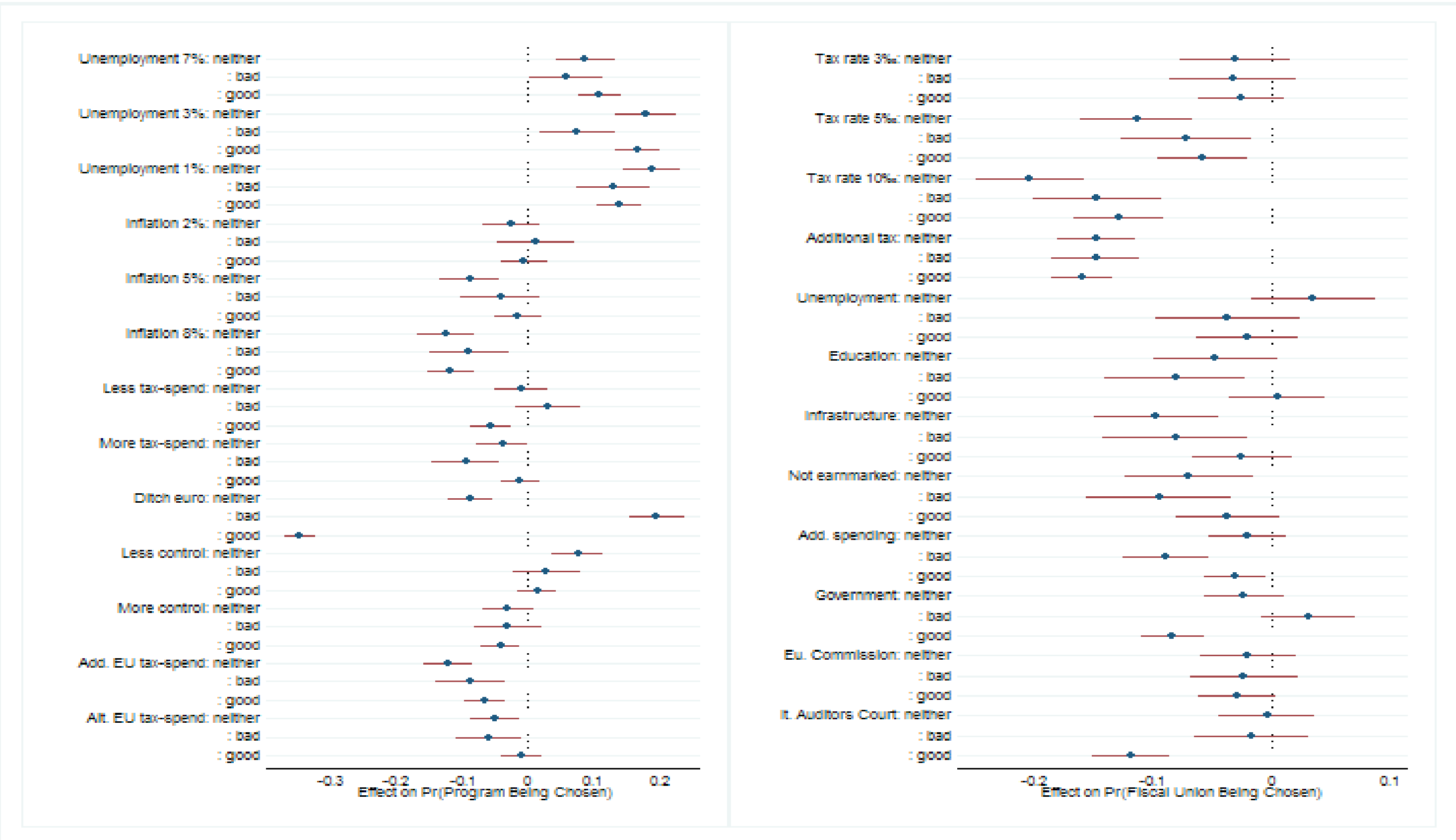
[9] Ideology affects mostly attitudes about national taxation and spending. Right-wing respondents reward, whereas left-wing subjects penalize, spending cuts and lower taxes (F test p > 0.000); additionally, right-wing respondents sanction higher spending and taxation (F-test p > 0.038).

The remaining panels of Figure 3 illustrate the stronger internationalist orientation of left-wing individuals. A fiscal scheme that is centered on national, rather than supranational, institutions is penalized by left-wing participants, compared to right-wing subjects. Equally noteworthy in the top two panels is that right-wing respondents penalize ditching the euro less severely than left-wing participants and they (weakly) reward less budgetary control.

*Attitudes toward the European Union*

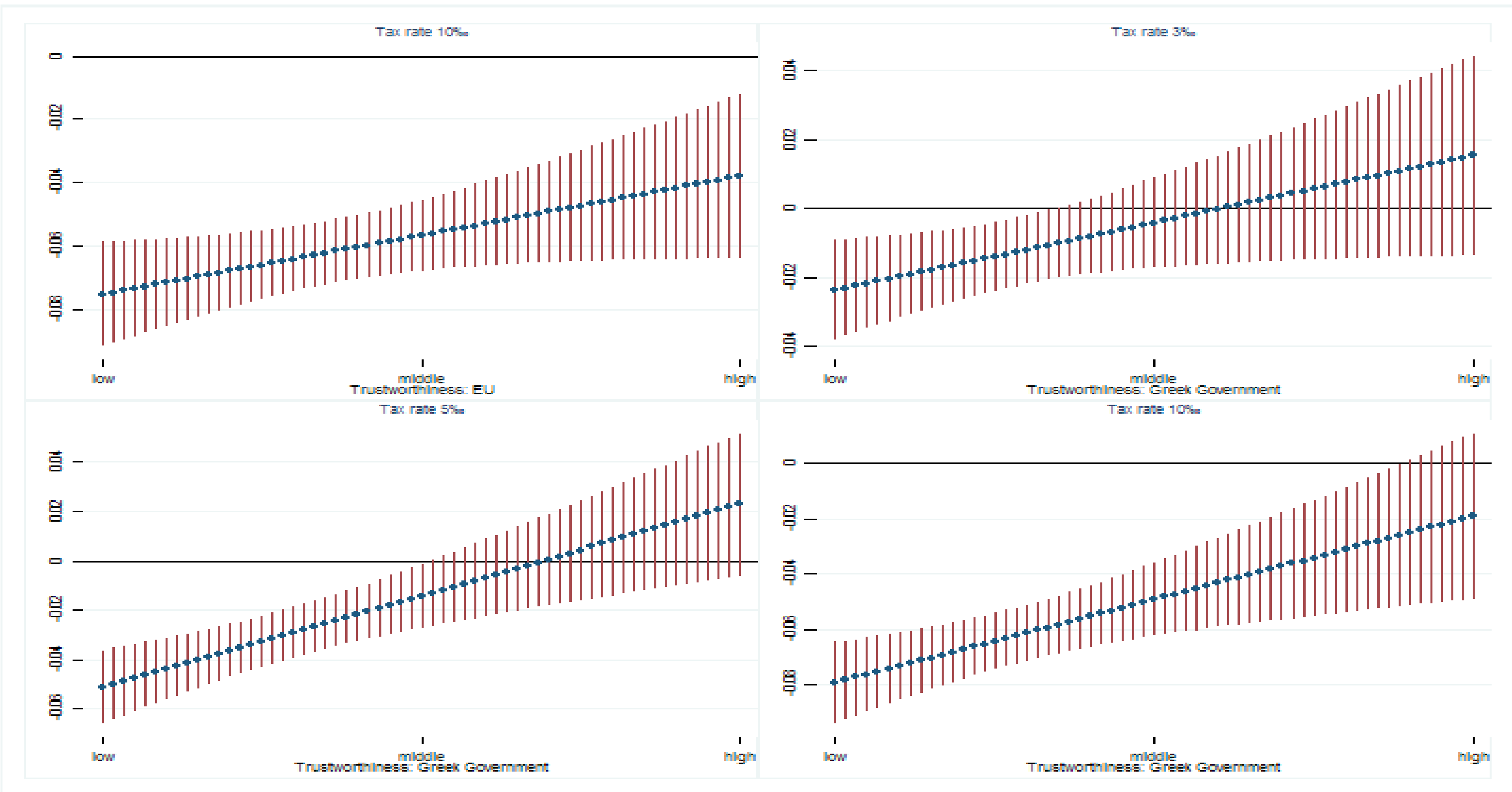
Figure 4 displays the marginal effects of models interacting assessments about EU membership and attributes of economic policy programs (left panel) and of fiscal union schemes (right panel). Beginning with the left panel (bottom half), the most interesting result is the lack of significant interactions between good and bad evaluations and the features concerning EU budgetary oversight and fiscal capacity (those providing a neutral assessment seem to differ most). On the other hand, evaluation of EU membership is the most important correlate of support for the euro. Those who assess positively EU membership are 54 percentage points (se = 2.46) more likely to reject a program ditching the euro than respondents evaluating membership negatively. This resonates well with the existing literature.

FIGURE 4. EFFECTS OF PROGRAM AND SCHEME ATTRIBUTES ON PROBABILITY OF BEING SELECTED BY ASSESSMENT OF EU MEMBERSHIP



Some differences emerge more clearly in the right-hand panel. Positive and negative evaluators still do not display a markedly dissimilar willingness to contribute. However, additional spending is more strongly opposed by respondents that are critical of membership, while those that have positive views are particularly opposed to schemes that are centered on national institutions.[10] If we replace evaluations of EU membership with measures of European identity, we obtain a similar picture (see the discussion of Figure S3 in the SM).

FIGURE 5. EFFECTS OF SELECTED FISCAL UNION TAX RATES ON PROBABILITY OF BEING SELECTED BY TRUSTWORTHINESS




*Notes*: The reference category is the 1 per thousand tax rate. Clockwise from top left panel F-test p-values greater than: 0.046; 0.002; 0.000; 0.040.

[10] Respondents criticizing membership are, respectively, 5.8 and 6.8 percentage points (se = 2.28 and 2.50) more likely to oppose additional spending than positive and neutral subjects. Positive evaluators are, respectively, 6 and 11.4 percentage points (se = 2.17 and 2.42) more likely to reject national governments as spending institutions than neutral and negative respondents. They are also 11.5 and 10.16 (se = 2.63 and 2.95) percentage points more likely to reject the national over the European Court of Auditors than neutral and negative respondents (10.6 and 9.6 percentage points (se = 2.57 and 2.94) when comparing the national court with the European Commission).

*Trustworthiness*

We conclude our analysis assessing the impact of trustworthiness of political authorities. Figure 5 displays the significant marginal effects derived from models with interactions between assessments of trustworthiness, employed in Table 1, and attributes of fiscal union schemes. Lower trustworthiness leads respondents to oppose more strongly schemes with higher tax rates. Trustworthiness of the EU matters only when the highest tax rate is compared with the lowest one (see upper left panel of Figure 5).[11] For smaller differences, it has no impact. On the other hand, low trustworthiness of the Greek government dampens the willingness to contribute across the whole range of tax rates. Respondents who assign low trustworthiness are significantly more likely to reject a scheme than more trustful respondents, even when a 3 per thousand tax rate is compared to a 1 per thousand rate. We also find that lower trustworthiness of the EU dampens support for additional spending, while high trustworthiness strengthens support for the Commission as the spending institution (F-test p-values > 0.010 and 0.015).

## Economic performance, support for the euro and for a fiscal union

We conclude the analysis highlighting the key policy trade-offs underpinning the adoption of a fiscal union. We then briefly summarize the main results.

The debate about this policy originates from the consideration that, at least by the standards of monetary unions in developed economies, the policy mix of the Eurozone is inadequate: while constraining national public spending, it has no credible fiscal mechanism to facilitate macroeconomic adjustment within member countries. This inadequacy results from well-known political dynamics (Jones *et al.*, 2015; Schimmelfennig, 2015) and it has predictable consequences when facing economic shocks: increased divergence.

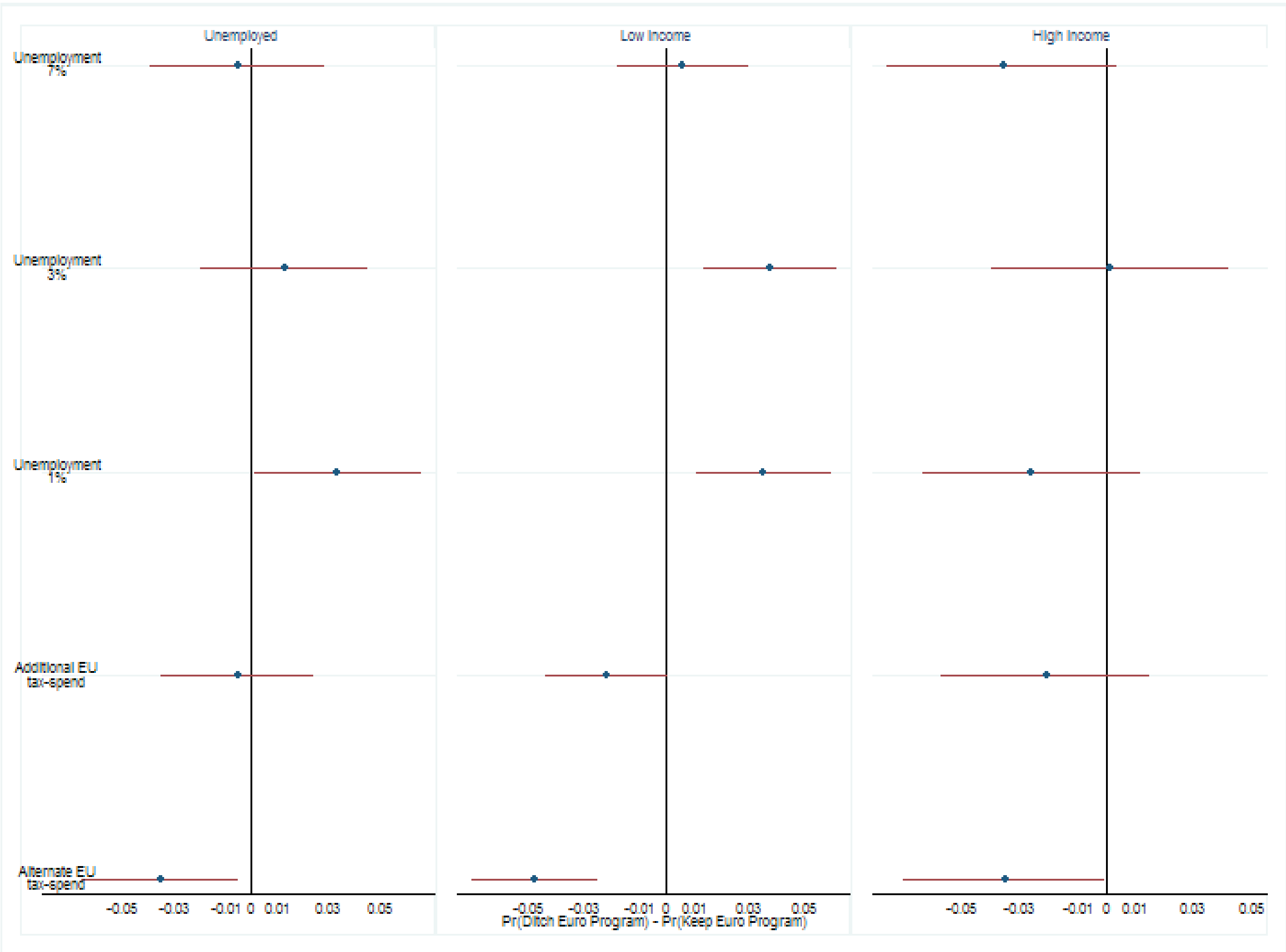
European policymakers readily admit this (Juncker, Tusk, Draghi *et al.*, 2015: 4), but reforming a policy requires trade-offs. We focus here on the key relation between economic performance and the euro-fiscal union policy mix. Public support for the single currency is centerpiece here and we know that, despite the piecemeal reforms, it has remained high during the crisis. This aggregate trend however hides important changes in the structure of support, both across and within countries. At the individual level, utilitarian considerations have become even more important than affective ones (Hobolt and Wratil, 2015). At the country level, higher unemployment has sapped support for the currency and trust in the European Central Bank (Roth *et al.*, 2015). After 2010, average support is lower than in the period since its launch in all original members, except for Finland, Germany, Greece and the Netherlands.

[11] This is also the case for interpersonal trust, see Figure S4.

Aside from identity considerations, there is broad agreement – and the economic policy conjoint experiment confirms it - that individuals with high income and high human capital are the core constituency supporting and benefiting from European integration and the single currency (e.g. Banducci *et al.*, 2003; Gabel, 1998, 2000; Hakhverdian *et al.*, 2013; Hobolt and Wratil, 2015). But how much is the euro really worth?

Figure 6 displays the differences in the estimated probability that a program that advocates ditching the euro is chosen over one that wants to keep the currency. Estimates come from the first conjoint analysis. Positive values mean that the "ditch-the-euro" program is preferred. For the top three cases, this program also delivers lower unemployment. For the bottom two cases, the "keep-the-euro" alternative includes a fiscal union.

FIGURE 6. DIFFERENCES IN PROBABILITY OF A "DITCH-THE-EURO" PROGRAM BEING PREFERRED




*Note*: Other program attributes are kept at their current values.

Unemployed and low income respondents are readily willing to leave the Eurozone for lower unemployment. For instance, low income respondents are 3.8 percentage points more likely to prefer a program that delivers 3 percent unemployment rate, but ditches the euro, over one that keeps the single currency and the current 13 percent rate. On the other hand, there is no unemployment level that would convince higher income respondents to leave the Eurozone. Moreover, these participants are 3.5 percentage points more likely to prefer keeping the euro with an alternate fiscal union over ditching the common currency. Even an additive scheme does not tip the balance in favour of dropping the euro. Given the pro-European inclinations of high income subjects, these are lower bound estimates and, needless to say, a fiscal union which prevents short-term unemployment to become structural would be even more welcome.

Summing up the other results, the fiscal union conjoint experiment offers further illuminating insights. If we consider the willingness to contribute, as measured by the tax rate and type, high income respondents not only do not oppose additional taxation more than other income groups, but they are also indifferent among low tax rates and penalize higher rates less than other groups. High income participants are therefore more willing to pay for the fiscal union insurance. This result is notable because the experiment was fielded during the Greek bailout negotiations when redistributive considerations were probably more publicly visible than insurance ones.

This is not to say that the policy would be controversial. Analyses of both the survey question and the economic policy conjoint experiment corroborate the expectations that high income right-wing participants with low trust, weak European identity and negative assessment of EU membership are more likely oppose it (though, ideology and assessment lose relevance in the conjoint experiment and income comes into play only in case of alternate schemes). Also as predicted by Meltzer and Richard's (1981) model, the fiscal union conjoint experiment shows that, all else being equal, respondents prefer a fiscal union with a lower and alternate tax rate. Softer factors play some role as well. Low trustworthiness, especially of the Greek government, undermines the willingness to contribute. In the SM, we show that respondents feeling more Italian than European are less willing to contribute.

Lastly, attitudes toward spending and institutions are also as expected. Right-wing participants with a negative assessment of membership or low trust of the EU oppose additional spending (the SM discusses spending destinations). Left-wing respondents with stronger European identity or a positive opinion about EU membership prefer supranational involvement in both spending and auditing.

## Concluding remark

There is no doubt that the pathologies of EU political decision-making are significant barriers for the adoption of a fiscal union. Some governments, especially in Northern

European countries, that have also been net contributors to the bailout programs, have been very reluctant. Admittedly, official proposals have a hollow ring because they often refer to economic convergence as a key prerequisite, conveniently ignoring that the lack itself of fiscal stabilization may be a cause of divergence. Nevertheless, the issue will resurface when the next recession hits and recalcitrant governments have demonstrated in the past a willingness to take unwelcome steps to save the currency. According to Luque, Morelli, and Tavares (2014), higher income volatility could make a fiscal union a necessary and, under some conditions, a feasible step for the survival of the monetary union. Specific proposals are beyond our purpose, but our contribution reaches a perhaps surprisingly optimist conclusion: a fiscal union may be politically feasible. High income individuals, likely net contributors of the policy but also supporters and beneficiaries of the single currency, display greater willingness to contribute. Our findings may be conditioned by country-level variables that are omitted in our single country study, but both the redistributive and insurance perspectives do not suggest obvious reasons why these results would not apply to other higher income countries that have made similar per-capita contributions to the recent bailout programmes. One would need to argue that redistribution is assessed more negatively or that insurance is not a normal good in these countries. Further research will tell.

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## Abstract

We investigate public attitudes toward the fiscal union: a policy advocated in official European Union documents and designed to address asynchronous economic fluctuations in the Eurozone. We employ survey questions and conjoint analyses embedded in population-based panel surveys in Italy, and draw expectations from political economy theories of tax-and-transfer public insurance schemes, and theories of party cues, identity and trust. High income right-wing individuals with low trust, weak European identity and negative assessment of EU membership are more likely to oppose the measure. However, high income respondents display greater willingness to pay, especially in order to keep the euro, whereas lower income participants are readier to ditch the currency if the monetary union does not deliver good economic performance. The political feasibility of this policy seems therefore to rest on the willingness to contribute by the core constituency supporting the euro.

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