Fiscal policy challenges for Europe

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The fiscal policy framework in Europe is complex and, in many respects, unsatisfactory. Yet, paradoxically, the principles underlying the framework are quite straightforward: Member States retain full competence and are supposed to pursue policies consistent with fiscal sustainability as part of a stability-orientated macroeconomic policy. They are expected to exercise fiscal discipline in line with the Stability and Growth Pact (SGP) and related obligations, as well as the Fiscal Compact agreed in 2012 as part of the separate inter-governmental Treaty on Stability, Coordination and Governance. They are also, according to articles 121 (for all Member States) and 136 (Eurozone) of the Treaty (TFEU) expected to ‘regard their economic policies as a matter of common concern’. Provisions for coordination across countries are designed to avoid damaging spillovers, but supranational public expenditure is confined to a narrowly defined set of largely allocative tasks.

Insofar as fiscal policy is to be used for macroeconomic stabilisation, Member States are further expected to generate ‘fiscal space’ in good times, enabling automatic stabilisers and some discretionary policy to act in bad times. The trouble is that doing so is politically difficult because of a double difficulty. Governments with strong public finances come under pressure to cut taxes or boost public spending, the more so if there is seen to be a windfall gain in tax revenues. Governments with weak public finances, having often already struggled to push through austerity programmes, are expected to take their foot off the brakes when the economy starts to recover. In both cases the political incentives for the public sector to ‘consolidate’ – the euphemism for cutting deficits – are lacking.

Equally, there are wider challenges confronting fiscal policy in the EU. Discontent about the social consequences of tough austerity policies has led to political backlashes and cast doubt on the validity of the rules-based policy framework. In all Member States, albeit to differing degrees, the population is ageing and there is a need to anticipate future demands on public spending, including by increased public saving today, so as not to over-burden the next generation. Reducing public investment is often the preferred method of cutting public spending, because it has a less immediate effect on citizens, but not enhancing public assets can have an adverse effect on growth prospects and means the legacy left to the next generation is less generous.

This chapter looks at the challenges facing fiscal policy in Europe, highlighting the trade-offs. The next section revisits the debate on fiscal rules, asking whether their role in fiscal policy needs to be re-thought. Prompted by recent analyses from prominent economists, the case for a different approach to public debt and, more generally, the austerity paradigm is then examined, drawing attention to dilemmas around public debt, fiscal sustainability and public investment. Reflections on fiscal governance and conclusions complete the paper.
Should rules still rule?

This deficit bias in public finances is well-known and lies behind the various mechanisms deployed to constrain governments, principally through rules aimed at keeping them on a path towards sustainable fiscal policies. The principles behind good fiscal rules have been much discussed in the academic world, while the IMF and other international agencies have long championed increased resort to rules. Frequently cited work by Kopits and Symansky sets out eight key features of a ‘good’ fiscal rule: it should be ‘well-defined, transparent, simple, flexible, adequate relative to the final goal, enforceable, consistent with other policies, and underpinned by public finance reforms’.

Rules have proliferated in Europe and have also been increasingly adopted elsewhere. According to the database maintained by DG Ecfin of the European Commission, the number of rules in force across the EU28 rose tenfold between 1990 and 2016, from just 11 to 105. Much of the increase occurred in the last five years, with an increase from 64 in 2012 to 105 in 2016, to attain an average of nearly four per Member State. This is explained by the various agreements intended to enhance fiscal discipline, notably the Fiscal Compact which obliged Member States to adopt domestic rules consistent with adhering to the SGP. Three problems have, however, become evident:

- First, rules have become increasingly complex, leading to criticism that they have gone too far. Thus Marco Buti, the Director-General of DG Ecfin of the European Commission, argues that the underlying objectives of EU rules – anchoring public debt while leaving room for fiscal policy to stabilise the economy – are hard to discern ‘in a framework which is overly complicated and suffers from an “authority gap” from the centre’. Buti then interprets the problem to be one of trust, implicitly highlighting the crucial political economy challenge of a reconciling national sovereignty in fiscal policy with the exigencies of conducting a common macroeconomic policy. Even the German Finance Ministry, in a so-called ‘non-paper’ released in 2017 criticised EU rules for having ‘become much too complex and unpredictable’.

- Second, with so many rules in operation, they can conflict with one another, leading to confusion within government about which rule to follow, but also confusing other economic actors concerned to anticipate how governments will react. There are also instances when rules point to different policy actions, or (especially where they rely on indicators that are empirically hard to measure, such as the output gap).

- The third concern with rules is implementation. At national level, some rules bite harder than others, especially if they are legally strongly embedded, as is the case with constitutional debt limits. At EU level, the European Commission is responsible for analysis, monitoring and proposing sanctions if it deems rules to have been breached, but the decision on sanctions is taken by the Member States sitting as the Council of

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1 https://www.bookstore.imf.org/books/title/fiscal-policy-rules
Ministers. Otmar Issing, former chief economist of the ECB, described this situation as one in which potential sinners pass judgment on actual sinners (cited in an IMF analysis of the Eurozone edited by Petya Koeva Brooks and Mahmood Pradhan\(^3\)). Despite all the breaches of the deficit threshold over the years, no Member States has had the financial sanctions provided for in the relevant regulations imposed on it. Similarly, a political compromise allowed the autumn 2018 dispute between Italy and the Commission over the draft Italian budget for 2019 to be resolved (at least temporarily) without obliging Italy to conform fully to the rule.

When to diverge from rules and whether provisions about exemptions from rules can be adequately codified are further questions. Some flexibility is needed, but where to draw the line is problematic. The obvious danger is that once countries become used to applying flexibility, they will continue to expect to use it, resulting in a progressive undermining of discipline. The Commission issued guidance in 2015\(^4\) spelling out what would be countenanced, although the document is at pains to stress that it is about interpretation rather than changing the rules, identifying three main areas where there should be latitude:

- Policies which boost investment will be favourably regarded with contributions to the European Fund for Strategic Investment (EFSI) favoured. The implication is that a one-off increase in the deficit or debt does not alter the underlying structural values for these variables. The logic is that, precisely because it is one-off, it does not alter the sustainability of fiscal policy. This reasoning can be defended for the deficit, but is more dubious for the debt, because an increase in debt would have an enduring effect on the level of future debt service charges, unless the assets funded by the public investment generate a sufficient return.
- Second, if structural reforms offer the prospect of higher growth or lower future demands on the public purse – pension reforms, for example – they can justify breaching the rule.
- Cyclical conditions are the third, with governments allowed more latitude in approaching their medium-term fiscal consolidation objectives (MTO) in a downturn, perhaps reflecting the criticism that demands for consolidation were over-done in the crisis years.

Escape clause are, inevitably, highly political and one of the big challenges for fiscal policy is to reconcile the political and economic reasoning behind them. If exceptions are allowed too often, they undermine any credibility in rules. But if rules are applied too rigidly, they may fail to take account of changed circumstances and lead to inappropriate policy choices. The trouble is often that the decision-making procedures lack the required flexibility and major crises are a case in point. The financial crisis of the late 2000s and the subsequent

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Eurozone crisis were not only exceptional in their severity, but also rare events. With hindsight, overly rigid application of rules may have exacerbated the crises by causing a vicious cycle of declining GDP and the need for still greater austerity policies. What is needed is a new balance between flexibility and underlying discipline, more attuned to the trade-off between stabilisation of the real economy and sustainable public finances.

**Is public debt too high to be fiscally sustainable?**

As figure 1 shows, Eurozone public debt reached its lowest level of 65% of GDP in 2007 just before the crisis years. The severity of the recession from 2008 saw aggregate public debt rise rapidly to peak at 94% of GDP in 2014 and, although it has edged downwards to a forecast level of 85% of GDP in 2019, it is manifestly a long way above the 60% reference value. An IMF study⁵ published in 2015 emphasises the point: ‘since 1999, about half of the countries have missed the 60 percent target more than half of the time. Smaller countries have tended to be more compliant than larger countries’.

**Figure 1 Eurozone general government debt to GDP ratio, %**

![Eurozone general government debt to GDP ratio, %](source: AMECO database)

Although deficits have in nearly all cases fallen below the 3% Maastricht threshold during the years of recovery since 2012 and the aggregate nominal deficit is now under 1% of GDP, deficits have been consistently above the medium term target of close to zero (red and

The more contentious question is whether these ratios have any worth in the current policy environment. Debt dynamics in Europe are under scrutiny for a number of reasons. In his 2019 presidential lecture to the American Economic Association, Olivier Blanchard challenges the received wisdom about the risks of high public debt, suggesting increases in debt may have little or no cost for society.

Nevertheless, one of the most vexed policy questions of the day is how much public debt to have. The Maastricht convergence formula of a 60% debt to GDP ratio and 3% deficit represents a steady state when the economy grows at a nominal rate of 5%. In the early 1990s, these parameters represented the average among putative Eurozone members. Today, however, with barely any inflation and real growth stuck between 1% and 2%, the underlying arithmetic no longer holds and a 3% deficit would result in growing debt.

However, in an era of low nominal interest rates, debt service charges are very low. This means that much higher levels of debt can be sustained, leading many commentators to argue for a reappraisal of the level of sustainable debt. Blanchard has initiated new thinking on when high debt is welfare enhancing, even for future generations who might be expected to bear the cost.

How much emphasis to give to fiscal discipline is a difficult question, not least because the answer may vary depending on the state of the economy and the stance of monetary policy. In ‘normal’ times, the interplay between the two arms of macroeconomic policy can allow

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for one to offset the other. But as Blanchard convincingly demonstrates, when monetary policy has reached the lower bound of zero interest rates, coordination between the two enters new territory. He takes the view ‘that, while public debt is probably bad, it is not catastrophic. It can be used but it should be used right’. His reasoning is straightforward: if the rate of interest is lower than the growth rate of the economy, then the debt can be rolled over without increasing its share of GDP. He notes a number of criticisms and technical concerns, not the least of which is identifying which rate of interest to apply. But his argument plainly raises questions about whether the EU approach should be re-thought.

In part, the answers hinge on whether markets demand a risk premium from countries with high debt to GDP ratios. Other things being equal, a country with sound growth prospects and with the bulk of the debt owned by domestic lenders will be in a stronger position. There are also more amorphous considerations about trust in the politicians and the public administration, together with the profile of the debt. Greece, today, for example, seems to have turned a corner and much of its debt is both of long duration and owned by official creditors who charge low interest rates. As figure 3 shows, the debt service burden has fallen throughout the Eurozone since the euro crisis abated in 2012.

**Figure 3. Debt service expenditure, % of GDP, (annual average in each period)**

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<tr>
<th>Country</th>
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Source: Ameco database

Note: Eurozone members ranked by 2017-8 share of GDP
Several inferences can be drawn from this chart. First, the high debt service burden on the countries worst affected by the euro crisis have fallen markedly, but remain well above the Eurozone average. The improvement is most striking for Ireland, whereas Italy continues to face a sizeable debt burden, the largest in the EU. A second striking figure is the negligible debt service burden of Germany and some of the smaller Eurozone members. But a third figure should also be highlighted: the low debt service of Japan, despite having a debt level which peaked at a high of over 250% of GDP just two years ago.

The fall in the debt service burden is also visible in the ratio of interest payments to debt before and after the crisis years, presented for selected countries in Figure 4. Comparing 2007, before the start of the great recession, with 2018, the influence of lower interest rates is striking: for the Eurozone as whole, the cost of debt halved and it is intriguing to note that Germany and Greece saw almost the same percentage point decline, ‘gaining’ relative to Italy and Spain. In Greece’s case, the reason is the generous terms on which official creditors have loaned it money, much more so than the other countries supported during the euro crisis. According to the European Stability Mechanism\(^7\), the ‘saving’ in 2017 compared with market interest rates was 6.7% of GDP, compared with 2% for Cyprus, 0.7% for Portugal and 0.3% for Ireland. The ESM estimates that Spain (which had a more limited programme to assist in dealing with its banking crisis), gained 0.2% of GDP.

**Figure 4 Debt service burdens before and after the crisis years, % of GDP**

Source: AMECO database

\(^7\) [https://www.esm.europa.eu/impact-budgets](https://www.esm.europa.eu/impact-budgets)
Despite the financial crisis and the sharp recession in 2008/9, public investment held up well in the Eurozone as a whole, but as the crisis deepened after 2010, it fell by over one percentage point to just over 2.5% of GDP in 2016, and only increased very slightly as growth picked up in 2017 and 2018 (figure 5). These data draw attention to the likely longer-term negative effects on growth potential of a fiscal consolidation led by expenditure cuts, because they imply public capital is not being renewed.

**Figure 5 Public investment in the Eurozone, GDFCF as a % of GDP**

![Graph showing public investment in the Eurozone from 1999 to 2018](source)

The disparities among Eurozone members are striking, as can be seen from figure 6 which presents annual averages for the five years before (2006-10) and after (2014-18) the euro crisis. Only four of the nineteen saw an increase and, for two of them (Belgium and Germany), it was a very slight improvement from particularly low levels prior to the crisis. Some individual cases are noteworthy. Portugal, often cited as something of a success story for having navigated it way out its bailout without overly savage welfare cuts, saw a halving of its public investment, and four of the other countries most affected by the euro crisis (Ireland, Italy, Cyprus and Spain) have also seen sharp falls in the rate of public investment.

**Austerity and debt at a time of low interest rates**

Stability orientated fiscal policy has been questioned by a number of authors who query its value at a time of low interest rates, persistent unemployment in some Member States and quiescent inflation. Blyth, for example, has been especially critical of perverse austerity policies which prolong a downturn, and Olivier Blanchard has raised provocative questions about obsessive debt reduction.

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At its simplest, austerity is a fiscal policy designed to bring down public debt. However, as applied in the EU in recent years it has, in practice, also encompassed a wide range of structural reforms aimed at improving the resilience of economies and boosting growth (or potential growth). This conflation of objectives has led to confusion in policy debates, especially when blame for backlashes against the policies has been apportioned and the indirect effects have been assessed.

Figure 6 Public Investment before and after the euro crisis, GDCF, % of GDP

Yet as new work by Alesina, Favero and Giavazzi (2019)\textsuperscript{10} demonstrates, the verdict on austerity policies has to be much more nuanced. In assessing whether or not it works, they observe that if governments save during good times and dis-save during bad times, austerity would rarely be needed. However, they identify two reasons why this does not apply. First, governments are too easily tempted into spending more or taxing insufficiently when the economy is growing robustly: this ‘deficit bias’ leads to the policy prescription of seeking way to constrain governments. Second, if exceptional circumstances (they cite war or major disaster) push up debt, there will need to be a period of subsequent retrenchment to bring down debt, failing which financial markets will lose confidence in the government and push up interest rates. In the latter case, the clear risk is of a growing proportion of public spending having to be allocated to debt service.

\textsuperscript{9} Op cit.
\textsuperscript{10} https://press.princeton.edu/titles/13244.html
An intriguing finding from Alesina et al. is that fiscal tightening by raising taxes has had very different effects from cuts in public expenditure, even when the impact on the deficit is broadly the same. Raising taxes to improve the fiscal position is shown to be systematically more damaging than expenditure cuts. They acknowledge that when too many countries simultaneously engage in fiscal tightening, it can have a cumulatively negative effect. They also confront the claim that when monetary policy is at or near the zero lower bound, fiscal retrenchment is damaging, but still find the distinction between tax and expenditure led fiscal tightening. They also observe that their findings are at odds with the much publicised claims by Blanchard and Leigh\(^{11}\) that multipliers are much higher in a period of downturn, with the result that a fiscal consolidation aggravates the downturn.

**Governance**

Much ink has been spilled on how the fiscal governance of the Eurozone should be reformed, albeit with progress prone to be too little and too late as far-reaching proposals are systematically watered-down (for example those in the Four Presidents’ Report or the various, less ambitious follow-up initiatives – see a recent Funcas paper by Begg\(^{12}\)). Proposals for a Eurozone budget for stabilisation purposes or common debt instruments have foundered, there is no obvious appetite for a Eurozone Treasury and Finance Minister, and reluctance to shift towards more coordination of fiscal policy in the interest of enhanced macroeconomic stabilisation.

There is coordination of sorts, latterly through the semester process, organised by the Commission, which provides monitoring, analysis and some peer pressure intended to encourage Member States towards sound policies and to avoid damaging spillovers. But it falls well short of arriving at a coherent aggregate fiscal stance within which individual countries are pushed towards commitments they would not unilaterally take. This is the nub of the coordination dilemma of the Eurozone.

At EU level, the SGP remains the cornerstone of the fiscal framework, yet it faces a range of criticisms. The simple early version of the Pact has evolved to become much more complex (with the *Vade Mecum* setting out how it to be implemented running to 220 page). The European Fiscal Board (EFB)\(^{13}\) highlights inconsistencies with apparently perverse effects. Thus, the demands for fiscal adjustment under the preventive arm can be greater than under the corrective arm, even though the logic of the Pact should be that a greater correction is needed from countries in excessive deficit. Similarly, compliance with the debt rule may demand different actions from compliance with the MTO, while the complexity of the rules and the need for judgement on certain variables – notably the resort to an estimated output gap to arrive at the structural deficit – can result in judgements over-

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\(^{12}\) [https://www.funcas.es/funcaseurope/Reform_of_the_EU_fiscal_framework](https://www.funcas.es/funcaseurope/Reform_of_the_EU_fiscal_framework)

\(^{13}\) Op cit.
riding objective criteria. Such discretion is frequently valuable, but the cost can be to weaken commitments.

The establishment of independent fiscal councils has the potential to make a difference by scrutinising national fiscal policy decisions, and it is also worth noting the creation of the European Fiscal Board as a further means of strengthening policy coordination. The Board’s role is advisory and, although its most recent report offers a wealth of valuable analysis and policy recommendations, it can only influence, rather than shape the more contentious policy decisions. Regarding fiscal councils, the verdict of the EFB is categorical: ‘our review of the contributions from councils in countries which faced difficulties in complying with the rules in 2017 leaves us with the impression that there is quite a long way to go before the problems with the rules we have analysed will be eased’.

The EFB is also critical of how an agreement reached in 2016 to put more emphasis on capping public expenditure, rather than the budget balance, has functioned. Part of the problem is that the regulations governing the SGP are unchanged, leading the EFB to the view that ‘it is difficult to imagine that Member States would forego options offered by current legislation, if the expenditure benchmark turned out to be more restrictive than the structural budget balance. This view is confirmed by a first experience in 2017’.

Concluding comments and issues to consider

Eurozone fiscal policy is at a crossroads and is struggling find the direction to take, both from a macroeconomic perspective and in relation to the ‘quality’ of public spending, a notion that tries to capture the connections between public spending and the growth and resilience of the economy. Worries about a further cyclical downturn could see a need for some loosening of macroeconomic policy. Given there is little room left for monetary policy to act, with interest rates so close to the zero lower-bound, fiscal policy may have to shoulder more of the burden. But the following dilemma remains a major obstacle: countries with the most scope for more expansionary fiscal policy have the fewest incentives to pursue it, while those most in need of such a policy are least able to do so.

Germany and Italy exemplify the difficulties, the former because it is effectively at full employment and the latter because of the debilitating consequences of its lack of growth over two decades. Both have to contend with rapidly ageing populations, implying a need to boost savings, but in other respects they differ. Seen through German eyes, the macroeconomic argument for a fiscal stimulus is unconvincing, implying Germany has no incentive to ‘do the right thing’ for the Eurozone. However, Germany is recognised to need public investment to enhance its infrastructure and a persuasive case can be made for boosting such investment at a time of low financing costs. Italy can make no progress in.

reducing its public debt while its growth flat-lines, yet struggles to pay the costs of growth-promoting reforms.

Both cases also highlight the quandary of how to reconcile the macro and micro dimensions of fiscal policy. The Alesina et al. findings on the distinctive consequences of tax or expenditure led austerity raise a further matter of whether more expansionary fiscal policy might also have asymmetric effects. An implication of their finding could be that tax cuts will have more favourable supply-side effects. However, the likely effects on demand are hard to predict because of uncertainty about multipliers: although there is evidence they are higher in a downturn, it may well be that they also vary in response to different forms of fiscal stimulus.

There is tension between, on the one hand, Member State responsibilities and their desire to retain control of the levers of fiscal policy, and on the other, the logic of a single currency being stabilised in a top-down manner. In an IMF study published in 2017\(^{16}\), the chapter by Eyraud, Gaspar and Poghosyan emphasises the need for the Eurozone to rethink incentives for ‘good policy’. They note, with concern, the ‘perception by many analysts that European fiscal governance releases countries from their national responsibilities. Nothing could be further from the truth: fiscal policy is, first and foremost, a national responsibility’.

For fiscal policy at the EU level, this will require a hard choice. There has been much discussion of reinforcing the scope for dealing with macroeconomic shocks by creating an additional fiscal capacity to complement the rather limited EU-level budget. However, it has proved difficult to agree on new mechanisms on a scale sufficiently large to make a tangible difference. How to combine risk sharing and risk reduction in fiscal policy remains a core political economy challenge. Despite the calls for such policy innovation, the timid response so far of introducing stabilisation instruments with insufficient resources is a compromise that will satisfy no-one.

The institutions of fiscal governance need further development and a fresh look is required at the purpose, effectiveness and utility of fiscal rules. One current idea is to focus on an expenditure rule, but is not a panacea and there are striking differences across the EU in what expenditure should be monitored. Moreover, it is easily broken (witness the chequered history of the UK during the Thatcher years when the ceiling was repeatedly breached). The semester process provides monitoring and a degree of peer pressure, but it falls well short of arriving at a coherent aggregate fiscal stance within which individual countries are pushed towards commitments they would not unilaterally take. This is the nub of the coordination dilemma of the Eurozone. If compliance cannot be ensured, countries in the Eurozone find it relatively easy to avoid hard choices and, as Italy (most visibly) last

autumn and France (over a number of years have done), the result can be to demonise the EU level.

A number of issues for consideration are put forward to respond to the challenges facing fiscal policy in Europe:

- *Political economy consideration make it hard to arrive at comprehensive solutions, but ‘kicking the can down the road’ in relation to reform of fiscal governance is not a viable answer. Instead, there is a need to inject urgency into agreeing a new approach.*
- *At a time of very low interest rates, the scope for fiscal policy to do more for stabilisation purposes should be exploited, despite the lingering problem of high debt.*
- *More efforts should be made to increase public investment, taking advantage of low financing costs.*
- *The proliferation and complexity of fiscal rules should be rationalised with the emphasis placed on debt sustainability and on national rules, rather than seeking the holy grail of better EU level rules.*
- *The implementation of rules should be recast to ensure a better balance between enforcement, compliance and appropriateness, giving more weight to economic analysis and the diversity of fiscal parameters among Member States.*
- *The governance of economic and monetary union will continue to be hampered until difficult decisions about an additional stabilisation instrument are taken.*