FISCAL REFORMS AND FISCAL SUSTAINABILITY IN EUROPE

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THE EUROPEAN GOVERNANCE AS IT USED TO BE BEFORE THE GLOBAL ECONOMIC AND FINANCIAL CRISIS

When designing the economic and Monetary Union (EMU), policy makers were well aware that progress on macroeconomic issues at large would be paramount:

> "[E]conomic and monetary union […] will require further major steps in all areas of economic policymaking. […] [C]ommon policies aimed at developing a more balanced economic structure throughout the Community […] would help to prevent the emergence or aggravation of regional and sectoral imbalances which could threaten the viability of an economic and monetary union. […] [T]he adoption of permanently fixed exchange rates would eliminate an important indicator of policy inconsistencies among Community countries and remove the exchange rate as an instrument of adjustment. [...] Economic imbalances among member countries would have to be corrected by policies affecting the structure of their economies and costs of production" (Committee for the Study of Economic and Monetary Union, 1989, p. 12).

Nevertheless, the tools selected for the task were partial and light.[1] In fact, on top of the design of the single monetary policy, only fiscal issues – in particular, fiscal sustainability and short-term flexibility in budgetary positions for coping with the economic cycle – comprised the core building blocks of the monetary union. Two basic facts played a major role. First, within a monetary union, the stability of monetary and financial conditions is a public good to which each country contributes by maintaining a sound and sustainable budget position. However, a country may be tempted to exploit the benefits accruing from the fiscal discipline of the others without contributing itself to the common good. This free-riding behavior may create a double cost for the other countries: the free rider's excessive indebtedness can determine interest rates to rise, resulting in bankruptcies requiring bailouts. Secondly, within a monetary union, the countercyclical role of fiscal policy gains more prominence: member countries can no longer rely either on a monetary policy tailored to national needs or on exchange rate adjustments. Therefore, each country's fiscal position has to allow for sufficient margins for using fiscal policy as a countercyclical tool.

Thus, at the time, the focus was on tools for achieving fiscal discipline while also providing room for short-term flexibility. In this respect, markets were considered ineffective as "[t]he constraints imposed by market forces might either be too slow and weak or too sudden and disruptive" (Committee for the Study of Economic and Monetary Union, 1989, p. 20). A clear consensus emerged about the introduction of common numerical rules and a multilateral surveillance mechanism (Buti & Sapir, 1998; Stark, 2001). Compared to institutional or procedural reforms, numerical rules are simpler to evaluate, easier to grasp, faster, and more straightforward to implement. Institutional reforms would have represented a feasible alternative only if more decisive steps toward a political union had been taken. Also, contingent reasons mattered: rules were instrumental to rapidly obtain radical changes in policies, to ensure the credibility of the monetary union, and to select the countries joining it. Therefore, first the Treaty of Maastricht in 1992 and then the Stability and Growth Pact signed in 1997 (reformed in 2005, European Central Bank, 2005) defined the rules for achieving both fiscal sustainability and short-term budgetary flexibility.

In order to pursue fiscal sustainability, the European rules set a deficit limit and a debt limit: (1) the deficit should not exceed 3 percent of GDP (unless under exceptional circumstances, the excess deficit is small, and it lasts only for a limited period of time), (2) the debt-to-GDP ratio should not be larger than 60 percent, and, if above this limit, it

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had to decrease at a satisfactory pace toward the threshold. In principle, if either of these two limits is breached a procedure intended to force adoption of corrective measures – the so-called Excessive Deficit Procedure – would be triggered. In practice, only the deficit rule has been implemented to date; the debt rule has not been implemented because no operational definition of a "satisfactory pace of reduction" has ever been agreed on.

For ensuring flexibility in fiscal positions to cope with the economic cycle, the fiscal rules also set a medium-term objective of a close-to-balance, or in surplus, budget. This objective is defined in structural terms (*i.e.*, cyclically adjusted and net of temporary measures) and is country specific. For each country it is computed to allow for safety margins against breaching the 3 percent of GDP limit and building up room for stabilization over the cycle, while safeguarding the sustainability of public finances.

In other words, overall the European rules require that each country pursues a budgetary target in structural terms and lets automatic stabilizers or discretionary actions operate symmetrically around it. The lower the budget balance with respect to the 3 percent threshold, the wider the leeway for countercyclical policy without the risk of falling into excessive deficit.

In addition, to guarantee for compliance with these rules, various tools were identified; *inter alia*, a multilateral surveillance mechanism (including the drafting of multi-year fiscal plans), the above-mentioned Excessive Deficit Procedure (which goes from recommendations to sanctions), and a common statistical framework.

Even if in designing the monetary union the focus was on fiscal rules, these would have proved not to be adequate. Indeed, even if budget out-turns were not in line with the deficit and debt rules, sanctions were never applied and, in some cases, the Excessive Deficit Procedure did not even start (this was the case of France and Germany breaching the 3 percent limit in the early 2000s). Moreover, incentives to comply with the common statistical framework were weak; in some countries there have been large *ex post* revisions in the deficit figures, weakening the credibility of the rule-based framework as a whole.

Overall, before the global economic and financial crisis, within the European framework fiscal soundness and sustaibnability were considered "s*trictu sensu,*" meaning that, back then, there was no recognition that macroeconomic imbalances could endanger fiscal sustainability and that a sovereign crisis could occur. Possibly, the underlying assumption was that a monetary union, whose members complied with predetermined fiscal requirements aimed at fiscal sustainability, would have led to macroeconomic convergence over time.

THE GLOBAL ECONOMIC AND FINANCIAL CRISIS

In spite of their weaknesses, EU rules have had and still maintain a relevant role in euro-area countries (European Commission, 2008) where the European fiscal framework has been and is at the centre of the debate about fiscal policy and fiscal rules. In spite of setbacks, multilateral surveillance and the common statistical framework have been and are important: stability programs impose a multi-annual framework, statistical rules ensure greater transparency, and the excessive deficit procedure affects government reputation. The joint long-term projections have inserted aging and sustainability within the national fiscal policy debate (European Commission, 2006).

Benefiting also from the European fiscal framework, at the outset of the global economic and financial crisis, the deficit of the euro area was the second-lowest of the previous 40 years (0.7 percent of GDP in 2007; see table 1). Over the following two years there was a sizeable worsening due to the cyclical downturn and, in some countries, to fiscal stimulus packages and measures implemented to support the financial sector. Soon afterwards, some countries began to undertake large public finance adjustments to secure fiscal sustainability. Compared to the United States, the euro-area public finances met the crisis on a better footing and their subsequent worsening was smaller.

In time, financial tensions emerged, involving Greece in the first half of 2010, Ireland in the fall of the same year, and finally Portugal. Over the summer of 2011, tensions intensified involving Italy and Spain, triggered by the deteriorating outlook for the global economy, the worsening of the Greek financial situation, and the announcement of the private sector involvement in the Greek debt restructuring.

Table 1
Deficit and debt
(as a percentage of GDP)

		2007	2008	2009	2010	2011
Deficit	Euro area	0.7	2.1	6.3	6.2	4.1
	United States	2.8	6.4	11.9	11.3	10.1
Debt	Euro area	66.4	70.2	80	85.6	88.1
	United States	67.5	76.5	90.1	99.2	103.5

Source: European Commission, Autumn Forecast (November 2012).

These developments brought to light two underlying factors: (1) pre-existing national (largely non-fiscal) economic vulnerabilities; and (2) shortcomings of the European governance.

Pre-existing national economic vulnerabilities were mainly due to macroeconomic imbalances (Spain, Greece, Portugal, and Ireland). In some cases, housing market disequilibria (Ireland and Spain) brought about banking system problems; in others, low growth and poor competitiveness performance were the main issues (Italy). So the origin of the sustainability problems of "troubled" European countries is largely not fiscal in nature. In other words, the crisis made apparent that in any case – even in the presence of well-designed fiscal rules and incentives – fiscal discipline by itself cannot guarantee fiscal sustainability. For example, in Ireland and Spain, during the three years before the crisis, the deficit and debt were far below the European rules' thresholds. Nevertheless, in the recent years an unprecedented credit expansion in both countries fuelled macroeconomic internal and external disequilibria which, in turn, jeopardized fiscal sustainability.

The economic and financial crisis has highlighted some problems regarding European economic governance concerning the fiscal framework, macroeconomic imbalances, and sovereigns' debt problems. Indeed, Europe's budgetary rules have not guaranteed the adoption of prudent budget policies, capable of properly exploiting the favorable phases of the economic cycle to strengthen public finances. Moreover, the system of multilateral surveillance was not equipped with effective tools to detect, prevent, and correct macroeconomic imbalances. Finally, there was no set protocol for intervention in the case of a severe financial crisis in a euro-area country.

REFORMS OF THE EUROPEAN GOVERNANCE

In the spring of 2010, a process of reform was started, involving both member states and European institutions (European Central Bank, 2011). To date, some of the reform proposals have already been implemented, with others still under discussion. All three areas of weakness have been tackled. With reference to the fiscal framework, rules have been made stricter and procedures more automatic.

As for macroeconomic imbalances, multilateral surveillance has been extended from purely fiscal aspects to macroeconomic issues at large. More specifically, an early warning system based on a scoreboard with minimum and maximum thresholds has been introduced. The indicators are analyzed in the Commissions' annual Alert Mechanism Report. In the event of particularly severe imbalances liable to put the monetary union at risk, the macroeconomic imbalance procedure can be launched. The procedure involves recommendations and may eventually lead to a sanction in the form of an interest-bearing deposit that is converted into a fine in cases of repeated failure to comply with the Council recommendations. Both penalties are decided by reverse qualified majority vote of the Council acting on the Commission's recommendation (*i.e.*, penalties are imposed unless a qualified majority votes against them).

With reference to mechanisms for intervention in the case of a severe financial crisis in a euro-area country, in May 2010 the Council of the European Union devised two temporary instruments: the European Financial Stabilisation Mechanism (EFSM, with a lending capacity of €60 billion) and the European Financial Stability Facility (EFSF, whose lending capacity amounted to €255 billion initially and was increased to €440 billion in July 2011). The strains on sovereign debt intensified in the first few months of 2011. In March the European Council increased the EFSF's effective lending capacity and established the features of the European Stability Mechanism (ESM) – a permanent crisis-management mechanism with a total lending capacity of €500 billion – which became formally operational in October 2012.

The rest of this note focuses on the first area of reform, *i.e.*, on the fiscal framework. On top of the so-called European Semester,[2] changes aimed at strengthening the fiscal framework have been introduced by: (i) a set of measures known as the "Six-Pack" that consists of five regulations and one directive and came into force in December 2011 (European Commission, 2011a; Council of the European Union, 2011; Council and Parliament of the European Union, 2011a, 2011b, 2011c, 2011d, 2011e); (ii) the Fiscal Compact included in the Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union, which was signed by all European Union countries except the United Kingdom and the Czech Republic in March 2012 and that will enter into force in January 2013 (European Central Bank, 2012). Additional measures for reinforcing the European fiscal framework are currently under discussion following a European Commission proposal comprising two regulations, known as the "Two-Pack" (European Commission, 2011b, 2011c), which aim at (i) defining common provisions for monitoring and assessing draft budgetary plans, at (ii) ensuring the correction of excessive deficit of euro-area countries, and at (iii) strengthening economic and fiscal surveillance on the euro-area countries, particularly those burdened with an excessive deficit, experiencing financial difficulties, or requesting preventive financial assistance.

The "Six-Pack" tightens European fiscal discipline and establishes minimum standards for institutions and national budgetary plans. More specifically, it reinforces the rules aimed at the preemption of budget imbalances (the so-called "preventive part" of the Stability and Growth Pact) by introducing an expenditure rule to complement the assessment of the convergence toward (or maintenance of) each country's medium-term objective (MTO). For countries that have reached their MTO, the annual rate of growth of expenditure must not exceed the potential medium-term GDP growth rate, unless the overshoot is offset by discretionary increases in revenue. Countries that have not yet reached their MTO should ensure that their expenditure grows at a pace slow enough to be consistent with an annual improvement of at least 0.5 percentage points of GDP in their structural budget balance. Countries that deviate significantly and persistently from the path of convergence toward their MTO will be subjected to a financial sanction in the form of an interest-bearing deposit of 0.2 percent of GDP.

The "Six-Pack" also improves the rules for the correction of budget imbalances (the so-called "corrective part" of the Stability and Growth Pact) by making the debt criterion of the Treaty of Maastricht operational. To be in compliance, countries whose debt exceeds 60 percent of GDP must reduce the differential over that threshold at an average rate of one-twentieth yearly over the last three years. Alternatively, the requirement has to be met in forward-looking terms: the Commission's projections should indicate that this will occur over the three-year period encompassing the two years following the last year for which the data are available. A smaller reduction does not automatically launch the Excessive Deficit Procedure, as account will be taken of the impact of the economic cycle and other relevant factors.[3] Euro-area countries that are under the excessive deficit procedure will be subjected to a sanction in the form of a non-interest-bearing deposit. The sanctions will be imposed on a more automatic basis in both the "preventive" and the "corrective" phase of the Stability and Growth Pact. Once proposed by the European Commission, they will be adopted, unless the Council reverses the decision by a qualified majority (reverse voting).

As far as the Fiscal Compact is concerned, it requires its signatories to introduce, preferably at the constitutional level, a rule requiring them to achieve and maintain national budgets that are structurally in balance or in surplus, and to introduce an automatic correction mechanism based on

common principles proposed by the Commission (European Commission, 2012) that are triggered in the event of deviation. The annual structural deficit must not exceed 0.5 percent of GDP; it may reach 1.0 percent in the case of countries with a debt-to-GDP ratio significantly below 60 percent and where the risk to the long-term sustainability of the public finances is low. The European Commission will assess the compliance with those requests and, in case of failure, the matter may be brought to the Court of Justice of the European Union. Following the Court decision, the country involved must implement the necessary measures. Financial sanctions can be imposed by the Court if the concerned country does not abide by the judgment.

The Fiscal Compact also extends the reverse voting mechanism to phases of the excessive deficit procedure where it is not yet envisaged by the "Six-Pack," including the launching of the procedure itself in the event of non-compliance with the deficit criterion.

CONCLUSIONS

The global economic and financial crisis and the euro-area sovereign crisis made the shortcomings of the European institutional set up apparent. In the last few years, spurred also by the tensions in the markets, significant progress has been made in strengthening the euro-area governance. Nevertheless, there remains room for improvement in the decision-making processes that are still long and complex.

The recent past taught that fiscal rules by themselves – even very well-designed and effective ones – cannot guarantee fiscal sustainability, as the latter is not a mere fiscal issue: non-fiscal matters have to be considered as well.

It should be recognised that if the euro area were viewed as a single entity, there would be no reason to worry about its fiscal sustainability. Indeed, in 2012 the euro area is expected have a much lower deficit than the U.S., the UK, and Japan, and it is the only one expected to show a primary surplus; its debt ratio is forecasted to be broadly in line with that of the U.S. and much lower than that of the UK and Japan. In addition, other non-strictly-fiscal sustainability indicators (*e.g.*, private sector financial debt and current account balance) show that the euro area as a whole does not have a sustainability problem. The issues are the heterogeneity across countries and the incomplete construction of the Union's institutions, which weighs heavily on the markets' judgment. There is still a mismatch between the ambitious monetary integration and the unwillingness to accept fiscal constraints or federal institutions. In this respect, times of crisis can turn out to be an opportunity for significant structural changes.

Notes

[1] Indeed, according to the Treaty establishing the European Community (article 99): "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council. […] The Council shall […] formulate a draft for the broad guidelines of the economic policies of the Member States and of the Community, and shall report its findings to the European Council. The European Council shall […] adopt a recommendation setting out these broad guidelines. […] the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Community […] and regularly carry out an overall assessment. Where it is established […] that the economic policies of a Member State are not consistent with the broad guidelines […] or that they risk jeopardising the proper functioning of economic and monetary union, the Council may […] make the necessary recommendations to the Member State concerned."

[2] The European Semester is a mechanism designed to improve *ex ante* economic policy coordination and was launched in 2011.

[3] The latter comprise: (i) the term structure and currency of the debt; (ii) the guarantees provided by the government (namely those to the financial sector); (iii) the liabilities stemming from population aging (both explicit and implicit); (iv) the level of private sector debt, and the risk that it may generate liabilities for general government; (v) the composition of public assets; and (vi) the size and determinants of the difference between net borrowing and change in the debt.

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