

Chapter 2

The Economic Rationale of Fiscal Rules in OCAs: The Stability and Growth Pact and the Excessive Deficit Procedure

Abstract This chapter examines the case of different regions within a single country that wish to share a common currency, even though they have divergent trends in unemployment, inflation, wages, non-wage costs and productivity. This situation compares with the case of a group of EU countries, each with its own decentralised national budget, that have established a monetary union and that are facing asymmetric shocks. As such an economic context requires fiscal commitments from national governments, we analyse the economic rationale of setting fiscal rules for a common currency area and the resulting EU institutional frame for the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP). We discuss the legal basis for the EDP and the relevant accounting definitions. We also provide the initial settings of the SGP, as well as a summary of the contents and the related assessment of the revised SPG in March 2005. The chapter concludes with a brief comment on the so-called “Six Pack” adopted by the EU in December 2011, which provides a wide range of macroeconomic indicators to improve the governance of EMU within euro-zone countries, through the Surveillance of Macroeconomic Imbalance Procedure.

Keywords Fiscal federalism • Fiscal rules • Excessive Deficit Procedure (EDP) • Stability and Growth Pact (SGP) • Six Pack • Surveillance of Macroeconomic Imbalance Procedure

2.1 Why Don't Regions Leave Currency Areas When they Experience Asymmetric Shocks?

We have presented above an overview of the economic rationale for a group of countries to share a common currency. I would like to start this second chapter by examining the case of regions that in spite of showing diverging trends in both unemployment and inflation rates, as well as in wages, non-wages costs and productivity, still consider it advantageous to be part of a wider country with a common currency.

Consider, for instance, the effect that the oil crisis of 1973–75 had on Spain. At the time, the Spanish economy had embarked on a public investment programme engineered through the National Institute for Industry (INI). In Leviathan fashion, the government had decided to invest the bulk of Spain's national savings in the shipyard and steel industries. It turns out that the State chose the wrong sectors, in a situation that has been repeated today in the construction sector after it received massive flows of private funds between 1999–2007.

What happened in 1973–75? Some regions in Spain like Cadiz or Valencia suffered a negative productivity shock as their respective shipyards and steel industries lost competitiveness. Subsequently, these regions experienced an excess of productive capacity which resulted in a fall in industrial output and a sharp increase in unemployment nine years. The negative supply shock had an asymmetric impact throughout the whole country, and the Bank of Spain implemented an accommodating monetary policy to support growth. However, whereas some parts of Spain were slowly recovering, the very lax monetary stance was unable to stimulate the severely damaged areas of Cadiz and Valencia.

Had these depressed areas had the opportunity to separate from the monetary union with the rest of Spain, they would have experienced a sharp devaluation, which would have stimulated exports and fuelled a strong growth recovery in the short-run. This was not, however, a politically feasible option. Why didn't these damaged regions choose to quit the currency area? Had these areas exited the monetary union, they would have incurred in huge losses as compared to short-term competitive gains. What happened instead?

- (i) investment opportunities remained in the chemical, textile, construction, and other sectoral economic activities, which were concentrated in the northern areas of Spain. As a result, physical capital flowed to areas in economic expansion and absorbed the redundant employment, which was coming from the depressed areas in the South (Cadiz) and the East (Valencia). Thanks to factor mobility, workers from Cadiz and Valencia moved freely to those Spanish areas which were experiencing both an economic expansion, and the corresponding increase in the demand for labour;
- (ii) because most of these workers remained within the country, the savings that Spanish society had previously used to invest in training and retraining this human capital was not lost but fully exploited within Spain, thus contributing to the financial *sustainability of the Spanish pension system*;
- (iii) those workers who had fewer job opportunities in the Northern industries and remained in the Southern/Eastern regions, received financial support from the national unemployment benefits schemes funded through the Spanish national *social security fund* which, in turn, was mostly funded with the social security contributions from people working in the North/Centre and North/East areas in expansion;
- (iv) to correct for the regional imbalances, which had been exacerbated by the asymmetric negative shock, the central government set up a plan to provide incentives for establishing companies in the damaged regions. The plan

included direct investment by the public sector, financial incentives and tax rebates for private companies—State aid policies which are prohibited now in the EU—and a training policy to fill the skills gap between the new skills required by the companies and the old skills of the labour force (Box 1). Again, as with the social security funds, all this support was funded through taxes collected by the *central government budget* whose main contributors were people and companies in the more flourishing regions; finally

- (v) the country increased its foreign indebtedness and, although part of the foreign debt was in dollars, the bulk was denominated in the national currency. The fact that Spain at that time had its own currency mitigated any insolvency prospects.

Box 1: Success Story of the Industrial Restructuring of the Altos Hornos del Mediterráneo Steel Company

The case of the Altos Hornos del Mediterráneo (AHM) Steel Company in Sagunto constitutes the *first traumatic industrial restructuring of such an industrial concern in Spain* and one of the few examples of a successful re-industrialisation of an old industrialised area. This is a case of a community with a single industrial concern that was retrofitted in its entirety. In 1975, Sagunto had more than 52,000 inhabitants and the economic base of the area was predominantly agricultural with the exception of the steel industry. From 1978–91, 800 industrial jobs were lost in the economic area around Sagunto, while the steel industry alone lost more than 4,000. The AHM Steel company went from 5,569 employees in 1976 to fewer than 1,000 in 1991, and the Sagunto area showed the highest unemployment rate in the region of Valencia. In 1996, in contrast, the population of the municipality of Sagunto was 60,000, and the city's unemployment rate was below the regional average. What is more, jobs were concentrated in the tertiary sector. More importantly still, the industrial sector boasted impressive employment dynamics.

The *industrial decline of the area* of Sagunto started in the *second half of the 1970s* with the decrease in the demand of steel and the resulting over-capacity of the steel sector at national level. In 1983, the Spanish government passed a law to close the AHM steel company, a process that was fully accomplished in 1984. The announcement of the closure was met with mass mobilisations led by the trade unions. These influenced the government to devise compensation schemes for the redundant workers and to reach agreements with the regional government to re-industrialise the whole area. *Early retirement measures* (from 55 years onwards) were offered to 1,013 workers, while the Employment Promotion Fund (FPE, for the Spanish Fondo para la Promoción del Empleo) guaranteed to financially support the other redundant workers for three years. Furthermore, the *Regional Government* together with the municipality and the unions

reached a political agreement in April 1984 to find new jobs for redundant workers under the age of 52 and those with temporary contracts and to provide them with the required training, funded by the FPE. The agreement also guaranteed that workers would make at least 80% of the income they had previously earned at AHM. The objective of the agreement was to create at least 1,700 new jobs for this type of redundancies in three years, the time span of the validity of this policy.

- The *legal and institutional framework* set up to implement the re-industrialising policy was the following:
 - Creation of the Fund for the Promotion of the Employment (FPE) to give financial support to the workers made redundant by the steel company while these workers were waiting to be re-allocated in other companies or to be eligible for early retirement. The FPE also subsidised employment in companies recruiting redundant workers from AHM.
 - Two laws declared the area around Sagunto as a “Zone for Preferential Industrial Location” (ZPLI) and “Zone for Preferential Industrial and Agroalimentary Location” (ZPLIA) and provided the legal basis for the policy of re-industrialisation. This implied that companies planning on expanding projects and investing in the area would enjoy such perks as subsidies to stimulate investments and employment, fiscal bonuses, etc.
 - Creation of the Commission for the Economic Promotion of Sagunto (CEPS) in charge of the management of the policy of re-industrialisation. The objectives of the CEPS were to promote and attract investments from abroad into the area and to increase the attractiveness of the area from a location viewpoint by ameliorating public infrastructures (retro-fitting the harbour of Sagunto and opening it to general maritime traffic and improving accessibility, providing industrial infrastructure etc.) and providing public industrial land at political prices. The regional government played a major role in influencing the final decision of the Italian multinational glass company SIVESA (Società Italiana del Vetro, S.A.) to locate its important investment in the area of Sagunto.
- The *instruments to stimulate* the installation of new activities in the area or the expansion of those activities already existing were as follows:
 - Direct investment by the public sector, which materialised in the above supply of infrastructures, and direct creation of employment through public companies. The state holding INI (Institute for National Industry) accepted the engagement to generate at least 500 new jobs either through new companies or by means of the plan for the enlargement of the state-owned steel company SIDMED that was expected to create around 2,000 new jobs. However, the public sector was unable to honour its commitments. The INI was able to bring the national

fertilisers company, ENFERSA, to Sagunto, originally planned for building in Cartagena, and generate 209 jobs. But the expansion of SIDMED ultimately resulted in the net loss of 300 jobs between 1985–87.

- Financial and tax incentives, which consisted in: (i) subsidies to investment, with a maximum limit up to 30 % of investment in fixed capital; (ii) preferential access to official credit, up to 70 % of the non-subsidised investment; (iii) several tax rebates; and (iv) the possibility to benefit from special depreciation plans.
- A training policy, through the Plan for Professional Occupational Training (funded by the FPE) which trained 1,404 people to fill the gap between the type of workers required by the new companies and the skills of the labour force. SIVESA and ENFERSA were the main beneficiaries.

During the 1984–89 period, the regional and national authorities took the lead of the re-industrialisation strategy. In early 1989, between the new companies set up and the expansion of existing ones, 54 projects received subsidies amounting to more than 35 billion pesetas (around 211 million euros), and 2,053 new jobs were created. The objective of finding new jobs for the workers made redundant by the steel company AHM was, therefore, reached. Furthermore, the improvements in public infrastructures and the location advantages of the area paved the way for a robust diversification of the industrial structure. Beyond the traditional industrial sectors such as metal working, new industries making chemical, glass, plastics, and auxiliary car products become a permanent feature of the industrial area of Sagunto.

Despite the successful results above the re-industrialisation strategy implemented by the various public authorities cannot by itself explain the flourishing economy the zone enjoys today. It did, however, pave the way for a radical change in the area's industrial dynamics. Despite the fact that many of the companies created with public support disappeared in the following years, the industrial base of the area continued to expand and diversify after the implementation of the official re-industrialisation programs. During the *second phase of re-industrialisation* (1988–92), numerous small companies were set up on the Sagunto Industrial Estate. They represent more the 30 % of the new jobs created. From 1988 onwards, two thirds of the new companies were created without any subsidies or financial or tax benefits. In this second phase of “free” re-industrialisation, factors such as improved public infrastructures and communications, proximity to customers, availability of industrial land at competitive prices, the existence of a skilled and well-trained labour force, were major determinants for attracting new companies.

Large transfers of savings from the less affected to the more severely damaged regions took place. This flow of funds took place without any regions having to pay any interest rate for the funding provided, as we shall discuss more in depth below. The above five elements are missing today in the analytical framework of the eurozone and we will come back to them later in the chapters of this book. Let me underline, however, the relevance of five elements right from the beginning. It is important that you keep them in mind during the coming chapters, as they are key elements challenging today's future of the eurozone:

- (i) factor mobility (labour and capital, physical investment) within the currency area;
- (ii) sustainability of the pension systems;
- (iii) common budget funding;
- (iv) common social security funds; and,
- (v) sovereign debt funding, with a single currency which is not a country's own currency.

2.2 The Economic Rationale of Fiscal Rules in a Monetary Union

As we have seen in the previous chapter as well as in the previous point, in the ideal world of *optimum currency areas* (OCAs), and within the framework of a unified and centralised State, the economic consequences that an asymmetric shock has on different geographical areas will be absorbed through a centralised budget (De Grauwe 1997; Sanchis i Marco 1998, 2011, pp. 201–221). Different areas will feel the shock with different intensity, some negatively, some positively. Residents of regions with difficulties will receive savings from residents in those regions that, thanks to the positive influence of the macroeconomic shock, are now in expansion. Savings from these more prosperous areas will be channelled to the residents of the regions adversely affected by the shock through the fiscal and the social protection systems by means of public transfers, in the form of either current or capital transfers. Savings flows that will be sent to residents in the regions with difficulties will be generous, because they will be channelled, by means of taxes and social security contributions, through both the centralised budget and the social security fund. As a result, the social protection benefits received in the regions in difficulties will not be accompanied by the request of interest payments for the transfer of savings from the regions in expansion.

However, in the real world, such as in a monetary union among countries that all have their own decentralised national budgets, when one country is negatively affected by a shock, *good economics* advises the flexible use of fiscal policies. That means that the public deficit should be allowed to increase and automatic stabilizer must come freely into play. This country's debt can be financed by its

neighbors with surplus savings as long as the capital markets are efficient and frictionless. It's government can increase its public deficit without having to face problems of solvency or fiscal sustainability.

However, the "real world situation" introduces several differences compared to the unitary State or the ideal world of *optimum currency areas*. First, the transfer of savings is not free, as the country in difficulties will have to pay the interest and principal of the loans received from the country of the monetary union experiencing an economic expansion. More importantly, the higher payments necessary to service the debt reduce the margin of manoeuvre of the country negatively affected by the shock. This happens at the very moment when the country needs to adjust to the shock in a flexible way and looks for a wider margin for manoeuvre of its fiscal policy. Moreover, the rapid accumulation of public deficit and debt puts upward pressure on real (inflation-adjusted *ex post*) long-term interest rates. This acts as a deadweight for growth and sets the debt/GDP ratio on a path of uncontrolled escalation, putting the country's financial stability in jeopardy.

A major weakness of the previous argument lies on the implicit hypothesis that governments would incur public deficit repeatedly without having to face solvency or fiscal policy sustainability problems. Experience of the European economies during the 1980s shows how fast public deficits and the stock of debt accumulated. As the rate of growth was lower than real interest rates, the ratio debt/GDP entered an explosive path undermining the sustainability of public finances.

The economic literature points out that for a monetary area to function properly, fiscal rules must be put in place. This is to prevent negative externalities in the less virtuous countries from affecting the more virtuous ones. Unsound financial policies would put heavy pressure on interest rates. That would increase interest payments of other members of the area obliging them to adopt more restrictive fiscal policies than otherwise, in order to face higher interest payments. Indeed, during the 1980s, expansionary fiscal policies interfered with the monetary policy of central banks as they could not free themselves from the high stocks of public debt when they wanted to tighten monetary and credit conditions. The same concern emerged when the European Central Bank would have limited power to tighten its monetary policy and would resist, for instance, raising the intervention rate.

Because of all the above reasons, the Treaty of Maastricht (Council of European Communities, Commission of European Communities 1992) set up certain rules to limit the size of public deficits (3 %) and the stock of public debt (60 %) with respect to a country's GDP. The aim was to preserve the autonomy of the future European Central Bank from eventual pressures of unsustainable levels of deficit and debts which might prevent it from eventually tightening its monetary policy when needed. These arguments, however, have been criticised because their underlying assumption is that capital markets are inefficient because they are unable to allocate different *risk premia* to public debt of each area member according to the specific situation of each country's public finances. If capital markets worked efficiently and were frictionless, negative externalities would not take place.

2.3 The Stability and Growth Pact

In spite of the safeguards described above, when assigning risk premia to countries with less sound public finances, financial markets may take into account the impact of one country's declaration of bankruptcy on others of the area's members. To mitigate this effect, Article 104B of the Treaty prohibits the Community or any member state from taking on the debt of another country.

However, without setting up rigorous fiscal rules concerning the size of the deficit allowed within the union, the problem of credibility in implementing this clause would continue to be open. Therefore, and in view of the difficulties to apply those rules, the Treaty replaced this idea by the *Excessive Deficit Procedure (EDP)* in article 104C, according to which, recommendations to Member States are formulated to make their public finances comply with the Maastricht criteria.

The Stability and Growth Pact (SGP) is a rule-based framework for the coordination of national fiscal policies in the EMU, which was set up to ensure sound public finances. The SGP consists of two arms: One preventive and the other dissuasive, along with an assessment of the long-term sustainability of public finances. In December 2011, a new set of indicators was announced to guarantee a correct monitoring of the cyclical macroeconomic imbalances within the eurozone member countries.

2.3.1 *The Preventive Arm*

Under the provisions of the preventive arm, Member States must submit annual stability or convergence programmes, in which they show how they intend to achieve or safeguard sound fiscal positions in the medium-term, taking into account the impending budgetary impact of the aging of the population. The Commission assesses these programmes and the Council gives its Opinion on them. This preventive arm includes *two policy instruments*:

- (i) the Council, on the basis of a proposal by the Commission, can address an *early warning* to prevent the occurrence of an excessive deficit; and,
- (ii) using the *policy advice*, the Commission can directly address policy recommendations to a Member State as regards the broad implications of its fiscal policies.

2.3.2 *The Dissuasive Arm: The Excessive Deficit Procedure*

The dissuasive part of the Pact governs the *excessive deficit procedure (EDP)*. The EDP is triggered should a country surpass the Treaty's deficit ceiling of 3 % of GDP threshold. If it is deemed that a country's deficit exceeds the limit as

expressed in the spirit of the Treaty, the Council issues recommendations to the member state concerned. This country is given a period of time to curtail its deficit. Non compliance with the recommendations triggers further steps in the procedures, the possibility of sanction for euro-area member states.

2.3.2.1 Legal Basis and Accounting Definitions

The *Excessive Deficit Procedure* is detailed in article 104C of the Treaty of Maastricht, as well as in its associated legislation, that is, in the *Protocol on the excessive deficit procedure*, and in the *Council Regulation (CE) no 3605/93* on the application of such Protocol (European Council 1993). In this article, it is stated that fiscal deficit and debt figures must comply with the methodology of the European System of Integrated Economic Accounts (ESA). Each country has to notify the European Commission twice a year of its expected and real deficit, as well as of its debt level.

Article 2 of the *Protocol on the excessive deficit procedure* of the Treaty of Maastricht states the following:

- “government means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial paper, as defined in the European System of Integrated Economic Accounts;
- deficit means net borrowing as defined in the European System of Integrated Economic Accounts;
- debt means total gross debt at nominal value at the end of the year and consolidated between and within the sectors of general government as defined in the first indent”.

However, before we discuss the economic rationale of the *Growth Stability Pact* and the *Excessive Deficit Procedure*, we need to keep in mind a few basic concepts concerning public deficit and fiscal effort. In terms of accounting, there are four definitions of public deficit depending of the breadth of economic operations and the size of the public sector considered. The two first refer to public accounting because of the government budget, whereas the third and fourth definitions refer to national accounts in the domain of the national statistical office.

- (i) *Deficit in cash terms* (State non-financial): indicates the balance between receipts and spending for non-financial operations of the central government (State) expressed in terms of Public Accounts (*Cash criteria*).
- (ii) *Deficit in accruals terms*: indicates the balance between recognised rights and obligations of the non-financial operations of the central government (State) expressed in terms of Public Accounts (*Accruals criteria*).
- (iii) *Deficit in national accounts terms*: this differs from deficits in terms of Public Accounts as far as it also includes extra-budget operations such as interest rate swaps, exchange rate, insurance of motorways, etc. This is the definition of deficit used by Member States when they have to deliver the required statistics

to the European Commission to comply with the convergence criteria of Maastricht (*Maastricht criteria*).

- (iv) *Deficit in economic and patrimonial terms*: this includes both financial and non-financial operations and is similar to the profit and loss account of the State public sector (*Public sector criteria*).

2.3.2.2 A Few More Economic Definitions

The concept of deficit as expressed in the Maastricht criteria and the Excessive Deficit Procedure is defined in the European System of Integrated Accounts. To grasp the economic meaning of public deficit and fiscal effort, we need to add a few more definitions:

- (i) *Actual deficit of general government*: according to the ESA95 definition, it is the volume of net indebtedness of the General government sector (S.13), and includes the sub-sectors of Central government (S.1311), State government (S.1312), Local government (S.1313), and Social security funds (S.1314).
- (ii) *Cyclically-adjusted general government deficit*: is obtained by subtracting the cyclical component from the actual budget. The determination of the cyclical component is obtained by multiplying the output gap with the marginal rate of change of both receipts and expenditure, respectively, with respect to GDP. Therefore, *when the output gap is positive* the cyclically-adjusted deficit figure will be greater (worse) than the actual deficit figure, as the extraction of the cyclical component will worsen (increase) the actual deficit figure. Conversely, a *negative output gap* will adjust the cyclically-adjusted deficit figure favourably, as it will correct (improve) the previous figure of actual deficit making the adjusted deficit smaller.
- (iii) *Fiscal effort of general government*: there are several definitions for this concept, but the most established is the one that considers *fiscal effort* as the annual change of the cyclically-adjusted budget balance. It is important to consider the evolution of the actual public deficit and the figures of fiscal effort from *a dynamic perspective to undertake sound economic analysis on public finance* as we will see. Moreover, it is important to underline that not all of the amount of the deficit has the same impact on growth in the long term, and this is why *the quality of public spending matters for growth*. The crucial distinction is between consumption and investment expenditure, not between private and public expenditure.

Commissioner Mario Monti, in a Letter addressed to the College of Commissioners in 1998, underlined that Art 104c, paragraph 3, of the Maastricht Treaty stated “If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium term economic and budgetary position of the Member State”.

Therefore, as Commissioner Monti said in his letter, the Treaty makes a distinction between deficits generated by government consumption and those generated by public investment. Indeed, what damages the formation of capital in an economy is not the total government deficit, but the part that funds government consumption (current expenditure). This constitutes “irresponsible” behaviour towards future generations, as it leaves them with an increase in public debt not properly balanced with a greater endowment of public capital. Recognizing the role of public investment is by no means contradictory to sound and rigorous budgetary policy and is known as the “golden rule”: government indebtedness is admissible, but only to cover government investment, not current expenditure. During the early stages of the Maastricht negotiations, the German delegation suggested that the “golden rule” should be introduced as the criterion for public finance. Although a numeric criterion (3 %) was finally introduced, the “golden rule” was indirectly recognized through of Art 104c.3 (Bulletin Quotidien Europe 1998, pp. 1–2).

2.3.3 The Long-Term Sustainability of Public Finances

EU Member States face the challenge of ensuring the long-term sustainability of public finances in the light of the impending budgetary impact arising from both the ageing of the European population—as people live longer and have fewer children—and lower employment rates in the EU compared to the US and Japan. To meet this challenge and taking into account the focus put on long-term sustainability by the 2005 reform of the Stability and Growth Pact, common long-term budgetary projections are today established at the EU level and each individual Member States’ situation is assessed and monitored. A comprehensive analysis can be found in the sustainability report. The long-term sustainability of public finances is also taken into consideration in the assessment of the stability and convergence programmes.

2.3.3.1 The Initial Setting of the Stability and Growth Pact (SGP)

The *Stability and Growth Pact* originally stated that a country with a deficit of more than 3 % of its GDP would have to pay a penalty 0.25 % of its GDP for every percentage point beyond the 3 % limit. No ceiling was placed on the penalties imposed. Only a country whose GDP had dropped by 2 % would be exempt. In December 1996, however, the Dublin European Council agreed that there would be a *grey zone* for those countries whose GDP fell between 0.75 and 2 %. The penalties were rounded out with a fixed component of 0.2 % of GDP for deficits above 3 %, increasing by 0.1 percentage points of GDP per each additional percentage point of deficit. There would also be a linear penalty of 0.2 % of GDP for debt ratios above 60 %. However, the maximum penalty would never exceed 0.5 % of a country’s GDP when the deficit penalty was combined with the debt penalty.

In June 1997, the Amsterdam European Council established the payment of a deposit without interests amounting to 0.1 % of GDP if a country's deficit was higher than 3 % of its GDP. A further penalty of 0.1 % of the country's GDP would be added for each additional percentage point of deficit beyond the 3% limit, up to a maximum of 0.5 %. The amount was blocked and, after two years, it would become a penalty for the profit of virtuous countries, which had respected the convergence criteria. Until the revision of the Stability and Growth Pact in 2005, the possible situations were the following:

- (i) if a country's GDP had fallen by 2 % or more, no penalty would be imposed, but the country had to take urgent measures;
- (ii) if a country's GDP fell between 0.75 and 2 %, the case could be presented for the consideration of the ECOFIN¹ Council; and,
- (iii) if a country's GDP dropped by more than 0.75%, it could be sanctioned if its deficit had not met the 3% criteria.

2.3.3.2 The Revision of the Stability and Growth Pact

In March 2005, the Brussels European Council approved a reform of the Stability and Growth Pact making it less stringent, considering more closely the circumstances of each case. The sanctions were no longer imposed automatically and more room was made for “relevant factors” in public spending, such as R&D, German reunification costs, international solidarity, etc. This reform was consistent with the lines previously established in the Commission Communication COM (2004) 581 on “Strengthening economic governance and clarifying the implementation of the Stability and Growth pact” (European Commission 2004). The major new elements of the Commission Communication were the following:

- (i) surveillance of the budgetary positions will focus more on *government debt and debt sustainability*. In particular, a reference rate for the satisfactory pace of debt reduction will be set up for highly indebted countries. It will take into account country-specific circumstances like the impact of ageing and contingent liabilities, the initial debt level and the potential output growth conditions;
- (ii) when defining the *medium-term deficit objective of ‘close to balance or in surplus’* or the path to achieve it, greater consideration will be given to country-specific circumstances. Deviations from its achievement will be assessed in light of national debt levels, potential output growth, inflation, existing liabilities related to ageing populations, the impact of structural reforms carried on. The need for additional net investment could be considered;

¹ The ECOFIN is the Economic and Financial Affairs Council, one of the oldest of the EU. It is composed on the Finance Ministers of the 27 Member States and of their Budgets Authorities when the budget is discussed.

- (iii) country-specific circumstances will also be taken into consideration for the definition of the *adjustment path to correct excessive deficits*, the related deadlines will be fixed according to the cyclical position and debt levels of the economy under scrutiny. Moreover, the *exceptional circumstances clause* will be modified in order to include protracted periods of sluggish economic growth;
- (iv) the *preventive side of the action* to avoid budgetary imbalances will be strengthened implying: a) running *symmetric fiscal policies* over the cycle to both prepare for the ageing of the population, and create sufficient room of manoeuvre for the full working of automatic stabilisers; and, b) *using the Broad Economic Policy Guidelines (BEPG) more effectively* to prevent procyclical policy in good times; and
- (v) the surveillance of fiscal policies will be encompassed in a broader perspective in the sense that economic and budgetary policies need to set the right priorities towards economic reforms, innovation, competitiveness and strengthening of private investment and consumption linking them to the *wider macroeconomic goals of the EU, including the Lisbon strategy*. Therefore, more emphasis will be put on the growth and employment enhancing role of public finances. This calls for a better coordination between the BEPGs, the SGP and the national budgetary processes, and for a revision of the economic calendar.

2.4 An Assessment of the Revised Stability and Growth Pact²

The revised 2005 Stability and Growth Pact calls for the use of more judgement and greater discretion in the implementation of the fiscal rules as they are intended to be consistent with economic theory. This is likely to enhance the legitimacy and enforceability of those rules. In particular, *the higher weight given to debt with respect to deficit makes is likely to reduce the moral hazard that might tempt member states, by providing fewer incentives for one-off or cosmetic operations just meant to bring the deficit below 3 %.*

However, the partial shift from rules to discretion is no guarantee for greater consideration of policy concerns in the reshaping of the fiscal framework. There is not necessarily an equivalence between rules and stringency, on the one hand, and discretion and loosening, on the other. Early in the 1990s, Manuel Guitián already underlined (Guitián 1992) that the dilemma between strict observance of rules and reasoned exercise of discretion is more apparent than real: (i) rigid adherence to rules in circumstances that call for the use of judgement and some discretion is inimical to the very existence of the rules themselves; and (ii) the longevity of rules in economic policy depends on the ability to adapt them when conditions warrant.

² The author would like to thank Ralf Jacob, a former colleague in DG EMPL, for the fruitful exchange of views that we maintained on these issues, such conversations made my own previous ideas change. Any remaining error is my sole responsibility.

The stronger emphasis on the growth enhancing role of public spending, long-term sustainability and country specificities advocates considering, within the implementation of budgetary surveillance, the total amount of *human capital-enhancing spending*.³ Here we refer to *education, training and Active Labour Market Policies (ALMPs)*, which improve a country's future macroeconomic performance in terms of productivity, growth and employment thereby helping to cope with the ageing issue. If those policies are properly targeted to older workers they delay the actual exit age from the labour market, leading to a direct relief for pension systems. Moreover, they help to prevent a skills mismatch in the labour markets. Higher flexibility in the close to balanced budget target, or in the path for excessive deficit correction—if not even in the threshold relevant for the latter—could be allowed when a significant share of GDP devoted to government expenditure—namely capital formation, including human capital—falls under the above items.

One should ask for a different approach in the assessment of the quality of public expenditure under which social expenditure is no longer regarded as unproductive. Looking at spending aggregates, which are arbitrarily defined as productive or unproductive, is inappropriate. Therefore, one should stress that every type of public expenditure can be more or less productive, depending on whether it meets real needs in the most cost effective way. Moreover, one should recognize the social returns of policies against poverty in terms of, for instance, lower criminality and health care costs.

In the area of social expenditure, incentive effects are particularly important. This touches upon the issue of making work pay (European Commission 2003) and the degree to which tax-benefit systems provide the right incentives for unemployed people to take up even low-paid jobs, for workers to progress towards better paid jobs—through the right level of marginal effective tax rate—or for workers to remain longer in the labour market longer.

An interesting example of the complexity of the issue is the size of unemployment benefits, which is negatively correlated with employment protection legislation in the Western countries. Higher spending on such benefits appears to be more efficient than employment protection legislation in facilitating structural change, enhancing economic performance and raising employment. Clearly, the emphasis between the two policy tools is also a matter of Member States' preferences and traditions and there is no national model that should be systematically adopted by the other countries. Still, this evidence shows that an approach relying on supposedly unproductive expenditure can be more efficient than an approach which does not show up in public expenditure at all.

Regarding future liabilities linked to ageing, it is important to avoid too narrow a view. Considering only the total amount of implicit liabilities (present value of the future stream of pension payments that would be due according to current legislation) is not sufficient. This will be high for some countries, which rely primarily on public

³ We must avoid any approach that looks at the share of such spending in overall public expenditure, as this will be distorted by the choice between public and private pension and health care provision. However, it would make more sense to look at the share of GDP devoted to capital formation, including human capital.

pension provision, but these countries are generally also able to raise more revenue for such schemes (need to consider acceptance of contributions/taxes for financing public pension schemes). Therefore, the revenue side also needs to be considered.

It is also important to take into account the adequacy situation: countries with generous pension systems (high replacement rates available at a relatively young age) have room to manoeuvre and can reduce future liabilities more than countries where benefits are already low (two contrasting examples could be Greece and the UK). Finally, room for manoeuvre might come from the increase in employment rate, as long as a country is willing to carry out the necessary policies to prompt it. Similar considerations can be applied to the area of health and long-term care where ageing is also expected to lead to expenditure, although this is even more difficult to quantify than pension expenditures.

A more sophisticated analysis of a country's ability to cope with the impact of ageing is required in the framework of the revised Stability and Growth Pact. In the previous SGP, the assessment was too much based on simple projections of public spending without taking into account any of the considerations mentioned above. The Open Method of Coordination (OMC) on pensions and health/long-term care plays an important role in developing a more comprehensive assessment of the long-term sustainability of the social protection systems.

2.5 The Six Pack: Scoreboard for the Surveillance of Macroeconomic Imbalance Procedure

Despite the above strict procedures involved in the surveillance of the economic and budgetary situations of Member States, the current financial crisis revealed weaknesses in the governance framework of the EMU. As a result, the EU adopted the so-called *Six Pack*, that is, a set of legislative proposals to enhance economic governance. The legislative package entered into force on 13 December 2011, and introduced a new surveillance procedure for the prevention and correction of macroeconomic imbalances, the so-called, *Macroeconomic Imbalance Procedure (MIP)* built around a 'two-step' approach: the first step is an alert mechanism consisting in a scoreboard with *early warning indicators* put in place by the Commission to focus attention on risks; in a second step, a more in-depth analysis is undertaken in those countries identified in the *Alert Mechanism Report (AMR)*.

As stated in the Commission report, the indicators and thresholds of the scoreboard aim at providing "[...] a reliable signalling device for potentially harmful imbalances and competitiveness losses at an early stage of their emergence [...]" The scoreboard consists of the following ten indicators and indicative thresholds:

- three-year backward moving average of the *current account balance* in percent of GDP, with a threshold of +6 % of GDP and -4 % of GDP;
- *net international investment position* in percent of GDP, with a threshold of -35 % of GDP;

- five-year percentage change of *export market shares* measured in values, with a threshold of -6% ;
- three-year percentage change in *nominal unit labour cost*, with thresholds of $+9\%$ for euro-area countries and $+12\%$ for non-euro-area countries, respectively;
- three-year percentage change of the *real effective exchange rates* based on HICP/CPI deflators, relative to 35 other industrial countries, with thresholds of $\pm 5\%$ for euro-area countries and $\pm 11\%$ for non-euro-area countries, respectively;
- *private sector debt* in percent of GDP with a threshold of 160% ;
- *private sector credit flow* in percent of GDP with a threshold of 15% ;
- year-on-year *changes in the house price index* relative to a Eurostat consumption deflator, with a threshold of 6% ;
- *general government sector debt* in percent of GDP with a threshold of 60% ;
- three-year back moving average of the *unemployment rate*, with a threshold of 10% ” (European Commission 2012, pp. 6–7).

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