Economics Bulletin

Volume 31, Issue 1

The European fiscal framework: What lessons can we learn from the crisis?

Christophe Schalck
ESG Management School Paris

Abstract

This paper provides some explanation of recent fiscal developments in European countries and offers several guidelines for a new European fiscal framework. We propose a framework based on three pillars: a quantitatively and qualitatively extended preventive arm, an improved dissuasive arm and a financial arm that facilitates financial solidarity between member states, thus increasing the credibility of the euro area.

Citation: Christophe Schalck, (2011) "The European fiscal framework: What lessons can we learn from the crisis?", *Economics Bulletin*, Vol. 31 no.1 pp. 358-366.
Submitted: Sep 13 2010. **Published:** January 19, 2011.

1. Introduction

Since 1997, the European Union's fiscal framework has been defined by the Stability and Growth Pact (SGP). This framework, which was revised in 2005, builds on the Maastricht and Amsterdam Treaties. The SGP was established to safeguard sound public finances. The Pact consists of a preventive arm and a dissuasive arm. Under the provisions of the preventive arm, member states must submit annual stability or convergence programs showing how they intend to achieve or safeguard sound fiscal positions in the medium term, taking into account the impending budgetary impact of population aging. On the basis of a proposal by the Commission, the Council can issue an early warning to prevent the occurrence of an excessive deficit. The dissuasive part of the Pact governs the excessive deficit procedure (EDP). The EDP is triggered when deficits breach 3% of GDP, the threshold of the Treaty. If it is determined that the deficit is excessive, as defined in the Treaty, the Council issues recommendations to the member states for correcting the excessive deficit. It also provides a timeframe for doing so. Non-compliance with the recommendations triggers further steps, including the possibility of sanctions against member states.

Despite this framework, fiscal developments in most European countries show a strong increase of the public balance and the public debt ratios from 2008. In 2009, the public balance and public debt in the EU increased by 4.5 points of GDP and 12 points of GDP, respectively. Moreover, the Greek government had difficulties financing its debt, which led to the creation of a rescue package. Recent fiscal developments highlight weaknesses in the current framework. Consequently, there is an ongoing debate about the future of European governance. On one hand, the SGP should be strengthened; on the other hand, the framework should provide for increased coordination in economic policies.

The aim of this paper is to provide some explanation of recent fiscal developments in European countries and to offer guidelines for a new European fiscal framework. The paper is organized as follows: Section 2 presents recent fiscal developments, Section 3 analyzes the responses of the current fiscal framework, Section 4 discusses several views of the future European governance and proposes a revision of the Pact, and the final section concludes the paper.

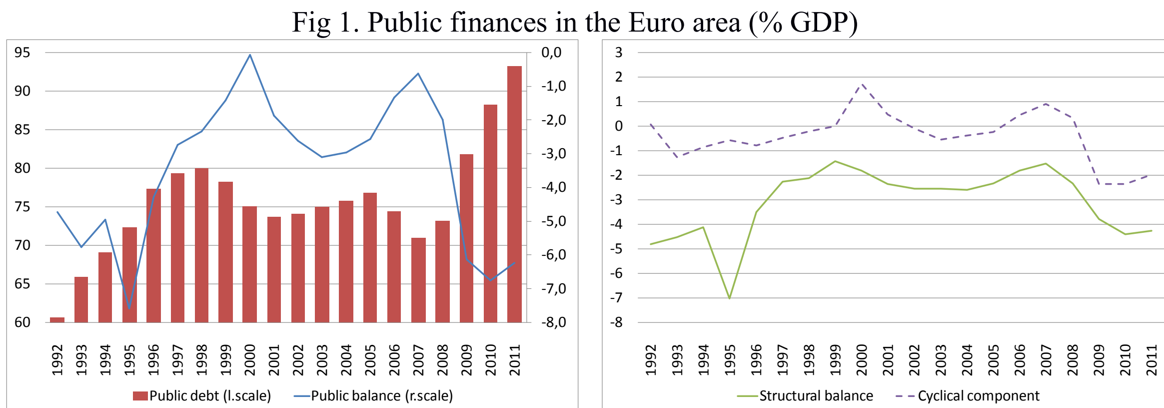
2. The European public finance in the crisis

2.1. A single destiny

Before the current crisis hit European economies, European public finances were experiencing a period of fiscal consolidation. The public balance in the euro area had been reduced by 2.5 percentage points of GDP since 2003 and had almost reached equilibrium in 2007 (-0.6% of GDP). Similarly, the ratio of public debt had declined by 4.1 pp over the same period to 70.9% of GDP. However, fiscal consolidation was largely made possible by a good economic situation, and the improvement in the structural balance was lower than expected (Fig 1).

The economic crisis led to a sharp deterioration in public finances (the public deficit in the euro area increased by 4.1 pp in 2009. Fiscal revenues contracted sharply due to the decline of tax bases (income, profit, consumption, and so on). Therefore, the increase in the deficit is mainly due to the automatic stabilizers: the cyclical component of the balance decreased by 2.6 pp in 2009 in the euro area. In addition, many European countries implemented discretionary measures to support economic growth. These measures, coordinated in the European Recovery Plan, should respect the 3T rule (Timely, Targeted, Temporary). The magnitude of the recovery plans was approximately 1.2% of GDP, which explains much of the change in structural balances. Another factor contributing to this change is the existence of revenue shortfalls. Revenue shortfalls correspond to revenue growth below what would normally be expected given legislative changes and by the development of macroeconomic variables used to proxy for tax bases. These recent significant shortfalls are mainly linked to financial and housing market developments (Morris et al., 2009).

Fig 1. Public finances in the Euro area (% GDP)



Source : OECD, EO 86

It follows that the deterioration of fiscal balances in Europe reflects the output shortfall and the use of fiscal policy to support growth. Hence, current fiscal deficits should not be considered as *"indicators of pre-crisis public finance structural imbalances that should be cured by restrictive fiscal policies"* (Mathieu and Sterdyniak, 2010).

As in all European countries, public finances in Greece have dramatically worsened during the crisis. In 2009, the public deficit reached 12.7% of GDP, and public debt reached 115% of GDP. The level of the Greek deficit is certainly high, but it is comparable to deficits in Ireland and the United Kingdom. However, Greek public finances have posed a special problem.

2.2. The Greek issue

Public finances in Greece have several particularities in comparison to other European countries. One distinguishing feature is the revision of public accounts. Since Greece joined the euro area, its public deficit figures have been revised several times. In 2009, the revision was both qualitatively and quantitatively different from previous revisions. The new government elected in October 2009 disclosed that that the budget deficit was

estimated at 12.7% of GDP instead of the previously estimated 6.7% of GDP. This gap could be explained by the use of securitization deals, which are structured finance products. Financial risk is distributed by aggregating debt instruments into a pool, and new securities are issued by this pool. Greece had classified these deals as sales of assets instead of loans. Thus, the deals were not included in the national accounts. Another feature of Greek public finance is the nation's persistent structural deficit. Its cyclically adjusted primary balance has been negative since 2003. This situation is explained by two factors: the development of a large public sector, especially the public wage bill[1], and a large underground economy (28% of GDP according to the World Bank).

Due to its high public deficit and interest charges (4.5% of GDP in 2009), the financing needs of Greece for the year 2010 are substantial (60 billion €). In the context of a negative economic growth rate and a positive interest rate, financing needs are subject to a snowball effect (i.e., the public debt is will continue to increase exponentially. Such an effect is not surprising in times of recession. Although it occurs in most European countries, the extent of this effect in Greece is much greater than in other euro area countries. In Greece, the spread between the primary balance and the debt stabilizing primary balance[2] was equal to 12.5% of GDP in 2009, while it was 7.4% of GDP in the euro area as a whole (Table 1). Thus, the situation of public finances in Greece is perceived as a source of uncertainty by financial markets. Rating agencies downgraded its sovereign rating, which signaled the possibility of default. Consequently, the market premium for Greek bonds increased; the yield spread between bonds issued by the German and Greek Governments widened to 614 basis points on April 26, 2010 (Fig 2).

Table 1. Primary balance and debt stabilizing primary balance
in the euro area in 2009 (% GDP)

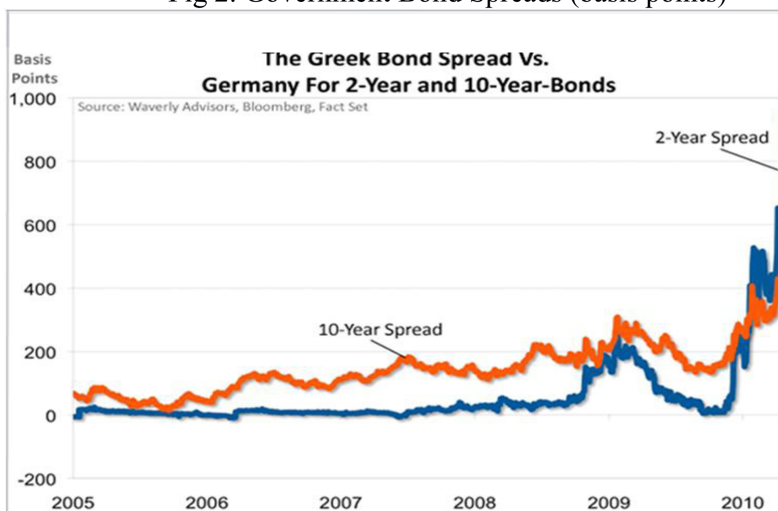
	AU	BE	FI	FR	GE	GR	IR	IT	LU	NL	PT	SP	EA
PB	-2.1	-2.1	-2.8	-5.3	-0.9	-8.2	-11.6	-0.6	-2.9	-2.7	-3.9	-8.5	-3.4
DSPB	4.9	6.0	2.2	4.4	5.9	4.3	8.9	8.5	0.3	3.5	-0.9	3.4	4.1
Spread	6.9	8.1	5.0	9.7	6.8	12.5	19.5	9.1	3.2	6.2	3.0	11.9	7.5

PB: primary balance, DSPN: debt stabilizing primary balance
Source: OECD and author's computations

[1] The growth of the public wage bill in Greece increased from 10.5% in 2000 to 11.5% in 2008, whereas the growth of the public wage bill in the euro area decreased from 10.5% to 10% during the same period.

[2] Debt stabilizing primary balances are computed as follows: $dspb = [(r-g)/(1+g)]b$ where r is the apparent interest rate, g is the economic growth rate, and b is the public debt ratio.

Fig 2. Government Bond Spreads (basis points)



3. The response of the current framework

Given the sharp deterioration in public finances, the European Commission applied the SGP, which resulted in the excessive deficit procedure (EDP). The Commission submitted 24 of the 27 EU countries to the EDP (Table 2). Most European countries are outside the fiscal framework, which leads us to think that this framework is not entirely appropriate. The increase in European deficits is the result of a negative aggregate shock and not the result of individual fiscal slippage. The EDP, as it is currently defined, does not distinguish between these two very different situations. The Commission has applied the SGP with some flexibility, setting deadlines for bringing down public deficits that are longer (2012 or 2014) than one year. Nevertheless, the Commission declared that consolidation should start in 2011 at the latest and go beyond the benchmark of 0.5% of GDP per year. The issue is that these consolidation requests and deadlines are constraints imposed independently of economic developments. Thus, the consolidation requirements should be revised, up or down, according to the economic growth rate.

In response to the Greek crisis, the EU reacted effectively and made a major coordinated effort to ensure the viability of the euro area. In May 2010, member states approved a rescue plan. The financial plan offered110 bn € to Greece over three years, with member states contributing 80 bn € and the IMF expected to provide the additional funding. The plan consisted of bilateral loans between member countries and Greece at rates below market rates but higher than refinancing rates. The European mechanism was also based on a "stabilization fund". This fund could contain up to of 750 bn €; the IMF could provide 220 bn €, the EU would contribute 440 bn €, and the other 70 bn € would be available if member states experienced "exceptional occurrences" beyond their control. This Special Purpose Vehicle (SPV) could offer loans or advances to member states until 30 June 2013. The particularity of this SPV is that it could borrow with the guarantee of 16 members, which would allow for financing at a lower rate.

Table 2. Overview of ongoing EDP

Country	Commission report	Council Decision	Deadline
Bulgaria	12 May 2010		
Denmark	12 May 2010		
Cyprus	12 May 2010		
Luxembourg	12 May 2010		
Finland	12 May 2010		
Austria	7 October 2009	2 December 2009	2013
Belgium	7 October 2009	2 December 2009	2012
Czech Republic	7 October 2009	2 December 2009	2013
Germany	7 October 2009	2 December 2009	2013
Italy	7 October 2009	2 December 2009	2012
The Netherlands	7 October 2009	2 December 2009	2013
Portugal	7 October 2009	2 December 2009	2013
Slovenia	7 October 2009	2 December 2009	2013
Slovakia	7 October 2009	2 December 2009	2013
Poland	13 May 2009	7 July 2009	2012
Romania	13 May 2009	7 July 2009	2012
Lithuania	13 May 2009	7 July 2009	2012
Malta	13 May 2009	7 July 2009	2011
France	18 February 2009	27 April 2009	2013
Latvia	18 February 2009	7 July 2009	2012
Ireland	18 February 2009	27 April 2009	2014
Greece	18 February 2009	27 April 2009	2014
Spain	18 February 2009	27 April 2009	2013
UK	11 June 2008	8 July 2008	2014
Hungary	12 May 2004	5 July 2004	2011

Source: European Commission

4. Toward a new fiscal framework?

There is a consensus on the necessity of improving the Pact. However, there are two opposing views on the appropriate direction for the future. One is based on a strengthened SGP, while the other is based on increased flexibility. We believe that there is an intermediate option that takes European financial relations into account.

4.1. A strengthened framework

Most international institutions have the same position: the SGP should be strengthened. According to the IMF (2010), advanced economies should return to pre-crisis debt levels because there could be a link between the public debt level and the real interest rate level. OECD (2010) has called for tightening fiscal policies (by 1% of GDP per year from 2012 to 2017) to avoid Ricardian behavior on the part of households and to reassure financial markets.

From the German perspective, the current fiscal developments show that the SGP was not strict enough. Therefore, Bofinger and Ried (2010) have proposed a European Consolidation Pact to supplement the SGP. Under this consolidation pact, members are obliged to detail a path towards balancing their budget, and they must implement an automatic tax increase law in case they stray from the defined path. Moreover, the soundness of fiscal policies must be monitored before and after each new government bond issue to obtain bond guarantees.

4.2. A flexible framework

A strengthened framework implies two main risks for European countries. First, it could imply "an Argentine risk": the implementation of restrictive policies could lead to a long period of slow economic growth. Moreover, there is a risk to long-term competitiveness; fiscal austerity leads European countries to reduce growth-enhancing public expenditures (R&D, education, green economy).

According to the flexible view, the fiscal framework should be based on the coordination of economic policies. Fiscal coordination appears to be compatible with the SGP, and coordination gains can actually be enhanced by the SGP (Schalck, 2006). The OECD also recommends the coordination of fiscal strategies, but such coordination is not possible if all countries have to consolidate at the same time. In a deeper way, SGP rules could be replaced by a coordinating process that takes economic circumstances into account (Mathieu and Sterdyniak, 2010).

4.3. Inclusion of monetary and financial issues

Several proposals have been made to improve debt monitoring in Europe. Gros and Mayer (2010) proposed a European Monetary Fund. A country with a public debt above 60% of GDP and/or with a public deficit higher than 3% of GDP would be expected to contribute. A country in difficulty could borrow an amount corresponding to its past contribution. To obtain more, the country would have to accept an adjustment program. The distinction between debt below 60% of GDP and debt above 60% of GDP is also present in the proposal of Delpla and von Weizäcker (2010). The debt below the 60% threshold debt is called "blue debt", and it is collectively issued and guaranteed. On the other hand, debt over the 60% threshold is called "red debt", and it is issued with a higher interest rate to discourage excessive public borrowing.

Yves Leterme proposed a European Debt Agency (EDA), which would issue debt for all countries. Diev and Laurent (2010) analyzed a model in which an agency would issue eurobonds and re-lend to participating countries. These eurobonds would have a Guarantee Fund supplied by the most risky countries, and a decision-making body would determine the price to be paid by the risky countries for the guarantee. However, this mechanism has significant drawbacks, including loss of contact with financial markets, lack of transparency, and political pressure. If the aim of the mechanism is to solve liquidity problems for EMU members, common eurobonds would be enough. The interest

rates that each government would have to pay for the bond should be exactly the rate that it pays on its national bonds (De Grauwe and Moesen, 2009).

4.4. A three pillar fiscal framework

Owing to past fiscal developments and the economic analysis above, we propose a reform of the SGP to improve cohesion and stability in Europe. This proposal is built around three pillars: a preventive arm, a dissuasive arm and a financial arm.

The preventive arm should be extended quantitatively and qualitatively. The Greek crisis demonstrated the need for repeated rigorous examinations of statistics. Therefore, the harmonization of statistics and auditing by European and independent institutions should continue. To maintain room to maneuver during downturn periods, it is necessary that the SGP be symmetric. Fiscal policy should include adjustments in good times and not only fiscal impulses in bad times. Moreover, public investment should not be a target for spending cuts when ensuring long-term growth. Thus, the economic cycle should be taken into account by focusing on structural balance without public investment. Finally, the financial crisis has shown that the main challenge for fiscal policy is less the public deficit than the public debt. The Pact should be more focused on this variable. In addition, Ireland and Spain have shown that macroeconomic analysis should be based on a global analysis of debt; it should include not only public debt but also internal and external debt. The savings-investment balance of each country should be considered. The lack of private savings can impose as much pressure on interest rates in the euro area as the lack of public savings. Moreover, if we consider the euro as a common good, it makes sense to target the external balance.

The dissuasive arm should be deepened. Aside from the reputation effect for the government, the sanctions in the EDP form a binary system: financial penalty or not. The corrective arm can be improved by incorporating gradual sanctions, such as the reduction of structural funds, suspended voting rights, or financial penalty. The application of different types and levels of sanctions would enhance the credibility of the framework.

The recent crisis has shown the importance of monetary and financial responses to crises. Thus, it appears necessary to introduce these aspects in the fiscal framework. The SPV could be maintained beyond 2013 in order to show financial solidarity between member states and thus increase the credibility of the euro area. As noted above, sovereign risk premiums can be controlled in part through common bonds because they reduce liquidity risk. Finally, a European rating agency could be created. This agency would specialize in controlling sovereign risk, it would have deeper knowledge of the specific features of public finances, and it would reduce the risk of self-fulfilling situations (and thus speculation).

5. Conclusion

This paper has provided some explanation of the recent fiscal developments in European countries and offered several guidelines for a new European fiscal framework. Most European countries have experienced significant increases in the public balance and the public debt ratio, but the deterioration of fiscal balances in Europe reflects the output shortfall during the recession and the use of fiscal policy to support growth. The Greek situation highlights the need for pan-European coordination, which has thus far only led to temporary mechanisms. Even if there is a consensus on the necessity of improvements in the Pact, there is no consensus about its future direction. Some proposals focus on strengthening the SGP, while others are based on increased flexibility. We propose an intermediate option based on three pillars: a quantitatively and qualitatively extended preventive arm, an improved dissuasive arm and a financial arm. The European integration would lead to an area that would be economically and politically sustainable. This objective cannot be achieved without an effective and credible fiscal framework.

References

Bofinger, P. and S. Ried (2010) “A New Framework for Fiscal Policy Consolidation in Europe”, German Council of Economic Experts Working Paper 03/2010.

De Grauwe, P. and W. Moesen (2010) “Gains for All: A Proposal for a Common Euro Bond” *Intereconomics* **3**, 132-135.

Delpla, J. and J. Weizäcker (2010) “The blue bond proposal”, Bruegel Policy Brief May.
Diev, P. and D. Laurent (2010) “Towards an European Debt Agency” mimeo.

Gros, D. and T. Mayer (2010) “Towards a Euro(pean) Monetary Fund” CEPS Policy Brief No 202.

IMF (2010) “Navigating the Fiscal Challenges Ahead” Fiscal Monitor May.

Mathieu, C. and H. Sterdyniak (2010) “European debt crisis and fiscal exit strategies” OFCE Working Paper No 2010/11.

Morris R., C. Rodrigues Braz, F. de Castro, S. Jonk, J. Kremer, S. Linehan, M-R Marino, C. Schalck, O. Tkacevs (2009) "Explaining government revenue windfalls and shortfalls: an analysis for selected EU countries" ECB Working Paper No 1114.

OECD (2010) *Economic Outlook* No 86.

OECD (2010) *Preparing fiscal consolidation* May.

Schalck, C. (2006) "The stability Pact and the coordination of fiscal policies in the EMU" *Economics Bulletin* **5(9)**, 1-11.