GOVERNING EUROPEAN UNION TO FINANCIAL STABILITY

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Abstract: In the last four years, a significant part of the European Union members has recorded a real decline in the sustainability of their public debt. The failure of Greece, Italy, Belgium or Spain to easily find funding at previous interest rates has induced the fear that the European Monetary Union would disintegrate. Such a scenario is not realistic because it does not take into account the economic interdependencies that have been created between the countries participating at the monetary zone. Nevertheless, we can say that the Stability and Growth Pact which aimed towards the coordination of national fiscal policies for ensuring the stability and prudence of the budgetary climate, has failed. This failure was primarily due to the lack of specific sanctions for those members that have not fought against the fiscal imbalances and secondly to the stopping the steps forward towards a common fiscal policy. Thus, we can say that the European Monetary Union is driven now by the wrong rule of “no taxation with representation”. For these reasons, this paper aims at showing that the European fiscal federalism is far away from becoming reality and that the new instruments chosen for the new stability of the European Monetary Union will be the task of the Member States themselves. This paper will also review the main rules that are projected to be the source for the future European financial stability and growth: the balanced budgets and the deficits built only on the “Golden Rule” premises, for which other amendments on European Treaties are expected.

Keywords: nominal convergence, golden rule, deficits, public debt.

JEL Classification Codes: E61, H61, H63.

1. INTRODUCTION

The main fiscal rules of the European Monetary Union which have established a threshold for budgetary deficit at up to 3% of GDP and for public debt at up to 60% of GDP were built in order to guarantee a relative solvency of Member States and to escape their governments from temptation to promote pro-cyclical policies. Furthermore, the fiscal nominal criteria laid down in Maastricht were aimed to remove any potential tensions between members, due especially to the spread of negative effects of economic imbalances.

Although the fiscal limitations were intended to strengthen the financial stability of the monetary area, these criteria have been strongly criticized from the very beginning as too rigid and limitative for growth and many countries have already questioned their optimal character, even the possibility of relaxing them. Among the states who wanted to relax the fiscal criteria were always Italy and Greece.

Another important issue is related to the lack of any type of sanctions against the countries that failed to combat effectively the excessive budget deficit, in the term of grace granted by excessive deficit procedure. Under these circumstances, Members like Greece, Italy, Belgium or Portugal have overlooked the fiscal recommendations laid down in the Stability and Growth Pact right from the creation of the European Economic Union. This attitude of disregard for the fiscal

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rules was extended among the other members, some of whom have had fiscal rules harsher than those required by the Stability and Growth Pact. Regarding this latest issue, the best example is United Kingdom which has abandoned “the Golden rule” a fiscal policy principle set out in 1997, which required keeping the public debt at a prudent level, below at 40% of GDP.

**Figure 1 - Public Debt Dynamic in E.U. 2000-2010**

(Percentage of GDP)

Halfway into the year 2007, the economic slowdown and the consequent reduction of revenues caused a stronger deterioration of public debt, and the frequently expressed growing fear of the sovereign risk chance of emerging. The concerns about the manifestation of such risk occurred not only among developed countries whose public debts exceeded their GDP, but also among the new Member States which still have relatively low debt levels, but faced with a general mistrust of credit markets.

The negative externalities arising from the debt restructuring of Greece, in October 2011, the spillover effect on governmental bond interests and the new wave of skepticism around the feasibility of the European currency in the absence of the common fiscal policy requires a fast action which must treat the causes of debt sustainability and not only the effects.

Several years ago the overestimation of economic growth due to “political distortions” on governmental policies were considered an exclusive feature of emerging economies (Gavin and Perotti, 1997; Talvi and Vegh, 2005, Iron and Bivens, 2010) and the main cause of the large annual deficits, leading to a higher public debt. Today, we can find that a similar fiscal behavior has been learned even by the developed economies.

We can say that the next way to reach the new financial stability is related to the constraint of political actors to adopt projects only within the potential resources of the national economy.

**2. REDISCOVERING AN OLD PARADIGM**

The balanced budget pattern and the dismissal of public debt is not at all a new concept about financial stability of a national economy. In the nineteenth century, the classical economists have strongly rejected the government borrowings for regular expenditures. The classics were not so much opposed to the potential use of loans for the capitalization of the
In the twenty-first century the balanced budgets had been demystified, understanding the need for a safety belt if an economic shock were to take place. Even the economists defending balanced budgets have accepted the strong need to allow the exception for loans, but achieving the circumstances of these exceptions was a very hard mission.

In 1929, Arthur Cecil Pigou, one of those economists which considered that a well-organized economy can cover their current expenditures by taxes, without needing loans, admits the need for exceptions. The exceptions that Pigou had anticipated were related to the spending for removal of negative consequences of natural disasters or caused by war that could negatively affect the capacity to collect taxes from the economy for a while. Pigou also recognizes that the loans made for the accumulation or production of capital goods can not be seen as dangerous.

Once the existence of an extraordinary budget deficit and the accumulation of public debt have been relatively accepted, a number of dilemmas were brought to light. “Who will pay? How much to loan? When to loan?” asked James Buchanan and Richard Wagner, thinking of the consequences in the field of intergenerational equity. The same economists defined the burden of accumulating a high stock of public debt through the analogy with the tax burden, considering the opportunity cost of public debt is the value of private goods that are given up in exchange for public goods (Buchanan and Wagner, 1958).

James Meade believes that a clear distinction must be made between external debt and domestic debt. While external debt is a burden for the community, because it produces transfers of real goods and services between debtor and creditor, domestic debt is a transfer from citizens, as taxpayers, to citizens as property owners and consequently nothing is lost (Meade, 1958).

Another dilemma is related on the long-term implications of public debt on economic growth. If the governments spend, for projects that produce a yield in the future, the gross debt burden could be offset by the expenses, so that the gross yield net result would be quite positive (Modigliani, 1961).

Through a rigorous analysis Fabrizio Balassone has reviewed the most relevant theories expressed about the distinction between ordinary and extraordinary expenditures or a budgetary distinction between ordinary and capital expenditures (Balassone, Franco, 2001, Balassone, Franco, Zotteri, 2004). This distinction leads the Italian economists to the double budget theory in order to explain which expenditures can be financed by recurrent revenues and which may be financed by deficit. In respect of this view the public budget may be divided into a current and capital account. “While the former must be balanced or in surplus, the later can run a deficit” (Balassone, Franco, 2001).

This latest budget conception has already been put into practice by the United Kingdom into the so called “Golden rule”. This budgetary rule stipulated in annex B, “public finances”, of the British Pre-budget Report 1999, states that over the economic cycle, the Government will borrow only to invest. The golden rule will be met if the average annual surplus on the current budget expressed as a ratio to GDP, measured from the year in which the economic cycle begins up to and including the year in which the economic cycle ends is in balance or surplus.

\[ d - i = g_c - t + rb \leq 0 \]

Where \( d \) is the deficit, seasonally adjusted, \( i \) - the net investments (% GDP), \( g_c \) - government spending, \( t \) - taxes, \( r \) - interests, \( b \) - public debt stock.
The second Government’s fiscal rule regards the sustainable investment rule which requires that the public sector net debt as a proportion of GDP must be held over the economic cycle at a stable and prudent level to below 40 percent of GDP over the economic cycle. Also, the automatic stabilizers have a significant impact on the public finances. The British Treasury estimates suggest that, after two years, a 1% increase in output relative to trend will lead to: an increase in the ratio of the surplus on the current budget to GDP of just under 3/4 percentage point; and a decrease in the ratio of public sector net borrowings to GDP of just under 3/4 percentage point (HM Treasury, 1999).

It must be said that the British model of fiscal consolidation requires a balanced budget over the economic cycle and not for one fiscal year. So, the fear of Balassone and Franco that the introduction of a deficit ceiling can conduct automatically to a reduction in net investments (Balassone, Franco, 1999) is ousted. Allowing the deficits in the bad years offset by surpluses in the next growth years and the permission for lending to public investments should disperse the worries that the objective of fiscal consolidation will adversely affect the investment and the economic growth perspectives. The permission for deficits in the bad times may calm the Krugman’s fury on frequent adopted policy in the latest years, which meant the reduction of the government expenditures and investments, for trying the construction of balanced budget in times of hard recession (Krugman, 2008).

Even the latest British Pre-Budget Statements was widely seen as an abandonment of Gordon Brown’s “Golden Rule”, more European members have already seen this rule feasible and have made engagements to include in their constitutional law the rules very similar to the English fiscal model.

3. TOWARD A COMMON FISCAL POLICY

It must be noted that in the latest European Council, held in Brussels, on the 9th of November, just the United Kingdom was radically opposed to the change of fiscal rules in the E.U. Treaty, in order to increase the fiscal integration of Member States. We have to admit that the U.K. has permanently expressed solid doubts on the advanced integration in monetary and fiscal field of European Union.

Despite the use of the U.K.’s “veto”, European members have understood that the European Monetary Union and the countries willing to use the European currency in the next years need a high level of integration of their fiscal and budgetary policies (Balassa, 1962).

Nevertheless, the main commitments stipulated in the Declaration of the Heads of States and Governments is far to be considered a progress towards the establishment of a common fiscal policy. The main rule adopted in this Council regards the objective of the signatory States to ensure balanced budgets or in surplus; this condition is considered to be met if annual structural fiscal deficit is below 0.5% of nominal GDP and accrual deficit at below 3% of nominal GDP. The option for permanent balanced budget is also an option for “tax-smoothing rule” (Barro, 1979) considering the tax revenues will be planned to be a constant share of GDP, the permanent tax rate or share (Buiter, 2003). The effectiveness of Council’s decision depends on the introduction of this budgetary mechanism into the national constitutions or into the laws with constitutional rank. The rules pursuing fiscal stability should not necessarily be implemented into the constitution of the State in order to achieve them (Catrina, 2011).

The balanced budget and the strong fiscal policy must be first of all an attitude of Governments, because the statement of some fiscal rules into constitutional acts does not guarantee the achievement of the financial stability objective. The best example is the U.S.’s fiscal performance which in the nineteen century and the first half of twentieth embodied a norm of balanced budget, without being stipulated in constitution but it was a part of “an accepted set
of attitudes about how government should, and must, carry on its fiscal affairs” (Buchanan, 1997).

It is possible to think a balanced budget rule could be used in the European Union? At this moment, the European budget is too small to achieve the fiscal redistribution, economic and social cohesion in the European Union. The latest crisis has clearly shown that the European Monetary Union needs a stronger fiscal policy in order to sustain the monetary policy.

It is true that in the compromised solution taken at the European Council held in Brussels, on the 9th of November 2011, we can find more decisions that significantly change the European fiscal policy. If the Maastricht Treaty has granted to Member States exclusive competence on fiscal policy, in the near future we will see the sharing of this power. As a result, the fiscal consolidation will start with the supervising of national budgets by European Commission and the automatic penalties for those which ignore the new budgetary nominal criteria. The implementation of these measures can be considered as one small step towards the common fiscal policy dreamt by the European federalists. Their view implies a common fiscal authority, a common strong budget and a common policy of taxation. It is also true that a common fiscal authority can be more efficient and faster in implementation of budgetary adjustment measures, can increase the trust in the Euro zone and can drive easier to financial stability. It has been already shown that the different systems of taxation have stimulated fiscal dumping, especially in Eastern Europe, like a solution to attract the foreign direct investments. For this reason it is necessary, as much as possible, the unification of the taxation system into the European Union. If this goal seems to be unreachable right now, a unification of taxation systems can be started in several stages.

A first step on the unification of the taxation should be the setting of a band of oscillation / a fiscal tunnel with a comfortable oscillation (+/- 2.5%) for the main European taxes: VAT, income taxes, profit taxes and others. I don’t believe that we should think about the construction of a new fiscal and budgetary authority, from the ground, while the European Commission already exists and has enough democratic legitimacy, legal instruments and experience to act in a multinational context. The European Commission has already been performing for many years in other European economic sectors like competition, agriculture, transports and others. Something that the European Commission is missing and should consider getting is a real fiscal and budgetary authority. First of all the European Commission lack the fiscal and budgetary powers coming by transfer from the European Union member states. I think that the transfer of monetary powers to the European Central Bank has already destroyed the myth of impossibility to yielding the sovereignty, despite the fact that the national currency was once the most important symbol of national states.

A common European budget must be also a stronger financial statement, by increasing transfers to up to 5% of GDP of each member, compared to current contribution limited to up to 1.1% of GDP, even though members like Germany, Italy, France or U.K. would become donors. A strong budget could increase the transfer capacity to less developed members and so the economic cohesion would be achieved and positive effects would be on the whole European Union. But, we should not ignore that a stronger European budget needs a clearer definition of levels of administration or in other words a reform of administrative decentralization, for telling us precisely where the European budget works and what will remain in the responsibility of local communities.

4. NEW MEMBER STATES NEED STABILITY AND FASTER GROWTH

For the New Member States who joined the European Union in 2004 and 2007, one of the goals sets in Copenhagen, in 1993, was the adoption of European currency within the shortest possible time. This objective has been misunderstood by the New Member States, because the
adoption of the Euro is not at all the end of the complex process of convergence but only one of its stages. Entry into the Euro area does not mean removing the need to solve macroeconomic imbalances existing in the Member State wishing to join the common currency. The wrong idea that macroeconomic imbalances are a natural component of the convergence process, rather than the result of bad management, has slowed the rhythm of the structural reforms in the most of the New Member States, after accession. Moreover, they have been misunderstood that the achievement of real convergence will be easily accomplished and that is a short time process. The previous accessions of Greece, Ireland, Spain or Portugal, have shown undoubtedly that the catching up takes a very long time and continue also a long time after accession and did not end with this. Despite the fact that these four countries have had a higher development degree than the New Members, it is important to note that for Greece the revenues fell soon after accession, for Ireland the revenues growth came much later than would be expected and Portugal has needed over 10 years to gain 17% GDP per capita growth. (IMF, 2006)

It must be said that, in the New Member States, the nominal convergence was privileged in relation to the real convergence, even if the fulfillment of the fiscal criteria had been negatively influencing the real economic variables. In fact, the two processes, the real and the nominal convergence, can not be seen but complementary. Even though the nominal convergence produces a deceleration of the real economic performance, fulfilling all the Maastricht criteria ensures a greater economic stability and a solid economic growth for a long run. For example, reducing inflation rate will lead to the higher economic performances and the increase of the real convergence of the revenues. Lower interest rates will also stimulate the growth of the investments and the growth of the real GDP. Knowing that the economic disparities between EU15 and the New Members States are still significant, the next fiscal measures, aiming the financial stability, should also respond to the high needs of catching up. The catching up process must be based on a higher rate of economic growth rather than average growth of the most developed economies of European Union.

How will the New Member States be affected by implementation of the latest budgetary plan adopted in Brussels? We have to say that so far the budgetary plan is only a project, a sum of ideas, which only defines the new levers of financial stability: the limitation of structural budgetary deficit (Blanchard, 1990) at below 0.5% of GDP. The choice for the structural deficit as the best barometer of public finances stability should be welcomed, because it reflects better the fiscal position through removing the economic cycle influences on the budget balance. But no one can say how much time is required to achieve a structural deficit at below 0.5% of GDP. An aggressive fiscal adjustment could compromise the future potential economic growth and the catching up objectives for the New Member States. This may happen as a result of the very rigid structure of the public expenditures and the option for a fast fiscal adjustment would reduce the public investments potential or the government capacity to create fiscal stimulus for growth.

5. CONCLUSION

Despite the negative effects of the economic crisis, which in Europe were reflected in the strong increase of government costs for financing excessive deficits and for refinancing the large public debts, neither the EU nor the EMU will disintegrate. The interdependencies that have developed between the European economies and the effects that could lead to disintegration are difficult to be estimated. In the latest sixty years, the European integration was many times faced with difficulties on the road of integration. The transfer of sovereignty to a supranational authority was always one of those difficulties, overcome by establishing the intermediate stages of transfer and integration of national policies. The current European debt crisis forces us to
return to the optimum currency area theory which recommends a mix of the monetary and fiscal policy for ensuring internal and external equilibrium.

Sooner or later, the fiscal union will be reached in the European Union. It’s also hard to say that the fiscal policy will be instantaneously shared and without intermediate stages of fiscal adjustments. The new budgetary amendments and the creation of the fiscal mechanism for automatic stabilization is not a short time process, as expected in Brussels. Conversely, the change of the constitutional laws will take at least two years, taking into account the different way of ratification in each Member State. Furthermore, the fiscal adjustments and the creation of automatic fiscal mechanism should be made gradually, without compromising the economic growth and the irreversible out of the recession.

The EU founders and the new members have to work together as a two-speed Europe, in terms of economic growth, faster for the new members in order to catch up to the EU15, but without exceeding the potential growth of New Member States.

The limitation of the deficits by constitutional laws will certainly affect the economic growth in the New Member States, through the impracticality to create fiscal stimuli or public investments. So, the only chance for stronger growth in these economies, and for reducing the gaps, remains the increase of transfers for new members from 4% of GDP to up to 6% of GDP. Although at first glance this decision would disadvantage the developed economies, the increase of the real convergence would reflect in a stronger European Union, more convergent, more competitive and less vulnerable.

The “Golden Rule” is feasibly for all the members of EU. Furthermore, for removing the negative effects of potential external or internal shocks, we could imagine together with the “Golden Rule” implementation, a new safety belt which takes the form of a budgetary buffer set between 2% and 5% of GDP.

The public debt threshold for New Member States should be revised and set below 40% of GDP and should be complemented with additional early warning mechanism to lower thresholds, 30% and 35% of GDP, limits which should lead to fast adjustment of public expenditures.

Whatever model chosen, it must be said that financial stability should be a tool and not the main goal of the fiscal policy. Financial stability should lead to a sustainable growth for all the 27 economies of the EU and should increase the living standards for all European citizens.

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