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The Recent Reform of European Governance: A Critical Review

This paper investigates whether the recent EU governance reform is a step in the right direction and discusses its ability to restore European financial stability. The authors argue that the reform appears incapable of dealing with the factors responsible for the sovereign debt crisis, and they stress the need for financial sector reforms and sound fiscal policies. To that end, the adoption of national fiscal rules seems capable of dealing with the profligacy of governments and tackling the problem of deficit bias. Regarding the introduction of the new Excessive Imbalance Procedure, this article argues that EU authorities should adopt a symmetric approach instead of the one currently being pursued.

The debt crisis in the eurozone is one of the most critical challenges in modern economic history. The decline of public finances in many member states constitutes an explosive mixture that threatens the eurozone's very existence and has significant implications for the global economy. As the leadership of the EU is still searching for solutions and actions which will counteract the problems and restore stability, an analysis of the causes which led to the systemic crisis, an examination of the institutional framework of European governance, and an evaluation of the measures and policies adopted are matters of great importance which require extensive analysis and a critical approach. The current paper attempts to consider these aspects from the perspective of fiscal policy, examining them from a theoretical background.

We deal with the recent reform of European governance, providing details of the reform package and discussing its appropriateness and its potential effectiveness in restoring European financial stability. We focus on the structure of the revised Stability and Growth Pact, and we approach the nature of the new mechanism for the prevention and correction of excessive macroeconomic imbalances, the so-called Excessive Imbalance Procedure.

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In order to overcome the systemic crisis, we consider that it is necessary for European authorities to push towards reforms in the financial sector, and we suggest that national fiscal authorities could tackle the profligacy of governments and ensure sound fiscal policies.

The Reform of European Governance Framework

The global financial crisis revealed not only the member states' true fiscal conditions but also the underlying weaknesses of the institutional framework of European governance. In 2010, the global financial crisis evolved into a debt crisis for the entire euro area, one which is now characterised as systemic. In order to overcome the impacts of the crisis and to restore stability, the EU leadership decided to adopt radical measures, which were also intended to shield the eurozone countries from future debt crises. The reform of European governance is considered a decisive step towards fiscal and political integration. This paper asks whether these reforms are sufficient and appropriate to restore stability in the EMU.

In brief, the reform package contains the following elements:

- A stronger version of the Stability and Growth Pact (SGP) with more severe enforcement mechanisms and sanctions as well as the introduction of a new debt criterion under the Excessive Deficit Procedure (corrective arm).

- A new directive on national budgetary frameworks which entangles the setting of minimum requirements in accordance with the fiscal framework of the EU into domestic legislation and the adoption of the golden rule for balanced national budgets (over the cycle).

- A robust framework for preventing and correcting macroeconomic imbalances. The introduction of the Excessive Imbalance Procedure aims to identify and alleviate macroeconomic imbalances via the use of an indicative scoreboard combined with techno-economic judgment.

- The enhancement of economic coordination with several interlinked and coherent policies for sustainable growth, convergence and high-level competitiveness through the implementation of the Euro Plus Pact.

- The establishment of a permanent European Stability Mechanism (ESM), which aims to offer financial assistance to member states incapable of accessing market financing. Access to the ESM will be provided on the basis of strict economic policy conditionality under an adjustment programme and a rigorous analysis of public debt sustainability. The ESM will coexist with the EFSF, and their overall financial capacity will be €500 billion.

A rational assumption is that the reform package can only be efficient if it addresses the factors that caused the crisis. What we can conclude from the nature of the reforms is that the major problem which must be addressed is fiscal indiscipline and the profligacy of national authorities. This is why the leadership of the EU promoted inter alia the enhancement of the SGP with both stricter rules and enforcement mechanisms. This leads to an important question: *Is a lack of fiscal discipline the root cause of the European sovereign debt crisis?*

Wrong Approach

Data analysis shows that in the period before the outbreak of the global financial crisis, public finances in the euro area were highly satisfactory. In 2007, the average deficit in the union reached 0.7%, which was not only a great reduction of the deficit level since the beginning of EMU but also a record low since the 1970s. Similarly, average gross public debt declined from 73% in 1998 to 66.5% in 2007, while the level of public expenditures decreased by nine percentage points.[1] Consequently, one conclusion that emerges is that the sovereign debt crisis is not the result of an inability of governments to run sound fiscal policies. Some of the countries that have been particularly afflicted by the debt crisis ran prudent fiscal policies in compliance with the rules of the SGP (e.g. Spain and Ireland). The great exception to this story is Greece, whose governments manipulated the data, producing the infamous Greek statistics.

There are two primary factors behind the deterioration of public finances. In order to alleviate the consequences of the global financial crisis, governments took on the challenge of saving the banking system, providing both liquidity and guarantees. At the same time, they tried to sustain economic activity at pre-crisis levels through the use of loose discretionary fiscal policy.[2] These actions undertaken by the national authorities illustrate both the inherent flaws of the financial sector and the failure of monetary policy, which was unable to apply stricter controls on the functioning of the banking system or to provide a regulatory framework which would ensure stability. The recession appears thus to be the result of an unsustainable private debt explosion, which forced governments to protect the private sector from the impacts of bubbles caused by the financial sector itself. As a result, what we can conclude is that the sovereign debt crisis was created by a combination of complex factors and that the deterioration of public finances seems to be more a consequence of the crisis rather than its fundamental cause.

Stricter SGP

The above conclusion raises doubts over the appropriateness of a more rigorous rule (such as the one introduced by the Commission), the objective of which is to counteract the current sovereign debt crisis. Beyond this, some problems have been identified regarding the expected efficiency of the SGP and its structure in general.

To begin with, in the short term, the direct implementation of the new provisions will bring about a wave of austerity measures which contain huge social costs and will result in a deepening of the recession – with dramatic consequences for the real economy. Thus the

1 J. Uxo, J. Paul: The reform of the economic governance of the eurozone: macroeconomic supervision and coordination, University of Castilla, 2011.

2 P. De Grauwe: Fighting the Wrong Enemy, in: Voxeu.org, May 2010.

adoption of radical measures will undeniably reduce aggregate demand and lead to a prolonged decline, while leaving no tool with which to restore the economy. This is what is called a vicious circle. Moreover, the reduction in government expenditure will lead to a great drop in activity and a lower GDP, resulting in a worsening of the gross debt ratio, at least in the short term. This will occur if the multiplier (Keynesian models) is higher than 1.0, i.e. if the government reduces its deficit by 1% of GDP by cutting expenditures while the multiplier is 1.8, the spending cuts will lower GDP by 1.8%, causing the debt ratio to increase.[3]

The tightening of the rules and the automaticity of enforcement mechanisms are going to reduce the flexibility that discretionary fiscal policy should have. Full compliance with the mid-term fiscal consolidation plans and an assessment on the basis of expenditure developments will definitely disable the capacity of fiscal policy to be used as a stabilising tool for business cycle fluctuations. On the other hand, building on the SGP, the fact that budget finances must be expressed in structural terms seems to be a step in the right direction, since structural terms can identify the roots of the tendency for deficit bias, which can assist inter alia the strategic planning process of fiscal authorities.[4] To sum up, the revised SGP predicts the conduct of countercyclical discretionary fiscal policy only in good times and leaves little room for countercyclicality during negative shocks. The necessary balance between flexibility and discipline is not achieved.

Structural problems are not avoided. The new obligation for member states to keep debt below (or on a sufficiently declining trajectory towards) 60% of GDP seems excessively ambitious, especially for countries subject to high gross public debt. Tamborini's technical analysis[5] demonstrates the degree of difficulty of the above target. Tamborini attempts to evaluate the new SGP rules by means of dynamic models of the debt-to-GDP ratio by focusing on its determinants: the real growth rate, the inflation rate and the nominal interest rate on the accumulated debt stock. He concludes that the convergence of the debt-to-GDP ratio at 60% and the target of keeping it stable over time can be achieved if and only if the prerequisite of uniform growth, interest rates and inflation rates for the entire euro area is satisfied. This appears quite difficult, since interest rate convergence seems impossible to achieve due to the historical differences in risk measures. Finally, he concludes that heterogeneity and interdependence entail different features for member states regarding the chances of success, the required efforts and the spillovers towards the SGP target, which ultimately seems infeasible.

The revised SGP assigns national responsibilities (decisions on tax policy and public spending) to EU institutions. The role of supranational institutions becomes more extensive and more powerful. In particular, the Commission may impose sanctions under the jurisdiction of the European Court of Justice, and it may ask member states to reduce public expenditures or to adjust their tax policies. This suggests that member states should surrender their national sovereignty to the EU. These procedures also lack legitimacy, as the European supranational institutions do not face democratic political sanctions for their decisions and actions.[6]

It is worth mentioning that some economists are in favour of the content of the revised SGP but voice concerns regarding its efficiency, the main one being the lack of automatic sanctions. Even though the penalties will have a much greater degree of automaticity via the use of reverse QMV,[7] the lack of automatic sanctions will still allow member states to avoid their obligations under the Pact, increasing room for discretionary manoeuvres by the national authorities in the European Council.[8] Fuest[9] states that the reform package places a lot of emphasis on the coordination and supervision approach instead of introducing more compliance via automatic sanctions and enforcement mechanisms. Schuknechat et al.[10] asks for greater independence for the Commission in its administration of the Pact and for restrictions upon member states' veto rights.

Competitiveness and the Excessive Imbalance Procedure

It is generally admitted that fiscal policy does not by itself guarantee fiscal stability and therefore should not

3 D. Gros: Can austerity be self-defeating?, in: Voxeu.org, November 2011.

4 L. Calmfors, S. Wren-Lewis: What Should Fiscal Councils Do?, in: Discussion Paper Series No. 537, University of Oxford, 2011.

5 R. Tamborini: The New Rules of the SGP. Threats from Heterogeneity and Interdependence, University of Trento, 2011.

6 There can be no taxation without representation. See P. De Grauwe, op. cit.

7 According to the so-called reverse qualified majority vote, the sanctions will be adopted unless a qualified majority of the Council vote against them.

8 J. von Hagen: The Sustainability of Public Finances and Fiscal Policy Coordination in the EMU, in: CASE Network Studies & Analyses, 2010.

9 C. Fuest: Will the Reform of the Institutional Framework Restore Fiscal Stability in the Eurozone?, University of Oxford, 2011.

10 L. Schuknecht, P. Moutot, P. Rother, J. Stark: The Stability and Growth Pact, Crisis and Reform, in: Occasional Paper Series No. 129, ECB, 2011.

be examined in isolation. Rather, broader macroeconomic surveillance is necessary to ensure the sustainability of public finances. The existence of excessive macroeconomic imbalances, including divergences in current accounts and competitiveness, directly affects member states' public finances and makes them more vulnerable to negative shocks. In order to shield member states from macroeconomic imbalances, the EU leadership introduced the Excessive Imbalance Procedure. The philosophy underpinning this new provision seems to be the correction of trade imbalances across the EU through the enhancement of competitiveness.

However, the direction of the adopted approach seems to have serious weaknesses which may jeopardise the functioning of the single market. The correction of current account imbalances requires more than just increased competitiveness in countries with significant current account deficits. Large current account surpluses should also be addressed, since countries with such surpluses have greater room for fiscal manoeuvres. A symmetric approach seems more appropriate to cope with imbalances within the EMU.[11]

Nonetheless, the Commission has decided to promote an asymmetric approach based on the reasoning that current account deficits or trade deficits are the result of a lack of competitiveness and surpluses come from high-level economic efficiency. This leads to the Commission's aim to improve the competitiveness of the entire euro area.[12] This asymmetric approach ignores the fact that there is strong trade interdependence among the member states. The structure of EU trade (intra-community trade mainly) suggests that if one member state increases its competitiveness, another country must lose competitiveness. Overall improvement of EU competitiveness can be achieved only if the terms of trade with the rest of world become better.

Furthermore, it is generally accepted that macroeconomic imbalances within a monetary union are not necessarily negative, as they demonstrate an improvement in the regional allocation of capital.[13] Also, changes in competitiveness reflect the convergence of living standards for certain countries in the euro area. Finally, it is likely that the process of correcting trade imbalances may lead to conflicts with other areas of EU policy, such as regional development policy, labour market policy, single market policy, etc.

Finally, technical problems are unavoidable. The competitiveness of an entire economy is very difficult to determine, as the relative prices and the remunerations depend on many aspects of labour and capital market institutions. Evaluating and enhancing competitiveness constitutes a difficult task, since many criteria determine the production costs and they must all be examined, as opposed to focusing all attention solely on the aspect of direct labour costs. Lastly, the determination of specific thresholds for each member state beyond which an existing imbalance becomes crucial and dangerous lacks technical methodology and would appear to be unreliable and arbitrary.[14]

Need for Financial Sector Reforms

Taking into account that the major causes of the sovereign debt crisis in the eurozone are fiscal indiscipline and the accumulation of private debt, the reform of European governance should not only focus on the fiscal surveillance framework but also on the financial sector and on the conduct of monetary policy.

The adoption of a permanent mechanism that will help preserve the economic and financial stability of the Union itself by providing financial assistance and containing specific provisions for debt restructuring should be combined with fundamental reforms in the financial sector, since debt and banking crises are two sides of the same coin. The reforms in the financial system should firstly provide legal provisions and guarantees to prevent the outbreak of a new banking crisis. Secondly, they should undertake corrective actions to ensure that the financial sector is sufficiently robust to absorb the impacts of a sovereign default or a potential debt restructuring.

11 J. Uxo, J. Paul, op. cit.; A. Belke, G. Schabl, H. Zemanek: Current account imbalances and structural adjustment in the euro area, in: Journal of International Economics and Policy, Vol. 7, 2010, pp. 83-127; C. Goodhart, D. Tsomocos: How to restore current account imbalances in a symmetric way, in: Eurointelligence, 2010; J. Pisani-Ferry: Fiscal discipline and policy coordination in the Eurozone: Assessment and proposals, Paper for the European Commission President's Group for Economic Analysis, 2002; U. Dadush, V. Eidelman: Germany: Europe's Pride or Europe's Problem?, Carnegie Moscow Center, 2010; E. Stockhammer: Greek debt and German wages. The role wage policy and economic policy coordination in Europe, Economic policy: in search of an alternative paradigm, Middlesex University, 2010.

12 C. Wyplosz: Germany, current accounts and competitiveness, in: VoxEU, 31 March 2010; Bundesbank: On the problems of macroeconomic imbalances in the euro area, Monthly Report, July, Deutsche Bundesbank, 2010.

13 J. von Hagen, op. cit.

14 A. Belke: Reinforcing EU Governance in Times of Crisis: The Commission Proposal and Beyond, Diw Berlin, Discussion Papers 1082, 2010.

The accumulation of private debt in banks is the greatest concern. European institutions should establish a regulatory framework that will govern banking transactions and monitor the operation of the banking system. In that framework, the sustainability of European banks should be assessed via strict stress tests[15] monitored and supervised by independent European institutions. A crucial parameter is the monitoring of economic indicators that may prevent the creation of bubbles in the financial sector. Authorities should identify risks and send warnings to national authorities so they can prepare for a potential collapse.

The eurozone's permanent bailout fund, with a lending capacity of €500 billion, offers financial assistance to member states when their regular access to market financing is impaired; the granting of loans and assistance to bank institutions depends on the discretion of national authorities. From this perspective, if the ESM were able to support the banking system with extra capital under specific terms, the moral hazard related to the government rescues of banks would be reduced significantly. Concerning the involvement of the private sector in debt restructuring, this should not be unique to Greek debt; rather, it seems essential to introduce standardised and identical procedures and provisions in other countries. In addition, these provisions should be associated with guarantees and legal provisions which will ensure the sustainability of the banking system.

The main conclusion we may derive is that the current reform package is insufficient to improve financial sector stability. This also applies to the Basel III process, which contains specific measures for broader financial stability. We have our doubts whether these measures will make the sector more stable over the long run, thus raising economic growth.[16] Furthermore, an ongoing issue of great concern is the role of rating agencies and the operation of derivatives markets.[17] In particular, investors can buy credit default swap (CDS) contracts referencing national debt without owing any national bonds, providing them with motives to engage in bearish financial speculation. As collective speculative actions may threaten the stability of the system, the EU should adopt measures to ban CDS speculation.

It is also essential that European authorities push towards bilateral agreements with countries known as tax havens in order to get valuable fiscal information for the fight against tax evasion and corruption, giving European societies inter alia a sense of justice.

National Fiscal Rules

The global financial crisis laid bare the weak public finances of many eurozone countries, leading to the outbreak of the ongoing systemic crisis for the entire euro area. The key determinant of the deterioration of public finances is the deficit bias of national fiscal authorities, which brings about large and persistent deficits and accumulating public debts. The causes behind the phenomenon of deficit bias are rooted in political business cycle determinants and can be summarised as follows: impatience, informational problems, common pool problem, electoral competition, exploiting future generations and time-inconsistency problem.[18] Governments, whose primary objective is their own re-election, tend to conduct procyclical discretionary fiscal policy instead of countercyclical policy, which would be preferable[19] but could reduce their possibilities of being re-elected. This results in overspending and an accumulation of deficit and debt.

Literature suggests that the adoption of national fiscal rules can counteract political indiscipline and the sources of deficit bias, contributing inter alia to the implementation of sound fiscal policies. Ayuso-i-Casals et al.[20] distinguish between two types of fiscal rules: numerical fiscal rules and procedural rules. Numerical fiscal rules set targets or thresholds for budgetary aggregates. The aim in this case is to pose an *ex ante* permanent constraint on fiscal policy so as to promote credibility and discipline. Procedural rules govern the implementation of annual budgets, ensuring transparency and accountability.

In general, the scope of fiscal rules is very broad. They usually target different aspects, including debt, expenditure, deficit and sub-government goals, but all of them comply with the primary goal, which is the promotion of fiscal sustainability. Several studies have

15 Authorities have to deal with the problem of the undercapitalisation of banks and how banks ensure liquidity for the real economy.

16 There should be provisions which make sure that banks in countries undergoing a debt restructuring still have access to the liquidity of the ECB or to refinancing through the ECB. See C. Fuest, op. cit.

17 Derivative markets are investment markets for financial instruments that get their value, or at least part of their value, from the value of another security, which is called the underlier.

18 L. Calmfors, S. Wren-Lewis, op. cit.

19 IMF: World Economic Outlook, September 2004, International Monetary Fund, Washington DC 2004.

20 J. Ayuso-i-Casals, D. Gonzalez Hernandez, L. Moulin, A. Turrini: Beyond the SGP – Features and effects of EU national-level fiscal rules, in: J. Ayuso-i-Casals, S. Deroose, E. Flores, L. Moulin (eds.): The role of fiscal rules and institutions in shaping budgetary outcomes. Proceedings from the ECFIN Workshop held in Brussels on 24 November 2006, pp. 191-242.

noticed that the nature of fiscal rules has changed significantly over time. Countries prefer a combination of rules linked to sustainability instead of a single rule, which used to be the norm. The objective of curtailing the size of the public sector and the use of a structural target have also come to the fore.[21] Data shows that in recent years more and more countries have tended to rely on the effectiveness of fiscal rules to conduct fiscal policy and that the most common forms of fiscal rules among OECD members are debt, budget balance and revenue rules.

Empirical evidence demonstrates that the adoption of national fiscal rules is associated with sound fiscal policies and improved fiscal performance.[22] The higher the share of a government's finances that are governed by numerical fiscal rules, the lower the level of public deficit produced. *Ceteris paribus*, fiscal rules lead to balanced budgetary outcomes or lower deficits.[23] In particular, empirical evidence shows that strict fiscal rules are linked to better primary budgetary outcomes. Moreover, expenditure rules manage to counteract the profligacy of governments, since they internalise the cost of expenditures, alleviating inter alia the common pool problem, which is at the source of overspending. Experience indicates that fiscal rules are more effective as disciplinary mediums at the central level of government rather than in a decentralised framework, since they appear to be highly correlated with fiscal stability. However, under certain circumstances, fiscal rules at the sub-national level can provide a useful policy framework.[24] Furthermore, fiscal rules are considered a determinant of successful fiscal adjustment and consolidation.[25] Empirical research for EU countries shows that stronger fiscal rules are associated with a greater likelihood of successful consolidation.[26] Also, it must be mentioned that the different features of the rules constitute key elements that determine their effectiveness on budgetary outcomes. Finally, Manasse,[27] Von Hagen et al.[28] and Gali and Perotti[29] argue that the presence of numerical fiscal rules increase the degree of countercyclicality of discretionary fiscal policy.

Concluding Remarks

This paper has attempted to answer a crucial economic question, whether the recent reform of the European governance framework is sufficient to deal with the impacts of the current sovereign debt crisis and to restore stability.

From our perspective, the recent reform does not confront the roots of the crisis. The adoption of a stricter SGP will deepen the decline and reduce the flexibility of discretionary fiscal policy as a stabilising tool. The introduction of the Excessive Imbalance Procedure seems to be a step in the right direction, but a symmetric approach is needed. Finally, the financial sector is in need of reforms to shield the European economy from future crises.

National fiscal rules seem capable of neutralising political indiscipline. They have the potential to enforce successful fiscal consolidations and balanced budgetary outcomes. Moreover, under certain circumstances, the presence of numerical fiscal rules reduces the extent of procyclicality in discretionary fiscal policy.

In conclusion, we want to stress that even though we have identified several weaknesses and flaws concerning the recent European governance reform and its appropriateness, we would rather consider our remarks and the context of our critical review in general as useful warnings in the open debate on the future of EMU.

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23 J. Ayuso-i-Casals et al., op. cit.

24 T. Ter-Minassian: Fiscal Rules for Subnational Governments: Can they Promote Fiscal Discipline?, in: OECD Journal on Budgeting, Vol. 6, 2007, No. 3.

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