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Austerity Measures in Crisis Countries – Results and Impact on Mid-term Development

Since the onset of the sovereign debt crisis, the crisis-stricken countries in Europe have been pushed to take drastic steps to consolidate their finances and reduce their budget deficits. Despite strong public opposition and largely damaging short-run effects, the countries have undertaken many of the internationally recommended/mandated reforms and spending cuts. In this Forum, authors from Greece, Ireland, Italy, Spain and Portugal report on the fiscal consolidation achieved in their respective countries – and the sacrifices that have made it possible. Furthermore, the authors detail what remains to be done to resolve the crisis.

Vassilis Monastiriotis

A Very Greek Crisis

With little doubt, the last three years have seen for Greece one of the most astonishing reversals of fortunes a country has ever experienced. For about ten years beginning in the mid-1990s, Greece seemed almost unable to do anything wrong. The country was growing at amazing rates, by some 4.5% per year, a performance surpassed within the European Union only by Ireland. By the year 2000, it had achieved an impressive convergence programme, bringing down its inflation rates and budget deficits from the double-digit figures of the 1980s to within the strict limits of the Maastricht rules. In the process, Greece seemed to have dealt successfully with a number of historical challenges: the huge shock of post-communist transition in its neighbourhood, as it rather seamlessly absorbed a migration inflow representing some 10% of its population; the challenge of market liberalisation and economic modernisation, as it successfully implemented a number of deregulation/liberalisation policies including central bank independence and the privatisation of public utilities and the banking sector; and the Maastricht challenge, as it achieved its political goal of entry into the common currency with only a one-year delay.

In the dawn of the new millennium, Greece seemed to have transformed itself in numerous respects. For the first time in its history, it became a net capital exporter, with impressive foreign investments in the banking sector, in telecommunications, energy and increasingly in a wider range of activities. Political instability and contestation had given their place to “good governance” and concerted social dialogue. Transport and ICT infrastructure had also been upgraded immensely (despite problems with the implementation of the Cohesion Policy), a shift to green energy and modern technologies was slowly taking place, and Athens had been transformed, by universal admission, into a truly cosmopolitan capital. Unemployment rates were declining and a dynamic business class was developing, while levels of consumption and wealth accumulation were unprecedented.

These developments were given their symbolic culmination in 2004, when the country successfully hosted the Summer Olympics (the smallest country to have done so in the history of the Games) and its national football team won the UEFA European Championship. A year later, Greece even won the Eurovision song contest! By 2005, Greece was unquestionably a success story: in socio-economic terms, the country had all but converged to the development levels of “Europe”; in political-economic terms, it had reinstated itself firmly on the map of the “European core”. How all this changed so dramatically in the space of just a few months – from September 2009, when Greece first indicated a substantial divergence from its budget deficit target, to February 2010, when the Greek government openly admitted that it was unable to refinance its debt through market borrowing – must be a stupefying puzzle to any outside observer.

But it happened. Behind this flashy picture, structural problems persisted in the Greek economy, politics and society: problems of clientelism and corruption, problems of policy making and governance, and problems of competitiveness (a weak industrial base, strong product market rigidities and a mounting current account deficit). Largely owing to these, as is well known by now, Greece closed the 2009 financial year with a budget deficit of 15.8% (which, at the time, was estimated at 12.7%). As borrowing rates started climbing towards 10%, the country asked its eurozone and IMF partners for an emergency loan – a bailout package – and in May 2010 it was granted a loan worth a staggering €110bn, in a move that seemed to violate all EMU principles and of a size that surpassed that of the loans granted to Europe under the Marshall Plan. With this loan (and subsequent ones) came a strict and pervasive conditionality for the implementation of a broad range of reforms and fiscal consolidation actions. It is widely recognised that Greece has been slow to implement the agreed measures, showing both problems of implementation/capacity and a general lack of commitment. Still, for three years now Greece has been implementing perhaps the most extensive fiscal consolidation programme seen in Europe – and in doing so it has gotten itself into a deep and prolonged recession and, for many, a vicious circle of austerity-induced recession and recession-induced fiscal derailment.

Much has been said – and plenty more will be said in the future – about the wisdom and appropriateness of this "solution". Trapped within its own political constraints – excessive trust in the political economy of incentives (the fear of "moral hazard") and a self-defeating adherence to rules – the eurozone was unable to react quickly and boldly to address the solvency problems of Greece.[1] Its sloppiness and indecision fuelled uncertainty with regard to Greece's continued membership in the EMU and assigned an elevated role to financial markets and institutions to dictate economic developments, leading to a realisation of the much-feared domino effect as the crisis spread to Portugal and Spain. But in comparison to the countries in the rest of the "European south", the management of the crisis in Greece has been much more complex and the impact of austerity much more pervasive. I argue that despite valid criticisms about the policy recipe, the explanation for "the Greek predicament" lies predominantly with failures observed in the domestic policy field.

Reform and fiscal consolidation effort in Greece

Despite its negative reputation concerning its commitment to reforms and its implementation record, Greece has put forth an immense effort over the last three years and indeed has taken impressive steps toward achieving fiscal sustainability, with occasionally remarkable results. In the three years since the beginning of the crisis, it implemented a fiscal tightening of some 20% of GDP (around €50bn, while it has committed to measures cumulatively totalling €65bn by 2015) and reduced its budget deficit by an impressive nine percentage points, despite having lost a fifth of its GDP since 2009. How did this come about?

After some initial hesitation in the wake of the crisis, some first measures were announced in February and March 2010 – before the first bailout. These included a 10% cut in salaried bonuses and a recruitment freeze in the "narrow public sector" (central government); increases in VAT rates (from 19% to 21%) and in taxes on petrol, cigarettes and alcohol along with some parametric changes in income taxes; and some moderate cuts in expenditures (including in public investment) and central government operating costs. The first Memorandum of May 2010 introduced a much more pervasive set of measures. Wages in public utilities were cut initially by 3%; the so-called 13th and 14th salaries (bonuses for Christmas, Easter and annual leave) were capped at €500 for public sector employees, €400 for pensioners and completely abolished for high-wage earners; VAT rates increased further (to 23%) and additional tax hikes were imposed on luxury consumption (e.g. an additional 10% tax on imported cars), on so-called inelastic expenditures (alcohol, cigarettes and fuel) and on property; additional levies were imposed on high pension earners and business profits; and further savings were envisaged through controls on public expenditure and investment.[2]

The Memorandum also saw a radical reform of the pension system (voted on in Parliament in July 2010). The retirement

1 For an early discussion of this, see the Forum titled "Challenges Facing EMU" in this journal (Intereconomics, Vol. 45, No. 2, 2010).

2 For the extent and potential impact of these early measures, especially in their geographical dimension, see V. Monastiriotis: Making geographical sense of the Greek austerity measures: compositional effects and long-run implications, in: Cambridge Journal of Regions, Economy and Society, Vol. 4, No. 3, 2011, pp. 323-337.

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age was raised from 60 to 65 (from 55 to 60 for special categories) and was to be equalised for men and women by 2015. Penalties were introduced for early retirement, and pension payments were to be suspended for pensioners who were still employed – completely for pensioners below the age of 55 and by up to 70% for older pensioners. The number of insurance and pension funds was to be reduced through mergers and consolidations, aiming at the establishment of three unified funds by 2018, resulting in a sizeable reduction of pension entitlements for a number of professional occupations (lawyers, journalists, doctors, etc.). Replacement rates for new retirees were capped at 65% and all final salary schemes were to be abolished. Finally, limits were imposed on pension transferability (to offspring and widowed spouses). Changes were also introduced on the wider economy, including legislation for the liberalisation of closed professions (decided again in July 2011 and still not fully implemented), the consolidation of various public bodies and companies (also not yet fully implemented), and changes in employment protection legislation (reduction in notice periods, rise in the lawful redundancy rate, softening of unfair dismissal rules and a drastic cut in severance pay entitlements).

The measures implemented in 2010 achieved a remarkable degree of fiscal consolidation, bringing the government deficit from 15.8% in 2009 to 10.7% in 2010. However, Greece's fiscal position remained unsustainable (despite some changes to the terms of the Greek loan, too), as implementation of some of the measures was slow or incomplete and the recession in the Greek economy turned out to be much deeper than initially hoped for (a 5% drop in GDP in 2010), especially in the absence of measures to boost investment. In June 2011 and again two months later (following a negative outlook from official data during the summer), the government introduced further austerity and reform measures, most of which were tax/revenue based – including a higher income tax rate at the upper income scale, a sizeable levy on own account workers, a controversial new property tax and a lowering of the tax-free income allowance. Additionally, a highly ambitious privatisation programme was announced, aiming to raise up to €50bn from privatisation receipts by 2015.

On the expenditures side, the government promised to implement a "compulsory holiday" measure for public sector employees nearing retirement (the so-called "labour reserve") and a universal pay scale for all public sector employees (neither of which has been fully implemented as yet), while it also introduced further cuts in pensions and bonuses. Additionally, it sought to increase labour market flexibility and reduce labour costs by introducing a lower minimum wage for new labour market entrants and extending the maximum duration of fix-term contracts to three years.

Further labour market measures were taken in the winter of 2011/2012, as it became evident that the fiscal consolidation programme had become derailed and the recession deepened further (GDP fell by an additional 7% in 2011).[3] Following negotiations for a second bailout, the government introduced a new "Midterm Package" in February 2012 which reduced the minimum wage by a staggering 22% (32% for new labour market entrants), fully decentralised the wage bargaining system (giving seniority to individual contracts over the wage floors agreed on in national and occupational pay agreements), abolished the life-tenure rule in large parts of the public sector and foresaw a cut in public sector employment by 150,000 by 2015 (15,000 in 2012). Further taxes on property were introduced and a number of social benefits were cut, as was expenditure in key sectors such as health and social security. Earlier measures were re-announced and amended, including the opening of closed professions (i.e. the deregulation of occupational licensing), the extension of the universal pay scale to all public sector employees and the consolidation of public bodies outside the central government, while a number of structural reforms (e.g. in university education, public administration and health) were also (re-)introduced.

These measures generated huge public discontent and led to prolonged political instability, which started with a major cabinet reshuffling in July 2011, continued with the forced resignation of Prime Minister George Papandreou in November 2011 (replaced by former ECB Vice President Loukas Pademos, who was not an MP) and climaxed with the double election of May/June 2012, which led to the current three-party coalition government under the premiership of centre-right leader Antonis Samaras. Negative assessments by the troika experts regarding the pace of, and commitment to, reforms added to these developments, creating a prolonged period of uncertainty about a possible "Grexit" – despite the successful completion of a substantial haircut of the Greek debt held by the private sector (agreed to in July 2011, modified in October 2011 and implemented in February 2012).

As a result, implementation of many of the measures (especially those relating to rationalisation of expenditures and public sector restructuring/reform) remained slow for most of this period, while structural reforms stalled until the autumn of 2012. Then in October 2012, a new agreement was reached with the country's creditors for the release of the funds under the second bailout agreement of February 2012

3 For a detailed account of the labour market reforms since the crisis, see P. Kyriakoulias: Employment relations after the Memorandum: a panorama of labour law reform 2010-2012, National Institute of Employment and Human Resources, Athens 2012; and A. Koukiadaki, L. Kretsos: Opening Pandora's Box: the sovereign debt crisis and labour market regulation in Greece, in: Industrial Law Journal, Vol. 41, No. 3, 2012, pp. 276-304.

(under much more advantageous repayment terms and including a partial buy-back of Greek debt) in exchange for a new set of measures that were approved in Parliament in November 2012. These measures have been largely in line with measures agreed to or legislated previously, but this time with much stricter safeguards on implementation. Amongst the new elements are a further reduction in social benefits, further increases in fuel taxes, complete abolition of the 13th and 14th salaries, some further cuts in pensions, further reduction in dismissal notice periods in the private sector and the introduction of new taxation legislation.

All in all, between January 2010 and January 2013, pensions and public sector pay have declined by over 25% on average, effective tax rates have increased perhaps by more than 20%, public sector recruitment has been frozen and labour laws have been substantially deregulated (especially concerning employment protection and wage-setting). At the same time, wages in the private sector have declined by at least 15% cumulatively[4] and are set to decline much further this year following the new minimum wage legislation (especially given that in Greece practically all wages are indexed to the minimum wage). In turn, unemployment has skyrocketed (from less than 9% in 2009 to over 26% by the end of 2012).

On the other hand, very little has been achieved with regard to privatisation (less than €1bn has been generated so far), the closure/amalgamation of redundant public bodies, public sector downsizing (the target of 15,000 dismissals was not even close to being met, while at the same time a number of key services experienced significant understaffing) and especially with tax evasion.[5] Also, some of the measures implemented seem perverse or incoherent. For example, the new tax bill legislated a rise in tax rates for all income categories (immensely hurting the poor and indiscriminately harming the self-employed) as well as for businesses, for obvious revenue-generation reasons. However, at the same time it lowered the rate of tax on distributed profits and on rents from property. Apart from further suppressing consumption and employment, this also penalises dynamic firms that reinvest their profits, while it incentivises wealth-management investments, including in housing, at the expense of productive investment. Similarly, despite the government's intentions to stabilise and recapitalise the banking system, the bill raises the tax rate on interest earned from 5% to 15%!

4 Bank of Greece: Governor's Report for the Year 2011, Bank of Greece, Athens 2012.

5 See EC: The Second Economic Adjustment Programme for Greece, European Economy Occasional Paper, No. 94 (March), European Commission, Brussels 2012, for a detailed evaluation of the measures up to the spring of 2012; and EC: The Second Economic Adjustment Programme for Greece – First Review, European Economy Occasional Paper, No. 123 (December), European Commission, Brussels 2012, for the latest evaluation.

A Greek paradox: policy effort without policy outcomes

Despite the delays and problems of implementation, the recent changes in the political situation and the debt reduction instigated by the October 2012 agreement seem to have put the country on track for a reversal of the negative spiral of derailed fiscal consolidation and austerity-induced recession. According to current data on budget execution,[6] the end-of-year general government balance is within €0.4bn of the budget target (at €15.9bn) and down 30% from the previous year, suggesting that the overall budget deficit for the year will be close to the target of 6.6% of GDP (from 9.4% in 2011). Still, this only came after two substantial haircuts on Greek sovereign debt (the PSI of February 2012 and the buy-back of December 2012), two gigantic bailout loans with unprecedented concessions on their repayment terms and even greater liquidity provision. Given this unparalleled international effort, why has Greece not been able to exit its crisis and enter a path of economic recovery?

One explanation lies of course with the inconsistency of policy at the international level,[7] which created a setting of never-ending policy shocks: seemingly every month or so, the question of a Greek default resurfaced and a new mini-crisis triggered a new round of emergency eurogroup meetings and contradictory policy statements by officials. To this, one can add the role of inflated expectations: worried more about convincing themselves and appeasing the markets than about getting the numbers right, the troika kept making unrealistic and self-defeating projections,[8] thus allowing the markets to declare an imminent default (and a "Grexit") every time any of these projections failed to materialise. Nevertheless, policy inconsistency and inflated expectations seem insufficient to fully explain the situation.

An alternative explanation has to do with the systemic character of the crisis, for example the problem of the "fragility of the eurozone",[9] which creates a vicious circle of shocks being transmitted from the government to the banking sec-

6 P. Monokroussos: Latest budget execution data point to a likely outperformance of the revised fiscal targets, Greece Macro-Monitor, Eurobank, Athens 2012.

7 For example, the ECB has time and again destabilised the Greek market by refusing in various instances to accept Greek sovereign bonds as collateral for liquidity provision to commercial banks in Greece, while at the same time regularly bending its own rules to do exactly that.

8 For example, the troika predicted a negative inflation rate for 2011 (it turned out to be 3.3%) and a primary surplus for 2012 (which has not materialised), while it repeatedly had to revise its growth projections downwards, having overestimated the effect of internal devaluation on exports and, by its own admission, having underestimated the effect of the fiscal squeeze on incomes and domestic consumption.

9 As identified by P. De Grauwe: The governance of a fragile Eurozone, in: Australian Economic Review, Vol. 45, No. 3, 2012, pp. 255-268.

tor and from the banking sector to the government. However, this fragility does not seem to have affected Spain (for which the argument was developed) nearly as much as Greece, despite the fact that the Greek banking sector was much less exposed to the crisis.

Instead, perhaps there is more truth in the "austerity does not work" argument, which identifies the problem with the policy recipe. Indeed, criticism to the austerity prescription has been mounting over the years, and influential voices, among them the Nobel Laureates Paul Krugman and Joseph Stiglitz, have frequently made the rather simple argument that austerity suppresses demand and investment, negating the benefits of fiscal consolidation. Even the IMF seems to have accepted this, recognising recently that the assumptions about the size of fiscal multipliers under austerity have been far too unrealistic.[10]

When criticising austerity, however, one should be wary of the alternatives. Whereas tax hikes and spending cuts are undoubtedly recessionary, fiscal expansion can in turn be highly inflationary and will almost invariably lead to a deterioration of the current account, thus leading to more borrowing. This is especially so in a country such as Greece, where market rigidities are acute, savings are low and the propensity to import is particularly high. With the existing "leakages" found in Greece (high imports, black market economy, tax evasion) and the weak production base (manufacturing accounts for a mere 15% of nationwide gross value-added), it is extremely unlikely that any form of fiscal expansion – and definitely any expansion that would be income- or transfer-based rather than investment-based – would be able to generate the size of the spillovers needed to halt the rising trend of public debt. Taking into consideration the political and credibility constraints that made an externally financed fiscal expansion (the "grow yourself out of the crisis" recipe) practically impossible leads to the conclusion that austerity was – in every practical sense – the only option.

Taking the above – the systemic pressures and policy constraints – as givens places an elevated responsibility on the implementation strategy, which is the only remaining factor which can affect the policy mix and the policy prioritising in the hope of containing the pervasiveness of the effects of austerity. On this, Greece already had a poor record,[11] but the handling of the crisis seems particularly illuminating. From the very early stages of the crisis, Greece appeared to enter into a form of collective denial, with the majority of Greeks failing to appreciate the severity of the country's fiscal problems and, with an evident lack of introspection, engaging in unproductive blame-shifting (blaming the Germans, the banks, the markets, the politicians, even capitalism at large) and occasionally in short-sighted and self-interested acts of civil disobedience (such as the "refuse to pay" movement).

Although such reactions are consistent with wider descriptions of the Greek mentality,[12] the political elite – almost uniformly across the political spectrum – played a key role in legitimising and even mobilising public discontent. As early as the spring of 2010, even the Prime Minister was attacking the "irrational and profit-seeking markets" (implying that profit-seeking is irrational) for "engineering" high bond premia for a country that just a few months earlier had admitted to the largest misreporting of statistics in European history. Meanwhile the opposition – including the party that later came to implement most of the austerity measures – was denouncing all fiscal consolidation efforts, suggesting that reforms and fiscal consolidation were not necessary.

In those circumstances, the handling of the crisis revealed five important collective failures by the Greek political system: a *failure of communication* (to the public of the need for austerity and the criticality of the situation), a *failure of co-ordination* (among and within political parties, which appeared uninterested in abandoning party tactics even when the country was at the brink of collapse), a *failure of negotiation* (with the eurozone partners for a fiscal consolidation programme that was more feasible, less harsh, more constructive and growth-oriented), a *failure of implementation* (of the various reforms which were announced time and again – resulting in a huge accumulation of political costs – but which were often not implemented) and a *failure of strategy* (astonishingly, the idea of a "Marshall Plan for Greece", which was eventually agreed to in July 2011 but has yet to be activated, came from the Commission – not from Greece. To this day, Greece has said very little about a new "Investment Compact" for the country, other than the helpful but emphatically limited release of pre-committed Cohesion Policy funds).

Given these failures, it is no wonder that the crisis became increasingly unmanageable, that resistance to reforms and to austerity became stronger and more legitimate, that government expenditures became increasingly inelastic, and that policy design and implementation became largely reactive, with little attention to policy complementarities and synergies. It is also no wonder that Greece's creditors became increas-

10 See IMF: Coping with High Debt and Sluggish Growth, World Economic Outlook (October), International Monetary Fund, Washington DC 2012.

11 See V. Monastiriotis, A. Antoniades: Reform That! Greece's Failing Reform Technology: Beyond 'Vested Interests' and 'Political Exchange', Ch. 4, in: S. Kalyvas, G. Pagoulatos, H. Tsoukas (eds.): From Stagnation to Forced Adjustment: Reforms in Greece, 1974-2010, C. Hurst & Co, London 2012, for a general argument about the weaknesses of the "reform technology" of Greece.

12 See A. Chalari: The causal powers of social change: the case of modern Greek society, GreeSE Paper No. 64, Hellenic Observatory, London 2012, for a recent study in relation to the crisis.

ingly impatient, demanding tougher measures which then reinforced the vicious cycle of recession and de-legitimisation.

Outlook

Luckily, or perhaps simply due to the passage of time, the situation today seems to be stabilising. The Greek government seems more committed to reforms and more conscious of the need for a holistic strategy to exit the crisis. The eurozone has also come a long way, agreeing to support Greece's fiscal consolidation and economic recovery efforts more wholeheartedly and with more consistency and showing a commitment to fixing the flaws identified in the EMU design. But this institutional fix cannot come soon enough for Greece. Although a prospective agreement on a banking union, on a framework for national debt mutualisation and on a mechanism for future crisis management and prevention will undoubtedly help the long-term stability of the eurozone, for Greece this is a *deus ex machina* too far – one could argue that the resolution of the Greek crisis is a precondition for such institutional developments to materialise.

Instead, what Greece needs is policy consistency, a credible commitment to the fiscal consolidation effort and, above all, carefully designed policies that will push the country towards a different development path – one that will forge the country's ability "to withstand the competitive pressures of the internal market" (and of the common currency), similar to the preconditions imposed in the accession conditionality of the Eastern enlargement. On that, the signs are still rather disappointing: policies continue to be ad hoc and piecemeal, and an overall development strategy, with a robust industrial policy, is missing.[13] Nevertheless, with the prospective stabilisation of the fiscal position of the country, it is in this area where Europe can help most: by providing the policy incentives, the know-how and the funds – most realistically with substantial private-sector involvement – that will help support the reorientation of Greece's sectoral specialisations and the modernisation of its economic base. The emphasis on fiscal consolidation has been necessary for pragmatic reasons; but in view of Greece's structural problems – and how these reproduce the asymmetries identified within the eurozone – it was never to be sufficient.

13 As evidence to this, just days after commissioning a study on the future comparative advantages and growth model of Greece, the Finance Minister used the opportunity of a speech in honour of former Prime Minister Loukas Papademos to announce his industrial policy priorities for the new development path of the country.

Niamh Hardiman, Aidan Regan

The Politics of Austerity in Ireland

Ireland has featured prominently in recent times as the most successful of the countries that have been required to implement tough austerity budgets since the onset of financial crisis in Europe in 2008. The EC-IMF-ECB (troika) loan programme which Ireland entered in December 2010 has severely constrained domestic budgetary discretion: all budget decisions must be cleared with the troika, fiscal performance is subject to quarterly reviews and troika personnel are embedded in the core government departments. But it has been noted that since Ireland has a strong export-oriented sector, if recovery through austerity can take place anywhere, it will be here. The official Irish government position is that Ireland is indeed complying well, and the current Prime Minister Enda Kenny has been pleased with his accolades, including an appearance on the cover of *Time* magazine under the title "The Celtic Comeback" in October 2012, followed by the award for "European of the Year" in Germany. As Ireland took over the presidency of the EU in January 2013, Kenny announced that Ireland hoped to exit the troika bailout programme before the end of the year.

However, it would not be unduly sceptical to suggest that much of this upbeat talk is built on wishful thinking – or more accurately, perhaps, to suggest that the real purpose is to prepare the way for Ireland to make a hard case for better terms on part of its debt liabilities, particularly those to do with recapitalising the banks, since this is the component of Ireland's fiscal crisis that is the most crushing and about which public discontent is strongest. The Irish financial cum sovereign debt crisis is directly related to a decision in September 2008 to guarantee all the private liabilities of its principal national banks – without full information, but under severe pressure from domestic banking interests. To put the Irish case in a comparative perspective, Ireland accounts for 1.2 per cent of the eurozone population and less than two per cent of GDP, yet it has paid 42 per cent of the total cost of the European banking crisis. In the aftermath of this government decision, the public debt-to-GDP ratio increased from less than 40 to almost 100 per cent; it is due to hit 120 per cent at the end of 2013, just as the EC-IMF-ECB funding is due to run out. Despite this, the troika adjustment programme remains firmly set on reducing the fiscal deficit to three per cent of GDP by 2015, with major implications for economic performance and for the democratic welfare state.

For while it is true that Ireland has been achieving its fiscal retrenchment targets, and at a relatively low cost to date in terms of social and political conflict, it is also the case that the Irish experience confirms what most economic theory has always taught, which is that contractionary budgets produce economic and employment contraction. The Irish economy has experienced a severe downturn since 2008 and is currently flat-lining; living standards have fallen, and both unemployment and emigration have risen. The political and social costs of managing austerity are rising rapidly. This paper will outline the scale of the fiscal effort that has been made to date in Ireland and the implications for economic and employment growth. The manner in which fiscal adjustment has been undertaken and the implications for the profile of spending cuts and tax increases will be analysed, and the distributive consequences will be considered. Finally, the main lines of conflict between what Irish recovery prospects need and what the European policy framework permits will be identified.

The scale of adjustment

Ireland experienced a very sudden worsening in its fiscal balance with the onset of the crisis. During the buoyant 2000s, the government ran small deficits and occasionally a small surplus. But weaknesses had been built up in the public finances during these years of house-price inflation that worsened the effects of the crisis. A series of exemptions had narrowed the tax base, additional spending commitments had been incurred and increasing reliance was placed on revenues flowing from property-related transactions. The tax base was increasingly narrowed, and 50 per cent of employees were taken out of the income tax pool altogether. When credit stalled and construction activity abruptly came to a halt in 2008, the gap between public expenditure and revenues diverged sharply, resulting in a deficit of 7.3 per cent of GDP in 2008 and 14 per cent in 2009.[1] During 2008-09 government revenues fell by almost €18bn, or 20 per cent of GNP. Given the rapid rise in unemployment and associated social protection payments, government expenditure increased from 37 to 47 per cent of GNP.[2]

However, what has proven particularly difficult to manage in Ireland is the consequences of bailing out the banks. The state guarantee for the liabilities of six main domestic financial institutions was intended as a short-term measure, on the assumption that they were facing a liquidity crisis. In fact, risky lending had been undertaken on such a scale that the banks were insolvent. The total cost to the Irish taxpayer amounted to €64bn, or about 40 per cent of GDP.[3] In effect, Irish taxpayers have "taken one for the team", preventing the Lehman-style collapse of an Irish bank, which could have had catastrophic consequences for the whole European banking system. But in the absence of any Europe-wide bank rescue mechanism, the ECB has resisted Irish proposals to restructure this debt. Therefore, the terms on which the recapitalisation of the Irish banks is funded continue to be a contested issue in relations between the Irish government and European officials.

Ireland has managed to meet its fiscal adjustment targets to date, and the deficit in 2013 is expected to be below the deficit ceiling of 7.5 per cent of GDP. But the growth projections on which the credibility of the loan programme depends have consistently had to be revised downwards. Irish GDP is barely into positive terrain, with an outturn of about 0.5 per cent in 2012 as export performance slowed in the context of weak demand in other markets. What is most worrying is that the domestic economy is in much worse condition than GDP data suggest. This is because of a peculiarity of the Irish economy, whereby the exporting sector is largely powered by foreign-owned investment, which is largely impervious to cyclical tendencies but which repatriates most of its profits. The bulk of employment, however, is in the domestic economy, in traded manufacturing and services and in the non-traded service sector. Between 2008 and 2011, real GDP declined by 11.8 per cent, while real GNP declined by 14.5 per cent, implying a more severe reduction in domestic living standards than is reflected in the GDP data.

The *ex ante* fiscal effort undertaken by the Irish government between 2008 and 2012 amounted to about €24bn, which represents 16 per cent of GDP in 2011. The general government primary balance improved by some seven percentage points between 2009 and 2012. Only Greece (14.5 points) and Iceland (nine points) experienced larger adjustments, while the change in Spain and Portugal was almost as significant as in Ireland. The further adjustment measures to be introduced in Ireland between 2012 and 2015 are expected to come to about €8.6bn, or an additional five per cent of GDP. In total therefore, between 2008 and 2015, the Irish economy will have experienced total cuts of about 20 per cent of GDP. This does not take into account any of the multiplier effects on unemployment, output and prices resulting from the withdrawal of demand from the economy.[4]

1 S. Dellepiane, N. Hardiman: Governing the Irish Economy: A Triple Crisis, in: N. Hardiman (ed.): Irish Governance In Crisis, Manchester University Press, Manchester, 2012, pp. 83-109, http://www.ucd.ie/geary/static/publications/workingpapers/gearywp201103.pdf.

2 A. Regan: The Rise and Fall of Irish Social Partnership: The Political Economy of Institutional Change in European Varieties of Capitalism, PhD in Public Policy, University College Dublin, 2012.

3 B. Clarke, N. Hardiman: Crisis in the Irish Banking System, in: S. Konzelmann, M. Fouvargue-Davies (eds.): Banking Systems in the Crisis: the Faces of Liberal Capitalism, Routledge, Oxford, 2012, pp. 107-133, http://www.ucd.ie/geary/static/publications/workingpapers/gearywp201203.pdf.

4 J. FitzGerald: Fiscal Policy for 2013 and Beyond, in: T. Callan (ed.): Budget Perspectives 2013, ESRI, Dublin, 2012, pp. 1-25, here p. 13, http://www.esri.ie/UserFiles/publications/JACB201239/JACB201239.pdf.

The composition of fiscal adjustment

Ireland's budget deficit management relies on expenditure cuts for about two-thirds of the adjustment and tax increases for one-third. This is consistent with "orthodox" liberal views about the appropriate fiscal adjustment policy mix.[5] In assessing the fiscal adjustment plans of both the centre-right Fianna Fáil-Green and the similarly centre-right Fine Gael-Labour coalition, it is important to analyse what is "off the agenda", which illustrates the domestic political (as opposed to troika-induced) choices that have been pursued. The composition of the Irish policy package is shaped by a number of compromises reached with important actors in Irish public life. A key element is the priority accorded to maintaining Ireland's low-tax regime, particularly in relation to the business sector.

The 12.5 per cent corporate tax rate, which is the lowest in the EU15, remains unchanged; it is the central element of Ireland's industrial policy to attract inward investment and promote export-led recovery. This reflects a consensus amongst all of the main political parties in parliament, employer groups and some trade unions that any attempt to adjust corporate tax rates would lead to capital flight and a collapse in foreign direct investment. It also underpins the Irish government's decision to oppose the introduction of a co-ordinated European Financial Transaction Tax in the eurozone. There has been no increase in social insurance contributions for employers, which remain the lowest in the EU15, and there has been no change in marginal income tax rates, though there have been changes to exemptions and tax credits and to the ceiling on social insurance liability. The average tax take for all households has increased, especially through indirect measures. But marginal rates remain below the European average, with only Spain, Portugal and Greece taxing high-income households less. This commitment to a low-tax regime is part of an overall policy preference to maintain Ireland's business-friendly labour market. According to Eurostat and the OECD, Ireland has the second most flexible labour market in the EU, and this is defended as a comparative advantage by government officials.[6]

The preferential consideration given to corporate taxes, and the priority accorded to keeping income tax rates constant, has important implications for the distributive impact of fiscal consolidation. It means that tax increases must be found in other areas. It also transfers the burden of fiscal adjustment to the public sector through cuts in pay and services, including downward pressure on social welfare payments where demand is increasing due to rising unemployment.

Ireland's welfare regime relies heavily upon tax expenditures (or tax breaks) as a mechanism to encourage the private purchase of social services, including health, education and pensions. In 2005, it was estimated that tax expenditures in Ireland were equivalent to some 18 per cent of all tax revenue, compared with an average of 5.6 per cent in 22 other EU countries. Some of these have been closed off, but those related to private pensions and finance are still generous compared with provisions in other countries, including the UK. In 2011, the Fine Gael-Labour government introduced additional tax breaks for the financial sector to incentivise corporate executives to relocate from London to Dublin.

The commitment to neither increase income tax rates nor introduce a third, higher rate of income tax was central to the electoral platform of the main political party in government, Fine Gael. Most of the tax increases have been implemented through indirect measures such as an increase in VAT. A universal social charge has been put in place. So too has a flat tax rate for all households, originally set at a low level and subsequently changed into a higher-yielding property tax based on the value of the house. This tax has been the focus of widespread discontent in response to austerity measures in Ireland and reflects an implicit constraint facing policy makers and government. In the good times, the Irish economy could commit to higher public spending while sustaining a low-tax regime. The electorate now experiences higher and more visible taxes, just at the moment when the quality of public services is becoming significantly worse.

Distributive implications of fiscal adjustment

In 2009 and again in 2010, the government cut public sector pay by a total of 15 per cent on average. This was designed to send a signal to the rest of the economy that internal devaluation requires downward wage flexibility to improve national competitiveness. In 2009 the Fianna Fáil-Green party coalition cut the minimum wage by 15 per cent, but this was restored by the Fine Gael-Labour coalition in 2011. However, there is minimal evidence that wage reduction strategies have been pursued in the private sector. Both pay and employment in the export-oriented FDI sector remained relatively buoyant, in the context of high reported levels of productivity. Most of the adjustment in the domestic business, retail and construction sectors has occurred through employment losses. Unemployment surged from 6.4 per cent in 2008 to 14 per cent in 2010 and to nearly 15 per cent in 2012. These figures, however, mask the extent of the employment

5 S. Dellepiane, N. Hardiman: The New Politics of Austerity: Fiscal Responses to the Economic Crisis in Ireland and Spain, in: UCD Geary Institute, Dublin, 2012, Geary Working Paper, No. 2012/07, http://www.ucd.ie/geary/static/publications/workingpapers/gearywp201207.pdf.

6 A. Regan: The Political Economy of Social Pacts in the EMU: Irish Liberal Market Corporatism in Crisis, in: New Political Economy, Vol. 17, No. 4, pp. 465-491, 2012, http://ciisn.files.wordpress.com/2011/01/aidan-regan-public-policy-ucd-irish-neo-liberal-corporatism-in-crisis.pdf.

crisis. Long-term unemployment (over one year) is becoming more common, rising from half of those unemployed in 2010 to 60 per cent in 2012. Since 2008 net emigration has increased rapidly (82,000 in 2012) and currently functions as a safety valve in the Irish labour market. The job vacancy ratio is 54:1. Only a quarter of those aged 15 to 24 are working, down from half before the crash, and this cohort is shrinking significantly through emigration. In the absence of mass emigration, youth unemployment figures would be closer to those in Southern Europe.

Social welfare payments were reduced at a rate comparable to public sector pay in 2009 and 2010. The Fine Gael-Labour coalition pledged not to cut headline social welfare rates further. But not cutting headline rates masks significant cuts in the payment of child benefits, carers' allowances, single parent supplements, and other transfers and services targeted at vulnerable groups. Eligibility and means-tested criteria for benefit payments have become more stringent, reinforcing the liberal nature of Irish social assistance. Indeed, Ireland has the highest proportion of social protection payments that are means-tested in the EU15. Presently, those who are over 21 and unemployed receive a flat-rate monthly payment of €188 for 12 months. Under pressure from the troika's structural adjustment priorities, it is anticipated that this payment period will be reduced to 9 months. Labour market policy is now firmly focused on supply-side reforms aimed at workplace activation, even though the employment crisis is principally due to the collapse in domestic economic demand.

In addition to cuts in public sector pay and social security payments, the government adjustment strategy has relied heavily upon downsizing the public sector (health, education, security and civil service) through voluntary redundancies. The political process through which this has taken place has been via a centralised public sector agreement between the state (represented by the Department of Finance, Expenditure and Reform) and the public executive committee of the Irish Congress of Trade Unions. This deal, known as the Croke Park agreement after the conference centre in which it was negotiated, was agreed to in mid-2010. This is not a tripartite social pact involving private sector employers but a sectoral agreement between government as employer and public sector trade unions (and professional associations). It breaks significantly with the Irish industrial relations tradition developed in the 1990s and 2000s of comprehensive and competitiveness-oriented social partnership agreements aimed at employment growth.

The core features of the Croke Park agreement include a government commitment not to impose further pay cuts until 2014 in return for industrial peace and productivity increases, reform of the bonus payment system, a recruitment embargo in the health and education sectors, and significantly reduced pay and conditions for new entrants to the public sector. The bulk of the cost savings arise through voluntary redundancies and early retirement in an attempt to reduce the pay bill by a further €3bn by 2014. Since 2008 public sector employment has been reduced from 320,000 to 291,000 employees, with most of the losses in the health and education departments. This is despite the fact that the public sector in Ireland remains relatively small compared to international standards. In 2011 Ireland recorded one of the lowest levels of industrial action: there were only eight strikes (or 4,000 days lost), despite the employment crisis and unprecedented austerity budgets. The Croke Park agreement has delivered on its core objective, which is to provide political stability to the government whilst it implements the EC-IMF-ECB adjustment programme.[7]

In 2013, the government will have to decide whether to renew the Croke Park agreement with the public sector unions or to proceed with further unilateral pay cuts. It appears likely that an agreement will be renegotiated based on another policy package of reducing costs through employment numbers rather than wages. The impact of this strategy of fiscal adjustment is twofold. First, it reinforces a trend toward labour market dualisation: new entrants will be entering the public sector on significantly reduced pay and conditions compared to their older, unionised colleagues. In turn, this feeds into a public backlash against what is perceived to be an insider deal obtained by the higher echelons of the public sector (with a high wage premium and secure employment) in the context of an increasingly precarious private sector labour market. Secondly, if the government is committed not to cut social welfare and public sector pay, then it is inevitable that social services will be hardest hit in the additional austerity measures to be introduced between 2013 and 2015.

The net distributive consequences of budget measures can be hard to assess, and all sectors have grounds to feel aggrieved.[8] But the Irish Central Statistics Office suggests that the cumulative outcome of Irish fiscal adjustment, particularly the 2012 budget, has been regressive. According to the Survey on Income and Living Conditions, the bottom decile has seen net disposable income reduced by 25 per cent, whilst top decile income increased by five per cent. Consistent deprivation levels have increased. So too has the percentage of those at risk of poverty, which has risen to 15.8 per cent – or 700,000 people, 220,000 of whom are children. The modest gains in reducing household poverty that were achieved throughout the Celtic Tiger period have effectively been reversed.

7 Ibid.
8 T. Callan, C. Keane, M. Savage, J.R. Walsh: Distributional Impact of Tax, Welfare and Public Sector Pay Policies: 2009-2012, in: Economic and Social Research Institute, Dublin, 2012, https://www.esri.ie/UserFiles/publications/QEC2011Win_SA_Callan.pdf.

The unresolved issues

Official EMU policy requires the countries of the EU periphery that are currently in crisis to undertake sharp fiscal corrections within a tight timeframe, and this imperative is all the more pressing for the countries that are currently in loan programmes (Ireland, Portugal and Greece). The assumption is that by persisting with efforts to reduce their fiscal deficits, these governments will increase market confidence in their performance, which will benefit their capacity to borrow on the open markets. Furthermore, by engaging in internal deflation, they are expected to become more competitive relative to other countries, which is meant to boost exports and to encourage private sector investment.

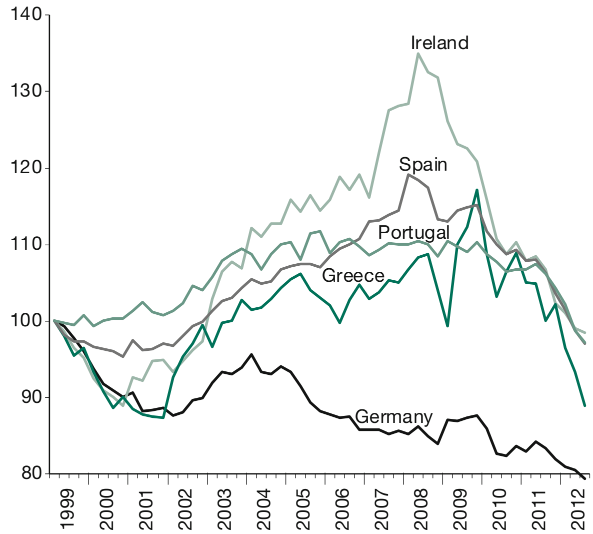
But all these assumptions are seriously problematic. Ireland has undertaken a particularly severe internal deflation, as Figure 1 shows. But none of the pain that has been endured by the populations of the countries of the European periphery is translating into growth. Besides, while they gain in competitiveness relative to their earlier experiences during the period of excessively cheap credit, Germany is doing the same. This is a beggar-thy-neighbour cycle, and the knock-on deflationary effect among countries further intensifies domestic contraction. Investment is stagnant because demand is lacking. Eurostat expects Ireland to have the lowest level of public and private fixed capital formation in the EU in 2013.

But even if there were an appetite for new private investment, funding it would prove very difficult. There are still major unresolved problems in the Irish banking sector, and until these are resolved it will be difficult to see how any recovery is possible. The two main functioning Irish banks are second only to those in Greece in their low rates of lending activity. They have received massive amounts of bailout funds, and their ravaged deposit base has largely been replaced by ECB-provided liquidity. But they are now exposed to growing volumes of non-performing household debt, especially mortgages. Furthermore, the terms of the bailout itself create disincentives for the banks to function as normal lenders. The Irish government is on the hook for the repayment schedules. The close link between banks and sovereign debt, in Ireland as elsewhere, has not been broken but rather is in many ways closer than ever.

This is why there was great interest in Ireland over the 29 June 2012 statement from the Euro Area Summit, which seemed to indicate a willingness to move quickly to permit the European Stability Mechanism (ESM) to take over bank recapitalisation. This statement also seemed to recognise that the commitment already undertaken by the Irish state to shoulder the whole burden of bank rescue should be replaced by the ESM. Equity funding would function as a form of "patient capital" stake in Irish banks, as the IMF proposed in December 2012.

Figure 1

Harmonised competitiveness indicators based on unit labour costs



Source: ECB Statistics website.

This would improve the prospects of the Irish banks returning to profitability. It would support a fall in the debt-to-GDP ratio, which in turn would increase the chances of Ireland being able to exit its loan agreement on schedule.

However, as so often happens with EU summitry, the waning of the sense of crisis meant that putting new ESM measures into place soon seemed less urgent. The ESM timetable has now been pushed back until after the creation of a new bank supervisory mechanism and, indeed, until after German elections in autumn 2013. The appetite for negotiating a suitable deal with Ireland has noticeably waned.

Ireland has another urgent problem relating to its bank bailout, though, and this is now at the centre of Irish lobbying activity both with the European Commission and within the ECB. This concerns the "promissory notes" to fund the €28.5bn bailout of Anglo Irish bank, which the rescue vehicle known as Irish Bank Resolution Corporation must repay. The terms of the deal currently in place are "equivalent to the state borrowing money at expensive terms to repay a low-cost interest-only perpetual loan"[9], with massive implications for the sustainability of the public debt. The government was able to sell sovereign debt on the open market at acceptable interest rates toward the end of 2012, suggesting that exit from the loan programme may be feasible. But many aspects of expected performance, and indeed of debt manageability,

9 K. Whelan: ELA, Promissory Notes and All That: The Fiscal Costs of Anglo Irish Bank, in: Economic and Social Review, Vol. 43, No. 4, 2012, pp. 653-673, here p. 662, http://www.esr.ie/vol%2043_4/x4%20Whelan%20PP.pdf.

depend on growth projections that have, time after time, been downgraded, making current debt-to-GDP ratios even more burdensome. ECB permission for some form of restructuring of this debt is therefore considered to be a very high priority for the Irish state. Irish governments have not openly challenged or opposed the current European policy framework; rather, they have implemented all the terms of the onerous fiscal adjustment, including the full weight of the bank bailout, and on schedule. The clear expectation from the Irish government side is that some form of payback is now due.

Conclusion

Ireland has endured significant hardship in implementing austerity budgets since 2008 in response to the international financial crisis. As in other eurozone periphery countries, this has further slowed economic activity, which in turn has further depressed revenues and intensified the effort required to reduce budget deficits. The scale of the Irish deficit, and of the accumulated debt, has been very much worsened by the terms of the bank bailout. Large numbers of people now feel the effects of increases in direct and indirect taxes and of the visible worsening of public services, especially in health and education. Many sectors of employment have suffered badly, and many businesses are on the brink. Persistently high unemployment, unserviceable mortgages and houses in negative equity have a demoralising effect over time. The skills and talents of a whole generation of young people are being put to waste.

So far, Irish governments have managed to implement the terms of the EC-IMF-ECB loan programme on schedule and without major social conflict. But there are indications that this situation may not persist indefinitely. Unlike other countries, no systematic reckoning has been undertaken in Ireland of what exactly happened and why – and who was really responsible and for what – in the run-up to the crisis and in the early stages of its management, when some of the most catastrophic decisions were taken. While renewed emigration siphons off a good deal of youth discontent, there is still real anger over what has happened An active if still fairly low-level tax resistance movement is welling up. The electorate took its revenge on the one-time establishment party, Fianna Fáil, which was devastated in the election of February 2011; the incoming coalition of Fine Gael and the Labour Party gained a historic majority. But the implosion of one pole of political competition leaves a whole new range of potentially unaligned political opinion. Confidence in political institutions is at an all-time low. Ireland awaits a European game-changer. It is all we can hope for.

Chiara Goretti and Lucio Landi*

Walking on the Edge: How Italy Rescued Italy in 2012

The global crisis entered into a new and dramatic phase in 2011, involving strong tensions in European sovereign debt markets. Fears of contagion spread through Southern Europe, also affecting Italy in mid-summer.

In this paper, we aim at presenting the wide-ranging strategy to restore confidence, strengthen fiscal sustainability and foster growth that was adopted by the Italian emergency cabinet in charge since November 2011.[1]

Some background

Italy is a well-known example of a country that has had weak budgetary discipline in the past, which led it to accumulate one of the highest public debts in the world. Since the introduction of the euro and its fiscal rules, Italy has been engaged in a rigorous process in which the multilateral surveillance has helped to build a more disciplined environment for public policies.

Over the past decade, Italy's real GDP growth per capita has been among the weakest in the OECD, which reflects very low underlying productivity growth. The recommendations of international organisations, including the OECD, have long argued for better regulation, more competition and more flexibility in the labour market. Italy has made progress in some of these areas since the late 1990s, although in the same period its relative economic performance deteriorated. Membership in the Economic and Monetary Union and rapid globalisation increased the costs of inflexibility, the burden of which has materialised over time. Hence, the unprecedented global crisis that erupted in the US in 2008 hit slow-growing Italy particulary hard, bringing about a huge toll in terms of GDP (-5.5 per cent in 2009) and unemployment (8.4 per cent in both 2010 and 2011, 10.8 per cent in 2012, and 11.4 per cent in 2013). As opposed to most countries, the cabinet

* The views expressed are those of the authors and do not reflect the official position of the Italian Senate or the Ministry of Economy and Finance.

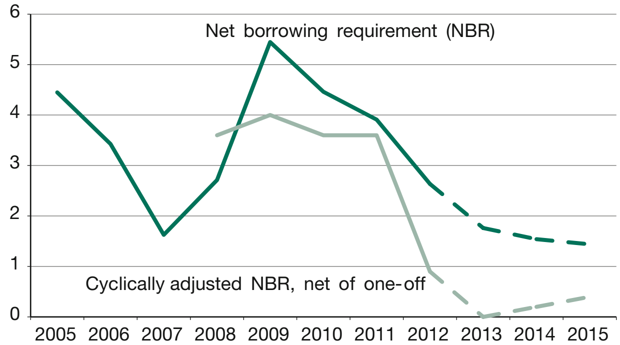
1 Information on the package can be found in Italy's Major Structural Reform. Progress Report, December 2011-November 2012, Ministry of Economy and Finance of Italy, at: http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_en/analisi_progammazione/analisi_programmazione_economico/Structural_reforms_LC_master_26_11_2012_LC_clean_x2x.pdf.

Table 1
Key public finance projections
% of GDP

	2010	2011	2012	2013	2014	2015
Net borrowing requirement (NBR)	-4.6	-3.9	-2.6	-1.8	-1.5	-1.3
Cyclically adjusted NBR, net of one-off	-3.6	-3.6	-0.9	0	-0.2	-0.4
Change in cyclically adjusted NBR, net of one-off	-0.4	0	-2.8	-0.9	0.3	0.2
Primary balance	0.1	1.0	2.9	3.8	4.4	4.8
Public debt	119.2	120.7	126.4	126.1	123.1	119.9
Public debt (net of support to EU)	118.9	119.9	123.3	122.3	119.3	116.1

Source: Ministry of Economy and Finance: Update of 2012 Economic and Financial Document, 20 September 2012.

Figure 1
Net borrowing requirement (NBR) vs. cyclically adjusted (net of one-off) NBR



Source: Ministry of Economy and Finance: Update of 2012 Economic and Financial Document, 20 September 2012.

then in charge (which had been in power since 2008) avoided countercyclical actions to address the crisis, while public finances remained largely under control, in part because no banking sector rescue package was needed. It launched some interventions in the area of structural reforms (for example, simplification of administrative procedures and an overhaul of the apprenticeship system), although the resistance of vested interests succeeded in blocking a consistent strategic design. Finally, in summer 2011, as a consequence of financial market turbulence and possible contagion from other EU countries, bond market sentiment deteriorated, as fears on Italy's fiscal sustainability emerged. In the effort to address the mounting tensions, the cabinet adopted two consolidation packages, in July and in August. However, due to persistent tensions, the centre-right government resigned in mid-November 2011 and an emergency cabinet, the Monti government, took over.

Immediately after taking office, the new government adopted an additional emergency intervention in December 2011, the "*Salva Italia*" (Save Italy) law. It mainly consisted of fiscal consolidation measures, including a new round of pension reforms, but also included some growth-enhancing actions, mostly focused on the business environment and liberalisation. Building on these first structural reform measures, the "*Cresci Italia*" (Grow Italy) and "*Semplifica Italia*" (Simplify Italy) laws were adopted in March 2012 to foster competition in product and service markets and to further improve the business environment, mainly by reducing the administrative burden on firms and citizens. Other actions undertaken include two "development" decrees, a spending review, labour market reform and an anti-corruption law. At the same time, Parliament approved the constitutional reform of public finances submitted by the previous government in September 2011.

Public finance: how to address a legacy of high debt

After decades of efforts to control persistent Italian deficits, the September 2012 Update of Italy's Economic and Financial Document (the government's planning document) envisages that the general government structural budget will be balanced by 2013, confirming the commitments undertaken by the country at the EU level. Moreover, by 2012 the general government net borrowing is expected to return below the three per cent threshold, leading to the closure of the excessive deficit procedure (EDP) opened against Italy – and most EU member states – in 2009, when the nominal deficit hit the unsustainable level of 5.5 per cent due to the dramatic slowdown of the Italian economy.

The attainment of a balanced budget by 2013 would put the Italian debt, the fourth largest in the world, on a declining path. This result would confirm the success in addressing the legacy of weak discipline inherited from the past and would offer a promising outlook on the Italian budgetary position.

The consolidation packages

Current public finance figures give evidence of the country's hard work. The effective consolidation effort started in 2006 – kicked off with an EDP procedure launched the previous year – and it was suspended only in 2008 and 2009, the years when the world crisis was at its deepest. In those years, when other countries adopted countercyclical measures to cope with the crisis, significantly worsening their budget positions, the Italian budget strategy focused on limiting discretionary measures to a minimum and allotting a significant share of public resources to automatic stabilisers. Indeed, in 2008-2009, the government adopted mainly temporary budget-neutral measures.

Net borrowing figures for the following years reflect the dramatic circumstances characterising Europe in the unprecedented spiral of the sovereign debt, euro, banking system and real economy crises. Between 2011 and 2012, the structural budget deficit was reduced from -3.6 to -0.9 per cent, driven by emergency actions taken in 2011, first by the centre-right government and then by a large majority government supported by most parties. These huge efforts aimed at increasing confidence in the sustainability of Italian debt and at avoiding contagion to a country that was considered "too big to fail". Even though the already deteriorated economic scenario worsened further in 2012 (a 2.4 per cent drop in GDP is projected) amid high unemployment rates and an increase in poverty, the country has reacted in a relatively calm way, and disorders have been very limited. Indeed, while the social situation remains serious, the emergency packages seem to have been accepted.

The cumulative reduction in the structural budget balance between 2006 and 2013 amounts to 5.5 percentage points. The primary surplus is expected to reach almost four per cent in 2013 and to exceed this level in the following years. Against baselines, the financial effects of the measures adopted are even more impressive. According to official estimates, in a single year, 2013, stabilisation packages adopted in previous years will reduce net borrowing by more than €90bn (5.5 percentage points of GDP), limiting government spending and increasing revenues.

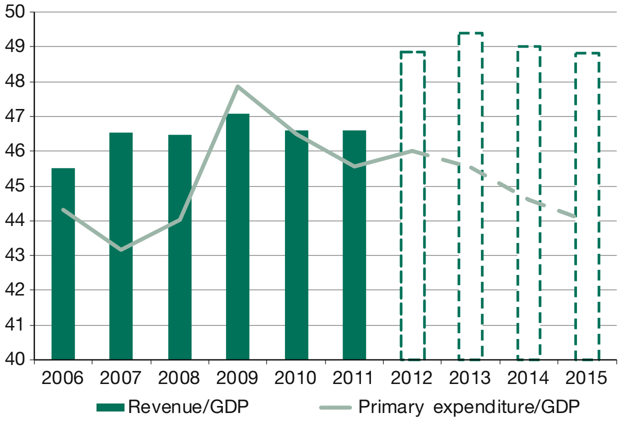
Looking at the composition of consolidation measures, the main contribution comes from the revenue side (two-thirds of the correction package in 2013). The expected effects of stabilisation packages would increase the revenue-to-GDP ratio by 2.2 percentage points in 2012 and by 0.5 percentage points in 2013. Consequently, the revenue-to-GDP ratio in 2013 is expected to reach 49.4 per cent, compared with an average ratio of 46.4 per cent in 2006-2011 (see Figure 2). On the expenditure side, despite the large corrections (€33bn estimated for 2011) on primary spending, the ratio of primary expenditure-to-GDP in 2012 is 46 per cent, showing a relevant decline only at the end of the forecast period (43.9 per cent) due to the rigidity of primary expenditure and the loose financial effects of spending rationalisations.

More specifically, on the revenue side, the consolidation strategy has called for both an increase in total revenues and the reduction of high distortions enshrined in the current tax system. To this aim, there has been a general shift in taxation from both labour and income to consumption and real estate property, as well as an aggressive stance in fighting tax evasion.

In particular, the packages envisage an ordinary VAT increase of one percentage point, an increased tax on real estate and

Figure 2

Revenue-to-GDP vs. expenditure-to-GDP



Source: Istat, Ministry of Economy and Finance: Update of 2012 Economic and Financial Document, 20 September 2012.

a reform of taxation on financial instruments (including the introduction of the Tobin tax on financial asset transactions), as well as higher taxes on energy companies and financial operators and more revenues from gaming and excise duties. On the other hand, the packages provide for a new tax framework for businesses (Aid for Economic Growth) that reduces the tax burden on capital investment and for a reduction in the taxation of labour, which is further reduced for female employees, for workers under 35 years old and for firms located in "disadvantaged" regions.

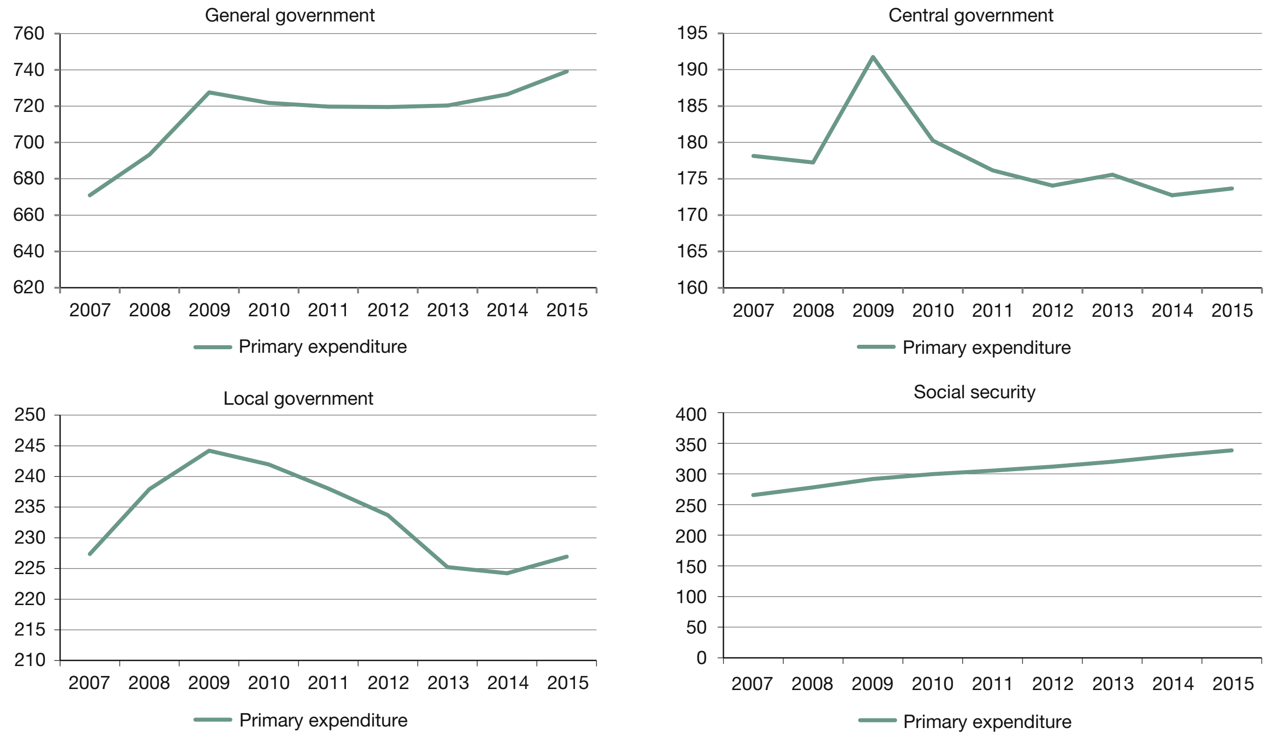
The fight against tax evasion and avoidance has been reinforced through the strengthening of controls and procedures in detecting tax evaders. In view of incentivising tax compliance, a softer regime will apply to taxpayers who are compliant with so-called sectoral studies, and "tutoring" procedures will give assistance to taxpayers (especially the smaller ones), while anti-evasion activities will focus on large taxpayers and VAT frauds. New synergies with the Social Security Institute and other public administrations are envisaged to crack down on undeclared economic activity. Other measures contained in the packages include the lowering of the legal threshold for cash payments to €1,000 and additional obligations imposed on banks and financial intermediaries, such as requirements of disclosure to the Revenue Agency (for example, of all transactions involving economic agents located in the OECD's "blacklist" countries).

On the spending side, measures are sharp and painful, and all sectors have been involved. Some sectors, such as education and health care, are required to contribute to rationalisation efforts in public spending mainly through efficiency gains, while spending (e.g. on pensions) has been reformed and reduced. Such measures involve important reorganisation processes and deeper cultural changes, the results of

Figure 3

Primary expenditure, net of grants to other government units, by sectors

in billions of euros



Source: Istat, Ministry of Economy and Finance: Update of 2012 Economic and Financial Document, 20 September 2012.

which have to be evaluated in terms of structural savings and capacity to preserve the quality of public services for citizens in the medium term. The expenditure consolidation focuses primarily on current expenditure; the rationalisation has been framed by a formalised process of spending review which started in 2012 with the appointment of a Commissioner and the establishment of a specific inter-ministerial committee.

The first group of actions aims at introducing changes in public procurement, particularly in the health sector and in local government, since purchase prices of goods and services are extremely differentiated across the country, often without good reason. Purchases will be managed solely by Consip (the central government procurement agency) or by regional procurement agencies according to the best practices already established in certain regions of Italy. Consequently, transfers to local government and health authorities have been cut.

The second important consolidation area refers to public sector staff. The most recent reductions in the number of civil servants (employment will decrease by 10 per cent and by 20 per cent at the managerial level) build on previous turnover and salary freezes. Since 2007 the number of public employees has declined by 4.3 per cent, and their compensation has declined by 2.3 per cent.

Additional savings are expected to stem from other minor measures, such as limits on furniture expenditure, purchase or leasing of new motor vehicles and a more cost-efficient use of government buildings. Moreover, public entities performing similar functions have been merged and some small entities were closed.

Reorganisation will involve all layers of government at the central and local levels. By January 2014, the number of provinces in ordinary statute regions will be reduced from 86 to 51. The streamlining of provinces is meant to be the first step of a wider process involving the territorial government offices (*prefetture*), as well as the Department of Motor Vehicles. Similar reorganisations have been completed for tribunals.

Finally, the measures adopted to reduce public debt are worth noting. Intense debate over selling off public assets (real estate properties and stock holdings) to reduce the huge public debt is not a novelty brought about by the crisis but an old concern. The value of those assets is quite high, though it is difficult to get a reliable, complete and updated appraisal (a tentative estimate of asset value is about one third of GDP). In July 2012, the government committed to sell real estate assets and privatise state-owned companies to ensure one percentage point of GDP per year in debt reduction over the next five years. Since local government debt is only six per cent of GDP, while about 54 per cent of real estate assets and stock holdings are at the local level, policy implementation requires strong co-operation with local governments. Some government holdings (in particular Fintecna, SACE and SIMEST) were sold to *Cassa Depositi e Prestiti* with proceeds earmarked for the Public Debt Sinking Fund or for payment of commercial debt. Recent legislation foresees that real estate assets are to be transferred by central and local governments to a special real estate fund (under the control of a management company owned by the Ministry of Finance) entrusted to either manage or sell assets. Looking at stock holdings – more than 7,600 entities – the three major listed companies (worth about €12bn) are perceived as strategic, while for others there is no market appetite. Moreover, current off-peak prices for many companies and real estate assets will limit the potential financial benefits from privatisation.

The expected result of consolidation actions and the future challenges for the Italian public budget are better understood by examining primary expenditure dynamics by subsectors. These trends reflect the specificity of the Italian budget, incorporating both the characteristics of the spending legislations enacted in the past 30 years and the corrective actions adopted in more recent years. In particular, the increase in the general government's nominal primary expenditure over 2013-2015 (about 0.9 percentage points) is due to social security expenditure, while local government spending – including health provision and other important social services – is expected to turn marginally positive at the very end of the forecast period. The central government will see a continued reduction in its spending trends.

In a nutshell, expenditure control faces two constraints: the interest burden, exogenous at least in the short-term, and pension payments for existing pensioners. Despite the indexation freeze on most current pensions and the strict reforms of age requirements and contribution formulas, pension expenditure is increasing, because it incorporates a large chunk of past entitlements. In light of the need to stick to aggregate targets and the aforementioned constraints on some balance sheet items, fiscal room for possible tax reduction and other prospective needs would require savings from other subsectors and other policies. This is the intergenerational dilemma the country will face in the future.

Pension system reform

Public pension expenditure in Italy was 14 per cent of GDP in 2005, exceeding that of all other OECD countries. The ratio of expenditure to GDP increased to 15 per cent in 2010. Successive governments, in a series of reforms beginning in 1992, have worked to avoid a growing expenditure trend in the long term. In 2010, legislative adjustments raised the retirement age for women in the public sector, made the retirement age conditional on life expectancy and postponed entitlement to early and old age retirement through the use of the so-called "exit window", which is equivalent to an increase in the retirement age. Considering all the reforms between 1992 and 2010, the main changes have been a move from a defined-benefit system to a defined-contribution system with notional accounts – including a mechanism linking pension payments to life expectancy – and a higher retirement age, indexed to life expectancy, beginning in 2015. In December 2011, a new set of strict measures were adopted by the new government aiming at curbing pension expenditure in the short term while improving the long-term sustainability of the system at the same time, partly by increasing the statutory retirement age and partly by reducing the amount of pension benefits.

First and foremost, the contribution-based regime was extended in 2012 to all workers pro rata to those previously subject to earnings-related or mixed regimes. Then a rapid tightening of eligibility requirements for old-age retirement was introduced: 1) the Statutory Retirement Age (SRA) for men (employed in both the public and private sector) and women working in the public sector increased from 65 to 66 years in 2012; 2) all workers were aligned to the same SRA, with a gradual increase of the SRA for women working in the private sector (previously set at 60); 3) as of 2013, all age requirements are linked to changes in life expectancy at 65. After 2019, such adjustments will be carried out every two years rather than every three. As of 2018-2019, the SRA will become 67 years for all workers. Also, a tightening of eligibility requirements for early retirement has been introduced. As of 2012, the contribution period to be eligible for retirement, regardless of age requirement, was increased from 40 to 42 years and one month for men and 41 years and one month for women. Furthermore, as of 2013, all requirements, including those related to age and contribution periods, will be updated in line with life expectancy at 65. After 2019, such adjustments will be carried out every two years.

New rules for pension benefits were also introduced: 1) the transformation coefficients for the computation of pension benefits are now calculated taking into account the probability of death from the age of 57 up to the age of 70 (65 according to previous legislation); 2) the transformation coefficients will be updated every three years as of 2013 and every two years as of 2019; 3) the contribution rates for the self-employed (artisans, shopkeepers and farmers) will be gradually increased from 21.3 per cent in 2012 to 24 per cent in 2018; 4) an indexation freeze will be imposed on pension benefits that are three times higher than the minimum provision in 2012-13.

Pension system interventions will produce savings, net of fiscal effects on Italy's public finance, which are estimated to reach €7.3bn by 2014 and almost €22bn by 2020. As a result of the reform, the average age at retirement (taking into account both the old-age retirement requirements and the early retirement requirements) will increase from 60-61 in 2006-2010 to about 64 in 2020, 67 in 2040 and about 68 in 2050. The increase in the projected retirement age would have profound implications for the labour market. According to the EU 2012 Ageing Report, by 2020 the labour participation rate of 55-64-year-olds will rise to 57 per cent, a considerable increase relative to the 38 per cent participation rate in 2010. In the absence of additional measures enhancing the demand for older workers, it is questionable whether the labour market will be sufficiently flexible to accommodate a higher proportion of older workers. In our view, one of the shortcomings of the reform is the lack of flexibility for labour market exit. Indeed, some flexibility, balanced by proper decreases in the pension benefits calculated in present value terms, might be necessary for some categories, in particular women and workers with physically exhausting jobs.

Finally, it has to be noted that as a result of unintended flaws in the design of the reform, about 130,000 workers who retired prior to its implementation (4 December 2011) but had not yet received a pension were left without a pension for a significantly longer period than they had anticipated (referred to in the press as "*esodati*"). Moreover, other workers might be in the same situation in the coming months, as they leave their jobs on the basis of previous union-employer agreements in restructured firms. No reliable estimates are available for this category (referred to as "*esodandi*"). To avoid these unintended effects of the reforms, specific exceptions have been authorised.

The constitutional reform

In April 2012, Parliament approved a constitutional amendment that introduces a balanced budget provision in line with Fiscal Compact requirements. The new rule will enter into force in financial year 2014. The constitutional amendment defines the basic principles of balanced budgets for the whole government sector (i.e. central administrations, regions and local governments) and of the sustainability of public debt in accordance with the European legal framework. It also establishes specific rules for the central and sub-national governments to pursue the new budgetary objective.

In particular, the central government budget shall respect the structural balance between revenue and expenditure. Therefore, it is allowed to borrow only within the limits of the effects determined by the economic cycle or in exceptional circumstances that cannot be addressed by ordinary budgetary measures. Exceptional circumstances must be declared by Parliament with an absolute majority vote. Sub-national governments shall keep their financial autonomy with the addition of the new balanced budget requirement. The new rule for these entities is defined in nominal terms. The constitutional amendment also establishes that sub-national governments can only borrow to fund capital expenditures, with the adoption of amortisation plans, provided that the overall budget of the entities in each region is balanced. Moreover, it is confirmed that no state guarantee is allowed on loans contracted by sub-national governments. Finally, the reform states that sub-national entities share the burden of fiscal adjustment required by the European rules with the central government. It also establishes the creation of an independent body within Parliament that is responsible for monitoring public finance. The Italian fiscal council shall also check for compliance with fiscal rules.

The necessary secondary legislation for the new provision to become operational and consistent with the EU budgetary framework was adopted in December 2012 by a qualified majority (absolute majority of the members of each House). The secondary legislation defines, in line with Fiscal Compact provisions, the exceptional circumstances and the functioning of the corrective mechanism in case of significant deviations from fiscal targets. It also defines the structure, functions and financing of the fiscal council, named the Parliamentary Budget Office (PBO), in line with the Common Principles endorsed by ECOFIN in June 2012. Several challenges are likely to arise in the implementation phase. As to fiscal rules, the constitutional provision should result in substantial changes in legislative actions, as well as in budget execution, by transferring the budget constraint to each individual management process. As to the effectiveness of the PBO, the challenge lies in the appointment of truly competent and independent experts as members of its governing body (a three-member board), as envisaged by the law approved in December. Additionally, the selection of highly skilled technical staff through open competition will be a crucial element in the institution building. Finally, guaranteeing the fiscal council full access, in a timely manner, to all relevant information in the Ministry of Finance, including methodology and assumptions underlying the budget and macroeconomic projections, will be decisive for the PBO's success in fulfilling its remit.

Structural reforms: how to address a legacy of weak growth

Labour market reform

The labour market reform undertaken by the emergency cabinet consists of four pillars: 1) changes to the apprenticeship system; 2) rationalisation and expansion of the unemployment benefit system; 3) increased incentives to award permanent contracts; 4) reduced incentives to award fixed-term contracts.

The government aimed at strengthening apprenticeships to facilitate youth employment following an overhaul of the system by the previous government in 2011. Apprenticeships have a minimum duration of six months. At the end of this period, companies are encouraged to take on – through open-ended contracts – at least half of the apprentices hired over the previous three years. Contributions are generally set at low rates in the first three years, with even lower rates for firms with less than ten employees.

The reform has also taken steps towards a more universal unemployment benefit system, which is to be fully phased in by 2017. "*Assicurazione Sociale per l'Impiego*" (ASPI) aims at reducing the persistent insider-outsider dualism, and it will gradually apply to all dependent workers. In particular, it is designed to cover apprentices and public and private workers employed with temporary contracts. Once the scheme is fully phased in (as of January 2017), ASPI will be available for a maximum of 12 months for workers younger than 54 and 18 months for workers older than 54 (compared to eight months for workers younger than 50 and 12 months for workers older than 50 in the current unemployment benefit system). The amount of benefits depends on the amount of remuneration received over the past two years. ASPI foresees a 15 per cent reduction in benefits after the first six months, followed by a further 15 per cent reduction after twelve months. Workers with at least two years of social security contributions and 52 working weeks over the previous two years are eligible. Unemployed workers with a shorter contribution history are entitled to benefits for a shorter period of time (so-called mini-ASPI), while independent workers are entitled to a lump-sum benefit. ASPI is partly funded by the state and partly through increased contributions paid by employers which can be reimbursed if the worker is hired on a permanent contract. The "ordinary wage supplementation scheme" (*Cassa Integrazione Guadagni*, CIG) for firms with more than 15 employees has been extended to sectors previously excluded. On the other hand, the "special wage supplementation scheme" (*Cassa Integrazione Guadagni Straordinaria* – CIGS) is no longer available for firms facing bankruptcy procedures: employees from those firms will be covered by ASPI.

To increase the incentives to hire employees on permanent contracts, some relaxation of dismissal restrictions and simplification of procedures for dispute resolution have been introduced. In particular, the circumstances in which judges can order reinstatement following unfair dismissals have been circumscribed, and the procedures for dispute resolution have been streamlined through the introduction of mandatory conciliation and simplified court procedures for dismissal cases. When conciliation fails and a judge rules that dismissal is unfair, the worker is entitled to a maximum compensation equivalent to 12 months of wages and reinstatement. In all other cases, with the exception of those involving clear discrimination, only compensation shall be provided, which is capped at a level equivalent to 24 months of wages. At the same time, the government decreased the incentives to hire workers on fixed-term contracts. The cooling-off period between two fixed-term contracts has been extended, and the fiscal incentive for some types of fixed-term contracts has been reduced; in particular, employers will have to pay higher social contributions on most fixed-term contracts, which can be reimbursed when these are converted into permanent ones (the so-called "stabilisation bonus").

Additional new measures include greater protection of maternity and paternity leave and new public employment services for unemployed workers within three, six and 12 months of job loss, such as career orientation services and vocational training activities.

The reform impact is quite controversial, with some academic commentators and employers' associations arguing that the measures are less effective than intended. In particular, the apprenticeship contract seems to be less attractive for firms than projected, while the extension of the coverage of ASPI appears to be limited. Moreover, first empirical evidence from courts seems to point to more judicial discretion in dispute resolution, not less, as intended by the reform.

Product and service markets

Since December 2011, the Monti cabinet has introduced a wide range of measures to help overcome some of the major weaknesses in the business environment by reducing product market regulation and promoting competition. They are expected to have a positive effect on GDP. The main interventions include the following: 1) strengthening the powers of the Competition Authority, including powers over local public services and the operation of tenders; 2) more competition in public transport, with a new independent regulator; 3) separating network ownership from production and supply in the gas industry; 4) further deregulation in some professional services (e.g. abolition of minimum fees, easier access to professions with a reduction of the compulsory traineeship); 5) further simplification of administrative procedures for businesses and individuals (e.g. elimination of *ex ante* controls, limits, permits and licenses for start-ups, substantial simplification for SMEs); 6) increasing the average size of judicial districts and developing specialised commercial courts; 7) further deregulation in the retail sector (e.g. increasing the number of pharmacies and notaries, liberalisation of opening hours for retailers).

According to many commentators, some interventions could have been more incisive; however, interest groups were able to resist, being fully represented in political parties sitting in Parliament. Recent events provide evidence that the ability to carry out structural reforms in a country like Italy requires deep cultural changes in the community as well as in people's understanding and the full sharing of reform objectives.

Concluding remarks

The packages adopted by the emergency cabinet since November 2011, as well as some of the previous cabinet's measures with saving effects from 2012 onwards, appear to have been successful in bringing the Italian budget under control. In parallel with the establishment of European firewalls, policies adopted in Italy contributed to restoring the confidence of financial markets in fiscal sustainability, as shown in sovereign bond spread trends in recent months. Also, the constitutional balanced budget rule and the establishment of the fiscal council will, hopefully, strengthen credibility and responsibility of fiscal policy making in the coming years. Hoverer, the toll of the huge fiscal consolidation packages has clearly exacerbated the current recession and past deficiencies, hindering recovery prospects. The related social tensions and the increase in poverty in certain areas of the country risk jeopardising the efforts to change, and youth unemployment endangers the capacity of an entire generation of individuals to shape their futures.

"Homework" (i.e. domestic fiscal discipline and pro-growth structural reforms) is a necessary requirement, but unfortunately, it is insufficient to save the Union and the single currency. Domestic imbalances and a lack of fiscal discipline in the past contributed to the crisis that has enveloped the eurozone. However, they were not the only determinants. Indeed, the crisis in southern European countries is also a consequence of flaws in the European construction dating back to its inception. Therefore, in our view, the current systemic crisis of Europe calls for reconsidering European institutions and their mandates. In particular, with member states under strict fiscal discipline requirements (in many cases imposed at the constitutional level), there is a need for pro-growth interventions carried out by the Union itself, in particular in infrastructure, and for central budget transfers in case of asymmetric shocks. Ultimately, the establishment of a European federation appears to be the only cure for the EU's congenital failings.

J. Ignacio Conde-Ruiz and Carmen Marín

The Fiscal Crisis in Spain

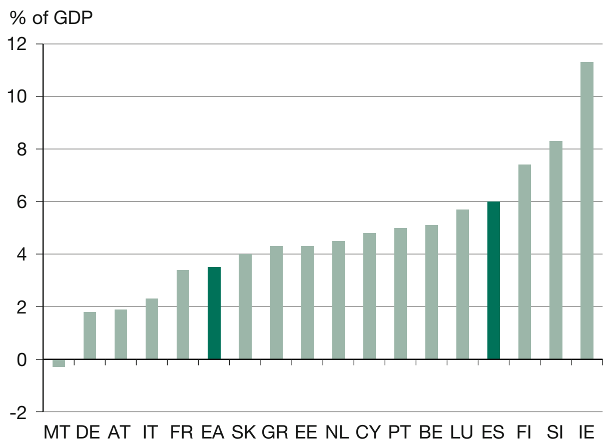
The macroeconomic outlook for the Spanish economy is grim, as the government expects to finish 2012 in recession (-1.5% GDP growth), with no growth expectations for the coming years and an unemployment rate which stood at 26% in November. Spain has the highest level of unemployment in the eurozone and has one of the highest public deficit levels (just behind Ireland).

The main cause of the high level of unemployment in Spain is that GDP growth during the boom was based on labour-intensive sectors, which were very badly hit by the recession, leading to the elimination of a lot of jobs. We must remember that the collapse of the housing market was responsible for the destruction of almost half of the jobs lost during the crisis. The housing bubble increased debt levels in the Spanish economy, and when it burst, the balance sheets of several financial institutions were heavily damaged. In the Spanish labour market, there are two main types of job contracts: open-ended and temporary. During the crisis, a large number of temporary contracts – mostly for young workers – were not renewed, and this led to a huge increase in unemployment. In November, the unemployment rate for young people in Spain was 57%, compared to 24% in the eurozone. The problem is even more serious if we consider that nearly a million currently unemployed young Spaniards had dropped out of compulsory education in order to work in the booming construction sector.

The imbalances in the Spanish budget arise partly from the increase in public sector expenditure but mainly from the reduction in public revenues. In Figures 1 and 2, the increase or reduction of public sector revenue and expenditure between 2007 and 2011 for all countries in the eurozone can be seen. As can be observed, Spain is the country where revenues fall with greatest intensity (-5.4% of GDP) and is the country with the fourth greatest increase in expenditure (6% of GDP) after Ireland, Slovenia and Finland. Spain's main problem is not the increase in expenditure, since government spending usually increases in recessions as a result of automatic stabilisers coming into play. Moreover, the level of expenditure in Spain in 2011 (45% of GDP) was below the average eurozone expenditure (50% of GDP).

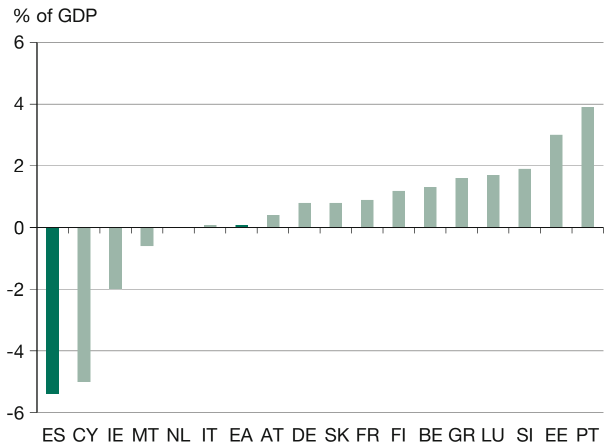
The fiscal crisis in Spain is a revenue crisis. Since the crisis started in 2007, most countries in the eurozone have increased their revenues as a percentage of GDP; only four countries have seen a reduction in revenue: Spain, Cyprus, Ireland and Malta. How can we explain such a big reduction of government revenue in Spain? One reason could be the growth of the black market economy and tax fraud, but in

Figure 1
Change in government expenditure, 2011 – 2007



Source: Eurostat.

Figure 2
Change in government revenue, 2011 – 2007

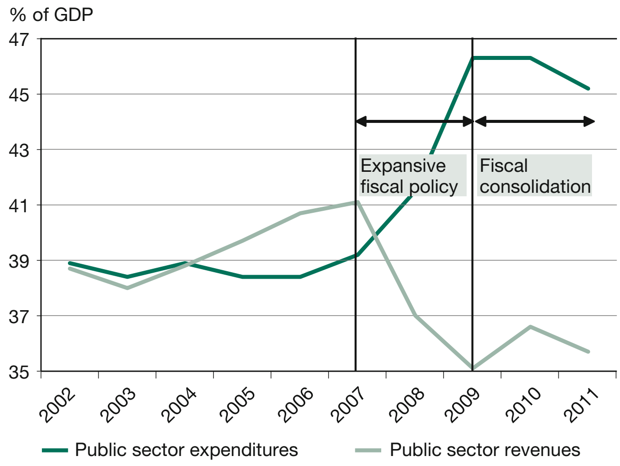


Source: Eurostat.

fact most of the reduction in revenues has come from another source: the housing bubble. The Spanish tax system was closely entwined with the housing bubble, more so than with the evolution of GDP. During the boom, the government collected extraordinary revenues through a transfer tax (on the purchase and sale of dwellings), corporate taxes (extraordinary profits of banks and builders) and through VAT on imported goods and services (Spain had a very negative current account balance which reached 10% of GDP). Once the bubble burst, revenues decreased dramatically.

The problem was that with the *temporary* revenues collected from the housing bubble, politicians (of central and re-

Figure 3
Public sector revenues and expenditures in Spain



Source: Eurostat.

gional governments) drew up *permanent* spending outlays. Spain now has an inefficient tax system that is not collecting enough to finance the country's permanent expenditures. Spanish revenues were 36% of GDP in 2011, while the eurozone mean was 45% of GDP.

In this report, we analyse the Spanish fiscal consolidation process from the beginning of the crisis in late 2007. We analyse the different phases of the crisis and outline the main aspects of the necessary tax reform before turning to an explanation of the difficulties associated with overseeing public finances in the regions.

The two phases of the fiscal crisis

We divide the crisis into two different stages. During the first two years (2008 and 2009), a fiscally expansive path was followed in eurozone countries, in line with recommendations from international institutions. However, beginning in 2010, as a result of the severe deterioration of public finances (see Figure 3), the main strategy has been to pursue fiscal consolidation. This surprising change of direction had important consequences for Spanish fiscal policy, as we shall see below.

Expansive fiscal policy (2008-2009)

In the first two years of the crisis, European countries applied expansive fiscal measures to offset the sharp deceleration of activity, following the recommendations of international institutions such as the IMF, which affirmed in the World Economic Outlook of October 2009:

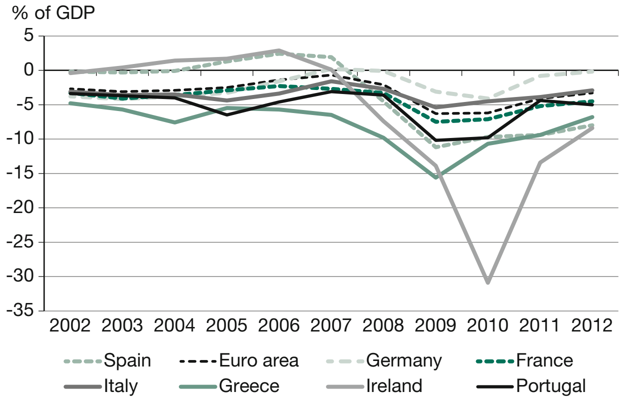
> Notwithstanding already large deficits and rising public debt in many countries, fiscal stimulus needs to be sus-

Table 1
Main fiscal expansionary measures in Spain (% of GDP)

		2008	2009	Total
Revenue side	Total revenue measures	-1.8	-1.2	-3.0
	Tax cuts	-1.3	-0.5	-1.8
	Liquidity support	-0.5	-0.7	-1.2
Expenditure side	Total expenditure measures		1.1	1.1
	State fund for local investment		0.7	0.7
	Special fund to stimulate activity		0.3	0.3

Source: own elaboration.

Figure 4
Fiscal deficit



Source: Eurostat.

tained until the recovery is on a firmer footing and may even need to be amplified or extended beyond current plans if downside risks to growth materialize.[1]

Specifically, Spain introduced a package of expansionary measures in 2008 and 2009 totalling 4% of GDP (see Table 1). On the revenue side, tax cuts amounted to 1.8% of GDP in 2008 and 2009. These cuts included income and corporate tax reforms in 2007, a personal income tax rebate of €400, elimination of the wealth tax in 2007 and the 2007 introduction of child benefits (€2,500) payable at birth. Additionally, the government introduced liquidity support measures to households and companies that reduced revenues by 1.2% of GDP in 2008 and 2009 (advances on the income tax deduction for house purchases and monthly VAT returns for companies).

On the expenditure side, the government introduced two main sets of measures: a fund for local public investment called “Plan E” which was endowed with €8 billion euro (0.7% of GDP) and a special fund to improve the prospects of certain strategic sectors (e.g. the automotive industry or R&D) and public consumption projects (0.3% of GDP).

As a result, public accounts shifted from a surplus of 2% in 2007 to a deficit of 11% in 2009 and public debt increased from 36% in 2007 to 54% in 2009. The deterioration of public finances was very marked in these two years. Spain was, after Ireland, the country with the biggest fiscal deficit increase in the eurozone (see Figure 4).

To sum up, the Spanish government applied expansionary measures during the years 2008 and 2009 to fight the crisis but did not introduce any of the structural reforms that Europe was calling for. This period of expansive fiscal policy should have been carried out in parallel with structural reforms, i.e. labour market reform, pension reform and product market liberalisation. All of these reforms have been pending for decades, and yet even today they have not been completely implemented.

1 http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/exesum.pdf.

Fiscal consolidation policy (2010-present day)

In 2009, most countries in the eurozone exceeded the deficit ceiling of 3%. As these countries became immersed in excessive deficit procedures, they had to take fiscal consolidation measures to rectify their situations. As the 2007 financial crisis turned into a sovereign debt crisis in 2009, the countries with the greatest fiscal imbalances had difficulties in issuing public debt. Greece, Ireland and Portugal were obliged to ask for financial assistance from Europe to finance their debt. The European Commission radically changed its recommendations for the peripheral countries. This was the end of the expansive stage and the beginning of the consolidation stage.

Table 2 summarises the main fiscal measures adopted by the Spanish government from 2010 to 2012. The fiscal adjustment measures started in May 2010 when, due to contagion from the Greek economy, Spanish sovereign spreads increased significantly, reaching a historical high of 170 basis points. Over the past two years, Spanish sovereign spreads have gone up and down as political and economic news influenced investor sentiment. Whenever sovereign market conditions got worse, fiscal adjustments were made, without following any rational, well-designed plan.

While it is very difficult to analyse the ultimate fiscal impact of the various measures adopted to combat the deficit, the expected impact is presented in Table 2. On the revenue side, the government introduced measures with an expected impact of 3.9% of GDP from 2010 to 2012. On the expenditure side, the measures applied have an expected impact of 3.5% of GDP.

Table 2
Main budgetary measures, Spain

			% GDP	
2010-2011	Revenue side (1.7% GDP)	VAT increases: general rate from 16% to 18% and reduced rate from 7% to 8%	0.8	permanent
		Increase in excise taxes	0.4	permanent
		Withdrawal of personal income tax credit of 400 euros	0.5	temporary
		Increase in taxation on saving	0.1	temporary
		Reduction in the corporate tax of SMEs	-0.1	
		Elimination of the deduction for purchase of main residence		
	Expenditure side (-1.8% GDP)	5% cut in public sector staff remuneration	Total: -1.8	permanent
		Freeze of public sector wages		temporary
		Reduction in pharmaceutical costs		permanent
		Implementation of 10% replacement rate for all public sector staff		temporary
		Reduction in public investment		temporary
2012	Revenue side (2.2% GDP)	Supplementary levy on personal income tax	0.4	temporary
		Increase revenue from corporate tax, mainly by cutting deductions	0.7	temp-perm
		Fiscal regularisation	0.2	temporary
		Fight against tax fraud	0.2	permanent
		VAT increases: general rate from 18% to 21% and reduced rate from 8% to 10%	0.2	temporary
		Tax on property	0.1	temporary
		Additional revenues from autonomous communities	0.3	temporary
		Reintroduction and re-elimination of the deduction for purchase of main residence		
	Expenditure side (-1.7% GDP)	Cuts in education and healthcare	0.4	
		Reduction of drugs bill (pensioners pay part of cost), central drugs purchasing platform	0.5	permanent
		Extension of working hours for public sector employees	0.6	temp-perm
		Suppression of December 2012 bonus for all public employees		
		Reduction in public investment		
		Unemployment benefits standardised from seventh month	0.2	

Source: Commission Staff working Documents from 2010 to 2012, Ministry of Economy and Competitiveness and own elaboration.

Although the fiscal adjustments put into practice by the government were very ambitious, their effects on the deficit are mostly temporary. As a consequence, most of these measures have not reduced the structural deficit. This is the case for the measures relating to personal and corporate income taxes, the fiscal regularisation process, the rise in VAT and the suppression of the salary bonus for public employees. Approximately half of the total revenue measures have temporary effects (two percentage points of GDP). Moreover, the government has greatly delayed the introduction of some measures and structural reforms. The pension reform, for example, was approved in January 2011 but does not come into force until 2013.

A good way to assess the fiscal consolidation process is to analyse the evolution of expenditure from the maximum level reached in 2009. As can be seen in Table 3, the government is reducing expenditure mainly via the reduction of public investment, which has decreased by 60% since 2009. Public investment cannot be reduced any further and cannot continue at such a low level for long because there are not enough resources to finance depreciation. Public employees' wages represent the second biggest reduction, a total of 4% since 2009. On the other hand, spending on interest payments has increased by 70% since 2009 as a result of the higher level of public debt and the increased cost of market financing.

On the revenue side, the most significant measures are the rises in VAT and personal and corporate income taxes, as well as the reintroduction of the wealth tax. The government also carried out a tax regularisation process. As Table 2 shows, the main measures put into practice have not produced great changes in the Spanish tax system. As mentioned above, the Spanish tax system was closely entwined with the housing bubble. Now that the bubble has burst, revenues are not going to be recovered unless the government draws up a radical tax reform. The question is, how can the revenue crisis in Spain be solved?

Table 3

Non-financial expenditure, public sector

Million euros

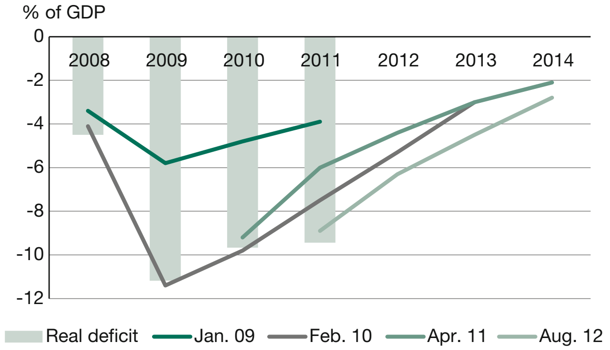
	2009	September 2012, annualised	Variation rate 2012/2009
Public wages*	125 710	120 708	-4%
Interest expenditures (EDP)	18 565	31 585	70%
Other current expenditures	278 533	283 228	2%
Gross capital formation	46 763	20 167	-57%
Investment aid	15 233	3 834	-75%
Non-financial expenditures**	484 804	459 523	-5%

* The suppression of the December 2012 bonus is not included because it does not reduce the structural deficit. ** Aids to the financial sector not included.

Source: Ministry of Finance and Public Administration and own elaboration.

Figure 5

Budgetary objective deficit in Spain



Source: Stability and convergence programmes, Spain.

Although Spanish personal and corporate income taxes have high marginal rates, not enough money is raised, mainly because of the deductions that can be applied. For example, if all deductions were eliminated, the expected increase in personal income tax collections in 2012 would be €9 billion (0.9% of GDP). Moreover, to attract foreign investment, Spain must be attractive to foreign companies and highly skilled workers. For this reason, it is important to reduce progressivity in the taxation of personal and corporate income. Spain has very high marginal rates for personal income taxes, with a maximum marginal rate of 52%, although some regions have imposed an even higher marginal rate of up to 56%. If the government reduced the maximum marginal rate to 40%, the lost revenue would be only 0.2% of GDP. Corporate income taxes present the same problem: a high marginal rate (30%), whereas the effective rate is lower (below 18%). So the reform required is clear: reduce marginal rates and eliminate deductions. Additionally, we propose a new wealth tax to oblige rich taxpayers to pay more.

After the second tax increase, the VAT rate is now similar to the rate in other European countries. However, only 42% of the consumption basket is taxed at the general rate. This is not the case in other countries. For example, in Germany 82% of the consumption basket is taxed at the general rate, in France 71% and in Italy 58%. As with the Spanish income tax rates, the general VAT rate is high and the effective rate is low.

Despite the fiscal adjustment measures introduced by the government, the ultimate effects are sometimes not the ones initially expected. As shown in Figure 5, Spain has not usually met the deficit objectives agreed upon with Europe. Specifically, we can observe the following pattern: i) First, the EU establishes an ambitious deficit objective path. ii) Next, the Spanish government agrees to comply with the plan, but as the adopted fiscal measures fail to bring the expected results, deviation becomes probable. iii) Faced with this situation, the EU relaxes the initial objectives and Spain definitively deviates from the objectives.

Regional public finances

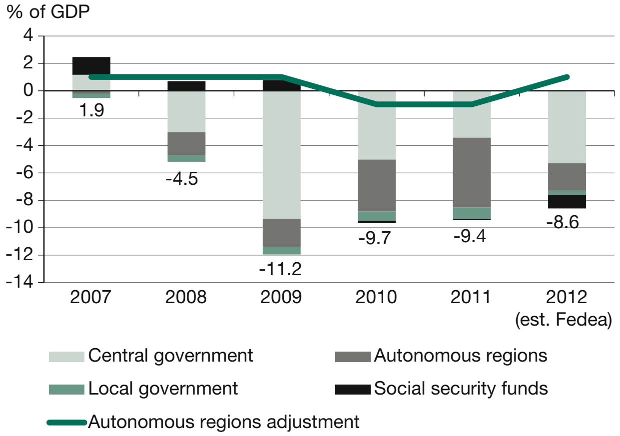
It is difficult to understand the fiscal consolidation process in Spain without first understanding the behaviour of the autonomous regions. The regions are primarily responsible for Spain missing the medium-term deficit objective in 2011, and they will contribute to the missed target of 2012 as well. The system for financing the autonomous regions needs important changes for two reasons.

First, the regions are responsible for 35% of total expenditure (the most important outlays are health care, education and social services) and receive only 19% of revenues. At the regional level, there is a clear lack of fiscal responsibility, and in effect the regions are spending institutions.

Second, the payment on account mechanism does not work well. The regions receive 80% of their revenues from this mechanism, which includes the shared taxes (VAT, personal income, excise duties) and funds. These revenues are estimated in the year t-1 and are transferred by the central government to the regions during the year t. Discrepancies between the tax estimates and the taxes actually collected are sorted out and accounted for two years later and affect the deficit of that year. In the absence of fiscal responsibility, this mechanism is pro-cyclical and delays fiscal adjustments for two years.

As can be seen in Figure 6, the autonomous regions' deficit swelled in the years 2010 and 2011 because of the negative discrepancies of 2008 and 2009 which adversely affected regional public finances with a delay of two years.

Figure 6
Public deficit



Source: Eurostat, Ministry of Finance and Public Administration and own elaboration.

This explains why fiscal adjustment in the autonomous regions started late, damaging Spain's international reputation. In 2009, the public deficit was 11% of GDP (9.3% ascribed to the central administration and 2% to the regions). However, the regions' real deficit in 2009 (not counting bookkeeping transfers of revenues and expenditures across different years) was 5% of GDP and not the 2% of GDP which appears in Figure 6. The initial deficit of 2% should be increased by: i) 1.7% of GDP, corresponding to the negative payment on account discrepancy of 2009 which affected the deficit of 2011; ii) 0.6% of GDP, corresponding to the positive payment on account discrepancy of 2007; and iii) 0.7% of GDP, which is the compensation received for the introduction of the new funding mechanism in 2009. Although the total deficit does not change, the breakdown does: the autonomous regions' deficit in 2009 should have been 5% of GDP instead of 2%. Since the regions were late in starting their fiscal consolidation process, Spain as a whole has been unable to successfully reduce its fiscal deficit.

To improve the management of public finances, we have proposed a financial mechanism based on fiscal federalism which would match the independence the autonomous regions enjoy in expenditure with independence in raising revenue. It is also essential to replace the current transfer tax, which is very much influenced by the housing bubble, with another tax that generates revenues in a more stable way.

Conclusion

The reduction of the deficit is a priority, as set out by the Commission in its recommendations in July 2012: "Spain is experiencing imbalances, which are not excessive, but need to be urgently addressed."[2] Spain might end 2012 with a deficit close to 7% of GDP (not counting the aid to financial institutions). Even if Spain misses the deficit objective (it was 6.3% of GDP), closing the year with a deficit of 7% of GDP would be a deficit reduction of two percentage points of GDP in one year. Given that the Spanish economy is suffering an unprecedented double-dip recession, such a deficit reduction reflects a great effort.

Although the EU can ease the deficit objectives for the coming years, as it has done in the past, the fulfilment of these objectives is important to restore the market confidence that is currently missing.

Expansive fiscal policies triggered a huge deterioration of public finances. In 2009, the fiscal deficit rose to 11% of GDP, and public debt increased to 54% of GDP. Spain had accumulated one of the highest public deficits in the eurozone, behind only Greece and Ireland. In the short term, Spain must reduce public expenditure to reach its deficit targets, which have been regularly eased by the EU. Government expenditure adjustment has affected public investment and, to a lesser extent, current expenditure. For this reason, for the fiscal consolidation strategy to be successful, there will have to be big adjustments in the coming years affecting essential public services (pensions, education and health care).

On the revenue side, the government should increase revenues as a percentage of GDP. A far-reaching reform of the tax system will be necessary and should include raising the effective rates of personal and corporate income taxes (by reducing marginal rates and eliminating deductions), increasing VAT revenues (by increasing the number of items in the consumption basket taxed at the general rate), the introduction of a wealth tax and the elimination of the transfer tax.

Ultimately, in view of the stability objectives for the coming years, we can see a long hard road ahead which will inevitably affect current spending – including structural spending – since investment cannot be cut any further. With this in mind, Spain should maintain its current level of spending which is important for growth, such as education, R&D and active policies. It is also highly probable that in order to meet its fiscal objectives, Spain will have to undertake ambitious and comprehensive tax reform, which must include the country's regions, in order to increase revenues without damaging growth. It should not be forgotten that foreign investment will only find Spain attractive when the country eliminates the uncertainties over tax increases or when the cost of finance drops sufficiently. This will only be possible when Spain gets its public finances under control.

2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0310:FIN:EN:HTML.

Ricardo Cabral*

The Euro Crisis and Portugal's Dilemma

Portugal's (and the euro's) current economic crisis is primarily an external debt and balance of payments crisis, rather than a sovereign debt crisis. Therefore, this brief overview of Portugal's macroeconomic history will focus on its balance of payments.

According to the available statistics,[1] in 236 years of history, Portugal recorded only seven years with balance of good surpluses. The most recent surplus years occurred in 1941-1943, when Portugal's wolfram exports – used in the manufacture of munitions and weaponry – to Germany, the UK and the US led to three consecutive years of trade surpluses.

Most observers believe that the introduction of the euro explains Portugal's recent current account imbalances. The standard explanation is that with the euro, Portugal (and the other peripheral countries) lost "competitiveness", i.e. these countries' export sectors became less competitive.

However, the available data raises questions about this hypothesis. For example, between 1974 and 1995, when Portugal had its own currency and higher import duties and tariffs, its trade deficit was, on average, 9.1% of GDP. Portugal's trade deficit between 1996 and 2010 was, on average, 8.5% of GDP. That is, the trade deficit when the country had the euro or was in the process of adopting it was marginally better than when the country had its own currency.

One could also point out that Portugal's traditional goods export sector (e.g. textile and shoe industries) experienced a cumulative nominal growth of -1.5% between 2000 and 2010. This performance was likely the result of the EU-wide lowering of import tariffs for sectors in which Portugal's export sector was strongest (e.g. those resulting from China's entry into the WTO in 2001). When such traditional sectors are excluded from the analysis, goods exports grew, on average, by 5.3% per year, which does not seem to support the hypothesis of a large loss in competitiveness caused by the euro.

However, it is clear that Portugal experienced a marked deterioration in its financial position between 1995, when Portugal had a roughly balanced net international investment position (IIP) and negligible levels of net external debt, and 2010, when Portugal's IIP reached about -108% of GDP and its net external debt was approximately 85% of GDP (see Figure 1). It is also a fact that the deterioration of Portugal's financial position was a consequence of large and recurring current account deficits.

Figure 2 shows that the main difference between 1974-1995 and 1996-2010 lies in the current transfers and in the income balances.

My explanation for the accumulation of current account deficits (and the resulting increase in net external debt) is thus that Portugal has always had significant trade deficits, but these did not cause crises comparable to the current one because currency devaluation had large effects on Portugal's financial balance sheet and on Portugal's current transfers and income balances. The recurring devaluation of the Portuguese escudo meant that the income and interest on Portuguese financial assets held by non-residents fell relative to the income and interest on foreign financial assets held by residents. This helped keep the income account in balance and the country's net external debt position under control, as foreign financial assets held by residents rose in value relative to domestic financial liabilities held by non-residents. It also meant that the current transfers account (favourably influenced by remittances from Portuguese emigrants) represented a significant and quasi-permanent source of external funding.

With the adoption of the euro, these effects disappeared. Current account deficits accumulated and these liabilities no longer devalued relative to foreign financial assets held by residents. In fact, through compound interest, they started growing rapidly.

Thus, the main reason Portugal presently faces an external debt crisis is not that its export sector lost competitiveness, but instead that the adoption of the euro removed the automatic stabilisers that helped maintain the levels of net external debt and balance of income deficits in check.

Now the balance of payments accounting identity can be rewritten as:

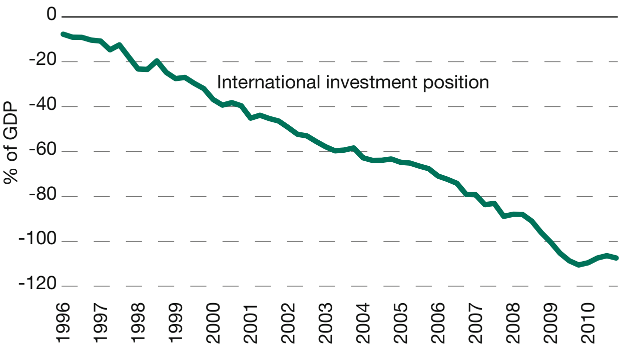
$$\textit{Net borrowing reqs.}\ (\textit{Pub} + \textit{Priv}) \cong (\textit{Trade} + \textit{Income})\ \textit{deficits} + \textit{other}$$

It is known that higher levels of net external debt tend to lead to higher income balance deficits. The above accounting identity then indicates that higher income balance deficits would tend to result in higher public borrowing needs. Thus,

* I would like to thank Francisco Louçã, Viriato Soromenho-Marques and the journal editors for helpful comments and suggestions.

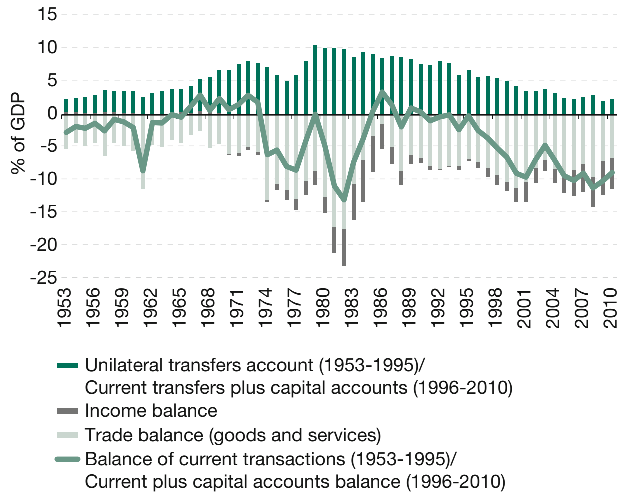
1 Séries Longas para a Economia Portuguesa and Relatórios Anuais, Bank of Portugal, and Estatísticas Históricas Portuguesas, National Statistics Institute, 2001. The foreign trade statistics go back to 1776 but are unreliable for the years before 1953, with numerous gaps of several years. The historical statistics also do not include gold exports.

Figure 1
Portugal's international investment position



Source: BdP, INE.

Figure 2
Portugal's balance of payments components



Source: BdP.

as Portugal's net external debt grew, its public borrowing requirements would have trended higher, *ceteris paribus*.

The explanation of the crisis offered here leads obviously to a much different policy prescription of how best to respond to the crisis.

EU-IMF policy objectives for Portugal

It should be noted at the outset that the EU governing institutions and the IMF have not adequately explained the causes of the crisis. The story they put forward is somewhat confusing and moralistic – almost a religions message of "sin and punishment".

This narrative contains two different villains, leading to two different objectives. First, the ECB and the European Commission, in representation of the European Council's views, argue that the causes of the crisis were "fiscal laxity" and the failure to comply with the rules those institutions to some extent defined and enforced, namely the Stability and Growth Pact (SGP). However, based on these criteria, the required adjustment imposed by the EU-IMF bailout programme for Portugal is relatively moderate. In fact, according to the IMF long-term debt sustainability analysis,[2] the primary balance should change from -0.4% of GDP in 2007-2008 (-7.2% in 2009-2010) to +3.2% of GDP by 2016 and thereafter.

The second villain, more in line with traditional IMF bailout programmes, are imbalances in the balance of payments. With respect to this criterion, the required adjustment is huge. The trade balance is required to improve by about 13.6 percentage points of GDP between 2007-2008 and 2017. According to the troika plan, Portugal should achieve, by 2017, a trade surplus of 5.1% of GDP and a current account surplus, excluding interest payments, of 7.1% of GDP.

That is, the EU-IMF adjustment programme demands that a country which historically has had systematic trade and current account deficits suddenly transform into one with a trade and current account performance superior to that historically achieved by Germany. And this should occur at a time when the EU and the IMF are demanding that several countries in the periphery of the EU – leading trading partners of Portugal – adopt identical policies with the same objectives.

It is, in my view, a plan with no adherence to reality.

The objective of the EU-IMF adjustment programme, as outlined in the IMF long-term projections, seems to be that Portugal achieve a huge improvement in its net saving capacity, so as to make the country self-sufficient in terms of financing its flows. The expectation seems to be that this would result in the lowering of the interest rates on Portuguese private and public debt, which in turn would allow Portugal to refinance its existing stock of external debt. Portugal would have to maintain high levels of net saving capacity for decades merely in order to service the interest on its external debt – that is, the country would likely remain a "slave" to its external debt for decades. The IMF assumes that this effort would have no effect on the country's nominal growth perspectives.

EU-IMF mandated policies

In May 2011 the Portuguese government signed Memoranda of Understanding (MoU) with the EU and the IMF for €78bn (approximately 45% of GDP) of loans under strict conditionality, following negotiations with the troika of EC, ECB and IMF staff. This discussion will focus on the EU MoU.

2 IMF Country Report No. 12/92 ("Fifth review").

The original MoU had 222 main action items spread across 34 pages. Since then, several new MoUs have been signed by the government which contain more austerity measures, some of which are quite substantial.

The initial MoU should be seen as a plan to reengineer the entire country. It foresees measures for a very wide swath of private and public economic activity. It seems much more like a plan drawn up by central planners in a command economy than an adjustment programme for a market economy.

Banking sector policy measures

While representing a small fraction of the text of the MoU, the single most important part of the plan – with the highest economic value – deals with the banking sector.

However, the MoU did not adopt best international practices, such as the recommendations by IMF staff based on IMF experience in previous crises or along the lines of the FDIC Improvement Act. Rather than immediately adopting a special resolution regime for banks, the MoU opted for state-funded bank recapitalisation and guarantees on bank-issued debt. In total, the MoU-mandated public support for the Portuguese banking system amounts to 27.2% of GDP.

The troika opted for a bank recapitalisation programme in large part due to the role of the ECB in the bailout negotiations. The Eurosystem is the largest single creditor of the banking system of Portugal (as well as of Ireland, Greece, Spain and Italy). It would likely have faced losses if a bank resolution process were adopted. Thus, the ECB faced large conflicts of interest in its double role as main creditor and as designer of the adjustment programmes.

The MoU allocated €12bn of the total loan to a new bank recapitalisation programme. This can be thought of as a large new public entitlement programme, representing, in interest outlays alone, roughly half of the government expenditure on the Portuguese higher education system. Important characteristics of each recapitalisation operation are decided by the finance minister. The state receives non-voting shares, and bank management continues to be chosen by the old bank shareholders.

The troika (with input from the Bank of Portugal) also required that the eight largest banks reduce their credit-to-deposit ratios from 147% in 2010 (158% for the entire banking system) to 120% by 2014. It further required Portuguese banks to increase Tier 1 capital ratios from 8% to at least 10% by the end of 2012 (the ratio in June 2012 surpassed 11%). To a large extent as a result of the above targets and programme, the national banking system cut domestic credit by about 16% of GDP between April 2011 and October 2012.

However, this dramatic fall in domestic credit likely underestimates the real impact. This is because Portuguese bank managers face perverse incentives to manage their credit portfolios so as to meet the two ratios defined by the troika. From a bank manager's perspective, to meet the mandated credit-to-deposit ratio, it is better to loan, say, €3 million to a client that commits to maintain a deposit of €2.1 million (a ratio of 142.9%) than to loan €1 million to a client with a deposit of €0.1 million (a ratio of 1000%).

On the other hand, to meet the capital ratios mandated by the troika and to avoid further capital dilution through capital injections by the state, bank managers have an incentive to roll credits and to grant more credit to clients with poor prospects of ever repaying the loans so that these clients are able to service interest payments on the loans. This way banks do not have to set aside additional capital as loss provisions, which would lower their Tier 1 capital ratios.

But as a result of these incentives, banks see themselves forced to cut credit (or to make credit prohibitively expensive) to the clients with the best economic prospects.

Other policy measures

The initial MoU austerity measures included, inter alia, increases in some VAT rates; increases in property taxes; some increases in personal income taxes; increases in fees to access public services such as hospitals, the court system, and public highways; a reduction in personal income tax deductions; a public sector hiring freeze; and a freeze on any promotions in the public sector. In the education sector, according to the Fenprof syndicate, there were nearly ten thousand fewer school teachers in 2012/2013 than in 2010/2011, as school curricula were trimmed, school class sizes increased and the number of schools in the network reduced. The contracts of thousands of teachers, some with decades of experience, were not renewed.

As a result of successive cuts to nominal wages and employment, as well as of changes in the structure of public administration, the public sector wage bill is scheduled to fall from a high of 14% of GDP in 2002 to 10% of GDP in 2012. Note that this occurred even as real GDP fell 0.5% between 2002 and 2012.

Additional (post-MoU) austerity measures have included, for example, permanent public employee and pensioner wage cuts of 14% (later ruled unconstitutional by the Constitutional Court but fully applied in 2012), further increases in the VAT, and a massive increase in personal income tax rates for 2013 which included, among other things, a 3.5 percentage point rate increase in every tax bracket. Finally, in November 2012, the government announced that it had reached an agreement with the troika for an additional cut of "social state" expenditures worth approximately 2.4% of GDP, to be defined in detail and implemented by February 2013.

EU-IMF policy results

In terms of fiscal consolidation, partially because of increases in the perimeter of consolidation, general government debt rose from 93.5% to 120.5% of GDP between 2010 (before the bailout) and 2012. Every quarterly review by the troika has brought with it an increase in the level of public debt and the worsening of the public debt trajectory (see Figure 3).

Despite the consolidation effort, minor variations in the average interest rate and in the nominal economic growth rate put Portugal's sovereign debt on an unsustainable trend.

The austerity measures imposed as a condition to the bailout, i.e. the EU-IMF policies, have resulted in a small improvement to the budget deficit. In the first three quarters of 2012, the budget deficit was 5.6% of GDP, above the revised target for the year approved by the troika (5%) as well as the initial MoU target (4.5%) and only 1.1 percentage points below the budget deficit in the first three quarters of 2011 (the MoU was signed in the second quarter of 2011).

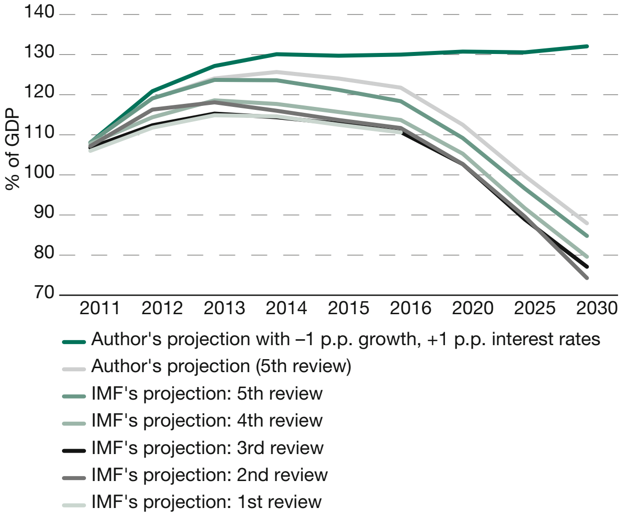
In the first 11 months of 2012, central administration tax revenues ran 5.8% below 2011 levels, despite widespread increases in tax rates. Expenditure fell 1.3%, mainly due to an 18.7% reduction in public employee wages and to a large cut in pensions, but also negatively influenced by a 13.2% increase in interest outlays.

Domestic demand, which is a much better indicator than GDP in the current context, is scheduled to fall by 12.2% in real terms between 2010 and 2012. This will put domestic demand at the level achieved between 1998 and 1999, i.e. just before Portugal adopted the euro. That is, after two years of "austerity", the well-being (consumption and investment) of Portuguese families, businesses and government has regressed by more than the gains made in the previous 13 years. At the current rate, by 2015 Portugal will have already lost two decades of gains before it even starts paying down its debt.

In 2012, Portugal is scheduled to have its first trade balance surplus in 69 years. This is a stark indicator of the size of the shock the Portuguese economy is being subjected to through this EU-IMF adjustment programme.

From the first quarter of 2011 through the third quarter of 2012, the unemployment rate jumped 3.4 percentage points, from 12.4% to 15.8% (210 000 jobs). This is well above the levels registered in the first quarter of 1999. Moreover, the youth (15-24) unemployment rate now stands at 39%.

Figure 3
Projections for Portugal's general government debt levels



Source: IMF "reviews" and author calculations.

The causes of the euro crisis

Various factors contributed to the euro crisis, including poor fiscal management in the peripheral countries and the international financial crisis.

Ultimately, however, the euro crisis is the result of shortcomings in the governance of the EU. These led to a flawed architecture of the third phase of the Economic and Monetary Union (EMU), which is where the main roots of the euro crisis are to be found.

The EU governance weaknesses

The EMU architecture and main euro area macroeconomic policies were and continue to be defined by a chosen few – likely less than a hundred select cadres – in EU and member country institutions. These cadres, who are often little known to the public, are frequently ministerial and central bank insiders, and they are typically appointed to key committees and EU governing institutions by politicians from key member countries.

The design of the EU Treaty and of major EMU policies such as the SGP and the statutes of the ECB and of the European System of Central Banks was and continues to be mainly shaped by these appointees, as well as by DG ECFIN and ECB staff, typically working in committees under non-public or even confidential deliberations. Scrutiny of executive branch proposals by the European Parliament and by national parliaments is either too weak or comes too late in the decision-making process to be effective.

In some high-level decisions, these elite bureaucrats – in the ECB (and its predecessor the EMI), in DG ECFIN and in the Economic and Financial Committee (and its predecessor the Monetary Committee) – defined the competences and accountabilities of institutions that would later become their employers, and which some of them would come to lead.

This governance structure resulted in like-minded thinkers developing friendships and informal networks, which reinforced their power and career perspectives. But it also meant that these cadres, as they were promoted, moulded the character of the institutions at the core of the euro area and influenced debate, e.g. in determining hiring and promotion policies. Such a setting limited the possibilities for fresh thinking to emerge. Accordingly, the response to the euro crisis has been based on the same perspective of the designers of the EMU architecture, which led to the crisis in the first place. Perhaps the cadres' biggest design failure is that the EU governing institutions do not include the proper checks and balances and insufficient resources were committed to ensuring transparent and robust processes in policy preparation and in decision making.

The ECB and its monetary policy strategy

It should be no wonder then that these cadres made the ECB the most independent central bank in the world.[3] The ECB proceeded to design monetary policy that departed radically from established central bank practice by treating private debt on an equal basis to sovereign debt and by treating private banks more favourably than member states.[4] It granted itself absolute discretionary powers over counterparties and over member states.[5]

Moreover, the instruments and procedures of ECB monetary policy were one of the main direct contributing factors to the euro crisis, as they allowed intra-euro area current account deficits to accumulate for far longer than would otherwise have been possible.[6]

ECB monetary policy also has very large fiscal effects. For example, the low interest rates on the large TARGET2 outstanding balances result in subsidies (i.e. fiscal transfers) from euro area creditor countries to the private banking systems of peripheral countries worth, on a yearly basis, 1.3% of the peripheral countries' GDP.[7]

The EU can ill afford to continue to have a self-managed public institution which commands unlimited public resources, is not accountable to anyone and which has taken to the practice of playing a leading role in the fall of democratically elected governments in at least four euro area member countries.[8]

Consequently, any proper response to the crisis requires a substantive change in the monetary policy strategy, instruments and procedures of the Eurosystem. But in addition, Europe needs a far different central bank: one in which the monetary authority is not the central actor in euro area financial intermediation, sovereign debt markets and financial markets. Instead, it must become an agent of the state of secondary importance with a much smaller economic role, and it must be truly accountable and de facto subordinated to the democratically elected executive and legislative branches of the governing institutions of the EU.

The EMU fiscal policy strategy

The SGP was "inspired" by a November 1995 memorandum presented by Theo Waigel, the finance minister of Germany at the time. The Monetary Committee, whose members included Jürgen Stark, State Secretary in Germany's Finance Ministry and seen as a protégé of Theo Waigel, prepared an SGP proposal that was approved with only minor modifications by DG ECFIN. The proposal was adopted by the European Council at its June 1997 meeting.[9]

Although the SGP is generally seen as ineffective, the EU governing institutions have argued that the reason the euro area now faces a crisis is that some of the peripheral countries systematically flouted the SGP nominal deficit targets. Thus, as part of the policy response to the crisis, the European Council in July 2012 adopted a much stronger pact – "the fiscal compact". In contrast with the widely held view that the SGP is ineffective and weakly adhered to, I contend that the main problem with the SGP is – on the contrary – that it is too strong and its effects are counterproductive to the objectives it set. For example, in Portugal's case, the SGP has represented a binding constraint on fiscal policy in every year since the introduction of the euro, leading to major changes and reforms in the country's public administration. Thus, it has had much larger consequences than anyone anticipated.

3 W. Buiter: Monetary economics and the political economy of central banking: Inflation targeting and central bank independence revisited, in J. Carrera (ed.): Monetary Policy Under Uncertainty, Proceedings of the 2007 Money and Banking Seminar, Banco Central de la Republica Argentina, Buenos Aires, 2008, pp. 218-243.

4 R. Cabral: The roots of the euro crisis lie at the doorsteps of the ECB, EconoMonitor, 1 October 2012.

5 K. Whelan: The Secret Tool Draghi Uses to Run Europe, Forbes.com, 22 July 2012.

6 R. Cabral, op. cit.

7 Ibid.

8 K. Whelan, op. cit.

9 M. Heipertz, A. Verdun: The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact, in: Journal of European Public Policy, Vol. 11, No. 5, 2004, pp. 765-780.

The SGP addressed only the symptoms of macroeconomic disequilibrium rather than the causes. Moreover, the short-term focus on the budget deficit meant that long-term fiscal sustainability was sacrificed at the altar of short-term results. In Portugal, for example, every single finance minister since at least 2001 has resorted to ad hoc measures that resulted in extraordinary revenues just before the year's end – typically validated ex ante by the EC and validated ex post by Eurostat – in order to meet the nominal deficit targets previously agreed upon with the EC. These ad hoc deals were worth up to 3% of GDP in some years and were nearly always accomplished in the late days of December. These deals resulted in significant net present value losses for the state, i.e. the short-term improvement in the deficit was attained at the cost of much higher deficits in the future.

Portugal's dilemma

After a year and a half of implementation of the EU-IMF adjustment programme in Portugal, most seem convinced that it is counterproductive and contrary to the national interest. However, the country continues to struggle through, although it no longer believes in the success of the outcome. The dilemma Portugal's future policy makers face is how to convince the EU governing institutions to change the current policies.

The paradox of the situation in which Portugal finds itself is that it does not necessarily need the EU-IMF bailout, which was and is only necessary to avoid default in the short term – it merely postpones default. The adjustment policies it imposes are damaging the country's output, competitiveness and future perspectives, in addition to having enormous social costs.

However, the country's negotiating position is much stronger than acknowledged. The general thinking is that the peripheral countries have to abide by the decisions of the EU governing institutions, since they could cut ECB funding, thereby precipitating a domestic crisis. But contrary to widespread belief in public and academic circles, Portugal could stay in the euro for as long as it wished, even if the ECB cut funding to the Portuguese banking system. This is because the country's net lending capacity, before interest and dividend net outlays, is already significantly positive (+4.3% of GDP) and the budget's primary balance on a cash basis is already in surplus. Thus, if the country were to default on a substantial part of its stock of public and private debt, it would not have any external financing needs for the foreseeable future, *ceteris paribus*.

It is only a matter of time until the fall of the government in Portugal or one of the other euro area peripheral countries leads to the election of a political leader who will opt to defy the rule of Brussels and Frankfurt. In the European Union, the peripheral countries are currently experiencing what the early American colonists must have experienced in the 18th century under British imperial rule. The EU governing institutions are profoundly non-democratic, i.e. dictatorial. Brussels and Frankfurt decide how far to raise taxes and how much expenditure to cut. "We the People" have no saying in this process, and the national constitutions are ignored.

As in 18th century America, "taxation without representation" ultimately leads to revolution. Should the EU governing institutions not change course quickly, they can and should expect a revolution in the EU periphery. One can only hope that this revolution will be civilised, non-violent and relatively orderly.

Concluding remarks

By participating in the European Union building process, Portugal had an opportunity to become a developed country for the first time in centuries. It was in the process of doing so, but the EU-IMF austerity policies are setting the country back extremely quickly and in many instances irreversibly. The ramifications of these policies extend far beyond Portugal's borders. The EU cannot survive on the current policy course, which will set Europe back for decades.

Creating the euro was a difficult, complex endeavour. It was not humanly possible to anticipate all contingencies that would later materialise. The architects of the euro, the policy makers in EU institutions and member states, the people who designed the third phase of the EMU and/or managed it up to its present state of affairs – people like Otmar Issing, Jean-Claude Trichet, Klaus Regling, Marco Buti, Mario Draghi, Jürgen Stark, Durão Barroso, Vitor Constâncio, Vitor Gaspar and many others – have been widely praised and have earned the admiration and respect of their peers in academia, government, business and politics. They acted according to their beliefs of what was best for the euro area and for the EU.

However, they should know that their ideas and decisions drove the European Union to the brink of failure. The policies they helped put in place or managed have led the euro area to the largest peacetime balance of payments and external debt crisis the world has ever seen. They should know that their policy response to the euro crisis – the "stay the course" policy[10] – is actually aggravating the crisis, not solving it. They should know that the widespread hardship, despair, hunger and suicides are not unavoidable random events but the predictable outcome of their misguided policies. Unless a major policy change is quickly adopted, they should know that when History is finally written, their names will be forever linked to the hubris, the blind ideology and the wilful ignorance that doomed the euro and the European Union.

10 O. Rehn: Europe must stay the austerity course, FT.com, 10 December 2012.