Economic choices for a reformed Eurozone

The Eurozone is not doing well. Its growth performance is lagging and unemployment rates are high in many of its member states. One cause that is often mentioned as a possible explanation for poor economic performance is the governance system of and the resulting economic policy mix for the Eurozone area: the argument is that this system does not provide the right incentives for political and economic actors to support the general performance of the economy, the disappointing evolution of the Lisbon Agenda being a prime example. While the common currency has now been firmly in place for some time, its surrounding framework, together with its formal and informal rules and institutions of decision-making have been repeatedly criticised and calls for sweeping reforms are numerous. Looking at the French and Dutch referendums, one might even come to the conclusion that dissatisfaction with European economic performance and policy-making is one main explanation for the no-votes.

Could the economic performance of the Eurozone be improved? And, if so, how exactly? The Policy Brief will focus on a series of reforms that have been suggested to improve the constituent elements of the governance framework. This includes the Stability and Growth Pact, mechanisms of fiscal co-ordination, a common European budget and a Community stabilisation mechanism, as well as changes to the European Central Bank's policies. To this end, it is vital to consider the interaction between economic rationale and political viability. Are there proposals that would be economically desirable and politically feasible at the same time or do all reform suggestions have to negotiate an inherent trade-off between economics and politics? To lay out the different governance choices, weighing their economic and political virtues and likelihood, is the aim of this Brief.

The Stability and Growth Pact

One of the key pillars of the Eurozone's governance system is the Growth and Stability Pact (SGP), a set of rules regarding the conduct of the member states' fiscal policies. Attached in Amsterdam as a protocol to the Union Treaty (Article 104), the SGP aims for national budgets to be 'close to balance or in surplus' over the medium term. It consists of mutual fiscal surveillance mechanisms and targets of sound public finance that can be enforced by means of the excessive deficit procedure. Annual budget deficit and public debt levels must not exceed 3 per cent and 60 per cent of GDP respectively.

It does not work like this…

The Pact, taking a central position in the Eurozone's governance set-up, is the obvious place to start any discussion on governance reform. Since its creation at the urging of the German government in 1997, it has been subject to a fierce debate regarding its economic justification. A majority of academics and many policy-makers seem to have reached the conclusion that the SGP in its original form has at least serious shortcomings, and possibly fatal flaws. Many in particular believe that the inflationary experience of the 1980s led the drafters of the SGP to believe that a highly "prudent" and "rules based" fiscal stabilisation mechanism for Eurozone

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member-states was in all circumstances preferable. Events over the past decade have cast considerable doubt upon this preference.

Above all, the '3/60' rule has proven to be arbitrary in its effects, leaving too little room for national 'automatic stabilisers' to counteract asymmetric demand shocks. Those stabilisers, which work without explicit policy action by the government by way of higher transfer payments and lower tax receipts, are thought vital to the functioning of an economy as they even out potentially harmful output fluctuations. While the creators of the SGP acknowledged the importance of such automatic fiscal flexibility, they assumed states would make budget surpluses in booms, which would provide leeway for stabilisation efforts in the downswing. However, governments have not saved enough – perhaps because governments acted more myopically than expected, perhaps because countries started off in a worse fiscal position than assumed in the first, or perhaps because the underlying aspiration of national governmental budgets tending over time towards zero was anyway a delusion, based on no underlying economic analysis. (Germany's transfer payments to the East, for instance, have made it very difficult for the government to run a surplus, even in times of economic upswing.) . The outcome has in any event been undesirable: in the event of a shock, instead of running a budget deficit, governments have had to find ways to cut other expenditure or raise taxes, which has tended to act pro-cyclically and in a destabilising fashion.

Current account deficits of national governments are in any case a crude way of measuring a country's fiscal position, as they ignore off-budget liabilities such as public pensions or future health care costs. Even more importantly, a more sensible way of assessing a government's fiscal position should not focus on flow variables like current account surplus or deficits, but rather to look at underlying stock variables such as government indebtedness. The 'balanced budget rule' (which over the long term means reducing public debt to zero) has led core Eurozone countries over the past decade to cut back public investment, contributing to deepening the downswing. Furthermore, the SGP makes it difficult for governments to push for necessary (supply side?) reforms to their national economies that might be costly in the short run and thus require transitional government deficits. A clear sign of the Pact's failure was the suspension of France and Germany's deficit procedures in 2002 and 2003, when both countries argued that the Pact was incompatible with their economic position and counterproductive to their domestic efforts for economic reform.

…and why it may be needed nevertheless

None the less, scrapping the existing SGP does not extricate policy-makers from the need to adopt some measure to exert fiscal discipline under a single currency. Some mechanism is needed to reduce the 'moral hazard problem': in a decentralised governance set-up, national governments might be incited to 'free ride' on other states' fiscal prudence because they believe that the European Central Bank (ECB) cannot credibly threaten states to raise interest rates in response to individual irresponsible fiscal authorities. Furthermore the SGP's advocates often express the fear that, with the ECB being relatively new, any apparent wavering in the Eurozone's commitment to sound public finances might make it more difficult for the markets to feel

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confidence in the new currency, leading in turn to higher interest rates and a weakening of the euro. Critics of the SGP insist that the danger to the euro and the Eurozone from the latter's current lacklustre economic performance should outweigh any such fears in the minds of policy-makers.

The reform of the SGP: mere cosmetics?
For the reason set out in the preceding paragraph, many proposals to reform EMU's governance have aimed at improving the SGP and making it more supportive of anti-cyclical and pro-investment fiscal policies, rather than scrapping it altogether. Concrete proposals include the introduction of flexible or more 'generous' fiscal targets or a shift away from deficits to debt levels. This in turn would allow the automatic stabilisers to tap their full potential. To lessen the restrictions on governments to conduct pro-growth public investment, a British Treasury-inspired Golden Rule for fiscal policy has been proposed, allowing governments to ignore the 'balanced budget rule' and to borrow to invest in growth-enhancing activities.

Some of these suggestions have been picked up: in March 2005, the European heads of states and governments agreed on a partial reform of the SGP (also referred to as 'SGP II'). In the light of past non-compliance with fiscal targets (most notably by France and Germany), they decided to apply the latter more flexibly and with several more exemptions. If an individual country now faces negative growth (before, it needed growth of at least - 2 per cent), or if a government can prove that it has initiated structural reforms, deadlines for sanctions under Article 104 can be extended. This in turn should give national governments more time to steer the economy out of recession. Is the reform a substantive advancement? Opinions diverge. The reformed Pact has some economic merit because it has taken into account its previous effectively pro-cyclical operation. Furthermore, the reformers should be given credit for acknowledging that the Pact and its adherence to a strict reading of targets had been politically hollowed out given that some countries had simply decided to ignore it.

In search of better rules
However, the hard-won deal only tweaks at the margins of the Pact. It has kept, for instance, the '3/60' reference values that must in principle be adhered to. Although governments have gained more flexibility through further extenuating circumstances, it is still difficult for them to embark on sweeping reforms that might be costly in the short-run. A case in point are the new German government's difficulties in seeking to boost the economy while at the same time having to curtail spending further to meet EMU's fiscal criteria. In addition, while the likelihood of future breaches of the Pact seems to have been reduced, the underlying issue – namely the problem for countries credibly to commit to it in the long term – does not seemed to be solved by SGP II. The new Pact is more realistic, but not necessarily more credible and effective in overcoming inherent problems of co-ordination in the Eurozone. Vast political capital was put into this small reform merely a year ago. The political omens are not good for further substantial change in the near future.

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Fiscal Co-ordination

The underlying institutional architecture of the Eurozone's governance seems to reflect the belief that it is sufficient for the different constituent parts of EMU's governance set-up to 'keep their own house in order. ' The ECB will be responsible for monetary policy and the national governments will exercise their fiscal responsibilities under the SGP Against this 'official view', however a broad consensus seems to be developing that some form of fiscal co-ordination is necessary to make the Eurozone run more smoothly and coherently. Fiscal co-ordination as defined here is as an alignment of individual national fiscal stances, so that all member states jointly expand or decrease budgetary spending irrespective of their absolute fiscal levels or their spending priorities.

Economic rationale for increased co-ordination

The underlying argument in favour of increased fiscal co-ordination, runs as follows. A single currency forges a strong link among member states because it creates interdependence between national economies through a common foreign exchange rate and a single monetary stance arising from the decisions of the European Central Bank. In consequence, national economic policies produce externalities for other member states, thus making economic governance a common concern. For these reasons, co-ordination increases consistency between the policy decisions of national governments, with individual fiscal impulses or 'signals' having a joint macroeconomic impact – whether contractive or expansionary – on the Eurozone's overall economic performance.

In addition, fiscal co-ordination reduces the built-in incentives of fiscal 'free-riding' in a decentralised fiscal system, where member-state governments might find it advantageous to abuse other states' sound fiscal policies, given that the ECB may be unwilling to raise interest rates in response to individual irresponsible fiscal behaviour by a single country, particularly a small one. Fiscal co-ordination, it is argued, would not only ensure sustainability of public finances, but would also make it easier for governments to embark on concerted reform efforts with the certainty that the ECB would adjust its monetary reaction appropriately. Richard Musgrave has argued that an optimum currency area should have both a federal monetary and fiscal authority. Currently, the Eurozone has the first but not the second of these.

Existing forms of co-ordination

The Union's legal framework already provides for some co-ordination to enable stability and growth-oriented macroeconomic policies. Apart from the already-mentioned SGP, existing measures include the Broad Economic Policy Guidelines (BEPG), the European Employment Strategy and the Lisbon Agenda for economic competitiveness. All those existing measures however are characterised by their relative toothlessness, a criticism brought out in the Sapir report of 2003. The measures rely on member states' good will and the power of 'naming-blaming-shaming', since decisions are based on the so-called 'open method of co-ordination', which does not have official sanctions for non-compliance with the stated guidelines and performance indicators. According to the method's critics, this does not suffice for ensuring substantive co-ordination. For instance, in 2001 Ireland found it

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economically more sensible to renege from BEPG targets in 2001 - and the EU could not force them to do otherwise. (Ironically, subsequent events have suggested that the Irish government was right to ignore the BEPG targets for 2001. No long term damage has been done to Irish inflation or government indebtedness by that decision.)

Increasing authority

What all reform proposals have in common is their objective to make co-ordination between the various actors in the Eurozone's governance more effective. Some argue for a better-enforced SGP or BEPGs, for instance by giving the Commission the right to issue warnings or manage the deficit procedure more independently. Yet, even 'hard rules' that can involve penalties do not automatically ensure that they will be obeyed, especially when they prove too inflexible or inadequate for a specific country's economic situation – the examples of Germany and France are a case in point. The question that arises is: how can a governance system be designed that is economically rational, for the Eurozone as a whole and yet does not regularly confront national governments with the choice between observing the rules and following the economic policies which their country's situation demands? Thus, it has been suggested that the Eurogroup should be made into a proper executive body or that an Economic Policy Council should be created to act as a co-ordinating fiscal authority like a European *gouvernement économique*[i]. Some even go as far as proposing a full-blown European government in a 'European Republic'[ii] to overcome the co-ordination problem.

The politics of supranational co-ordination: An inherent dilemma?

The economic case for co-ordination to overcome collective action and free-rider problems seems very strong. Yet, intergovernmental policy co-ordination has so far failed to produce authoritative and binding solutions and – for obvious political reasons – it will be difficult to create overarching fiscal authorities, as those policies lie at the heart of national political decision-making. Furthermore, agreeing on a common stance might be beneficial for the performance of the Eurozone as such, but – at least in the short-run – might well run counter to national economic perceived needs. This confronts policy-makers with an inherent dilemma between the political difficulty (currently particularly pronounced) of creating central authorities and the economic benefits of running the Eurozone more coherently. It is central challenge for those seeking to reform the Eurozone to find innovative ways of ensuring co-ordination while refraining from politically centralising measures in the short term – while trying to convince member states of the merits of more substantial co-ordination in the long run.

The European Budget

The European Union was created without a significant budget. The resources at the disposal of European institutions are in the range of 1.0 to 1.24 per cent of total GDP and Union spending concentrates very heavily on a few specific policy areas (notably agricultural policy and structural funds). This did not change at all with the establishment of the European Monetary Union and the introduction of the euro.

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Suggestions to enlarge the European budget, dating back to the 1977 MacDougall Report, have since then gained momentum and academic underpinning. Fiscal federalism and studies on optimal currency areas[iii] have suggested that a currency union cannot function properly unless there is a common, macroeconomically significant budget.

A common budget to deliver economic stability and growth
The extent to which a budget impacts on employment and economic output is debated. It is safe to say though that for a budget to have an impact, it would need to be much bigger than the current EU-level (possibly a double-digit figure). What could a sizeable common budget achieve? Apart from redistributive functions and the provision of goods and services, the traditional rationale for a substantial central budget lie in its stabilising and growth-enhancing properties. Budgets act as economic stabilisers: they offset asymmetric demand shocks by way of automatic adjustments to government spending levels (tax receipts minus transfer payments). Thus, transitory demand shocks affecting individual countries – who in a currency union by definition can no longer adjust via the exchange rate or national monetary policies – could then be balanced out by transfers from a European budget.

A neo-Keynesian analysis would go further in its understanding of the potentially beneficial effects of central budgetary action. . Apart from the automatic counter-cyclical effects of national budgets (which some economists anyway regard as lessened by today's less progressive tax systems), governments can, on this neo-Keynesian analysis, use their central budgets creatively to put their national economies on a more favourable trajectory by increased spending in times of low aggregate demand. Few economists would deny that the current low level of aggregate demand is one reason for the poor overall performance of the Eurozone. A substantial European central budget might be a way of resolving this conundrum in a more effective fashion than could be done by any individual national government.

Fiscal Transfer Mechanisms – a way out of the political deadlock
As already noted above, for a budget to have significant macroeconomic effects, it needs to be substantial (though opinions diverge on what a 'substantial' budget has to look like). However, a common budget presupposes an agreement on the spending focuses and forms of public provisions. In the light of the recent budgetary negotiations and the vehement opposition of some member states to an increase of the budget by decimals of a percentage point of GDP, the prospects of a bigger European budget that would be macroeconomically important are apparently remote in the current political climate.

What has therefore been suggested as an alternative is a European transfer scheme[iv] for stabilisation in the Eurozone. Under such a system, a member state hit by an asymmetric shock would receive transfer payments in the following year. The amount of transfer would be determined by the decline in GDP caused by the deviation of unemployment from the trend compared to the Eurozone's average trend. Payments would be met by rule-based payments from each member state or made from a special shock absorption fund[v].

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This suggestion is novel in that it resolves the stabilisation problem in a currency union, but does not pose the same political challenge as a centralised budget. Due to its specific design, it has been estimated that it would achieve the same degree of stabilisation as the US federal budget. Furthermore, if negative shocks to an economy are random, on average each member state would pay as much for such an insurance mechanism as they would receive in the long-term, so the political requirement of *juste retour* would be ensured. As transfer is calculated as a proportion of deviation from the trend (and not from absolute levels of unemployment), the incentive to have higher-than-average levels of unemployment is eliminated. Furthermore, payments could be partial and temporary to decrease incentives for a country to postpone policies to get out of the economic slump.

After all: An economic necessity, but a political dilemma?
Intuitively the economic merits of "fiscal federalism" are attractive, particularly in the more targeted variant of "transfer payments." The Eurozone will soon contain a number of less developed European economies, in which national stabilising mechanisms are unlikely to work effectively. A European contribution to their stabilisation makes economic sense and has a political logic in reinforcing the positive image of the Union in the new accession countries. It must, however, be asked whether that political logic is one currently accepted by electorates and policy-makers in such countries as France, Germany and the Netherlands. More than in any other area of the debate about better governance of the Eurozone, there seems to be in any discussion of the European budget an inevitable potential conflict between economic rationality and political reality.

Policy harmonisation
Different proposals to reform the governance structure of the Eurozone imply varying degrees of sovereignty pooling and surrendering of national policy traditions. In this respect, policy harmonisation lies somewhere midway between a full-blown European budget and co-ordination mechanisms: it does not necessary entail a large-scale transfer of powers to a common authority, but it goes beyond agreeing on the general direction of economic policies. Regulatory harmonisation is generally proposed as means to create a level-playing field between national economies to enhance overall convergence.

Currently, the EU only has competence for taxes that directly affect the functioning of the Single Market. Yet on different occasions, the argument in favour of further tax harmonisation has been made (one of the most prominent proponents was Gerhard Schröder's first finance minister Oskar Lafontaine). In times of a higher degree of capital mobility in the course of European capital market liberalisation, non-tariff measures like corporate taxes become an important tool in influencing goods and service streams. The fear is that in such an environment, capital and income taxes are reduced to attract new capital, which might lead to a race-to-the-bottom in tax rates and social dumping. A harmonisation of tax rates would on this view serve as a counteracting measure to 'unfair' competition. Similar arguments with the view of

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preventing intra-EU social dumping have been made regarding social systems, suggesting common minimum standards of employment protection or pensions.

Common levels, different traditions

Both forms of harmonisation are controversial. Arguably, there are economic benefits of tax competition to reduce inefficient government spending. Moreover, there are technical problems for establishing comparability between differing tax and social systems. Efficient models of tax convergence would need to distinguish between rough comparisons of different tax bases and what is called the 'effective tax rate', which includes not only the headline tax rates but also different forms of allowances and tax-deductible items. Within the European Union there are different "worlds" of welfare states[vi] with regards to social provisions and generation – whether because of historical tradition or because of varying needs of different forms of capitalist economies. Moreover, from an empirical point of view, there is little data supporting the spectre of a " race to the bottom." in social policy. (The rhetoric of the British government, both about its own policies and those of many Central Europeans, is misleading in this respect.). It is not clear that the economic arguments for harmonisation of tax or social policies would be sufficiently weighty to compensate for the political and legal difficulties that such changes would involve. A number of present and future members of the Eurozone could confidently be expected to set their faces firmly against any substantial move towards fiscal or social harmonisation.

Monetary policy and the European Central Bank

So far this Brief has focused on variations of the theme of fiscal co-ordination (including the SGP, the budget and fiscal harmonisation). Other key ingredients of the European economic governance system that have been the subject of reform suggestions are EMU's single monetary policy and – related to this – the European Central Bank's statute and procedures. One particular bone of contention is the ECB's lack of transparency. According to its critics, this not only hampers general public acceptance of the Bank's policies but also the smooth running of (forward-looking) financial markets which base their behaviour on the long-run predictability of central bank behaviour. Proposals to improve transparency and certainty go in the direction of enhancing the ECB's reporting practice either to elected bodies (such as the European Parliament) or – like the Bank of England – the obligatory publishing of Governing Council minutes and forecast models to understand how the ECB derives its decisions.

Accommodating guardians of the currency?

The ECB as chief monetary authority was established with a clear non-accommodating monetary policy mandate and with the overriding objective of holding inflation down. Its inflation target (a mixture of inflation forecasting and money supply targeting) was set between 0 and 2 per cent (the objective is said to be 'asymmetric' in that inflation undershooting is preferred to overshooting). It is only when this goal has been assured that the ECB takes other economic objectives, such as growth, employment or European cohesion, in its policy decisions into account. The argument for a more accommodating monetary policy is that – together with the SGP – EMU is locked into an exclusively anti-inflationary policy mix. If the ECB

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pursues a restrictive monetary policy and national governments are forced to pursue correspondingly restrictive fiscal policies, the whole bias of the economic system will inevitably be against growth and reform. It has therefore been suggested that the ECB should be required to relatively more weight on output and employment (similar to the Bank of England or the Federal Reserve) and to make the inflation target more generous and symmetric. This could either be done by a revision of the Bank's Statutes or a more flexible interpretation by the Bank of its existing responsibilities.

Governing council minutes are not published by the ECB, so members of the board are not pressured to vote according to national lines but for the common good of the stability of the euro – or so the argument goes. It might well be that this objectivity would be put at risk if more publicity were given to the details of the Bank's deliberations. Moreover, there would be potential disadvantages for a generally more accommodating stance emanating from the European Central Bank. One should bear in mind that the ECB is a very new central bank that has not yet built up a reputation for consistently robust decision-making. It might therefore reasonably believe that it will have to be more non-accommodating now to build up credibility with the markets. Critics respond that it is unsurprising that this approach should commend itself to the bankers of the ECB. There are, however, dangers for the future standing of the single currency arising from the mediocre economic performance of the Eurozone which are at least as important are those arising from temporary market perceptions of the ECB as adopting too accommodating a stance.

The Wider Political Economy

Some commentators rightly draw attention to the fact that a governance set-up includes policies beyond the narrow confines of the fiscal and monetary realm, which – taken together – form a complex web of interacting institutions and procedures. Thus, improving auxiliary policies and procedures can indirectly ameliorate the Eurozone's governance. For example, there is economic merit in facilitating the smooth working of financial markets so that national fiscal authorities with otherwise restricted policy tools can borrow and stabilise on their own national account, irrespective of the existence or not of a substantial European central budget. Furthermore, long-term inter-country differences in a single currency area can now longer be resolved by the manipulation of (nominal) exchange or interest rate policies anymore. Necessary adjustments have to happen 'the hard way' via adjusting real wages and in this way improving the real exchange rate (as in Germany over the past five years). Improving the capacity for labour markets to adjust (via increased flexibility an/or concerted active labour market policies) thus becomes crucial.

Concluding remarks – economic choices and political decisions

The economic analysis of the Eurozone's governance structure allows several preliminary conclusions. There seems to be a strong rationale for increased co-ordination to introduce more coherence into European economic policy-making, although there are diverging views of how to go about. It is widely accepted that the governance structure of the Eurozone has until now struck an inappropriate balance between the need for procedures that ensure fiscal discipline and the need to ensure

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that such procedures do not impart an unbalanced, deflationary bias to the Eurozone's whole economic architecture. If sustained, this deflationary bias could put at risk the whole single currency project, and perhaps even the European Union itself. Given this background, it can in no sense be an "anti-European" approach to discuss and, where necessary, criticise the governmental architecture of the Eurozone Ultimately, decisions to reform the Eurozone's economic governance structure are connected to political and institutional choices by the members of the Eurozone. These choices will not be easy ones. But if the growing sense of unease throughout Europe with the workings of the single currency are justified, time is limited for the introduction of necessary changes to improve the economic and political workings of the Eurozone.

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[i] E.g. P Jacquet and J Pisani-Ferry (2001), 'Economic policy co-ordination in the euro-zone. What has been achieved? What should be done?' *Centre for European Reform Paper*, London.

[ii] S. Collignon (2003), *The European Republic - Reflections on the Political Economy of a Future European Constitution*, London.

[iii] X. Sala-I-Martin and J. Sachs (1992), 'Fiscal federalism and optimum currency areas: evidence for Europe from the United States' in: M Canzoneri et al. (eds.), *Establishing a central bank: issues in Europe and lessons from the United States*, Cambridge.

[iv] E.g. A. Italianer and M. Vanheukelen (1993), 'Proposals for a Community Stabilization Mechanism: some historical application', European Economy No. 5.

[v] See suggestions made for a rainy-day fund by the Sapir Report: A. Sapir et al. (2003), 'An Agenda for a growing Europe. Making the EU Economic System Deliver', *Report of an Independent High-Level Study Group*, Brussels.

[vi] G. Esping-Anderson (1990), *Three Worlds of Welfare Capitalism*, Princeton.

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