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## Fiscal policy in the European Economic and Monetary Union

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## *Chapter 1*

# Introduction

## 1.1 Motivation and research questions

“World peace cannot be safeguarded without the making of creative efforts proportionate to the dangers which threaten it.” These are the first words of the Schuman Declaration, pronounced on 9 May 1950, exactly five years after World War II ended (Schuman, 1950). In this declaration, Robert Schuman, the French minister of foreign affairs at the time, proposed the creation of a European Coal and Steel Community (ECSC). The ECSC aimed to pool Europe’s coal and steel resources, quintessential inputs to the war industry. With the signing of the Treaty of Paris a year later, the ECSC was formally established and comprised the first post-war supranational institution for Europe. Six countries at the heart of continental Europe – Belgium, France, Germany, Italy, Luxembourg and the Netherlands – participated in the project.

The significance of the ECSC was primarily political and not economic.<sup>1</sup> Pooling coal and steel production and liberalizing trade would make war between historic rivals France and Germany “not merely unthinkable, but materially impossible” (Schuman, 1950). Political integration as a driving force of European cooperation would not last for long, however. Soon after the Treaty of Paris was signed, the draft Treaty on the Establishment of the European Defence Community was circulated among the six members of the ECSC. In the summer of 1954, the

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<sup>1</sup>As commented by German Chancellor Konrad Adenauer in his memoirs (Bainbridge and Teasdale, 1995)

French National Assembly did not ratify the treaty, resulting in the abandonment of plans to establish a ‘European Political Community’ (Issing, 2004; Vanthoor, 1999).

With political integration of the table, a group of political leaders decided to pursue the path of economic integration. The six founders of the ECSC signed the Treaty of Rome in 1957, establishing the European Economic Community, the predecessor of the present-day European Union (EU), as well as EURATOM. The Treaty strove for setting up a common market, based on ‘four freedoms’: the free movement of goods, capital, services, and labor. Over the years, state aid was banned, a common trade policy was introduced, and intra-EU trade barriers were reduced significantly, amongst others. With the expansion of the EU, the outreach of economic co-operation only increased. Early 2019, just before the United Kingdom is set to leave the EU – the first country ever to do so – the EU counts 28 member states.

The EU and its internal market aim to contribute to the economic wellbeing of most Europeans. Most directly by facilitating cross-border trade, which lowers product prices and expands consumption possibilities. In the longer run, increased foreign competition could lead to more specialization and higher productivity, induce technical knowledge spillovers and strengthen incentives to invest in R&D (Straathof et al., 2008). A number of empirical papers indeed establishes a positive effect of Europe’s internal market on GDP, roughly in the range of 5 to 20%, with effects varying in size across individual countries and over the time horizon under investigation (see e.g. Aussilloux et al., 2017; Campos et al., 2014; Eichengreen and Boltho, 2010; Straathof et al., 2008; Breuss, 2001).

An important barrier to trade remained, however: the lack of a common currency (Hessel et al., 2017). Exchanging currencies entails costs and reduces transparency in the internal market, while exchange rate fluctuations make foreign trade and investment more risky. Moreover, as volatile exchange rates also cause movements in the domestic price level, they might deter long-term investments. For these reasons, there has always been some form of monetary policy coordination in Europe after World War II. Initially, under the Bretton Woods system, followed by the currency snake in 1972 and the European Monetary System (EMS) in 1979. However, none of these systems managed to secure permanently stable currencies.

By signing the Treaty of Maastricht in 1992, twelve European countries therefore engaged in a bold macro-economic experiment<sup>2</sup>: economically disparate as they were, they adopted a common currency, without establishing a political or fiscal union at the same time. Potential benefits were clear, but so were the risks. The history of monetary unions clearly suggests that their successful continuation is closely tied to political union (Arestis et al., 2003; Buiters et al., 1993). Nobel-prize winning economist Stiglitz (2016) even refers to the adoption of the euro without providing for the institutions that would make it work as a ‘fatal decision’.

Nevertheless, the euro was born. With fiscal or political union out of sight, an important question was how to fiscally discipline member states of the currency union: could this be left to financial markets or did the euro area need fiscal rules? At the heart of the issue are potential negative spillovers from profligate fiscal policy by individual member states. Unsustainable fiscal policy could, for example, increase pressure for a fiscal bail-out, by other member states, or a monetary bail-out, by the European Central Bank (ECB). If these bail-outs will credibly not take place, market pressure could work. Given the no bailout clause in the Treaty and the ECB’s independence, Buiters et al. (1993) suggest this could be the case. Although not dismissing this line of reasoning, the designers of the Maastricht Treaty feared that financial markets in practice would respond too lax in quiet times and too fierce in more turbulent periods to serve as an effective disciplining device for fiscal policy (Delors Committee, 1989). In the end, a set of fiscal rules was introduced – for the EU as a whole.

At the heart of fiscal rules in the EU, introduced in the Maastricht Treaty and further clarified and operationalized in the Stability and Growth Pact (SGP) of 1997<sup>3</sup>, is the (in)famous 3%-threshold: countries should avoid deficits exceeding 3% of GDP. If the deficit exceeds 3% of GDP, countries are to undertake consolidation efforts to undo the transgression of the threshold.<sup>4</sup> This rule and the corrective procedures

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<sup>2</sup>Whether the motivation for this move was primarily political or economic is still open for debate. Some argue that Germany gave up the Deutsche Mark in order to obtain support from other European countries for German reunification. Others claim there was a convincing case for introducing a single currency, with the political window of opportunity in the late eighties/early nineties at most being helpful (see e.g. Thygesen, 2016).

<sup>3</sup>Fiscal rules were subsequently amended in 2005 and 2011.

<sup>4</sup>Furthermore, in principle the government debt should not exceed 60% of GDP – unless it is suf-

that come with it, are also known as the ‘corrective arm’ of the SGP. Next to this, under the so-called ‘preventive arm’ of the Pact, countries are supposed to achieve a budgetary position of close to balance or in surplus over a complete business cycle. However, until several reforms in 2011, no sanctions were possible under the preventive arm. Even since then, the corrective arm has arguably remained the most important part of the Pact.

In particular the corrective arm of the SGP is hotly debated and criticized among researchers and policy makers. By forcing countries with deficits exceeding 3% of GDP to consolidate, this part of the SGP is inherently procyclical, as the threshold will most often be exceeded during recessions. Countries are thus forced to take austerity measures when they are most painful.

Criticism along these lines intensified with the onset of the global financial crisis and the euro debt crisis. At the same time when fiscal rules became more binding, empirical evidence started to mount that fiscal multipliers are larger during recessions than during economic booms (Auerbach and Gorodnichenko, 2012; Blanchard and Leigh, 2013). In combination with the fact that the European economy was in a liquidity trap and with consolidations occurring in many countries simultaneously, some argued that fiscal consolidation might even be counterproductive in the sense that this would cause debt levels to go up (Krugman, 2010; Holland and Portes, 2012). An aggravating factor might be that especially those government expenditures which promote long term growth, such as public investments, bore a large part of the fiscal adjustment burden, since they were politically more easily to reduce.

This brings us to the first two research questions of this thesis:

*1. Did fiscal adjustments during the great financial crisis improve perceived government solvency?*

*2. Did governments miss out on worthwhile investment opportunities during the crisis?*

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ficiently diminishing and approaches the 60%-threshold at a satisfactory pace. However, the debt-threshold was effectively irrelevant before the 2011 reform of the SGP. Even after this reform, the main focus has been on adherence to budget balance rules. See De Haan et al. (2016).

Notwithstanding (short-term) growth-reducing effects of fiscal consolidation, in order for the fiscal rules of SGP to have their alleged procyclical effects, one condition should be met: they need to affect government behavior. On the other end of the spectrum of critics are those stressing the poor compliance with the Pact's fiscal rules. The corrective arm of the SGP has been declared dead multiple times, for example when France and Germany refused to take corrective action in 2003 and got away with it unsanctioned (The Economist, 2003), or when Spain and Portugal were not sanctioned despite established non-compliance in 2016 (Gros, 2016). Compliance with the preventive arm also seems rather poor (European Court of Auditors, 2018; DNB, 2016), implying that countries do not steer away from the fiscal thresholds in good times, and are more likely to end up in the corrective arm – and thus be asked to consolidate – in recession times.

In line with ongoing discussions, the fiscal rules of SGP have been reformed at multiple occasions in an attempt to reconcile the felt need for flexibility with the presence of a credible, rules-based framework. As a result, rules have grown more and more complex over time. The mere description of the application of the rules now takes 220 (!) pages (EC, 2018). What is not so clear, however, is how well these rules are actually lived up to.

Clearly, these fiscal rules and the costs attached to non-compliance generate a whole set of incentives for governments subject to them. To start with, governments may want to resort to rosy forecasts, so as to reduce, postpone or potentially even avoid (the size of) fiscal adjustment to be undertaken. On the other hand, since refraining from fiscal adjustment becomes more costly, the incentive to deliver actual fiscal effort increases. This brings us to the next set of complementary research questions:

*3. Do European fiscal rules induce member states to provide more optimistic forecasts?*

*4. Do European fiscal rules induce actual fiscal adjustment?*

While discussions on the optimality of the institutional set-up in place continued,

the euro became the single currency on 1 January 1999, and citizens could use the new coins and notes for the first time on 1 January 2002. Today, the EU (including the United Kingdom) houses over 500 million people, of which about 340 million reside in the Economic and Monetary Union (EMU). The outreach of the common currency and European fiscal rules is simply huge and justifies thorough research into its effects. This thesis aims to shed light on the effects of EU's fiscal governance system on fiscal behavior, as well as on the effects of fiscal behavior in EMU member states on their economy. Hopefully the knowledge thus acquired contributes to better fiscal policy in the Europe of the future, and thus to the prosperity of Europe's citizens and maybe even, one day, to obtaining world peace.

## 1.2 Outline of the thesis

The (sub)questions introduced in the previous section form the basis of this thesis. Chapter 2 addresses the subquestion on forecast biases, hypothesizing that the European Commission's (EC's) forecasts are biased upwards when national governments expect European fiscal rules to bind. The empirical challenge in answering this question lies in the fact that the government's *true* expectation is unobserved; all we have are official forecasts, in which a potential bias could already be included. Therefore, we apply a novel identification strategy to retrieve the government's expectation for the budget balance. We start from the idea that an optimal forecast exists, based on all publicly and privately available information. The national government, having access to all relevant information, is able to construct this forecast. We recoup this forecast by purging the *realized* budget balance from any unexpected economic shocks that occurred after the original forecasting date by means of instrumental variable techniques. Reconstructing this expectation using real-time information, we show that for euro area countries the EC's fiscal forecasts are indeed biased upwards when the budget deficit threatens to exceed the critical value of 3% of GDP. For non-euro area countries, which do not face the risk of fines, this bias cannot be established. We furthermore offer suggestive evidence that the presence of independent fiscal councils at the national level helps to attenuate the bias induced by the 3% threshold.

Chapter 3 zooms in on the effects of the Excessive Deficit Procedure – a step-by-step procedure for countries with an established (projected) deficit above 3% of GDP, in which they are required to take corrective action to end the excessive deficit – and asks how this procedure affects projected and actual fiscal adjustment. We construct a real-time database containing all fiscal recommendations, and revisions thereof, given to EMU member states. We then estimate both real-time and ex-post fiscal reaction functions for a panel of EMU member states over the period 1999-2017. Apart from the more usual determinants of fiscal policy, we include EDP recommendations applicable at a specific forecast vintage as an additional explanatory variable to obtain an indication of their impact on fiscal policy. However, this comes with a challenge. Countries in an EDP almost by definition have budget deficits exceeding 3% of GDP. High deficits may be correlated with factors inducing a change in fiscal behavior other than EDP recommendations. We control for such factors in three ways. First, we allow the effect of recommendations to be different for countries in financial support programs. Countries receiving financial support may be subject to a more stringent fiscal governance regime, and generally went through hard economic times. Secondly, we control for interest rate spreads, which have been found to be correlated with being in an EDP (Diaz Kalan et al., 2018). Thirdly, to the extent that deficits above 3% might solicit a change in fiscal behavior for any remaining reasons, we allow the shape of the fiscal reaction function to vary with the level of the deficit. We find that EDP recommendations significantly affect both planned and actual fiscal policy. Overall, our results suggest that EDP recommendations have substantially shaped euro area fiscal policy, especially in the years 2010-2014, when EDP recommendations were both largest and most frequent.

Chapter 4 focuses on the effects of fiscal adjustments on perceived government solvency. From 2009 to 2013, the Netherlands were subject to the EDP, urging the Dutch government to impose substantial consolidation packages totaling about 8% of GDP. We investigate news announcements on the likelihood of extra consolidation taking place, tracking the whole political process leading up to a consolidation package. In order to find that consolidation announcements reduce interest spreads, two conditions need to hold. First, the announcement has to be believed to some extent. Secondly, market participants should believe that consolidation improves



fiscal sustainability and should not fear ‘self-defeating austerity’. As it turns out, even with spreads at low levels and the Netherlands as a relatively safe haven, we still find consolidation to improve investors’ perception of government’s solvency. Moreover, most of the spread-reducing effect was already realized in earlier stages of the process, i.e. before the official implementation date. This underlines the importance of carefully reading, analyzing and selecting the events of interest.

Chapter 5 investigates whether the importance of public capital for long run output growth has changed in recent years, given that in the fiscal adjustment process following the Great Recession, public investments were severely reduced in many countries. To this end, we expand time series on public capital stocks for ten euro area and ten other developed economies as constructed by Kamps (2006) and estimate country-specific recursive VARs. Results show that the effect of public capital shocks on economic growth has not increased in general, although results differ widely between countries. This suggests that the current level of public investments generally does not pose an immediate threat to potential output. Of course, this could change if low investment levels are sustained for a long time. Chapter 6 summarizes the main findings of this thesis and concludes.