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Master thesis

Explaining the mixed results of the EU-15 member states under the Stability and Growth pact: An analysis of domestic fiscal frameworks.

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Introduction:

The Economic and Monetary Union of Europe is currently under pressure. As the dust of the financial crisis is currently setting, Greece saw a hard-left swing of the government in the beginning of 2015, winning on the back of an anti-austerity campaign.[1] Greece is currently trying to find a consensus on the payback of lending's with the troika, representing a group bailout creditors consisting of the ECB, the European Commission and the IMF, but it is not the only euro country facing economic difficulties. Since the launch of the single European currency, mutual fiscal performances have been mixed.

In order to impose fiscal discipline on the Eurozone candidates, the Stability and Growth Pact (SGP) was implemented in 1997, reflecting a full set of fiscal rules and several monitoring- and correction mechanisms on a supranational level. However, after two rounds of reforms in 2003-2005 and 2010-2011, scepticism prevails. The latest reforms continue to reflect an unwillingness of member states to transfer the necessary degree of sovereignty over macro-fiscal objectives to the European level mirroring the need of further political integration.[2]

While these observations helps put the current tensions into perspective, they cannot explain *why* member states have been showing mixed results while being subjected to the same external constraints.[3] This research will try to seek answers to this question. Where problems occur on a supranational level due to the lack of political integration, there is a need for increased monitoring on a national level. The Economic and Monetary Union of Europe is in essence a two-way relationship. In the end, the increased fiscal imbalances in the euro area as a whole and the current critical situation in some of the member states, risk undermining stability, growth and employment, as well as the sustainability of the EMU itself.[4]

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[1] '' Greece's left-wing government meets Eurozone reality'', aljazeera.com/indepth/features/2015/02/greece-left-wing-government-meets-eurozone-reality-150205082726219.html, consulted at 23-02-2015.

[2] L. Schuknecht et.al. '' The Stability and Growth Pact, Crisis and Reform'', *ECB Occasional Papers* No. 129 (2011), 5.

[3] M. Buti, S. Eiffinger and D. Franco, '' Revisiting the Stability and Growth Pact: grand design or internal adjustment?'', *Economic Papers* No. 180 (2003), I.

[4] L. Schuknecht et.al. '' The Stability and Growth Pact, Crisis and Reform'', 5.

Chapter one: Outline of the research.

The starting point of the EMU in 1990 showed a divergent fiscal record for the euro candidates. With the ratification of Maastricht in 1992, countries spurred into action in order to meet the deficit criterion. The Maastricht Treaty had in some way a positive effect on fiscal consolidation.[5] Just two years before the implementation of the euro, in 1997, the SGP was adopted with the aim to ensure budgetary discipline among the Eurozone. Surprisingly, under this new set of rules, the 'positive effect' of Maastricht seemed to evaporate. [6]

Fiscal discipline and flexibility are the main principles of budgetary policy in a monetary union. Where fiscal discipline should allow the credibility of monetary policy to strengthen, flexibility is needed in order to deal with country-specific shocks. Unfortunately, the SGP could not adhere to its promises.[7] It has been criticized for various reasons. According to M. Buti et al. (2003), there are six main lines of criticism to be found. The SGP is supposed to: ''*reduce budgetary flexibility, work asymmetrically, does not sanction politically-motivated fiscal policies, discourages public investment, disregards the aggregate fiscal stance, focuses on short term commitments and disregards structural reforms*.''[8]

As a consequence, the SGP has been reformed to address its design flaws. In 2005, EU lawmakers amended the SGP to allow it to better consider individual circumstances and to add more economic rationale to the rules to which member states have to adhere to.[9] However, despite the reform of 2005, the financial crisis has unmasked several member states with shortcomings on a domestic level. They adapted to the requirements of the SGP on the surface while maintaining the legacy of past fiscal profligacy, weak domestic fiscal frameworks and engaged in creative accounting and 'one-offs' (V. Koen and P. van den Noord, 2005; A. Annett, 2006; Ayuso-i-Casals et al., 2007;).

Due to the financial crisis, fiscal governance now has gained a prominent role in the policy debate.[10] The shortcomings on a national level have led to an increased attention within

[5] A. Annet, '' Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe's Fiscal Framework'', *IMF Working Paper* 06/116 (2006), 8.
[6] A. Annet, '' Enforcement and the Stability and Growth Pact, 8.
[7] M. Buti, D. Franco and H. Ongena, '' Fiscal discipline and flexibility in EMU: the implementation of the Stability and Growth Pact'', *Oxford review of economic policy* Vol. 14:3 (1998), 81.
[8] M. Buti, S. Eiffinger and D. Franco, '' Revisiting the Stability and Growth Pact: grand design or internal adjustment?'', *Economic Papers* No. 180 (2003), 9.
[9] ''Stability and Growth Pact'', ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm, consulted at 04-03-2015.
[10] Directorate-General for Economic and Financial Affairs, '' National fiscal governance reforms across EU Member State: Analysis of the information contained in the 2009 2010 Stability and Convergence Programmes'', *European Economy Occasional Papers* No. 67 (2010), 5.

the academic sphere. A consensus exists that a sound governance framework is a prerequisite for successful and sustainable fiscal policies in EMU and that a 'quantum leap' in this regard is needed.[11] This is also recognized by the Economic and Financial Affairs Council (ECOFIN Council), who recognized that *'' important flanking policies to the fiscal exit will include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability.''*[12]

It is therefore ever important to engage in research that tell us *why* certain member states perform better than others. While before the crisis, much of the criticism is aimed at the Pact itself, SGP reforms are currently asking for time consistent national policies, individual budgetary transparency and ownership of the Pact.[13] This brings me to the following research question: Can the divergent results of the SGP be explained by weaknesses in the national budgetary frameworks of the member states? Also, due to the existing degree of political integration in the EMU, is internal adjustment rather than attempting to re-design the rules from scratch a more suitable way to bring about progress?[14]

In order to give answers to these questions, this research will start by analysing results of the past SGP-period. In order to categorize the performances of the Member States, chapter two will focus on the results of the Member States during three periods of time:

First, the post-Maastricht period starting from 1993 until the implementation of the euro in 1999. This period must be taken into account because many scholars have recognized a 'genuine consolidation effort' by the Member States.[15] The *second* period will analyse the results of the Member States between 1999 and 2005. Due to a recession most of the EMU countries saw their fiscal positions deteriorate which eventually led to a 'compliance crises' in 2003. Despite the European Commission's recommendation to take action, the ECOFIN Council decided to suspend the excessive deficit procedure against France and Germany.[16] This crisis eventually led to a revision of the SGP in 2005. The *third* period will reflect the

[11] L. Schuknecht et.al. '' The Stability and Growth Pact, Crisis and Reform'', 13.
[12] The Council of the European Union, ''Press release'', Council meeting 2967 (2009).
[13] A. Annett, J. Decressin and M. Deppler, ''Reforming the Stability and Growth Pact'', *IMF Policy Discussion Paper* No. 2 (2005), 1.
[14] M. Buti, S. Eiffinger and D. Franco, '' Revisiting the Stability and Growth Pact: grand design or internal adjustment?'', 2.
[15] M. Buti, ''Will the new Stability and Growth Pact succeed? An Economic and Political Perspective'', *European Economy Economic Papers* No. 241 (2006), 5.
[16] J. de Haan, H. Berger and D. Jansen, '' Why has the Stability and Growth Pact Failed?'', *International Finance* 7:2 (2004), 236.

period from 2005 until 2013, the year with the latest known figures according to Eurostat.[17] Although the period prior to 2007 entailed a renewed improvement of the overall fiscal balances in the Eurozone, when the financial crisis erupted, member states were distinctly ill-prepared.

During the Eurozone crisis the term 'PI(I)GS' gained traction as an acronym for a group of countries worst hit by the financial crisis: Portugal, Ireland and/or Italy, Greece and Spain.[18] But even before the crisis, the literature observed another pattern of wrongdoers: in the early years of the millennium, scholars noted a gap between the 'large' and the 'small' countries. Starting with the analysis of general observations, chapter two will therefore outline the available literature on these structural patterns. How can we explain these divergent results? Why do these member states show a considerable underperformance?

There are well-grounded theories and evidence to suggest that governments do not always have the right incentives to pursue an appropriate fiscal course. According to R. Morris (2006), *'' the primary rationale for fiscal rules such as those prescribed by the SGP relates to the observation that, unless restrained in some way, fiscal policies are prone to deficit and spending biases.''*[19] Consequently, the current literature provides many instruments who have the potential to contribute to fiscal sustainability. Chapter three will provide an overview. Starting by exploring the sources of the deficit and spending biases of governments, the ultimate aim of this chapter is to analyse key components that make up a resilient fiscal framework.

Now that the key components are reflected, chapter four will engage in a comparative research using key indicators on fiscal governance. The analyses will focus on the link between the strength and/or existence of the instruments of chapter three and the structural results of chapter two. The results of this chapter will be checked by two case studies in chapter five, where a well-performer as well as a wrongdoer will be analysed in an in-depth review. Can we explain the divergent results under the Stability and Growth Pact by looking at the strength of domestic fiscal frameworks?

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[17] Eurostat, ec.europa.eu/eurostat/web/government-finance-statistics/data/main-tables, consulted at 08-03-2015.
[18] The London school of economics and political science, '' The 'PIIGS' acronym had a clear negative impact on the response of financial markets to the 'PIIGS countries' during the crisis'', blogs.lse.ac.uk/europpblog/2014/12/12/the-piigs-acronym-had-a-clear-negative-impact-on-the-market-treatment-of-the-piigs-countries-during-the-crisis/, consulted at 04-02-2015.
[19] R. Morris et.al. '' The reform and implementation of the Stability and Growth Pact'', *European Central Bank Occasional Paper Series* No. 47 (2006), 5-6.

Chapter two: Analysing the results of the past.

2.1: Analysing the period of post-Maastricht until the implementation of the Euro (1993-1999).

The Maastricht Treaty is special. For the first time (although broader budgetary agreements could already be seen in the United States) the Treaty of Maastricht created an international budgetary treaty where each country had to converge to the same targets.[20] According to the Delors Report (1989), the monetary union could be achieved in three stages. The last stage (1999-onwards) was focused on the fix of final exchange rates and the transition to the euro.[21] In order to qualify for the third stage, Member States could apply for admission if they fulfilled the following convergence criteria:

1. *An annual inflation rate of no more than 1.5 per cent above the three best inflation performers in the EU.*
2. *A planned or actual budget deficit (as a percentage of GDP) of no more than three per cent.*
3. *A government debt to GDP ratio of sixty per cent or less.*
4. *An average long term interest rate at most of two hundred basis points above the levels observed in the three countries with the best inflation performance.*
5. *No devaluations or revaluations of the exchange rates within two years preceding accession.*[22]

The biggest stumbling blocks for the EMU candidates were supposed to be the fiscal criteria, most notably the debt ratio. [23] The focus on results will therefore be at the general deficit/surplus[24] and the general government gross debt[25] compared with point 2 and 3 of the convergence criteria of Maastricht. The performance of the Euro opt-out countries Denmark and UK, and future Euro-candidate Sweden are also taken into account since they also have to adhere to the EMU limits on governance finance. Table one and two shows the results of EMU candidates from 1993-1998.

[20] J.D. Savage, '' Budgetary Collective Action Problems: Convergence and Compliance under the Maastricht Treaty on European Union'', *Public Administration Review* Vol 61:1 (2001), 43.
[21] ''Phase 3: The Delors Report'', http://ec.europa.eu/economy_finance/euro/emu/road/delors_report_en.htm, consulted at 17-02-2015.
[22] J.E. McKay, ''Evaluating the EMU criteria: Theoretical constructs, Member compliance and Empirical testing'', *Kyklos* Vol 50:1 (1997), 65.
[23] J.E. McKay, ''Evaluating the EMU criteria: Theoretical constructs, Member compliance and Empirical testing'', 70.
[24] General government net lending (+)/net borrowing (–) as percentage of GDP.
[25] General government consolidated gross debt, as percentage of GDP.

Table 1: General deficit/surplus of the EMU, 1993-1998.

	1993	1994	1995	1996(1)	1996(2)	1997(1)	1997(2)	1998(*)(1)	1998(2)
B	-7.1	-4.9	-3.9	-3.2	-4	-2.1	-2.3	-1.7	-1.0
DK	-2.8	-2.8	-2.4	-0.7	-2.5	0.7	-1.2	1.1	-0.4
D	-3.2	-2.4	-3.3	-3.4	-3.4	-2.7	-2.8	-2.5	-2.4
EL	-13.8	-10.0	-10.3	-7.5	-9.1	-4.0	-6.7	-2.2	-6.0
E	-6.9	-6.3	-7.3	-4.6	-5.4	-2.6	-3.9	-2.2	-2.9
F	-5.8	-5.8	-4.9	-4.1	-3.9	-3.0	-3.6	-2.9	-2.4
IRL	-2.7	-1.7	-2.2	-0.4	-0.3	0.9	1.3	1.1	2.0
I	-9.5	-9.2	-7.7	-6.7	-6.6	-3.7	-3.0	-2.5	-3.0
L	1.7	2.8	1.9	2.5	1.3	1.7	3.8	1.0	3.6
NL	-3.2	-3.8	-4.0	-2.3	-1.7	-1.4	-1.3	-1.6	-0.9
A	-4.2	-5.0	-5.2	-4.0	-4.4	-2.5	-2.4	-2.3	-2.7
P	-6.1	-6.0	-5.7	-3.2	-4.7	-2.5	-3.7	-2.2	-4.4
FIN	-8.0	-6.4	-4.7	-3.3	-3.2	-0.9	-1.2	-0.3	1.6
S	-12.2	-10.3	-6.9	-3.5	-3.1	-0.8	-1.6	-0.5	0.9
UK	-7.9	-6.8	-5.5	-4.8	-4.1	-1.9	-2.1	-0.6	-0.2
EU-15 (average)	-6.1	-5.2	-4.8	-3.3	-3.7	-2.4	-2.0	-1.9	-1.2

Table 2: General government gross debt, 1993-1998.

	1993	1994	1995	1996(1)	1996(2)	1997(1)	1997(2)	1998 (1)	1998 (2)
B	135.2	133.5	131.3	126.9	128.5	122.2	123.8	118.1	118.8
DK	81.6	78.1	73.3	70.6	69.7	65.1	65.7	59.5	61.2
D	48	50.2	58	60.4	57.4	61.3	58.6	61.2	59.3
EL	111.6	109.3	110.1	111.6	113.1	108.7	109.7	107.7	107.9
E	60	62.6	65.5	70.1	65.6	68.8	64.4	67.4	62.5
F	45.3	48.5	52.7	55.7	59.4	58	60.8	58.1	60.8
IRL	96.3	89.1	82.3	72.7	70	66.3	61.7	59.5	51.6
I	119.1	124.9	124.2	124	116.3	121.6	113.7	118.1	110.8
L	6.1	5.7	5.9	6.6	8	6.7	7.9	7.1	7.6
NL	81.2	77.9	79.1	77.2	71.8	72.1	66.0	70.0	62.7
A	62.7	65.4	69.2	69.5	68	66.1	42.3	64.7	63.8
P	63.1	63.8	65.9	65	59.5	62	55.2	60.0	51.8
FIN	58	59.6	58.1	57.6	55.3	55.8	52.2	53.6	46.9
S	75.8	79	77.6	76.7	70.3	76.6	68.2	74.1	66.7
UK	48.5	50.5	53.9	54.7	47.9	53.4	46.9	52.3	44.2
EU-15 (average)	65.9	68	71	73	70.72	72.1	66.5	70.5	65.1

Sources:

(1) European Commission, ‘’Convergence Report of the European Commission, 1998.’’, *European Economy* No. 65 (1998), 81.

(2) Eurostat, ‘’ Government deficit/surplus, debt and associated data’’, ec.europa.eu/eurostat/web/government-finance-statistics/data/main-tables, consulted at 09-03-2015.

One year before the launch of the Euro, table one indicates that the budget deficit criteria of 3 per cent is achieved by all the Member States, where the overall EU deficit had fallen from an average of -6.1 per cent in 1993 to a -1.9 per cent in 1998. At least, according to the Convergence Report of the European Commission (1998). From 1996, tables one and two show values from two separate sources. Several figures were later revised by Eurostat. V. Koen and P. van den Noord (2005) write that during Maastricht and the SGP, several countries engaged in so-called *'one-offs'* and *'creative accounting and fiscal gimmicks'*. The ex-post adjustments of fiscal data for Portugal and Greece can be contributed to these observations.[26] Still, in comparison with 1993, the Member States preformed relatively well in bringing down their deficits.

This was however not the case for government debt. Table two shows that a large group of EMU countries did not achieve the 60 per cent debt limit. Furthermore, the EU-15 average debt remains fairly constant during the run up to the Euro. This was however considered not to be a problem. These budgetary ceilings were in no terms absolute. The Treaty refers to the convergence criteria as 'reference values'. It envisioned that a country could still qualify for membership if the level of deficit and debt as a per cent of GDP *"has declined substantially and continuously and reached a level that comes close to the reference value."*[27] If the convergence criteria of Maastricht were applied in a strictly manner, only a few countries would qualify for the euro. In practice, only Greece did not manage to qualify in 1997 but introduced the Euro in 2001 instead.

[26] V. Koen and P. van den Noord, '' Fiscal gimmickry in Europe: One-off measures and creative accounting'', *OECD Economic Department Working Papers* No. 417 (2005), 10.
[27] J.D. Savage, '' Budgetary Collective Action Problems: Convergence and Compliance under the Maastricht Treaty on European Union'', 45.

2.2: Analysing the results. The first years after the implementation of the SGP (1999-2004).

In 1997, the Stability and Growth Pact (SGP) was implemented to supplement the framework of Maastricht. Based on the concept of ‘multilateral surveillance’ as established in the Maastricht Treaty[28], the SGP was designed to prevent- and correct excessive government deficits to ensure that the fiscal policies of the Member States support the smooth functioning of the EMU.[29] In order to put constraint on the budgetary targets, a ‘preventive arm’ was implemented to bind the commitment of governments to sound fiscal policies. This arm requires member states to submit annual stability programs to the European Commission and ECOFIN Council, indicating how they plan to achieve or safeguard sound fiscal positions in order to meet their budgetary targets. When member states fail to reach these targets and excessive deficits or public debt levels are established by the ECOFIN council, a ‘corrective arm’ ensures correction trough a step-by-step approach, also known as the ‘Excessive Deficit Procedure’ (EDP). Failure to correct these deficits may ultimately lead to sanctioning, including fines of up to 0.2 or 0.5 per cent of the national GDP.[30]

Although the fiscal performances improved on the way to the euro, Europe was hit by a recession in the early 2000’s. Regarding the government deficits, table three shows mixed results. Deficits started to rise in several Euro countries from 2000, most notably in Germany, Greece, France, Italy, Austria, and Portugal.[31] By the end of 2004, only half of the euro countries (Belgium, Spain, Ireland, Luxembourg, The Netherlands and Finland)[32] had fiscal positions defined as ‘close-to-balance or in surplus’, with a minimum ½ percent cyclically adjusted deficit.[33]

The government debt levels of table four also shows divergent trajectories. The original high debt countries, Belgium, Greece and Italy were still far over the 60 per cent debt ceiling in 2004, although Belgium was able to consolidate substantially during the period of 1999-2004. This was also the case for Italy, Portugal and Austria, only not as much. A

[28] Art 121, TFEU.
[29] R. Morris et.al. ‘’ The reform and implementation of the Stability and Growth Pact’’, 5.
[30] For more information on these procedures, see: http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm, consulted at 05-03-2015.
[31] The same is applicable for the UK.
[32] The same is applicable for Sweden and Denmark.
[33] A. Annet, ‘’ Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe’s Fiscal Framework’’, 9.

decrease in debt could further be seen in Spain, Ireland, The Netherlands and Finland. In contrary to these countries both Germany and France saw their debt increasing.

As a consequence of the growing deficits due to the recession, six countries were pushed into the EDP. Portugal in 2001, Germany and France in 2002, Greece and the Netherlands in 2003, and Italy in 2004.[34] However, despite the European Commission's recommendation to take action, the ECOFIN Council decided in their meeting of 25 November 2003 to suspend the excessive deficit procedure against France and Germany.[35] This was later declared by the European Court of Justice (ECJ) to be an inadmissible, since it was not preceded by a Commission proposal. Still, due to political pressure, the EDP was formally suspended in December 2004. *'It turned out that the Pact's Achilles heel was its weak enforcement provisions.''*[36]

Table 3: General deficit/surplus of the EMU, 1999-2004.

	1999	2000	2001	2002	2003	2004
B	-0.6	-0.1	0.2	0.1	-1.8	-0.2
DK	0.9	1.9	1.1	0.0	-0.1	2.1
D	-1.5	1.0	-3.1	-3.9	-4.1	-3.7
EL	-3.2	-3.7	-4.5	-4.8	-5.6	-7.5
E	-1.3	-1	-0.5	-0.4	-0.4	0.0
F	-1.6	-1.3	-1.4	-3.1	-3.9	-3.5
IRL	2.4	4.8	0.9	-0.3	0.4	1.4
I	-1.8	-1.3	-3.4	-3.1	-3.4	-3.6
L	3.6	5.7	6	2.3	0.6	-1
NL	0.3	1.9	-0.4	-2.1	-3	-1.8
A	-2.6	-2.1	-0.6	-1.3	-1.7	-4.8
P	-3	-3.2	-4.8	-3.3	-4.4	-6.2
FIN	1.7	6.9	5	4.1	2.4	2.2
S	0.8	3.2	1.4	-1.5	-1.3	-0.3
UK	0.8	1.2	0.4	-2	-3.4	-3.6
EU-15 (average)	-1.4	0	-1.9	-2.6	-3.1	-2.9

[34] ''The corrective arm,''ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm, consulted at 19-02-2015.
[35] J. de Haan, H. Berger and D. Jansen, '' Why has the Stability and Growth Pact Failed?'', 236.
[36] L. Schuknecht et.al., ''The Stability and Growth pact: Crisis and reform'', 9.

Table 4: General government gross debt, 1999-2004.

	1999	2000	2001	2002	2003	2004
B	114.7	109.1	107.8	104.9	101.3	96.6
DK	57.7	52.4	48.5	49.1	46.2	44.2
D	59.9	58.7	57.5	59.2	62.9	64.6
EL	94	103.4	103.7	101.7	97.4	98.6
E	60.9	58	54.2	51.3	47.6	45.3
F	60	58.4	57.9	59.8	63.9	65.5
IRL	46.7	36.3	33.4	30.7	30.1	28.3
I	109.6	105.1	104.7	101.9	100.4	100
L	6.7	6.1	6.6	6.5	6.4	6.5
NL	58.5	51.3	48.8	48.3	49.4	50
A	66.4	65.9	66.5	66.3	65.5	64.8
P	51	50.3	53.4	56.2	58.7	62
FIN	44.1	42.5	41	40.2	42.8	42.7
S	61.5	51.3	51.8	49.9	49.1	47.9
UK	41.9	39.1	36.2	35.9	37.3	40.2
EU-15 (average)	62.2	59.2	58.1	57.5	57.3	57.1

Source: Eurostat, '' Government deficit/surplus, debt and associated data'', ec.europa.eu/eurostat/web/government-finance-statistics/data/main-tables, consulted at 09-03-2015.

2.3: Analysing the results. The SGP reform of 2005 and the sovereign debt crisis (2005-2013).

As a response to this 'compliance crisis', the ECOFIN Council agreed on a reform of the SGP in 2005. This reform was aimed to increase countries' ownership of the Pact. First, the 'medium-term objectives' were made more country specific in terms of debt and growth dynamics. Second, several procedural reforms were made in the preventive arm that resembled a shift towards more sophisticated rules. Third, the corrective arm has been made more flexible.[37] These reforms however, did not entail a fundamental change of the Pact. Instead, the 2005 reform introduced greater discretion, leniency and political control into the procedures.[38]

Despite this observation, the period prior to 2007 entailed a renewed improvement of the overall fiscal balances in the Eurozone. The average euro deficit of the EU-15 countries declined to a surplus of 0.1 percent as seen in table five. Still, *''these improvements were modest in cyclically adjusted terms''*.[39] This can be explained due to strong growth and

[37] For more information on the SGP reforms read: R. Morris et.al. ''The reform and implementation of the Stability and Growth Pact'', 41.
[38] L. Schuknecht et.al. ''The Stability and Growth pact: Crisis and reform'', 10.
[39] Ibidem, 12.

buoyant revenues caused by a boom in the real estate markets which helped to mask the expansionary expenditure policies in a number of countries. Countries like France, Portugal and the UK remained close to the 3 per cent limit in 2007, while fiscal policies were broadly relaxed. Lastly, the average government debt declined only marginally during the first nine years of the Euro, with an average debt standing at 53.7 per cent of GDP for the EU-15 countries in 2007 (table six).

The period between 1999 and 2007, can in retrospect be characterised as 'wasted good times'. There was little progress towards sound public finances, while the credibility of the fiscal rules were compromised.[40] When the financial crisis erupted in 2007, member states were distinctly ill-prepared. Public finances started to deteriorate significantly. [41] Starting with the announcement of the Greek government revealing its 12.5 per cent deficit ratio in October 2009, liquidity in the financial markets started to dry up. Risk premiums started to increase in Greece as a consequence of its fiscal imbalances and trading in Greek debt came to a standstill. In a chain reaction, the same happened over time for Ireland and Portugal. Credit Default Swaps (CDS) and government bond spreads started to move in tandem.[42] As a consequence, banks started to tighten the lending's as customers withdrew support and banks experienced increasing funding difficulties. Countries like Greece, Ireland and Portugal were forced to seek financial support.[43]

In response to the financial crisis, governments started to adopt a range of measures in order to stabilise the financial sector and the overall economic activity. In the EU, a European Economic Recovery Plan (EERP) was launched by the European Commission, foreseeing a short-term budgetary stimulus. This came on top of the effect of automatic fiscal stabilisers.[44] As a consequence, the average deficit started to increase to 7.5 percent whereas the average government debt rose to 74.3 percent in 2010. The fiscal costs of this sovereign debt crisis turned out to be high. These costs accumulated *'' through a combination of financial sector rescues, forfeited revenues owing to depressed activity and, more secondarily, discretionary counter-cyclical fiscal impulse to lessen the downturn.''*[45]

[40] Ibidem, 10.
[41] Ibidem, 12.
[42] P. Rother et.al. *More gain than pain, consolidating the public finances* (London: Politeia, 2011), 14.
[43] L.Schuknecht et.al., ''The Stability and Growth pact: Crisis and reform'', 12.
[44] Ibidem, 12.
[45] M. Buti and N. Carnot, '' The EMU Debt Crisis: Early Lessons and Reforms'', *Journal of Common Market Studies* Vol 50:6 (2012), 905.

Due to the financial crisis, the policy framework of the EMU has been addressed (again) in order to tackle initial gaps in the EMU architecture. The first set of reforms entered into force at the end of 2011, also known as the 'Six-Pack' followed by a 'Two-Pack' and a 'Fiscal compact'. Where the SGP reform of 2005 called for increasing flexibility, these new set of rules are aimed at strengthening the adherence to the SGP trough the improvement of monitoring tools and EU's economic governance rules in order to reinforce economic coordination between member states.[46]

Table 5: General deficit/surplus of the EMU, 2005-2013.

	2005	2006	2007	2008	2009	2010	2011	2012	2013
B	-2.6	0.3	0.0	-1.1	-5.5	-4.0	-3.9	-4.1	-2.9
DK	5.0	5.0	5.0	3.2	-2.8	-2.7	-2.1	-3.9	-0.7
D	-3.3	-1.5	0.3	0.0	-3.0	-4.1	-0.9	0.1	0.1
EL	-7.5	-5.2	-5.7	-6.5	-9.8	-15.7	-11.1	-10.1	-8.6
E	1.2	2.2	2.0	-4.4	-11	-9.4	-9.4	-10.3	-6.8
F	-3.2	-2.3	-2.5	-3.2	-7.2	-6.8	-5.1	-4.9	-4.1
IRL	1.6	2.8	0.2	-7.0	-13.9	-32.4	-12.6	-8.0	-5.7
I	-4.2	-3.6	-1.5	-2.7	-5.3	-4.2	-3.5	-3.0	-2.8
L	0.2	1.4	4.2	3.3	-0.5	-0.6	0.3	0.1	0.6
NL	-0.3	0.2	0.2	0.2	-5.5	-5.0	-4.3	-4.0	-2.3
A	-2.5	-2.5	-1.3	-1.5	-5.3	-4.5	-2.6	-2.3	-1.5
P	-6.2	-4.3	-3.0	-3.8	-9.8	-11.2	-7.4	-5.5	-4.9
FIN	2.6	3.9	5.1	4.2	-2.5	-2.6	-1.0	-2.1	-2.4
S	1.8	2.2	3.3	2.0	-0.7	0.0	-0.1	-0.9	-1.3
UK	-3.5	-2.9	-3.0	-5.1	-10.8	-9.6	-7.6	-8.3	-5.8
EU-15 (average)	-1.4	-0.3	0.2	-1.5	-6.2	-7.5	-4.8	-4.5	-3.3

[46] ''Stability and Growth Pact, ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm, consulted at 09-03-2015.

Table 6: General government gross debt, 2005-2013.

	2005	2006	2007	2008	2009	2010	2011	2012	2013
B	94.8	90.8	86.9	92.2	99.3	99.6	102.1	104	104.5
DK	37.4	31.5	27.3	33.4	40.4	42.9	46.4	45.6	45.0
D	66.8	66.3	63.5	64.9	72.4	80.3	77.6	79.0	76.9
EL	98.6	100.0	106.1	105.4	112.9	129.7	146	171.3	156.9
E	42.3	38.9	35.5	39.4	52.7	60.1	69.2	84.4	92.1
F	67.0	64.2	64.2	67.8	78.8	81.5	85.0	89.2	92.2
IRL	26.2	23.8	24.0	42.6	62.2	87.4	111.1	121.7	123.3
I	101.9	102.5	99.7	102.3	112.5	115.3	116.4	122.2	127.9
L	6.3	7.0	7.2	14.4	15.5	19.6	18.5	21.4	23.6
NL	68.3	67.0	64.8	68.5	79.7	82.4	82.1	81.7	81.2
A	49.4	44.9	42.7	54.8	56.5	59.0	61.3	66.5	68.6
P	67.4	69.2	68.4	71.7	83.6	96.2	111.1	124.8	128.0
FIN	40.0	38.2	34.0	32.7	41.7	47.1	48.5	53.0	56.0
S	48.2	43.2	38.2	36.8	40.3	36.7	36.1	36.4	38.6
UK	41.5	42.5	43.6	51.6	65.9	76.4	81.9	85.8	87.2
EU-15 (average)	57.1	55.3	53.7	58.6	67.6	74.3	79.6	85.8	86.8

Source: Eurostat, '' Government deficit/surplus, debt and associated data'', ec.europa.eu/eurostat/web/government-finance-statistics/data/main-tables, consulted at 09-03-2015.

2.4: General observations by the literature

The literature stipulates several reasons why member states lost an adherence impetus after the implementation of the Euro in 2002. Where all the Member States were able to bring their deficits down under the 3 per cent ceiling by 1998, six countries where pushed into the EDP by 2004. It turned out that the threat of not being allowed into the Eurozone was the underlying reason for the positive 'Maastricht effect'.

Conditionality for the Eurozone relied on the attraction of membership and its perceived benefits, with membership criteria functioning as a set of external constraints for aspirant members (Dyson and Featherstone, 1996).[47] Accordingly, Von Hagen (2005) concludes in his empirical research that '' *(...) the Maastricht process did create some political pressure of its own on the governments to undertake fiscal consolidations, and this pressure was effective mainly in the first half of the 1990s.''*[48] It has therefore been argued that the slowdown of overall results under the first years of the SGP can be contributed to an

[47] S. Blavoukos and G. Pagoulatos, '' Fiscal Adjustment in Southern Europe: the Limits of EMU Conditionality'', *GreeSE Paper* No 12 (2008), 6.
[48] J. Von Hagen et.al. , '' Budgetary Consolidation in EMU'', *Centre for economic policy research economic papers* No. 148 (2001), 39.

'adjustment fatigue' since the imminent threat of exclusion from the Euro had passed for the Eurozone countries (Hughes-Hallet, Lewis and von Hagen, 2004; von Hagen, 2005).

Another popular view is that the constraints of the SGP had a significant effect on the ability of Member States to conduct effective counter-cyclical stabilization policy. In return, some scholars have argued that fiscal policies actually became more procyclical after the introduction of the euro, *''especially as countries loosened in good times''* (Debrun and Faruqee, 2004; Balassone and Francese, 2004). This argument is however subjected to debate within the academic sphere (J. Gali and R. Perotti, 2003; A. Annett and A. Jeager, 2004).[49] Nevertheless, procyclical fiscal policies were still vivid during the SGP. A key failing of the SGP in its early years was its inability to prompt countries to adjust during the periods of high growth, where numerous countries loosened during good-times and conducted countercyclical policies during downturns.[50]

One reason for the loosening during good times can be contributed to overly-optimistic growth assumptions. These assumptions are part of the game that many governments play. According to L. Jonung and M. Larch (2004), government parties in power are prone to describe the economic future in an optimistic manner.[51] Furthermore, due to the emphasis on numerical values, and particularly the 3 percent deficit limit, incentives are created to circumvent the rules without taking the sustainable adjustments. V. Koen and P. van den Noord (2005) write that during Maastricht and the SGP, several countries engaged in so-called 'one-offs' and 'creative accounting and fiscal gimmicks'. Von Hagen and Wolff (2006) furthermore provide empirical evidence that indicate *'' that the introduction of the stability and growth pact and the excessive deficit procedure in Europe have resulted in creative accounting.''* [52]

Problems have appeared in sticking to the rules. This observation reflects trade-offs that are typical for supra-national arrangements.[53] But is this a consequence of the SGP design? Initially, the design of the Pact has been criticized frequently by a large group of

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[49] J. Gali and R. Perotti, '' Fiscal policy and monetary integration in Europe'', *Economic Policy* Vol. 18:37 (2003), 563.
[50] A. Annet, '' Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe's Fiscal Framework''12-13.
[51] L. Jonung and M. Larch, ''Improving fiscal policy in the EU: The case for independent forecasts'', *European Economy Economic Papers* No. 210 (2004), 11.
[52] J. von Hagen and G.B. Wolff, '' What do deficits tell us about debt? Empirical evidence on creative accounting with fiscal rules in the EU'', *GESY Discussion Paper* No. 148 (2006), 21.
[53] M. Buti, S. Eiffinger and D. Franco, '' Revisiting the Stability and Growth Pact: grand design or internal adjustment?'', 1.

scholars, and for various reasons, but how can this argument explain the mixed results while member states experienced the same external constraints?

2.5: Exploring the results after the implementation of the SGP.

A number of arguments have been raised by the literature in order to explain the emerging divisions among the euro-area. The first division appeared in the early years of the SGP, where a wide gap emerged between small and large member states. As a group, with the notable exceptions of Portugal and Greece, small countries have managed to achieve and maintain an underlying balance of their fiscal positions, while this was not applicable for the large countries.[54] A second division developed after the outbreak of the financial crisis, with an underperformance of Portugal, Ireland and/or Italy, Greece and Spain, the so-called PI(I)GS.

2.5.1: Structural patterns. Large vs. Small.

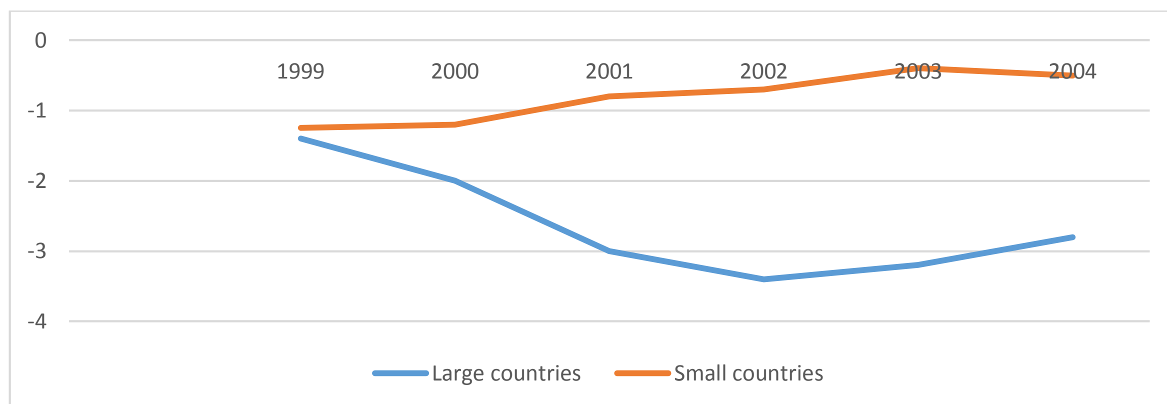
Although the overall balance of the Eurozone as a whole started to improve during the first SGP period (1999-2004), scholars started to identify the first structural pattern. Figure one shows the divergent trends between a weighted average of Germany, France and Italy on the one hand, and a weighted average of the other euro-area countries on the other. A. Annet (2006) writes: *'' one clear pattern, noted by many, is that a gulf opened up under the SGP between large and small countries (Annett and Jaeger, 2004; De Haan et.al, 2004; Buti and Pench, 2004; OECD, 2005; von Hagen, 2005).''*[55]

One argument stresses that the costs of fiscal consolidation tend to be larger in large countries which in return can explain their difficulties to reduce the deficit close-to-balance.[56] From here, the lack of consolidation mirrors the so called 'Maastricht-fatigue'. The call for budgetary retrenchment and structural reforms, as imposed by Maastricht, would not suit large countries while it may work in small countries. This comes forward from the observation that *'' Compared to large, relatively closed economies, smaller, more open economies have a stronger incentive to undertake supply-side reforms rather than pursuing an expansionary fiscal policy, since reforms not only boost potential output directly, but also*

[54] M. Buti and L.R. Pench, '' Why Do Large Countries Flout the Stability Pact? And What Can Be Done About It?'', *Journal of Common Market Studies* Vol. 42:5 (2004), 1026.
[55] A. Annet, '' Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe's Fiscal Framework'', 9.
[56] M. Buti and L.R. Pench, '' Why Do Large Countries Flout the Stability Pact? And What Can Be Done About It?'', 1027.

reduce inflationary pressure which allows them to gain competitiveness and increase external demand.''[57]

Figure one: Structural balance in large versus small countries in the Euro area, 1999-2004 (in percent of potential GDP)[58]



Source: A. Annett, '' Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe's fiscal framework'', *IMF Working Paper* 06/116 (2006), 11.

A second argument emphasizes that effective consolidation needs strong growth. M. Buti and R. Pench (2004) write *'' strong growth helps to reduce the budget deficit directly via the working of automatic stabilizers, but also eases structural consolidation to the extent that carrying out restrictive fiscal policies may be easier when the overall cake is growing and it is therefore easier to compensate the losers. Since large countries have grown considerably more slowly than smaller countries, their retrenchment efforts have been hampered (von Hagen, 2002; Fatás et al., 2003).''*[59] Accordingly, A. Annett (2006) writes *'' Countries experiencing high growth volatility tended to adopt more disciplined fiscal policy under the SGP (…). Growth volatility was also associated with lower forecast errors.''*[60]

Another set of arguments reflect the political nature of the SGP. Several scholars have explored the political impact of the SGP on fiscal behaviour of Member States. According to Chang (2006), the SGP pitted large states against small states, referring to the compliance crisis of 2003.[61] Since the ECOFIN Council comprises of all the EMU Member States,

[57] Ibidem, 1027-1028.
[58] The large countries are Germany, France and Italy.
[59] Ibidem, 1028.
[60] A. Annet, '' Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe's Fiscal Framework'', 23.
[61] M. Chang, '' Reforming the Stability and Growth Pact: Size and Influence in EMU Policymaking'', *Journal of European Integration* Vol. 28:1 (2006), 107.

ultimate decisions are made by a qualified majority voting.[62] This mechanism was used by the Council to extent the EDP for France and Germany, while in return, smaller countries (like the Netherlands) did receive formal notices. Chang argues that in a system where a monetary sanction is only used with extreme reluctance, the most powerful sanction therefore is public embarrassment, 'naming and shaming'. The usefulness of this procedure will vary according to country size. This can be explained according to the 'relative power argument' which stipulates that smaller countries tend to stick to the rules where large countries tend to ignore treaty rules. Large countries would suffer less from the sanctions, have lower reputational costs, and possess more influence than the smaller candidates.[63] M. Hallerberg (2011) sought verification for this argument using an empirical model. He concluded that countries having a contracts-based form of fiscal governance[64], which are usually small countries, are much less likely to receive a recommendation and, and once they get one, they comply.[65]

In summary, A. Annett (2006) writes, '' *Small countries are simply more accustomed to external influences over policy (Von Hagen, 1998; Von Hagen, Hughes Hallett, and Strauch, 2000). Also, as they tend to have less bargaining power, the loss of reputation from violating the fiscal rule is greater (De Haan, Berger, and Jansen, 2003). Small countries could also fear tangible pecuniary losses such as reductions in structural funds. Large countries may view the cost of profligate fiscal policy to be low, given that they suffer little diminution in reputation. Others note that while the Maastricht criteria were fully supported by the large countries, the political ownership of the fiscal rules subsequently shifted to the smaller countries which valued sound fiscal positions but had little influence with their peers (OECD, 2005).''*[66]

[62] Due to the economic crisis, six proposals for regulations and directives were adopted in November 2011, this 'SixPack' entailed a new form of voting in the European Council and a reversed qualified majority voting is now used. Source: K. Seng and J. Biesenbender, '' Reforming the Stability and Growth Pact in Times of Crisis'', *Journal of Contemporary European Research* Vol. 8:4 (2012), 452.
[63] M. Chang, '' Reforming the Stability and Growth Pact: Size and Influence in EMU Policymaking'', 117-118.
[64] See chapter 3
[65] M. Hallerberg, '' Member State Sanctioning and Compliance under the European Union's Stability and Growth Pact'', Paper presented at the 2011 EUSA Meetings (Boston, 2011), 27.
[66] A. Annet, '' Enforcement and the Stability and Growth Pact: How fiscal policy did and did not change under Europe's Fiscal Framework'', 15.

2.5.2: Structural patterns. The PI(I)GS.

The sovereign debt crisis proved to be the biggest test yet for the EMU. On October 16th, 2009, the newly elected Prime Minister G. Papandreou announced that the Greek debt and deficit figures regularly communicated to the European authorities, were deeply wrong. This statement proved to be a trigger: from that moment on, a succession of violent shocks spread out over the European continent.[67] Greece is currently seen as the most troubled country in the EMU. Characterized by a weak institutional budgetary framework in combination with an inefficient economy and government administration, Greece currently has to face hard austerity reforms posed by its bail-out creditors. The compliance results further suggest that Greece is one of the worst performers of under the SGP. This country will therefore be further analysed in a case-study in chapter five.

Ireland was hit first after the Greek announcement. Before the crisis, this Celtic Tiger had delivered a period of extraordinary growth: from 1987 to 2007, economic growth averaged 6.3 percent per year combined with steady improvements in productivity and employment. Although the supply-side policies turned out to be effective, the Irish government still lacked macroeconomic stabilization policies. Characterized by a housing market collapse, soaring unemployment and a full-scale banking crisis, this turnaround in Ireland's economic fortune was perhaps the most dramatic of any country in the euro area.[68]

Next up was Portugal, where the absence of growth fuelled doubts about the country's ability to repay its debts. In contrary to Ireland, Portugal had endured consecutive years of high deficits and an increasing level of government debt (see table 5 and 6). The prognosis for the Portuguese economy was pessimistic even before the financial crisis began. In 2006 the chief economist described Portugal as a country in serious trouble, with a deteriorated growth of productivity, very low economic growth, a large budget deficit and the likely prospect of competitive disinflation.[69] In May 2010, Greece became the first to receive financial assistance in exchange for implementing an economic programme designed by the Troika of

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[67] J. Pisani-Ferry, *The Euro Crisis and its aftermath* (London: Oxford University Press, 2014), 8.
[68] K. Whelan, '' Ireland's economic crisis: The good, the bad and the ugly'', *UCD centre of economic research working paper series* WP 13/06 (2013), 1.
[69] P. Pedroso, *Portugal and the global crisis: the impact of austerity on the economy, the social model and the performance of the state* (Berlin: Friedrich Ebert Stiftung, 2014), 2.

the European Commission, the European Central Bank and the IMF. Within a year, Ireland and Portugal followed the same path.[70]

In contrary to Portugal and Greece, Spain's growth prospects also looked promising as investments poured into the real estate sector. For example, in the year preceding the crisis, there were more housing starts in Spain (population 45 million) than in Germany, France and Italy combined (population 204 million). When this housing bubble popped, Spain was pushed into a crisis with over 25 percent unemployment, a depressed tax base, and increased government entitlement spending. [71] Spain's inability to cope with the housing crisis can be linked to the structure of the Spanish economy. Although Spain preformed much better with regard to the budget balance then the other PIIGS, the Spanish economy had an inflexible labour market, an insufficient and unregulated banking system, bad allocation of resources and a private debt to GDP of nearly 220 percent.[72]

Italy in an interesting case, as this country is both identified during the SGP as a 'large country' as well as one of the PIIGS. The Italian economy is the third largest economy in the euro zone, but it is plagued by inefficiency and the economy continues to shrink.[73] The major problem of Italy's economy is its widening competitiveness gap. Italy's traditionally high levels of public ownership, regulatory barriers to competition and administrative burden to start-ups makes it difficult to enter the world market (see chapter four). Italy's government debt surpassed 120 per cent in 2011 and since 2009, Italy has run a deficit well above the 3 percent limit. These deficits mirror the lack of economic growth rather than a deterioration of the country's own internal financial situation. The roots of this economic backwardness have been widely investigated and can be contributed to several factors: high inflation which in return led to a rise of nominal wages, thus weakening competitiveness, the internal regional division between North and South, a rigid labour market and lastly corruption which hindered the effectiveness of investments.[74]

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[70] J. Pisani-Ferry, A. Sapir and G.B. Wolff, *EU-IMF assistance to euro-area countries: an early assessment* (Brussels: Bruegel Bleuprint Series, 2013), 1.

[71] '' The Spanish Financial Crisis: Economic reforms and the export-led recovery'', studentpulse.com/articles/921/the-spanish-financial-crisis-economic-reforms-and-the-export-led-recovery, consulted at 18-03-2015.

[72] Ibidem.

[73] '' Basta 'La Casta': No End in Sight to Italy's Economic Decline'', spiegel.de/international/europe/economic-crisis-in-italy-continues-to-worsen-a-912716.html, consulted at 19-03-2015.

[74] E. Cencig, '' Italy's economy in the euro zone crisis and Monti's reform agenda'', *Research Division EU Integration Stiftung Wissenschaft und Politik German Institute for International and Security Affairs Working Paper* No.5 (2012), 19.

Consequently, it has been argued that the PIIGS do not form a homogenous group. Ireland and Spain in particular stands out. While the Irish growth model depended heavily on a low-tax, market conforming approach to encourage foreign direct investment, the southern European countries depended on a growth model that traditionally can be characterized by a strong state presence, shaping investments and generating demand stimulus.[75] Also, where Ireland faced particular problems with their banking system, Portugal and Greece had to coop with government mismanagement problems in their public finances and the economy in general. The latter is also applicable for Spain although they have performed rather well with regard to the budget balance. [76]

Despite these differences, the PIIGS all saw their debt spiralling out of control. Therefore, general insights in the literature tend to focus on the accumulation of government debt. As the introduction of the Euro led to soft budget constraints in the PIIGS countries, the fiscal rules of the SGP and Maastricht could not prevent the fiscally weak countries from returning to unsustainable fiscal policies.[77] According to A.L Costa Fernandes and P.R Mota (2011), the underlying reason for the underperformance of the PIIGS can be summarized due to the fact that: *'' in spite of their weaker economies, plagued by structural imbalances making them increasingly uncompetitive and, as a consequence, enjoying comparatively lower and more volatile growth rates of their real GDPs, PIGS chose to replicate the fiscal policies of their more prosperous member partners rather than adjusting in real terms. Faced with the negative external shocks arising from the financial crisis starting in 2007 and from its economic shockwaves, suddenly these countries were forced to confront themselves with the burst of their public debt burden.''*[78]

[75] S. Brazys and N. Hardiman, '' From tiger to PIIGS: Ireland and the use of heuristics in comparative political economy'', *Geary institute discussion paper series* No. 16 (2013), 10.
[76] A.L. Costa Fernandes and P.R. Mota, '' The Roots of the Eurozone Sovereign Debt Crisis: PIGS vs Non-PIGS'', *PANOECONOMICUS Special Issue* No.5 (2011), 640.
[77] T. Baskaran and Z. Hessami, '' A Tale of Five PIIGS: Soft Budget Constraints and the EMU Sovereign Debt Crises'', *University of Konstanz Department of Economics Working Paper Series* No. 45 (2011), 17.
[78] A.L. Costa Fernandes and P.R. Mota, '' The Roots of the Eurozone Sovereign Debt Crisis: PIGS vs Non-PIGS'', 642.

2.6: Conclusion.

The Stability and Growth pact was implemented to prevent and correct excessive deficits of the EMU countries, and is designed to ensure that the fiscal policies of the Member States support the smooth functioning of the EMU. However, since its implementation in 1997, it has frequently been criticized. While much of the criticism is aimed at the Pact itself, it is rather surprising that although the Member States were bound to the same external constraints, their results were mixed. Moreover, while the SGP sets budgetary constraints on a supranational level, many EMU candidates implemented the requirements on the surface, while returning to the legacy of past fiscal profligacy. After the introduction of the Euro, fiscal policies were broadly relaxed, and the first years of the SGP can therefore be described as *''wasted good times''*. There was little progress towards sound public finances, while the credibility of the fiscal rules were compromised.

After the implementation of the Euro, scholars started to notice a first structural pattern of poor performers. The large countries Italy, France and Germany continued to fail the budgetary targets set by the SGP whereas the small countries preformed relatively well. From here there is an abundant source of literature that explains why large Member States have more difficulties adhering to the Pact. In summary, large countries have higher consolidation costs, experience slower economic growth, are less susceptible to peer pressure and have more bargaining power. While the political ownership shifted to the smaller countries over time, they still had little influence with their peers. Moreover, small countries are more accustomed to peer pressure and political influence. They tend to suffer more from reputational costs and imposed fines when they do not comply. Also, high growth volatility and lower consolidation costs usually results in a stronger fiscal discipline. Over time, smaller countries performed better under the SGP than the large ones.

When the financial crisis erupted in 2007, the attention turned to another group of countries, all experiencing an explosion of increasing government debt, the PI(I)GS. Although the underlying roots of their problems differ, these countries choose to replicate the fiscal policies of their more prosperous member partners rather than adjusting in real terms. Furthermore, especially the southern countries of this group are currently facing structural problems with their economy resulting in a loss of competitiveness, macroeconomic imbalances and a high unemployment.

This does not mean that these latter problems where non-existent in the other Member States. Several countries relied on overly optimistic growth assumptions, engaged in creative accounting and circumvented the rules of the Pact without taking the sustainable adjustments. In reaction to these observations, new rules with regard to public finances where introduced. After the outbreak of the economic crisis in 2009, the European Council concluded that in order to support long-term sustainability, national frameworks need to be strengthened.[79] Looking back, many scholars now argue that *'' the observed failures in attaining sound and sustainable fiscal positions in a large number of EU countries in the pre-crisis period can largely be attributed to the significant weaknesses in the national fiscal governance structures across EU Member States''*[80] In order to confirm this notion, chapter three will reflect the instruments that make up a resilient fiscal framework. In what way can we link the compliance results and structural patterns with the strength of domestic fiscal frameworks?

[79] The Council of the European Union, '' Council conclusions on fiscal exit strategy'', *Economic and Financial affairs* No. 2967. (2009), 2.
[80] J. Ayuso i Casals, '' National Expenditure Rules: Why, How and When'', *European Economy Economic Papers* No. 473 (2012), 2.

Chapter three: Looking into the determinants of fiscal success.

The financial crisis has exposed fundamental weaknesses in the EU's economic framework.[81] In order to achieve fiscal discipline, governments have to maintain fiscal positions that are consistent with macroeconomic stability and sustained economic growth. The results of poor fiscal discipline translates in procyclical discretionary spending increases and tax cuts in good times, while in bad times pressing deficits and debt sustainability problems make countercyclical fiscal policy impossible.[82] The fiscal legacy of the financial crisis has raised concerns about the capacity of governments to maintain sustainable public finances. In order to raise credibility, commitments to sound public finances need to be strengthened.[83]

Fiscal governance has a twofold perspective. First, there is the EU-wide dimension. The Maastricht Treaty and the Stability and Growth Pact establish a European fiscal framework with the objective to enforce fiscal sustainability and stabilise public finances in the EU member states.[84] With the 2011 reform of the Stability and Growth Pact, several policies have been implemented to ensure sound fiscal governance throughout the EMU.[85] The Directive on requirements for budgetary frameworks of the Member States (2011) lays down rules to specific elements, in particular:

1) Systems of budgetary accounting and statistical reporting.
2) Rules and procedures governing the preparation of forecasts for budgetary planning.
3) County-specific numerical fiscal rules.
4) Medium-term budgetary frameworks. [86]

The second perspective refers to the domestic institutional context. While the EU member states all face the same constraints from the European policy framework, the application of fiscal rules and multi-annual targets varies considerably at the national level.[87] It is especially

[81] European Central Bank, '' The importance and effectiveness of national fiscal frameworks in the EU'', *ECB Monthly Bulletin* No.2 (2013), 73.
[82] M.S. Kumar and T. Ter-Minassian ed., *Promoting Fiscal Discipline* (Washington D.C.: IMF, 2007), 3.
[83] X. Debrun, '' Democratic Accountability, Deficit Bias and Independent Fiscal Agencies '', *IMF Working Paper* No. WP/11/173 (2011), 3.
[84] M. Hallerberg, R. Strauch and J. von Hagen, '' The design of fiscal rules and forms of governments in European Union countries'', *ECB Working paper series* No. 419 (2004), 7.
[85] These reforms included the 'Six-Pack', 'Two-Pack' and 'Fiscal Compact', which introduces greater macroeconomic governance, budget discipline and coordination of economic policies.
[86] '' Requirements for budgetary frameworks of the Member States'', europa.eu/legislation_summaries/economic_and_monetary_affairs/stability_and_growth_pact/ec0021_en.htm, consulted at 04-04-2015.
[87] M. Hallerberg, R. Strauch and J. von Hagen, '' The design of fiscal rules and forms of governments in European Union countries'', 7.

this perspective that has gained more attention from analysts and policy-makers. As Ayuso-i-Casals et al. (2007) write, ‘‘ (…) *the observed failures in attaining sound and sustainable fiscal positions in a large number of EU countries in the pre-crisis period can largely be attributed to the significant weaknesses in the national fiscal governance structures across EU Member States.’’*[88]

This chapter will provide an overview about the determinants of sustainable public finances with an emphasis on the domestic fiscal framework. Starting by exploring the sources of the deficit bias, this chapter will cover the available instruments to restrain decision makers and maintain long-term sustainability. The ultimate aim is to give a basic overview about the literature on fiscal governance and to establish a set of indicators for chapter four in order to link the compliance results of chapter two with the strength of the elements that define a resilient domestic fiscal framework.

3.1: The influence of the democratic political process on the deficit and debt bias.

Since the collapse of the Bretton Woods system of fixed exchange rates in the early 1970’s, it has been obvious that there is a bias in favour of increasing public debt levels.[89] The economic literature has identified a number of reasons why the deficit and debt bias are likely to emanate from the democratic political process.[90]

First, there is the logic of the standard c*ommon pool model.* This notion recognizes the fact that politicians represent different groups and have vested interests. They therefore have no incentive to constrain their spending demands because the overall costs are shared by the whole population. Policy makers engage in excessive spending because their constituencies and the people who they represent, do not have to bear the full costs of the public policy programs they bid for. M. Hallerberg et.al. (2004) writes: *‘’ Putting the argument into a dynamic context, one can show that the externality problem results in excessive deficits and debts (Velasco, 1999).’’*[91]

Secondly, politicians want to be re-elected (myopic). Therefore, politicians will focus on short-term electoral gain and neglect the longer term effects of running up debt. This also

[88] J. Ayuso I Casals, ‘‘ National Expenditure Rules: Why, How and When’’, 2.
[89] C. Cottarelli, ‘‘ Beyond the Austerity Debate: the Deficit Bias in the post-Bretton Woods Era’’, blog-imfdirect.imf.org/2012/05/21/beyond-the-austerity-debate-the-deficit-bias-in-the-post-bretton-woods-era/, consulted at 16-04-2015.
[90] L. Schuknecht, ‘’EU fiscal rules: Issues and lessons from political economy’’, 7.
[91] M. Hallerberg, R. Strauch and J. von Hagen, ‘‘ The design of fiscal rules and forms of governments in European Union countries’’, 9.

creates a deficit bias. Other origins of the common pool problem are (1) fiscal illusion, where voters do not fully understand the intertemporal budget constraint because 'information costs' are too high, (2) problems of representation and distribution, impeded by 'wars of attrition' across interest groups and (3) the problem of 'time inconsistency' where *ex ante* the government may announce fiscal adjustments, but *ex post* due economic- or political reasons do not renege on its promise and undertake additional spending. [92]

Another source feeding the deficit bias can be contributed to the implementation of pro-cyclical fiscal policies. This is especially the case when fiscal policy is asymmetric over the business cycle, being countercyclical during bad times, but procyclical during good times.[93] The fiscal rules of the SGP were designed to promote fiscal discipline without impairing fiscal flexibility. This is however less hard to achieve when structural budget deficits can be kept at lower levels.[94] Although it is been debated whether or not discretionary fiscal policy in the euro area has become more countercyclical after the implementation of the Euro (J. Gali and R. Perotti, 2003; A. Annett and A. Jeager, 2004; F. Huart, 2013), table 7 shows that pro-cyclical policies are still common in the EMU. Table 7 indicates that during the economic boom in 1999-2000, only Finland undertook substantial adjustments. The other countries loosened fiscal policies or stood still.[95]

Procyclical fiscal policies are generally regarded as potentially damaging for welfare. According to the literature '' *they raise macroeconomic volatility, depress investment in real and human capital, hamper growth, and harm the poor (Serven, 1998; World Bank, 2000; IMF, 2005; IMF 2005b).*''[96] So what causes procyclical fiscal policies? A common answer has to do with the supply of credit. In bad times, borrowing becomes more difficult and they cannot run deficits or have to cut spending. In good times, borrowing becomes easier and governments can therefore increase public spending. This answer however raises a critical questions: Why don't these countries self-insure themselves by building up reserves in good times? The current literature therefore suggests a number of explanations: Weak institutions, corruption, asymmetric information, common pool problems, a lack of fiscal rules and

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[92] L.Schuknecht et.al, '' The reform and implementation of the Stability and Growth Pact'', 7.
[93] F. Huart, '' Is Fiscal Policy Procyclical in the EuroArea?'', *German Economic Review* Vol 14:1 (2012), 73.
[94] F. Huart, '' Is Fiscal Policy Procyclical in the EuroArea?'', 73.
[95] A. Annet, '' Enforcement and the Stability and Growth Pact'', 13.
[96] P. Manasse, '' Procyclical Fiscal Policy: Shocks, Rules, and Institutions—A View From MARS'', *IMF Working Paper* No. 06/27 (2006), 4.

borrowing constraints and a lack of law-enforcement mechanisms all contribute to the tendency of governments to use pro-cyclical policies (P. Manasse, 2006; F. Huart, 2012).[97]

Table 7: Fiscal adjustment during SGP in the early years, 1999-2004 (change in cyclically adjusted primary balance).

Member State	Good Times 1999-2000	Bad times 2001-2004	Overall 1999-2004
Austria	-0.2	1.7	1.5
Belgium	-1.4	-0.6	-2
Finland	3.2	-4.9	-1.7
France	0	-1.5	-1.5
Germany	-0.6	-0.9	-1.4
Greece	-2.9	-4.6	-7.6
Ireland	-0.7	-2	-2.8
Italy	-1.4	-2.1	-3.4
Netherlands	0.2	-0.1	0.2
Portugal	-0.6	2.4	2.8
Spain	0	0.5	0.5
Denmark	0.2	0.7	0.9
Sweden	0.5	-3.1	-2.6
UK	0.3	-5.2	-4.8
Average EU-14	-0.2	-1.4	-1.7

Source: A. Annet, ‘’ Enforcement and the Stability and Growth Pact: How Fiscal Policy Did and Did Not Change Under Europe’s Fiscal Framework’’, *IMF Working Paper* 06/116 (2006), 13.

Fiscal behaviour can also be effected by the political cycle of a country. According to M. Buti and P. van den Noord (2003), the electoral budget cycle *‘’is alive and well in the EMU.’’*[98] They empirically tested the role of elections on the fiscal stance of the Member States for the period from 1999-2003. The results suggests that there is a clear tendency towards tax-cuts in (pre-) election years. Non-election years show a small bias towards tax increases. It is therefore likely that electorally motivated fiscal policy under the SGP may have contributed to an expansionary bias in numerous candidates. As elections come closer, governments tend to implement tax cuts and increase spending.[99]

The last argument suggests that deficits bias increases accordingly with the number of representatives that can make autonomous spending decisions. Therefore, the more *fragmented* the budget process is, the bigger the tendency to spend more and to run larger

[97] P. Manasse, ‘’ Procyclical Fiscal Policy: Shocks, Rules, and Institutions—A View From MARS’’, 4.
[98] M. Buti and P. van den Noord, ‘’ Fiscal policy in EMU: Rules, discretion and political incentives’’, *European Economy Economic Papers* No. 206 (2004), 37.
[99] A. Annet, ‘’ Enforcement and the Stability and Growth Pact’’, 14.

deficits.[100] This theory is strongly rooted in the political economy literature where political institutionalists are concerned on how certain institutions in the political system affect fiscal policy.[101] J. Hagen et.al. (2001) writes *''Since the most important representatives of individual spending interests in European governments are the individual spending ministers, an implication of this proposition is that government spending and deficits grow with the number of spending departments and ministers in a country's government. Kontopoulos and Perotti (1999) confirm this proposition empirically for OECD countries.''* [102]

In summary, the political economy theorists provide a various number of factors that can all contribute to a feed of the deficit bias. A. Annet (2006) writes: *''Among advanced economies, the literature shows that a plethora of interrelated factors— large and disparate coalitions, a high number of spending ministers, proportional electoral systems, electoral uncertainty, and short government duration—can all act to feed the deficit bias and generate suboptimal fiscal policy (Roubini and Sachs, 1989; Grilli, Masciandaro and Tabellini, 1991; Alesina and Perotti, 1995; Kontopoulis and Perotti, 1999; Annett, 2002; de Haan, Sturm and Beekhuis, 1999).''* [103] Furthermore, it is also important to recognise that deficit biases may be even greater in a monetary union for several reasons:

(1) *''The exchange rate risk and the associated interest rate risk premium is no longer operable, lessening the disciplining effect of fiscal policy.''*

(2) ''The costs of profligate fiscal policy can be shared with other Member States, which can exacerbate the deficit bias.''[104]

(3) ''Members may expect others to rescue them if they get into trouble.''[105]

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[100] M. Hallerberg, R. Strauch and J. von Hagen, '' The design of fiscal rules and forms of governments in European Union countries'', 10.
[101] M. Hallerberg, *Domestic Budgets in a United Europe: Fiscal governance from the end of Bretton Woods to EMU* (Ithaca and London: Cornell University Press, 2004), 10.
[102] M. Hallerberg, R. Strauch and J. von Hagen, '' The design of fiscal rules and forms of governments in European Union countries'', 10.
[103] A. Annet, '' Enforcement and the Stability and Growth Pact'', 5.
[104] Ibidem, 6.
[105] H.S. Basso and J.S. Costain, '' Fiscal Delegation in a Monetary Union with Decentralized Public Spending'', *Banco de Espana Research Paper Series - Working Papers* No. 1311 (2013), 6.

3.2: What makes a strong domestic fiscal framework? Analysing the budgetary procedure.

In order to tackle the deficit and debt bias, the literature provides several instruments who have the potential to improve the incentive for policy makers to use direction responsibly, reduce deficit biases and improve fiscal outcomes. This is why fiscal governance is important. The objective of fiscal governance is (1) attaining sound budgetary positions in particular by containing the deficit bias, i.e. tackling the tendency to conduct unsustainable fiscal policies giving rise to high deficits and increasing debt ratios, (2) reducing the cyclicality of fiscal policy making and (3) improving the efficiency of public spending. [106]

Instruments can be established who complement separate stages of the budget process. There are three principal stages of the budgetary process: planning, decision making and implementation. The budgetary procedure also has to be monitored and correctional mechanisms need to be implemented.[107] National fiscal governance or domestic fiscal frameworks can therefore be defined at those rules, regulations and procedures that influence on how budgetary policy is planned, approved, implemented and monitored.[108]

The design of resilient domestic fiscal frameworks are generally characterized by four main components:[109]

(1) Independent fiscal institutions.
(2) Budgetary procedures governing the preparation approval and implementation of budget plans.
(3) Following point two, medium-term budgetary frameworks for multi-annual budgetary planning need to be taken in consideration for the budget plans.
(4) Numerical fiscal rules.

Consequently, the next part of this chapter look on how these instruments work on a national level. Which instruments are regarded as most successful and how do they have to be implemented in order to be effective?

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[106] ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm
[107] M. Hallerberg, *Domestic Budgets in a United Europe: Fiscal governance from the end of Bretton Woods to EMU*, 22.
[108] ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm
[109] European Commission, ‘’ Public finances in EMU – 2010,’’ *European Economy* No. 4 (2010), 98.

3.2.1: The use of independent forecasters.

One of the reform options for the member states to consider is to constrain the decision-makers by putting greater reliance on independent agencies. Independent institutions have an important role for the first stage of the budgeting process: the budget planning. According to L. Jonung and M. Larch (2004) economic forecast errors account for deterioration in fiscal position over a relatively long period of time. Governments have a tendency to be overly optimistic on economic growth in the process of budget planning in order to play down the need for fiscal consolidation. Not only figures of growth, but also inflation rates and other variables are prone to optimistic biases. These optimistic biases are documented in various empirical studies of official forecasts.[110]

Two options are provided as a solution to this optimism bias. The first option is to improve the methods of forecasting within the *existing* institutional framework. This option used to be suggested by economist, but they tended to neglect the political incentive structure. Therefore, today, economists stress a better reform solution where the existing institutions are *replaced* with independent institutions in order to diminish the political incentive structure. In order to implement an effective independent institution, member states should consider the following:

- Independent institutions should be independent from the ministry of finance and the government, where the only task of this institution should be producing forecast growth and other variables that are crucial for the budgetary process.

- These institutes should be run by experts, protected by legislation from domestic political pressure.

- It should be open, transparent and accountable for its forecasts.[111]

During the SGP period, several economic figures of member states had to be revised as a consequence of 'creative accounting'. Independent forecasters can be a first line of defence against these practises. Secondly, member states can use independent bodies to evaluate their fiscal policies, marking up reputational costs, while possessing no formal fiscal policy powers. Belgium uses a High Council of Finance who recommends and provides policy assessments. Also Denmark's Economic Council evaluates both fiscal and structural

[110] L. Jonung and M. Larch, '' Improving fiscal policy in the EU: the case for independent forecasts'', European *Economy Economic Papers* No. 210 (2004), 11.
[111] L. Jonung and M. Larch, '' Improving fiscal policy in the EU: the case for independent forecasts'', 16.

policies. These institutional arrangements helped to contribute a turnaround in fiscal policy in these countries (Hallerberg, 2004; IMF, 2005).[112]

This positive effect is also recognized by the European Commission. They state that the established independent public bodies of the member state have been contributing positively to fiscal policy making trough one or several of the following three channels:

1) The provision of independent analysis on fiscal policy issues. This may also include the monitoring of budgetary developments, assessing compliance with the existing fiscal rules and/or the estimation of budgetary costs of specific policy measures.
2) The provision of unbiased inputs for the annual budget preparation. Most importantly, macroeconomic forecasts on which budgetary projections are based.
3) The issuing of regular assessments and recommendations relating to different aspects of fiscal policy.[113]

I will therefore use these three channels for further analysing purposes in the next chapter. Lastly, the economic crisis has led to the introduction of fast decision-making mechanisms to trigger measures for crisis prevention. Examples of such mechanisms are escape clauses allowing for temporary suspension of fiscal rules.[114] It should be stressed however that although these mechanisms may prove to be helpful in times of deteriorated economic conditions, credibility of the independent fiscal institutions must be insured at all times.

3.2.2: Resolving the co-ordination problem in domestic budgetary procedures: An institutional approach.

While correct forecasts can be provided by independent institutions, excessive spending and deficits may arise due to a co-ordination problem in the budgetary procedure. When the number of individual spending ministers rises, the budgetary procedure becomes more *fragmented*. The political economy therefore emphasizes the importance of decision-making rules that promote a comprehensive view of the externality problem, i.e., the common pool problem. The solution to fragmentation is thus *centralization* of the budgeting process, where

[112] A. Annet, ‘‘ Enforcement and the Stability and Growth Pact’’, 7.
[113] European Commission, ‘‘ Public finances in EMU – 2010,’’ *European Economy* No. 4 (2010), 104.
[114] European Commission, ‘‘ Public finances in EMU – 2010,’’ 104.

participants recognize the true cost and benefit of the projects financed from the general tax fund.[115]

This solution is part of a growing body of empirical and theoretical literature that suggests that the institutions governing the budget process are important determinants of a country's fiscal performance (von Hagen, 1992; von Hagen and Harden, 1994b; von Hagen, 1999; von Hagen and Strauch, 2000; Hallerberg, 2004). [116] There are two basic institutional approaches to achieve the necessary coordination overcoming the common pool problem: the *delegation approach* and the *contract approach*. Consequently, these two institutional approaches are suited for different types of governments.

The *delegation* approach emphasizes a minister of finance as a strong agenda-setter in the initial budget planning stage. Discretion is key in this approach. This minister takes on the role as a decision-maker with significant strategic powers who is less bound to special interests. Consequently, these powers can be used to correct deviations from the budget planning.[117] The effectiveness of this form of governance depends on the party structure of the government. The delegation approach is most effective in one-party governments for two reasons: First, in a coalition party, a conflict of interest may occur among the cabinet members since there is just one central player that monitors and punishes spending ministers. Coalition ministers simply don't trust a strong financial minister as they fear unequal treatment. Second, the punishing mechanism depends on the power of the prime minster, and by extension the finance minister, to replace overspending ministers. In one-party systems this has fewer consequences for the stability of the government whereas in a coalition government, this move might implicate a collapse.[118]

With the *contract* approach, coalition parties set the key budget parameters. Here, the process of negotiation must lead to the realisation of the externality to all the participants. This suggests that the planning stage is important to commitment states. Different parties negotiate a 'fiscal contract' involving strict budget targets, usually during the coalition negotiations. Therefore, commitment lends itself more to formal rules. Compliance with these

[115] M. Hallerberg, R. Strauch and J. von Hagen, '' The design of fiscal rules and forms of governments in European Union countries'', 10.
[116] Ibidem, 9.
[117] M. Hallerberg, *Domestic Budgets in a United Europe: Fiscal governance from the end of Bretton Woods to EMU*, 29.
[118] Ibidem, 32.

targets are monitored by the opposition in parliament. The minister of finance just has a monitoring and enforcing role, without any discretionary power.[119]

Next to these ideal systems, there is both a *mixed form* of governance and *fiefdom*. Under fiefdom, decision making is decentralized, where governments suffer from the common pool problem. Fiefdom is characterized by individual spending minsters who all suffer from additional spending by other ministers that comes from the same tax revenue pot. Fiefdom can only be identified by looking at one or more stages in the budgeting process. For example, concerning the decision-making stage, one should look for situations in which the minister does exactly what the party wants, without interference from other coalition parties or a strong minister of finance.[120] A *mixed form* of governance is usually suited for minority governments, where there are not enough votes in the parliament to pass legislation. Good examples are Sweden and Denmark. Here, the most effective method is to include selected opposition parties in budget negotiations early in the process.[121]

Now that the different systems are discussed, a classification can be made for the EU-15 member states. Table 8 categorizes the EU-15 for the time period 1973-2000. From here, several observations can be made. First, the overall budgetary process is more centralized now than in the early 1990's. Countries like Greece, Belgium, Italy and Spain all moved from fiefdom to a more centralized form of fiscal governance. A remarkable outsider is Austria, who has both seen a contract- as well as a delegation form of fiscal governance. Second, institutional reforms are now in line with the structure of government to the type of fiscal governance. The overall current pattern confirms that countries with predominantly coalition governments employ the contract approach while electoral systems leading to majority governments and persistent party constellations in government tend to follow a delegation approach.[122]

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[119] M. Hallerberg, *Domestic Budgets in a United Europe: Fiscal governance from the end of Bretton Woods to EMU*, 34-35.
[120] Ibidem, 26.
[121] Ibidem, 36.
[122] M. Hallerberg, R. Strauch and J. von Hagen, ''The design of fiscal rules and forms of governments in European Union countries'', 23.

Table 8: Categorization of States: forms of fiscal governance, 1973-2000.

Country	Form of fiscal governance
Austria	Fiefdom 1980-84, Commitment 1985-91, Fiefdom 1993-95,
	Commitment 1996-97, Fiefdom 1998-99, Delegation 2000
Belgium	Fiefdom 1980-92, Commitment 1993-2000
Denmark	Fiefdom 1980-81, Mixed 1982-2000
Finland	Commitment; Strengthened mid-1990's
France	Delegation
Germany	Delegation
Greece	Fiefdom 1980-96, Delegation 1997-2000
Ireland	Fiefdom 1980-87, Mixed 1988-91, Commitment 1992-2000
Italy	Fiefdom 1980-95, Delegation 1996-2000
Luxembourg	Commitment
Netherlands	Fiefdom 1980-82, Commitment 1983-00, strengthened 1994
Portugal	Fiefdom 1980-00
Spain	Fiefdom 1980-93, Mixed 1994-2000, Delegation 2000
Sweden	Fiefdom 1980-96, Mixed 1997-2000
United Kingdom	Delegation

Source: M. Hallerberg, *Domestic Budgets in a United Europe: Fiscal governance from the end of Bretton Woods to EMU* (Ithaca and London: Cornell University Press, 2004), 38.

Unfortunately, besides the work of Von Hagen and co-authors, there is little research on the choice of governance.[123] I will therefore not include further comparative research in the next chapter. Still, in an EU-wide dimension, an important observation is made by A. Annett (2006). He writes ''*with its emphasis on multi-annual targets and a regular review procedure, the SGP fits snugly with the numerical contracts approach associated with commitment states, but not so well with countries relying on domestic governance institutions (von Hagen, Hughes Hallett, and Strauch, 2000).''*[124]

So how can we link these observations with the structural patterns described in chapter two? According to A. Annett (2006), the fiscal governance hypothesis outlined above, can be used to explain the behaviour of all the relatively weak performers under the SGP. France, Germany, Italy and Greece are all delegation countries.[125] However, according to M. Buti and R. Pench (2004), not all of the delegation or quasi-delegation countries had problems in respecting the rules of the SGP. As a consequence of reforms, Spain and Austria both shifted

[123] M. Hallerberg, R. Strauch and J. von Hagen, ''The design of fiscal rules and forms of governments in European Union countries'', 8.
[124] A. Annet, '' Enforcement and the Stability and Growth Pact'', 15.
[125] Ibidem, 15.

to the delegation camp as from 2000. Moreover, this was not associated with a lower commitment to a tight implementation of the SGP.[126]

3.2.3: How Member States can overcome the deficit and debt bias: The use of numerical fiscal rules.

Although a proper institutional setting may contribute to a more comprehensive view to the budget, decision makers must extend the horizon of fiscal planning beyond the annual budgetary calendar.[127] Fiscal rules can provide a permanent constraint on fiscal policy, but these rules must go beyond the traditional indicators of fiscal performance (government deficits and government debt). The influence of fiscal rules on fiscal outcomes must provide a good mix between budgetary discipline and macroeconomic stabilization.[128] Moreover, in an empirical research, X. Debrun et.al. (2008) conclude that there is a robust link between the use of numerical fiscal rules and fiscal performance: *'' stronger and more encompassing fiscal rules tend to encourage higher cyclically adjusted primary balances, after taking into account other factors potentially affecting fiscal behaviour.''*[129]

Fiscal rules can take different forms and can consist of 'hard' (legally binding) and 'soft' (peer pressure) constraints. These rules supplement the monitoring of fiscal policy by voters and financial markets. They also provide a benchmark through which the actual course of fiscal policy can be assed. This should have a positive influence on the government's incentive structure. The quality of these rules are assed trough a number of criteria of which most cited are those of Kopits and Symansky (1998). [130] According to Kopits and Symansky, optimal fiscal rules should be: *Well-defined, transparent, adequate, simple, flexible, consistent, enforceable and efficient.*[131]

Numerical fiscal rules are one of the main elements in the domestic fiscal framework. They come in four different forms; *budgetary balance rules, debt rules, expenditure- and revenue rules.* They set binding objectives in terms of a budgetary aggregate such as a budget balance target or an expenditure ceiling. The numerical rules play an important role in improving the conduct of budgetary policy and attaining sound fiscal outcomes. The

[126] M. Buti and L.R. Pench, '' Why Do Large Countries Flout the Stability Pact? And What Can Be Done About It?'', 1030.
[127] European Commission, '' Public finances in EMU – 2010,'' *European Economy* No. 4 (2010), 106.
[128] European Commission, '' Public finances in EMU – 2010,'' 99.
[129] X. Debrun et.al., '' Tied to the Mast? National Fiscal Rules in the European Union'', *Economic Policy* Vol. 23:54 (2008), 342.
[130] L. Schuknecht et.al., '' The reform and implementation of the Stability and Growth Pact'', 8.
[131] Ibidem, 9.

importance of these rules have so far been underscored in both the literature as in a number of country-specific policy experiences. These fiscal arrangements are effectively used as an instrument to tackle procyclical tendencies and the deficit bias coming forward out of the political economy. The contribution of fiscal rules to macroeconomic stabilization however highly depends on the type of rule and its design features. J. Ayuso I Casals (2012) writes: *'' Simple balanced budget rules can actually increase pro-cyclicality, while other types of rules such as expenditure rules or cyclically-adjusted budget balance rules (or a combination of both) may be more conducive to an appropriate balance between discipline and stabilization.''*[132]

The most widespread fiscal rules across the EU are *budget balance rules.* According to empirical research, they can be linked with better budgetary outcomes (i.e. higher surpluses and lower deficits). Still, although they seem to address the deficit bias and enforce budgetary discipline, they might entail risks for the quality of public finance. Fiscal adjustment may rely on cuts to politically less sensitive expenditure categories such as R&D. Some countries have countered this problem with the introduction of budget balance rules that excludes investment expenditure, but these so-called 'golden rules' turned out to be difficult to operationalise in practice. Another criticism is the potential negative effect on the pro-cyclical bias in the conduct of budgetary policy. Again, the positive outcomes of these rules depends on their design. For example, one option is to supplement the budgetary rules with flexibility to account for cyclical fluctuations. Also, in order to be effective, these rules should be clear and confined to strictly specified circumstances in order to preserve credibility.[133]

Other forms of fiscal rules are *debt- and revenue rules. Debt rules* are also found to have a positive effect on fiscal discipline. Their effectiveness depends on the ambition of the target and on its design features. *Revenue rules* are not common across the national fiscal frameworks of the EMU countries and a crucial issue in the functioning of these rules is how to distinguish transitory from permanent revenue increases. For example, the economic crisis of 2009 led to incorrect assessment of the fiscal stance in Spain since overestimated structural revenues were calculated towards the booming property and asset prices.[134]

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[132] J. Ayuso I Casals, '' National Expenditure Rules: Why, How and When'', *''European Economy Economic Papers* No. 473 (2012), 12.
[133] European Commission, '' Public finances in EMU – 2010'', *European Economy* No. 4 (2010), 100.
[134] European Commission, '' Public finances in EMU – 2010'', 103.

One of the most promising forms of fiscal rules are *expenditure rules*. These rules in particular have received increasing attention both by literature as well as the European Commission.[135] According to the European Commission *'' (...) expenditure rules represent the cornerstones of the most resilient domestic fiscal frameworks in some EU Member States, namely those of the Netherlands, Denmark, Sweden, and Finland.''*[136] The IMF also confirms this notion as they write: *'' Our findings suggest that expenditure rules are associated with spending control, counter-cyclical fiscal policy, and improved fiscal discipline. We find that fiscal performance is better in countries where an expenditure rule exists. This appears to be related to the properties of expenditure rules as compliance rates are generally higher than with other types of rules (on the budget balance or debt, for example).''*[137]

Expenditure rules work by targeting the part of the budget that the government controls most directly, which should reduce uncertainty about meeting fiscal targets, enhance accountability and address the overspending, particularly in good times.[138] These rules should also be designed to be as credible as possible. According to a study of the ECB of 2010, their empirical results suggests that *'' deviation from neutral expenditure policies before and during the crisis has contributed strongly to public debt dynamics, notably in the macro-imbalances countries. Public debt ratios in the euro area would not have been much above 60% and in the macro-imbalances countries near or below 60% at the end of 2009.''*[139]

Consequently, the use of numerical fiscal rules in the EU-fiscal framework is enhanced through the implementation of expenditure benchmarks at EU level within the new rules of the 'Six Pack'.[140] Since 2006, the European Commission have compiled a dataset on domestic fiscal rules in force since 1990. These figures are annually updated since 2006 and will be used in the comparative research of chapter four.

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[135] T. Cordes et.al., '' Expenditure Rules: Effective Tools for Sound Fiscal Policy?'', *IMF Working Paper* Vol. 15:29 (2015), 3.
[136] European Commission, '' Public finances in EMU – 2010'', 102.
[137] T. Cordes et.al., '' Expenditure Rules: Effective Tools for Sound Fiscal Policy?'', 3.
[138] J. Ayuso I Casals, '' National Expenditure Rules: Why, How and When'', 12.
[139] S. Hauptmeier, J.S. Fuentes and L. Schuknecht, '' Towards expenditure rules and fiscal sanity in the Euro area'', *ECB Working Paper Series* No. 1266 (2010), 28.
[140] J. Ayuso I Casals, '' National Expenditure Rules: Why, How and When'', 12.

3.2.4: How Member States can overcome the deficit and debt bias: The implementation of medium-term budgetary frameworks.

The implementation of a medium-term budgetary framework (MTBF) is required by article 9(1) of the Budgetary Framework Directive which was adopted as part of the 'Six Pack'.[141] The European Commission defines MTBFs as *''those fiscal arrangements that allow government to extend the horizon for fiscal policy making beyond the annual budgetary calendar.''*[142] Since a single year perspective provides a poor basis for fiscal planning, MTBFs can contribute to long term sustainable fiscal planning. Although in general medium term budgetary objectives represent a weaker form of commitment than binding rules or targets, they may help to ensure budgetary discipline. Therefore, in order to be effective, two main elements are relevant: First, the medium term objectives need to supplement the expenditure rules for the budget balance based on cautious growth assumptions and realistic revenue projections. Independent forecasters can contribute to these demands. Second, The MTBFs should rely on binding spending ceilings in order to maintain credibility.[143]

The experience with these types of frameworks is however still limited, as most of them have been introduced only quite recently.[144] Before 2000, a small group of EU-15 countries had formal MTBFs in place. Finland adopted a multiannual budgetary framework in 1994, the Netherlands and Sweden in 1997 and the United Kingdom in 1998.[145] In Denmark the government also used to set and formulate fiscal policies on MTBFs before 2000, although the MTBFs were not part of a formal framework.[146] As from 2006, the European Commission monitors the existing medium term budgetary frameworks across EU member states through a series of annual questionnaires.[147] The first key findings were disappointing. The European Commission writes in 2009: *''Most of domestic MTBFs exhibited a large*

[141] Council Directive 2011/85/EU.
[142] European Commission, '' Medium-term budgetary framework in the EU Member States'', ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm, consulted at 04-04-2015.
[143] European Commission, '' Public finances in EMU – 2010'', 107.
[144] E.J. Lundback, '' Medium-Term Budgetary Frameworks – Lessons for Austria from International Experience'', *IMF Working Paper Series* WP/08/163 (2008), 8.
[145] C.B. Tita, A.V. Otetea and I. Banu, '' The Importance of a Medium-Term Budgetary Framework in Enhancing the Sustainability of Public Finances in Romania'', *Procedia Economics and Finance* Vol 16. (2014), 273.
[146] E.J. Lundback, '' Medium-Term Budgetary Frameworks – Lessons for Austria from International Experience'', 9.
[147] European Commission, '' Medium-term budgetary framework in the EU Member States'', consulted at 04-04-2015.

number of weaknesses. In particular, scant monitoring and a lack of pre-defined correction mechanisms in case of non-compliance emerged as the main shortcomings.''[148]

Since the implementation of the Budgetary Framework Directive of 2011, which obliges member states to have such a framework by the end of 2013, many member states have introduced new MTBFs or upgraded the existing arrangements. This is currently monitored in a medium-term budgetary framework database. Still, it is important to emphasize that the Budgetary Framework Directive only sets general requirements. Therefore, the MTBFs differ substantially between the member states. Crucial elements that contribute to the effectiveness of these frameworks like the coverage (general government and sub sectors), the level of political commitment and the monitoring and enforcement of the multiannual budgetary targets are still not in place or need to be strengthened in several member states.[149]

3.2.5: The need for structural reforms: lessons from the economic crisis.

By 2014, the economic recovery of the EU is still lacking behind with growth of just 1.3% compared to 2.4% in the US and 3.3% in the global economy.[150] The post-crisis EU-environment can be characterized with a large debt overhang, structural unemployment and weak productivity levels. The economic crisis highlighted the existence of an important interaction in a monetary union between fiscal and structural policies at national level.[151] The current pace of structural reforms in Europe is however worrisome. According to the reform barometer of spring 2015, 22% of the European Commissions recommended national-level reforms have been followed up with adequate implementation in comparison with 23% in 2014.[152]

Evidence of the interaction between fiscal outcomes and structural policies can be found when looking to Ireland and Spain in the aftermath of the crisis. As those countries both experienced relatively similar shocks emanating from the financial and construction sectors, they both saw their deficits deteriorate by around 13 percent of GDP between 2007 and 2009.

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[148] European Commission, '' Public finances in EMU – 2009'', *European Economy* No.5 (2009), 96.
[149] European Commission, ''Public finances in EMU – 2014'', *European Economy* No.9 (2014), 76.
[150] Business Europe, ''Still lacking consistent reform across Europe'', Reform Barometer spring 2015, 4.
[151] B. Cœuré, '' Lamfalussy was right: independence and interdependence in a monetary union'', (speech, Lamfalussy Lecture Conference, Magyar Nemzeti Bank, Budapest, 2 February 2015)
[152] Business Europe, ''Still lacking consistent reform across Europe'', 24.

By 2012, Ireland managed to reduce its deficit by more than 7 percent of GDP whereas in Spain the primary deficit was just less than 2 per cent lower.

How can these divergent results be explained? Benoît Cœuré (2014), member of the executive board of the ECB, argues that this observation can be contributed to the stronger consolidation efforts in Ireland as part of its adjustment programme. Although many other factors were also at play, the divergent results of Ireland and Spain showed that economic flexibility matters for the size and duration of deficits. When relating this observation to the rules of the SGP, Benoît Cœuré argues that there is a correlation between the ease with which countries comply with the rules and their progress on structural reforms. [153] Because some countries lacked structural reform, they have put themselves in a position of excessive deficit dependence. It therefore becomes difficult and costly for them to meet the obligations of the SGP. Furthermore, countries like Spain experience weak productivity trends as resources have been misallocated in low productive sectors like construction.[154] These conditions made stabilization policies less effective in boosting demand.

Supply-side policies can increase the effectiveness of demand-side policies and help empower demand. An important lesson from the economic crisis of 2009 is that sustainable economic growth in the Eurozone is about both the *demand* and *supply*. There are four key priorities for reform in Europe: there is an increasing need in getting people to work, increase competition, unlocking business potential and supporting an innovative environment.[155] In order to achieve this, EU Member States should make structural reforms which should contribute to economic flexibility and productivity growth. When they are not in place, fiscal policies are the only instruments in place to stabilize the economy which cannot be sustained over the long run. Fiscal space therefore becomes progressively exhausted.[156]

[153] B. Cœuré, ‘’ Lamfalussy was right: independence and interdependence in a monetary union’’,
[154] European Commission, “Catching-up processes in the euro area”, Quarterly Report on the Euro Area Vol. 12:1 (2013), 9-10.
[155] J. Trichet, ‘’ Structural reforms in Europe’’, oecdobserver.org/news/archivestory.php/aid/1847/Structural_reforms_in_Europe.html, consulted at 10-04-2015.
[156] B. Cœuré, ‘’ Lamfalussy was right: independence and interdependence in a monetary union’’

3.3: Summary

The financial crisis highlighted the need for resilient domestic fiscal frameworks. While fiscal governance is also regulated on a supranational context, this chapter has focused on domestic fiscal governance. This perspective has gained more attention from analysts and policy-makers in order to explain the different fiscal outcomes of member states while being subjected to the same supranational constraints.

A good starting point is by recognizing the externality that democratically elected governments have a tendency to accumulate debt. This deficit and debt bias has several sources and are part of the theory of the political economy. Government spending is commonly targeted at specific groups in society while being financed from a general tax fund. The result is an incongruence between those who benefit and those who pay. Other sources to the deficit bias are the use pro-cyclical policies, the political cycle of a country and a fragmented budgetary policy.

In order to combat this bias, the literature provides several instruments for governments to effectively combat deficit and spending biases. On an institutional level, governments have to strive for *centralization* of the budgetary process. This growing body of literature emphasizes that institutions governing the budget process are important determinants of a country's fiscal performance. Unfortunately, besides the work of von Hagen and co-authors, there is little research on the choice of the form of fiscal governance. Other instruments are therefore more promising for further analyses. These instruments are independent forecasters, national fiscal rules and the use of a medium-term budgetary framework. The economic crisis further shown that structural reforms should contribute to economic flexibility and productivity growth.

Chapter four: Analysing the important elements on national fiscal frameworks in relation to the fiscal outcomes under the SGP.

In the previous chapter has provided an overview about the main components that make up a resilient national fiscal framework. The European Commission currently monitors three of these components trough a database which is updated annually:

1) National fiscal rules
2) Independent fiscal institutions
3) Medium-term budgetary frameworks

The economic crisis has however shown that structural reforms on a national level are fundamental to ensure long sustainable growth while being closely linked with individual fiscal outcomes. The OECD provides several key indicators on this subject. I will therefore add an analyses on structural reforms to the upper list of components:

4) Structural reforms.

Through the analyses of these indicators, I will try to find a link between the structural patterns and the indicator scores. The hypothesis is thus that wrongdoers show weaknesses in their indicators in comparison with the well preforming member states. I will furthermore look if these results can be linked to the structural patterns outlined in chapter two. This will be done as follows:

- For each instrument I will use a summarizing indicator for comparison purposes. The construction of this indicator and the selected time interval will be elaborated at the beginning of the paragraph.
- In order to find out if the use of these instruments have increased in the EU-15 as a whole, I will start with a general observations paragraph.
- From here, the analyses will reflect progress on the structural patterns: ‘large vs small’ and the PI(I)GS.
- Lastly, a general conclusion will be drawn from these observations.

There is however a problem with the categorization of Italy, as this country can be assigned as a large country as well as one of the PIIGS. In the following comparative tables, Italy will be categorized for both. Still, when considering that Italy is currently the third largest economy in EMU, I will discuss Italy in the ‘large group’. This does not mean that I exempt Italy from being one of the PIIGS. The general conclusions will elaborate on this subject if necessary.

Lastly, it is important to emphasize that the indicators from the European Commission are based on self-reporting trough a questionnaire and may not reflect actual experiences.[157]

Chapter 4.1: National numerical fiscal rules.

Fiscal rules pose a permanent constraint on fiscal policy trough the setting of numerical targets for budgetary aggregates. Their primary objective is to enhance budgetary discipline. The European Commission has compiled a dataset on domestic fiscal rules in force since 1990 across EU countries.[158] The data is obtained through a survey that covers all types of fiscal rules (budget balance rules, debt rules and expenditure- and revenue rules)[159]. The questionnaire requests information on several aspects of the rule: description, definition, coverage, statutory base, monitoring and enforcement mechanisms and the experience with the respect of the rule.

The strength of the fiscal rules are calculated by the European Commission trough a fiscal rule strength index (FRSI). In order to be effective, fiscal rules need to be composed out of appropriate characteristics. Most cited are the characteristics stipulated by Kopits and Symansky (see chapter 3.2.3). The DG ECOFIN however looks at the following features:

(1) The statutory base of the rule.
(2) The room for setting or revising its objectives.
(3) The body in charge of monitoring respect and enforcement of the rule.
(4) The enforcement mechanisms relating to the rule.
(5) The media visibility of the rule.

The FRSI is calculated for each rule by aggregating the scores of the upper features.[160] Next, the FRSI's are used to construct a summary indicator for each member state trough a

[157] European Commission, ''Public finances of the EMU – 2009'', *European Economy* No. 5, 91.
[158] '' Numerical fiscal rules in the EU Member States'', ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm, consulted at 31-03-2015.
[159] For more information, see chapter 3.2.3.
[160] *''The scores of the five criteria are first standardised between 0 and 1. Then, a random weights technique is used following the method used by Sunderland et al. (2005). This technique uses 1000 sets of randomly generated weights to calculate the index in 10.000 different ways. The random weights are then drawn from a uniform distribution between zero and one and then normalised to sum to one. The resulting distribution for the index reflects the possible range of values given no a priori information on the weight to be given to each component. Given that the weights are drawn from a uniform distribution, the mean value of the composite index is asymptotically equivalent to the index calculated using equal weights for the constituent components, i.e. the un-weighted arithmetic average of the criteria.''* Source: European Commission, ''Fiscal rule database'' ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm, consulted at 01-04-2015.

comprehensive time-varying fiscal rule index for each Member State (FRI). The FRI is thus a single comprehensive score per country per year. It consists out of a summary of all fiscal rule strength indices in force in the respective member state weighted by the coverage of general government finances of the respective rule (i.e. public expenditure of the government sub sector(s) concerned by the rule over total general government expenditure).[161]

The FRI will be used for comparison purposes in table nine. This table shows the FRI for the EU-15 Member States using a four year interval starting with the implementation of Maastricht in 1993. The benchmark is the EU-15 average, where below average scores are highlighted in red.

Table 9: EU-15 results of the Fiscal Rule Index, 1993-2013.

Country	Structural pattern	1993	1997	2001	2005	2009	2013
B	Small	0,4110	0,5209	0,0511	0,0511	0,0511	0,0855
DK	Small	0,2948	0,5473	1,3983	1,3983	1,5037	1,5301
L	Small	-0,2990	-0,4992	0,9167	1,8405	1,8405	1,6949
NL	Small	-1,0147	1,0020	1,0020	1,0020	1,0020	1,0746
A	Small	-1,0147	-1,0147	0,2934	0,1732	0,7631	1,0740
FIN	Small	-1,0147	0,2803	1,0775	1,0334	0,1906	0,3152
S	Small	-1,0147	-0,0954	2,0081	2,0081	2,2847	2,2847
D	Big	0,3975	0,3975	0,3975	0,3975	1,1160	3,1964
F	Big	-0,6557	-0,4532	-0,0043	-0,0043	0,9355	3,5396
I	Big/PIIGS	-1,0147	-1,0147	0,0221	0,0221	-0,2676	-0,1949
UK	Big	-1,0147	1,8600	1,8600	1,8600	-1,0147	1,5024
EL	PIIGS	-1,0147	-1,0147	-1,0147	-1,0147	-1,0147	0,8707
E	PIIGS	-0,3410	-0,3410	-0,3410	1,5884	1,4203	3,0457
IRL	PIIGS	-1,0147	-1,0147	-0,9892	-0,7668	-0,7668	2,7502
P	PIIGS	-1,0147	-1,0147	-1,0147	-0,1517	-0,0967	1,7486
EU-15 Average	-	-0,6216	-0,1236	0,3775	0,6291	0,5298	1,6345

Source: European Commission, ''Fiscal rule database'', ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm, consulted at 01-04-2015.

[161] This methodology is based on a working paper of S. Deroose, L. Moulin and P. Wierts, '' National expenditure rules and expenditure outcomes: Empirical evidence for EU member states'', *Wirschaftspolitische Blätter* Vol: 1 (2006). *''This Fiscal Rule Index is obtained as follows. First, the above fiscal rule strength indices are multiplied by the coverage of general government finances by the respective rule. Next, the products obtained thereby are summed up. If more rules apply to the same general government sub-sector, then the rule with the higher fiscal rules strength index score is assigned weight one, while the second and third weaker rules obtain weights 1/2 and 1/3 respectively. The assigned weights are mainly determined by the fiscal strength of the rule and its coverage. This weighting is adopted to reflect decreasing marginal benefit of multiple rules applying to the same sub-sector of general government.''* Source: European Commission, ''Fiscal rule database'', ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm, consulted at 01-04-2015.

Chapter 4.1.1: General observations.

The EU-15 FRI average shows a steady improvement since the implementation of Maastricht. Although a temporal deterioration of the FRI can be observed during the outbreak of the financial crisis, the member states have rebounded with an extraordinary increase. The deterioration during the outbreak of the financial crisis can be partially explained due to the suspension of the rules in force in the course of the economic and financial crisis.[162] This is especially applicable for Finland and the UK. After 2009, the average FDI increases with a relatively strong pace as a consequence of the several initiatives that have been brought forward in order to strengthen the EU's fiscal governance.[163]

Chapter 4.1.2: The large countries.

The large countries show mixed results. Italy can be seen as the worst performer of this group but is also one of the worst performers overall. Between 1993 and 2013, Italy showed only minor improvements of their FRI which deteriorated after the outbreak of the financial crisis. In fact, Italy is the only country who scored negative in 2013. Here, no numerical fiscal rules existed other than those of the SGP before the financial crisis.[164] Fiscal rules are currently implemented due to the external constraints of Europe, but they still need to become effective.[165]

In contrast to Italy, Germany remains stable and above average during the first years of the SGP, reflecting their traditional devotion to tight fiscal policies. The German federal- and regional governments are constitutionally obligated to adhere to a 'golden rule', in which borrowing should only finance capital expenditures. Further fiscal rules were implemented after 2009. One particular example is the so-called '*Schuldenbremse'* or debt break.[166]

France showed a relatively low FRI before 2005. However, in contrast to Italy, France improved significantly after 2005 and especially after the outbreak of the financial crisis. Still, France lacks clear credibility features in their rules. Targets are usually not treated as binding

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[162] A. Iara and G.B. Wolff, '' Rules and risk in the euro area: does rules-based national fiscal governance contain sovereign bond spreads?'' *European Economy Economic Papers* No. 433 (2010), 11.
[163] Most notably the 'Six-pack','Fiscal Compact' and 'Two-pack' regulations. Source: C. Nerlich and W.H. Reuter, '' The design of national fiscal frameworks and their budgetary impact'', *ECB Working Paper Series* No. 1588 (2013), 3.
[164] T. Dabán et.al., '' Rules-Based Fiscal Policy in France, Germany ,Italy ,and Spain'', *IMF occasional paper* (2003), 11.
[165] European Commission, '' Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', *European Economy Occasional Papers* No. 91 (2012), 31.
[166] A. Truger and H. Will, '' The German 'debt brake' – a shining example for European fiscal policy?'', *Institute for International Political Economy Berlin Working Paper* No. 15 (2012), 1.

and well-specified escape clauses are missing, therefore decreasing transparency and credibility.[167]

The UK is a remarkable outsider. Since 1997, they have had the strongest FRI of the EU-15 which deteriorated in 2009 due to the financial crisis. While a 'code for fiscal stability' was implemented in 1998 (embedding two fiscal rules, most notably a golden rule for public finances), this code was abandoned 10 years later in view of public finance deterioration.[168] In response to the downturn, the UK government engaged in a short term fiscal stimulus, temporarily cutting taxes and bringing forward planned spending. Consequently, it has been argued that the fiscal rules have failed in the UK. A. Murray and G. Wilkes (2009) write that *'' They did not systematically affect the government's behaviour in fair times or foul. Politics determined the spending pattern of famine followed by feast that characterised Gordon Brown's Chancellorship.''*[169]

Chapter 4.1.3: The small countries.

The small countries score relatively well on their FRI scores in comparison with the other groups although both Belgium and Austria follow different trajectories. One group of small countries show relatively steady improvements of their FRI's between 1993 and 2013. This group consists out of the Scandinavian countries, the Netherlands and Luxembourg. Finland is a remarkable outsider. Although initially following the same path, their FRI deteriorated since 2005 towards one of the lowest scoring countries in 2013. This can be explained through the use of escape clauses as a consequence of a deteriorated economic environment due to the financial crisis.

In contrast to these countries, Belgium and Austria had difficulties to sustain their improvement pattern and experienced phases of improvement and deterioration. Belgium started as one of the countries with the strongest FRI after the implementation of Maastricht. However, after 1997, their score deteriorated to a somewhat constant value below the EU-15 average. Certain current- or former fiscal rules in Belgium are strictly complied with whereas in other cases there appears to be no connection between the rule and what actually happens.

[167] E. Bolva et.al., '' Fiscal Rules at a Glance'', *IMF working paper* No. 273 (2015), 28.
[168] C. Matieu and H. Sterdyniak, ''Do we need fiscal rules?'', *Sciences Po publications* No. 08 (2012), 10.
[169] A. Murray and G. Wilkes, ''Fiscal rules OK?'', *Centre Forum publication* (2009), 9.

There is still room for improvement.[170] Consequently, Belgium shows one of the lowest FRI's of the small countries.

Austria's FRI improved in the early years of the millennium, but could not sustain this growth pattern afterwards. Unfortunately, Austria's fiscal framework has not been able to prevent state governments from consistently missing their budgetary targets from 2001 to 2009, causing a significant drag on Austria's overall budgetary position.[171] In sum, the European Commission (2014) writes: *'' The Austrian experience seems to confirm the importance of combining well-designed fiscal rules with proper institutional arrangements able to provide an efficient incentive structure for subnational governments.''*[172]

Chapter 4.1.4: The PI(I)GS.

The PIIGS score considerably low on the FRI index until 2009. Both Greece, Ireland and Portugal had no effective numerical fiscal rules in place. For example, Ireland had three numerical fiscal rules in operation around 2011. Two expenditure rules applied for the central government and a budget balance rule existed for local governments. Still, the expenditure rules represented hardly any constraint in terms of spending containment. Moreover, targets of the budget balance rule have been missed regularly since 2007 and lacks a multiannual perspective.[173] Greece and Portugal had no fiscal rules in place at all before the implementation of the fiscal compact.[174]

Spain is an outsider in this group. According to the European Commission (2012), the prevailing fiscal framework has been instrumental in promoting multi-annual fiscal planning and showed an overall good record. Spain's fiscal framework relies on budgetary stability rules established in 2001. These rules allowed Spain to gradually improve fiscal balances and move from large deficits in the 1990's to surpluses between 2005 and 2007 and a gradual fall in government debt. Still, despite these rules, Spain continued to pursue a tax-friendly growth consumption and benefited from rising assed prices and a falling interest burden. Even though

[170] L. van Meensel and D. Dury, '' The use and effectiveness of fiscal rules and independent fiscal institutions'', *National Bank of Belgium Economic Review* No.11 (2008), 76.
[171] R. Fargnoli, '' Austria's fiscal rules: climbing the mountain towards effective fiscal relations'', *ECOFIN Country Focus* Vol 11:1 (2014), 1.
[172] R. Fargnoli, '' Austria's fiscal rules: climbing the mountain towards effective fiscal relations'', 8.
[173] European Commission, '' Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', 27.
[174] E. Bolva et.al., '' Fiscal Rules at a Glance'', *IMF working paper* No. 273 (2015), 31.

Spain's FRI has been strong since 2005, it has experienced severe macroeconomic imbalances in the wake of the crisis.[175]

Chapter 4.1.5: Summary

While the EU-15 average FRI has been rising gradually during the SGP period, table 9 indicates that this is mostly due to strong FRI's of the small countries until the outbreak of the crisis. Weak FRI's can be found in the large countries as well as the PIIGS. An exception for the large group is Germany while fiscal rules have not been effective in the UK and France. In Italy no fiscal rules existed other than those of the SGP before the outbreak of the financial crisis. This mixed pattern can also be observed for the PIIGS, where Spain can be seen as a positive outsider. Greece and Portugal both had no fiscal rules in place while fiscal rules in Ireland lacked credibility, representing hardly any constraints on spending or budget balance targets.

Table 9 therefore confirms the hypothesis, linking budgetary outcomes of structural patterns in chapter two with the use of numerical fiscal rules, although there are exceptions like Spain and Germany. This conclusion is also confirmed by the literature. In an empirical research on the link of national fiscal rules and fiscal discipline, X. Debrun et.al. (2008) conclude that there is a robust link between numerical fiscal rules and fiscal performance. They furthermore conclude that *'' the type and design of rules appear to matter for their effectiveness''*.[176] This observation can be linked with the experienced outcomes in the UK and Ireland.

[175] European Commission, '' Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', 121.
[176] X. Debrun et.al., '' Tied to the Mast? National Fiscal Rules in the European Union'', 343.

Chapter 4.2: Analysing the use of independent institutions.

With a survey of 2006, the European Commission compiled a broad set of indicators on national independent fiscal institutions in the EU countries. [177] The compiled information reflects the mandates and functions of these institutions, composition of governing boards, formal status vis-à-vis the government or parliament and media visibility.[178] The indicators of the survey are grouped in six sections: General description of the institution, mandate, role/function, composition, status, visibility.

Although all these sections are important for an independent institution in order to work effectively, this analyses will focus on the number of institutions and their functions or roles as a basic indicator. The European Commission specifies four main roles, namely: the analysis of fiscal policy developments *without* normative judgement; the analysis of fiscal policy developments *with* normative judgement; the provision/endorsement of independent macroeconomic and/or budgetary forecasts; and the issuing of recommendations (considering policy alternatives) in the area of fiscal policy.

From here, we can establish two basic roles with two institutional supplements. The two basic roles are (1) the analysis of fiscal policy developments *without* normative judgement and (2) the provision or endorsement of independent macroeconomic and/or budgetary forecasts. The importance of the latter was already stressed by The Council Report in March 2005 after the SGP reform, stating: *''it is important to base budgetary projections on realistic and cautious macroeconomic forecasts.''*[179] Macroeconomic forecasts are fundamental for preparation of budgetary plans. These figures largely determine revenue projections that in return form the basis for expenditure plans.[180] Institutions that provide the analysis of fiscal policy developments *without* normative judgement monitor whether fiscal developments are in line with the main fiscal policy objective of the government or with the traditional objective assigned to fiscal policy.[181]

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[177] This information is updated annually with the latest information coming from 2013.
Source: '' Independent fiscal institutions in the EU Member States''
ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm, consulted at 26-03-2015.
[178] '' Independent fiscal institutions in the EU Member States'', consulted at 26-03-2015.
[179] European Council, ''Council report'', *European Commission Press Release* No. 7619 (2005)
[180] European Commission, ''Public finances in EMU – 2006'', *European Economy* No. 3 (2006), 176.
[181] European Commission, ''Public finances in EMU – 2006'', 170.

Institutional supplements to these basic roles are (3) the analysis of fiscal policy developments *with* normative judgement and (4) the issuing of recommendations (considering policy alternatives) in the area of fiscal policy. These institutions issue statements and recommendations on the appropriateness of specific policy measures. Most importantly, they have the ability to influence the public debate and raise reputational costs for the conduct of unsound policies.

Table 10 shows the results on the establishment of independent institutions and their roles one year before the financial crisis (2008) in comparison with the latest data according to the survey (2013). The numbers used in the table reflect the institution in place for the given role or function. Where there is no institution in place, the figure is highlighted in red. Special attention goes out to the two basic functions as described above.

4.2.1: Looking for structural patterns.

The aftermath of the financial crisis led to an increase of independent fiscal institutes within the EU-15. This is however no coincidence. As from 2011, EU law requires the establishment of a technical and independent fiscal body within each member state.[182] The aim is ensuring compliance with EU and national fiscal rules and avoiding the deterioration of public finances.[183] Before the crisis, twelve of the EU-15 member states had established independent institutions. Member states without were Ireland, Finland and Italy. Still, as table 10 indicates, many of the institutions implemented were missing fundamental basic roles. This will further be reflected in the paragraphs below. The remaining member states however all implemented independent institutions after the outbreak of the crisis. A substantial increase of institutions that provide analysis of fiscal policy developments *with* normative judgement and the provision/endorsement of independent macroeconomic and/or budgetary forecasts can be observed by 2013 in comparison with 2008.

[182] Directive 2011/85/EU
[183] P. Lampreave, '' The New Regulatory Framework in the European Union and the Role of the Independent Fiscal Authority'', *Bulletin for international taxation* Vol 67:11 (2013), 592.

Table 10: Results of the independent fiscal institution survey of the European Commission, 2008-2013.

Country	Structural pattern	Number of independent fiscal institutions		Of which it provdides: analysis of fiscal policy developments without normative judgement		analysis of fiscal policy developments with normative judgement		provision/endorsement of independent macroeconomic and/or budgetary forecasts		recommendations (considering policy alternatives) in the area of fiscal policy	
		2008	2013	2008 -	2013	2008 -	2013	2008 -	2013	2008	2013
B	Small	2	2	1	1	1	1	1	1	1	1
DK	Small	1	1	1	1	1	1	1	1	1	1
L	Small	1	1	1	1	0	0	1	1	1	1
NL	Small	1	1	1	1	0	0	1	1	1	1
A	Small	4	5	3	4	3	5	3	3	4	4
FIN	Small	0	1	0	1	0	1	0	0	0	1
S	Small	2	2	2	2	2	2	1	1	2	2
D	Large	4	6	2	2	2	4	3	3	2	2
F	Large	2	3	2	2	1	2	1	2	1	1
I	Large/ PIIGS	0	1	0	0	0	1	0	1	0	0
UK	Large	1	2	0	1	0	0	0	1	0	0
EL	PIIGS	1	2	1	2	0	1	1	2	0	0
ES	PIIGS	2	3	0	1	0	1	0	1	2	2
IRL	PIIGS	0	1	0	0	0	1	0	1	0	1
P	PIIGS	2	3	2	3	1	2	0	0	1	2

Source: ‘’ Independent fiscal institutions in the EU Member States’’ ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm, consulted at 26-03-2015.

4.2.2: The large countries

By 2008, Italy remained the only 'large' member state without any independent forecaster. Both Germany and France had independent institutions implemented by 2008 providing all of the basic roles. This is however not applicable for the UK. Before 2008, the UK only had a National Audit Office (established in 1983) in place for the non-binding purpose of scrutinizing costings of policy measures that are produced by the Government. The UK did implemented an independent Office for Budget Responsibility in 2010, providing both analysis on fiscal policy and on macroeconomic/budgetary forecasts. A Parliamentary Budget Office in Italy was established by 2012, who's mandated to asses underlying assumptions of fiscal and macroeconomic projections as well as public finance sustainability, although it does not provide policy recommendations.[184]

4.2.3: The small countries

Most of the small countries had independent institutions in place of which some are relatively old, for example, the High Council of Finance in Belgium is created in 1936 and evolved along with the transition towards federalism in a context of sustained fiscal consolidation. Other 'veterans' are the Belgium Federal Planning Bureau, the Netherlands's Bureau for Economic Policy Analyses (CPB) and Denmark's Economic Council. New institutions have emerged since the late 1990's in Sweden (Swedish Fiscal Policy Council) and in Austria (Austria's Debt Committee).[185] These institutions all provided basic roles by 2008. Within this group of countries, Finland can be characterised as a remarkable outsider. While they are seen as one of the most disciplined countries throughout the EU-15, they implemented their independent institution relatively late. By 2013, all Member States of this group had implemented independent institutions who provided both fiscal analysis and macroeconomic and/or budgetary forecasts.

4.2.4: The PI(I)GS

As Ireland remained the only country in this group without any independent institution by 2008, most of the PIGS had institutions in place but only with a limited amount of (basic) roles or tasks. This is especially applicable for Spain and Portugal. Although they had institutions in place, none of them carried out any of the basic roles. Portugal had two

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[184] Senate Budget Service, '' Establishment of a Parliamentary Budget Office'', *Nota breve* No. 2 (2013), 2.
[185] X. Debrun and K. Takahashi, '' Independent fiscal councils in continental Europe: Old wine in a new Bottle?'', *CESifo DICE Report* No. 3 (2011), 46.

independent institutions in place before 2008, but even in 2013 there were no institutions that provided independent macroeconomic and/or budgetary forecasts. Within this group, only Greece had an institution in place that carried out both of the basic tasks *without* the providence of normative statements and recommendations by 2008. Still, this institute has been proved ineffective in controlling the deficit and debt biases of the Greek government (see chapter five).

By 2013, independent institutions were established in every Member State of the PIGS. With the exception of Portugal, all of these institutions are now providing independent analyses on fiscal policy and macroeconomic/budgetary forecasts. Progression efforts were speeded up through the implementation of the Directive on the requirements on budgetary frameworks in 2011.

4.2.5: Summary

The post-crisis period entailed an increase of independent fiscal institutions throughout the EU-15 Member States. While by 2008 Finland, Italy and Ireland were the only Member States without any independent institutions, especially the PIIGS (Italy included) and the large countries (including the UK) lacked institutions providing basic tasks. Table 10 thus confirms that weak budgetary outcomes under the SGP can be linked with the structural patterns of wrongdoers with the exceptions of Germany and France.

By 2013, independent institutions were implemented across all of the EU-15 Member States. Italy and Ireland however, still do not have institutions in place providing fiscal policy analyses whereas Portugal still needs an institution that provides macroeconomic and/or budgetary forecasts. The progression on the establishment of these institutes can be explained due to the implementation of the Directive on the requirements on budgetary frameworks of 2011.

Chapter 4.3: Medium term budgetary frameworks

The SGP reform in 2005 included country-specific medium-term budgetary objectives (MTO's) for all Member States, complemented with some simple provisions relating to the appropriate speed of adjustment towards the MTOs. From here, several studies have already demonstrated the potential benefits of medium term budgetary frameworks (MTBFs), notably on fiscal discipline (see chapter 3.2.4).[186] Just like the national numerical fiscal rules and independent institutions, the quality of MTBFs are annually assed trough a medium-term budgetary frameworks index.[187] The aim of this chapter is to link the strength of the MTBFs with the SGP results of the EU-15 Member States.

In line with the SGP reform in 2005, the European Commission launched a first survey in 2006 in order to evaluate the quality of MTBFs in the Member States. In contrast with 2000, almost every EU-15 Member State had complemented their fiscal institutions with a national MTBF in 2006. The only exceptions were Luxembourg, Ireland, Greece and Portugal.[188] The European Commission assesses the quality of MTBFs according to five dimensions:[189]

(1) Existence of a domestic MTFB.
(2) Connectedness between the multi-annual budgetary targets and the preparation of the annual budget.
(3) Involvement of national parliaments in the preparation of the medium-term budgetary plans
(4) Existence of coordination mechanisms between general government layers prior to setting the medium term budgetary targets.
(5) Monitoring and enforcement mechanisms of multi-annual budgetary targets.

The quality of medium term budgetary frameworks are analysed trough a calculation taking into account the existence and properties of national MTBFs along the upper five dimensions. Thereafter, the scores are combined following the same methodology as the Fiscal Rule Index

[186] European Commission, ''Public finances in EMU – 2007'', *European Economy* No.3 (2007), 149.
[187] '' Fiscal governance in the EU Member States'', ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm, consulted at 06-04-2015.
[188] European Commission, ''Public finances in EMU – 2007'', European Economy No.3 (2007), 156.
[189] For more information on the quality features: European Commission, ''Public finances in EMU – 2007'', *European Economy* No.3 (2007), 187.

(FRI).[190] The benchmark is the average EU-15 MTBF strength where surpasses are highlighted in red.

Chapter 4.3.1: Looking for structural patterns.

Table 10 shows the MTBF index scores of 2006, 2008 and 2013. The data indicates that the overall quality of the EU-15 MTBFs has increased. Still, progress was much slower than expected before the outbreak of the financial crisis. Between 2006 and 2008, only France adopted some significant changes. The European Commission concludes in their Report on Public Finances of 2009: *'' (...) the broad-based weaknesses in Member States' MTBFs identified in the 2006 survey still apply in 2008. These include poor monitoring mechanisms and lack of predefined measures in case budgetary developments depart from medium-term budgetary objectives.''*[191]

The financial crisis initiated a growing consensus on the desirability of adding the multiannual dimension to budgetary planning. Consequently, many EU Member States introduced new MTBFs into their legal order or substantially upgraded the existing arrangements. This process was further accelerated due to the Budgetary Framework Directive, which obliged the Member States to have MTBFs in their framework by the end of 2013.[192] Table 11 confirms this progress. The EU-15 average increased to 1.5 in 2013 and with the exception of Luxembourg, all of the EU-15 have MTBFs in place.

[190] See chapter 4.2
[191] European Commission, ''Public finances in EMU – 2009'', 99.
[192] Ibidem, 74.

Table 11: EU-15 results of the MTBF strength index, 2006-2008-2013.

Country	Structural pattern	MTBF index, 2006.	MTBF index, 2008.	MTBF index, 2013.
B	Small	1,4	1,4	1,4
DK	Small	1,6	1,4	1,8
L	Small	0,4	0,4	0,4
NL	Small	1,6	1,6	1,8
A	Small	1,6	1,6	1,6
FIN	Small	1,6	1,4	1,4
S	Small	1,6	1,6	1,4
D	Big	1,4	1,4	1,6
F	Big	1,0	1,6	2,0
I	Big/PIIGS	1,4	1,6	1,6
UK	Big	1,4	1,4	1,6
EL	PIIGS	0,4	0,4	1,8
ES	PIIGS	1,6	1,6	1,8
IRL	PIIGS	0,6	0,6	1,2
P	PIIGS	0,4	0,4	1,6
EU-15 Average		1,2	1,2	1,5

Source: European Commission, ‘’ Medium-term budgetary framework database’’, ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm, consulted at 08-04-2015.

Chapter 4.3.2: The large countries.

This group of countries all scored above average in the 2006 MTBF index. There is however one exception, France. By 2008 however, they had managed to recover and had turned their relatively weak MTBF index into the strongest by 2013. Italy also strengthened their MTBF index by 2008 but did not show an improvement after the outbreak of the financial crisis. This in contrary to Germany and the United Kingdom. They saw an increase of their MTBF index after 2013.

Chapter 4.3.3: The small countries.

Within this third group of countries, Luxembourg remains an extraordinary outsider. They adopted a multi-annual financial programming law in October 2014 as the last EU-15 Member State without an MTBF by 2013.[193] The poor strength of their index does however not correspond with their compliance on the SGP. Luxembourg is one of the EU-15 countries with the lowest government debt and -deficits (see chapter two). More remarkable is the average progression on MTBF index strength of the small countries. While the bigger

[193] European Commission, ‘’ Country Report Luxembourg 2015’’, *Commission Staff Working Document* No. 35 final/2 (2015), 11.

countries and the PIGS show signs of progression, most of the smaller countries showed none or even deteriorated. By 2013, only Denmark and the Netherlands improved their index in comparison with 2006.

Chapter 4.3.4: The PIGS.

In 2006, which marked the start of the MTBF survey of the Commission, especially the PIGS show poor results on the MTBF index. The only exception is Spain. Spain implemented Budgetary Stability Laws (BSL) in 2001 and 2007 in order to target fiscal balance over the cycle for the general government, excluding the social security system.[194] Still, in comparison with the other PIGS, this can be seen as exceptional. Greece for example, introduced their Medium-Term Fiscal Strategy (MTFS) by law in 2010[195] and a completely new MTBF was introduced in 2011. Ireland's processes of economic and budgetary governance are now under active review at EU level, and a number of commitments were set out in the *National Recovery Plan 2011-2014*. As from 2011, Ireland also has a MTBF that set out the medium-term parameters for budgetary policy.[196] Portugal introduced an MTBF in 2012 that obliges the government to annually submit to the parliament a draft law on a budgetary multi-year planning.[197] Table 10 shows an increase of the MTBF index for all the PIGS in 2013. Only Ireland remains below average. More importantly, some of these countries managed to reform their strength index to one of the best in the EU-15 by 2013.

Chapter 4.3.5: Summary

The use of MTBFs is a relatively new concept. Used to extend the horizon of the annual budget, only a limited amount of EU-15 countries have been using MTBFs in their legal constellation and budgetary practices. Also available data and empirical studies on the use of MTBFs are limited. As part of the SGP reform in 2005, the European Commission constructed a MTBF strength index which is updated annually.

Table 11 shows that especially the PIIGS were missing MTBF's (with the exception of Spain), while the other large and small countries (with the exception of Luxembourg) all had MTBF's implemented by 2006. The hypothesis thus excludes the large countries while it is

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[194] E.J. Lundback, '' Medium-Term Budgetary Frameworks – Lessons for Austria from International Experience'', *IMF Working Paper Series* WP/08/163 (2008), 29.
[195] Law 3871/2010.
[196] Department of Finance, '' Reforming Ireland's Budgetary Framework'' *A Discussion Document* No. 1 (2011), iii.
[197] European Commission, ''Public finances in EMU – 2014'', *European Economy* No.9 (2014), 74.

confirmed for the PIIGS, including Italy. The post-crisis period entailed an increase of the MTBF strength index were most notably the PIIGS saw a substantial increase of strength. In contrast to this progression, there is still room for improvement, especially in the small countries. Here, MTBF's have lost strength due to the financial crisis were multiannual planning had to be loosened in order to deal with country-specific shocks.

4.4: Structural reforms.

The European Union is currently using more supportive macroeconomic policies in order to enhance growth. Examples are the expended asset purchasing programmes of the ECB, a more flexible interpretation of the SGP as well as a lower exchange rate. Although it looks like these measures are having effect, Europe must not use this as an excuse to postpone essential structural reforms to both labour and product markets that can raise long-term output, ensure employment creation and sustainably raise European living standards. [198] Today, there is a continuing lack of consistent reform implementation across the EU (see chapter 3.2.4). Europe is especially falling behind in terms of competiveness.[199] As (southern) countries have lost competiveness and can no longer devaluate against their euro-zone trading partners, structural reforms are vital to ensure higher growth and declining debt burdens.[200]

There are three main categories of structural reform policies: enhancing competition, promoting business activity and improving labour markets.[201] In order to find a link between structural reforms and fiscal outcomes, table 11 shows scores on key indicators between 2008 and 2013 for the EU-15 countries obtained from the OECD database. In this database, the OECD monitors a set of quantitative indicators that allow for a comparison of policy settings across countries.[202] With regard to the three main categories listed above, indicators are picked which are essential to economic flexibility and productivity growth: indicators on employment regulation and barriers to entrepreneurship. The benchmark is the OECD average where surpasses are highlighted in red.

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[198] Business Europe, ''Still lacking consistent reform across Europe'', Reform Barometer spring 2015, 4.
[199] China's labour productivity has grown with more than 10 per cent between 2001 and 2013. For India, this figure is almost 5 per cent. When comparing, EU's productivity has grown with just 1 per cent between 2001 and 2013.
[200] The Economist, '' Structural reform in southern Europe: Patchy progress'', economist.com/news/finance-and-economics/21601008-some-signs-improvement-must-try-harder-patchy-progress, consulted at 10-04-2015.
[201] The Economist, '' Structural reform in southern Europe: Patchy progress'', economist.com/news/finance-and-economics/21601008-some-signs-improvement-must-try-harder-patchy-progress, consulted at 10-04-2015.
[202] The OECD, ''Going for growth: structural policy indicators'', oecd.org/eco/goingforgrowth.htm, consulted at 11-04-2015.

Chapter 4.4.1: Looking for structural patterns.

Table 11 confirms a lack of consistent reform implementations across the EU-15 countries. This is especially applicable for reforms on employment protection in order to ensure open, mobile and dynamic labour markets.[203] The competitive indicators on barriers to entrepreneurship shows an overall improvement in comparison with 2008, but the pace of reform is still marginal in most of the EU-15 countries. According to the business reform barometer of spring 2015, the costs of starting a business in the EU is still more than three times as high in comparison with the US whereas it takes about twice as long to set up a company in the EU. Consequently, there is still a need to simplify procedures and decrease administrative burdens in order to support business start-ups and companies expansion.[204]

Table 12: Indicators on structural reform in the EU-15, 2008-2013.

Country	Structural pattern	Employment protection legislation: (regular) 2008 - 2013	Employment protection legislation: (temporary) 2008 - 2013	Barriers to entrepreneurship: Complexity of regulatory procedures 2008 - 2013	Barriers to entrepreneurship: Administrative burden on startups 2008 - 2013
B	Small	2.08 - 2.08	2.42 - 2.42	2.47 - 1.47	2.55 - 2.53
DK	Small	2.03 - 2.10	1.79 - 1.79	2.03 - 1.28	1.38 - 1.30
L	Small	2.28 - 2.28	3.83 - 3.83	1.39 - 1.41	2.46 - 2.40
NL	Small	2.90 - 2.84	1.17 - 1.17	1.10 - 1.08	1.53 - 1.25
A	Small	2.12 - 2.12	2.17 - 2.17	1.03 - 1.02	2.44 - 2.01
FIN	Small	2.38 - 2.38	1.88 - 1.88	1.61 - 1.63	1.79 - 1.74
S	Small	2.52 - 2.52	0.79 - 1.17	2.77 - 2.77	1.58 - 1.45
D	Large	2.72 - 2.72	1.54 - 1.75	2.52 - 2.00	1.78 - 1.62
F	Large	2.67 - 2.60	3.75 - 3.75	1.38 - 1.57	2.49 - 2.16
I	Large/PIIGS	2.80 - 2.41	2.71 - 2.71	0.38 - 0.52	2. 43 - 2.14
UK	Large	1.25 - 1.11	0.42 - 0.54	3.10 - 2.46	1.42 - 1.33
EL	PIIGS	2.69 - 2.07	3.17 - 2.92	3.08 - 2.07	3.16 - 2.37
ES	PIIGS	2.22 - 1.95	3.50 - 3.17	2.84 - 2.83	2.58 - 2.34
IRL	PIIGS	1.13 - 1.50	0.71 - 1.21	3.36 - 3.37	1.42 - 1.49
P	PIIGS	4.17 - 3.01	2.29 - 2.33	1.41 - 0.41	2.82 - 2.48
OECD Benchmark	N/A	2.15 - 2.03	2.06 - 2.08	2.16 - 1.90	2.09 - 1.87

Source: The OECD, ''Going for growth: structural policy indicators'', oecd.org/eco/goingforgrowth.htm, consulted at 11-04-2015.

[203] Business Europe, ''Still lacking consistent reform across Europe'', Reform Barometer spring 2015, 5.
[204] Business Europe, ''Still lacking consistent reform across Europe'', 4.

Chapter 4.4.2: The large countries

The large countries show almost no progression towards reforms on the employment legislation by 2013 in comparison with 2008. They furthermore all remain above the OECD benchmark with regard to employment legislation, although this is not the case for Germany on temporary employment legislation. Progression is especially needed in France and Italy. The UK remains an outsider, where legislation on regular- as well as temporary employment legislation is one of the most flexible throughout the EU-15 countries.

The progression on reforms for barriers to entrepreneurship is mixed in this group of countries. Both in Germany and the UK, who experienced a relatively high indicator in 2008, showed progression on both the complexity of regulatory legislation as well as the administrative burden. This is however not the case for Italy and France although their complexity is low in comparison with the OECD benchmark.

Chapter 4.4.3: The small countries

The smaller countries also showed almost no progression on the reform indicators although they stay the strongest group on the indicators of barriers to entrepreneurship. In the Netherlands business federations continue to be satisfied with their country reforms. This in sharp contrast with Sweden and Finland. Although they are traditionally very competitive due to strong growth and employment performance, there is a substantial risk of losing ground as a result of failure to maintain a leading business environment.[205] Moreover, regular employment regulation remains to be high in these countries. This is also the case for temporal employment in Belgium, Luxembourg and Austria.

Chapter 4.4.4: The PIGS

The PIGS still lack behind on structural reforms with regard to both employment protection and barriers to entrepreneurship although they do show improvement, especially in comparison with the other EU-15 countries. The PIGS are showing stronger progression towards more flexibility on both regular- as temporary employment legislation and barriers to entrepreneurship. This is especially the case for Portugal on this particular set of indicators, which can be contributed to their assistance and adjustment programs.[206]

[205] Business Europe, ‘’Still lacking consistent reform across Europe’’, 5.
[206] Ibidem, 5.

In 2008, especially Portugal scored high on the protection of regular employment legislation whereas the same is applicable for Spain and Greece on the temporary employment indicator. By 2013, there is still a need for improvement as these countries can no longer boost short-term competitiveness trough currency evaluation. Progression towards flexible labour markets are therefore more than welcome in these countries.[207] Ireland still remains an outsider when looking to table 11. Here, indicators on both temporary and regular employment legislation remains one of lowest ranking EU-15 countries by 2013.

The PIGS can also be characterized in 2008 as those countries with the highest barriers to entrepreneurship. Complexity of regulations are far off the OECD benchmark in Greece, Spain and Ireland as well as the administrative burden. This in contrast to Portugal, where the complexity of regulations is one of the lowest by 2008 although the administrative burden is still relatively high. By 2013, the progression on reforms is patchy. Where Greece showed an improvement on both the indicators, progression is only marginal in the rest of the PIGS.

Chapter 4.4.5: Summary

Although the PIGS improved their reform implementation, there is still a need for the EU-15 Member States to step up. Table 11 confirms this notion. In contrast to the PIGS, there is almost no significant improvement by 2013 for both the large and the small countries in barriers to entrepreneurship and the labour market. The PIGS did however experience the highest barriers for the labour market and business environment in 2008. It remains important for these countries to step up reform measures as short term competitiveness can no longer be boosted with currency devaluation. Continued reforms might be socially challenging for these governments, especially labour reforms, but they contribute to an economic recovery on the long term.

[207] Ibidem, 22.

Chapter 4.5: Summary of the research

The outbreak of the financial crisis has exposes several institutional shortcomings on a national level. In return, the literature provides a number of instruments for governments to combat the deficit and debt bias. This chapter will try to find a link on budgetary outcomes and the use of these instruments on a national level, namely the use of:

1) Numerical fiscal rules
2) Independent fiscal institutions
3) Medium-term budgetary framework
4) Structural reforms

Indicators are used both from the European Commission and the OECD where the benchmarks are set on the EU-15 and OECD averages. The indicators are used to construct an overall indicator for comparative purposes between the structural patterns of chapter two. Can we link the structural patterns of budgetary outcomes under the SGP with the weaknesses of fiscal frameworks on a national level?

The general outcome of this research does indicate a link between the strength of domestic fiscal frameworks and budgetary outcomes, although there are some exceptions. The hypothesis is particularly difficult in order to explain the structural pattern of the 'large' countries, most notably in the case of France and Germany. Both countries have shown no considerable deviations on all of these instruments in comparison with the small countries although the Scandinavian countries, Luxembourg and the Netherlands show better scores. Italy and the UK are outsiders, where numerical rules have not been effective (in particular in the UK) and independent institutions absent, before the outbreak of the financial crisis.

The results do show particular shortcomings for the PIIGS, including Italy. Here, domestic fiscal frameworks were still inefficient and underdeveloped while these countries showed a low compliance on the budgetary targets of the SGP. One country stands out, Spain. This country has shown progression on all of the upper instruments, although it does not guarantee success. In the wake of the crisis, Spain has experienced considerable macroeconomic difficulties in combination with a full banking crisis.

Lastly, it is still important for the EU-15 as a whole to step up progression on structural reforms. While Europe is falling behind in terms of competitiveness and productivity, almost all of the countries are still showing high values in comparison with the OECD indicator benchmarks. More interestingly, progression is most strong in the PIIGS,

although this might be the result of their more troubled economies and more urgent competitiveness problems.

Chapter 5: Case studies.

Chapter four indicates that there are considerable differences to be found in the strength of the domestic fiscal frameworks of the EU-15 countries. These in-depth reviews will reflect two of the EU-15 member states. The first case study will be aimed at a well-behaved member state whereas the second will analyse a wrongdoer.

Table 13: Excessive deficits according to the results of chapter one, 1999-2013.

Country.	Number of excessive deficits in general deficit/surplus.	Number of excessive deficits in general government gross debt.
Belgium	4 (2009-2012)	15 (1997-2013)
Denmark	5 (2005-2008, 2012)	None-existent.
Germany	6 (2001-2005, 2009-2010)	11 (2003-2013)
Greece	15 (1999-2013)	15 (1999-2013)
Spain	6 (2008-2013)	5 (1999, 2010-2013)
France	10 (2001-2005, 2008-2013)	11 (2003-2013)
Ireland	6 (2008-2013)	5 (2009-2013)
Italy	9 (2001-2006, 2009-2012)	15 (1999-2013)
Luxembourg	Non-existent.	None-existent.
NL	4 (2009-2012)	9 (2005-2013)
Austria	3 (2004, 2009-2010)	9 (1999-2004, 2011-2013)
Portugal	13 (2000-2006, 2008-2013)	10 (2004-2013)
Finland	Non-existent.	None-existent.
Sweden	Non-existent.	1 (1999)
UK	9 (2003-2005, 2008-2013)	5 (2009-2013)

Source: Eurostat, ‘’ Government deficit/surplus, debt and associated data’’, ec.europa.eu/eurostat/web/government-finance-statistics/data/main-tables, consulted at 09-03-2015.

The selection will be based on the compliance results of chapter two where the Maastricht criteria will be applied in a strictly manner. Outcomes will therefore not reflect the established excessive deficits according to the ECOFIN Council, as this approach might lack a certain degree of objectivity.[208]

Table 13 therefore lists the consecutive number of excessive deficits for the budget and gross debt on an annual basis. From here, both Finland and Luxembourg are considered as the well performers whereas Greece stands out as the wrongdoer. For the purposes of this research, it will be desirable to compare countries that have (somewhat) comparable characteristics. Finland is therefore the best candidate to compare with Greece. For example,

[208] M. Chang, ‘’ Reforming the Stability and Growth Pact: Size and Influence in EMU Policymaking’’, 117-118.

the GDP of Greece reached 248.89 billion US Dollar in 2013. For Finland this was 247.14 billion in 2013. Luxembourg only accounts for 55.14 billion dollar in 2013.[209] The following case studies will therefore reflect Finland as a well-performer whereas Greece will be analysed as a wrongdoer.

Chapter 5.1: Finland

Just a few years before the launch of the EMU, in the early 1990's, Finland was hit by a severe recession. The country experienced a major bank crisis, unemployment rates deteriorated to over 15 per cent and the government debt raised from modest levels to about 60 per cent of GDP.[210] By 1995, the Ministry of Finance issued a report in which it argued that if policies remained the same, the overall debt would rise 30 per cent more to about 90 per cent of GDP.[211] How did Finland manage to recover and turnaround fiscal policy to one of the best preforming Member States on the SGP?

5.1.1: The economic crisis of the early 1990's.

Until the early 1990's, the Finish budget policy was characterized by stability. It maintained regular budget surpluses and government debt around 20 per cent of GDP. It furthermore experienced stable growth levels during the recession of the late 70's and early 80's while other western European counterparts where severely hit.[212] This success came to an abrupt in the early 1990's. Finland encountered a severe economic recession which can be characterized as *''a tale of bad luck and bad policies''*.[213] By the end of the 1980's, the Finish government had ended capital controls and abolished restrictions on bank lending rates, which led to a flood of capital into the market. As a consequence of a deteriorating economic environment throughout the OECD countries, an abrupt decline in Finland's exports following the collapse of the Soviet Union, high interest rates and an appreciation of the Finnish markka (FM) in the early 1990's, capital flowed out of the country just as freely as it came in.[214] The failure to reform regulatory schemes of the financial markets and the decision

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[209] Trading economics, tradingeconomic.com, consulted at 24-03-2015.
[210] C.J Dahlman, J. Routti and P. Ylä-Anttila (ed.), *Finland as a knowledge economy* (Washington: The World Bank, 2006), 2.
[211] M. Hallerberg, *Domestic budgets in a united Europe: Fiscal governance, from the end of Bretton Woods to EMU*, 146.
[212] Ibidem, 139.
[213] S. Honkapohja and E. Koskela, ''Finland's depression of the 1990's: A tale of bad luck and bad policies'', *Economic Policy* Vol 29:1 (1999), 400.
[214] M. Hallerberg, *Domestic budgets in a united Europe: Fiscal governance, from the end of Bretton Woods to EMU*, 149.

to leave tax systems unchanged when financial markets experienced deregulation were clear policy mistakes.[215]

5.1.2: The birth of the Finnish 'miracle' in the 1990's

A new government came in place in 1995, who started the design of a fiscal consolidation plan in order to tackle the explosion of debt accumulation and increased deficits. An important motivation behind this program were the requirements for a membership in the EMU, which came closer after becoming a member of the EU in the beginning of that year (M. Hallerberg, 2004; S. Honkapohja, E. Koskela and R. Uusitalo, 2006). A new Social Democratic proposal was adopted that reduced government spending of around 20 billion FM and the coalition negotiated a level of spending cuts per ministry for four years.[216] These fiscal consolidation plans in combination with a systematic execution and the improvement of monetary credibility in the form of inflation targeting were crucial for the turnaround and resumption of economic growth in Finland in the mid 1990's. [217]

The period that followed can be characterized by strong growth and structural reforms. From 1994, Finland encountered rapid economic recovery. The most important reason for the increased growth was the increase of labour productivity due to the increase in the skill-level of the labour force. The Nordic welfare state has a strong focus on education, which is free all the way to the university level. These safety nets were particularly important for dealing with high unemployment during the crisis. Unemployment benefits were linked with getting additional education which in return helped to restructure the economy toward high-technology industries. [218]

Additionally, an industrial policy was chased that supported R&D and related innovative activities at the micro level. In summary, *'' the Finnish system of innovation was characterized by public-private partnerships, consensus-building, and dense networking among companies, universities, and research organizations.''*[219] Finland followed an atypical pattern of industrial development transitioning from a nature-resource based economy into

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[215] S. Honkapohja, E. Koskela and R. Uusitalo, *Economic Prosperity Recaptured: The Finnish Path from Crisis to Fast Growth* (Cambridge: The MIT Press, 2006), 57.
[216] M. Hallerberg, *Domestic budgets in a united Europe: Fiscal governance, from the end of Bretton Woods to EMU*, 147.
[217] S. Honkapohja, E. Koskela and R. Uusitalo, *Economic Prosperity Recaptured: The Finnish Path from Crisis to Fast Growth*, 59.
[218] Ibidem, 102.
[219] C.J Dahlman, J. Routti and P Ylä-Anttila, *Finland as a Knowledge Economy: Elements of Success and Lessons Learned* (Washington: The World Bank, 2006), x.

one that relies heavily on high technology and knowledge. Nokia and Linux are examples of success, which grew to global giants in less than a decade. [220]

The combination of reskilling the labour force and providing fertile grounds for high tech industries turned out to be effective. But Finland is also characterized with other elements that contributed to this success. First, next to the build-up of a knowledge based economy, good public governance can also be contributed to the success of Finland. This country is traditionally known for being one of the least corrupt societies combined with a good public infrastructure and an efficiently functioning administration. Secondly, there is the high degree of coordination across different parts of government, and between the government and society. Thirdly, Finland can be characterized with a strong tradition of encouraging domestic competition. [221]

5.1.3: The reform of the Finish fiscal framework in the 1990's

The consolidation program of the Finnish government eventually led to smaller deficits and a decline of government debt as a result of strong fiscal consolidation based on the restrain of public spending. The adjustment was supported by a number of institutional reforms, of which the key components were:

1) A medium-term framework for central government expenditure, with annual ceilings for individual ministers.
2) Formal spending and taxation autonomy for local governments, who in practice tend to observe a balanced budget rule (although formally not in place).
3) A comprehensive and mandatory social security system, under partly private management but subjected to public regulation.[222]

Most important for Finland's expenditure management system was the implementation of a medium term budgetary framework in 1991.[223] Former separate processes of multi-year planning and annual budget preparation were merged into a single medium-term expenditure framework. The design of the framework was compromised out of a maximum level of total central government expenditure and expenditure ceilings for each ministry, both covering the

[220] C.J Dahlman, J. Routti and P Ylä-Anttila, *Finland as a Knowledge Economy: Elements of Success and Lessons Learned*, x.
[221] Ibidem, 33.
[222] IMF, ''Finland: Selected Issues'', *IMF staff country report* No. 99:122 (1999), 8.
[223] IMF, ''Finland: Selected Issues'', 36.

budget year and the two following years.[224] The experience with this new framework can be assessed as positive. While the cumulative real GDP growth between 1992 and 1998 was over 20 percent, two successive governments have been able to limit the primary spending of the general government. As a consequence, the total expenditure ratio dropped from 59 percent of GDP in 1993 to less than 50 percent in 1998. This successive expenditure restraint was therefore a key factor in the strengthening of Finland's fiscal position after the recession in the early 1990's.[225]

5.1.4: Finland's economic performance after the introduction of the euro

Finland's economic performance stands out among the EMU economies. It has been able to meet the Maastricht criteria every year since the introduction of the euro which can be contributed to strong public institutions, good governance, a strong rule of law and a well-educated labour force. More specifically, Finland has been one of the most competitive economies in the world.[226] In 2015, this country has been ranked 9th in the Doing Business Indicator[227] and 3rd in the Global Competitive Index of 2013-2014[228]. This helped Finland to maintain a steady growth of GDP between 1998 and 2008, but the outbreak of the financial crisis has put growth into a slowdown (see figure 2).

This slowdown is reflecting an unfavourable external environment but also some fundamental weaknesses. Exports are falling due to the lesser demand in traditional exports like paper and pulp (as a consequence of the global shift from paper to electronics) and a lesser demand in electronics (Nokia). Also the current economic crisis in Russia has (again) struck another blow to the Finnish export market due to worldwide trade restrictions.[229] Furthermore, as a consequence of high wage growth and a decline in labour productivity, there is a decline in growth per capita, which is problematic for the aging society.[230]

Several critical areas in Finland are therefore ripe for reform. The first are pension reforms. Here, a dialogue between stakeholders, including social partners, can avoid unnecessary delays in terms of legislation and implementation. Second, an increased spending

[224] IMF, ''Finland: Selected Issues'', 14.
[225] Ibidem, 16.
[226] IMF, ''Finland: Selected Issues'', *IMF country report* No. 14:140 (2014), 15.
[227] Doing Business, doingbusiness.org/data/exploreeconomies/finland/, consulted at 18-04-2015.
[228] World economic forum, weforum.org/reports/global-competitiveness-report-2013-2014, consulted at 18-04-2015.
[229] Reuters, '' Taste of its own medicine? Austerity overshadows Finland vote'', reuters.com/article/2015/04/12/us-finland-election-idUSKBN0N30JK20150412, consulted at 20-04-2015.
[230] IMF, ''Finland: Selected Issues'', *IMF country report* No. 14:140 (2014), 16.

on active labour market policies, especially targeted at older people. Third, a gradual reduction of unemployment benefits in order to increase labour supply. This can be particularly effective when implemented during a period of strong demand. Forth, product market reforms, especially in the retail sector in which regulatory barriers are among the highest out of the OECD countries.[231] Together, these structural reforms have the potential to enhance economic growth while mitigating the impact of fiscal consolidation, which is currently pursued by the government in order to cope with the aftermath of the financial crisis.

Figure 2: Finland's GDP growth rate, 1998-2014.

Source: Trading economics, tradingeconomics.com/finland/gdp-growth, consulted at 18-04-2015.

5.1.5: Reforms of the Finnish fiscal framework in the early 2000's.

The current fiscal framework in Finland has been established in 2003 and is anchored around multi-annual expenditure ceilings, mirroring the previous fiscal framework of 1991. The system is linked to parliamentary terms (four years) and experience with the framework suggests that governments abide by the rules.[232] This helped the successive governments to effectively pursue consolidation of public finances, especially during good times.[233] As a consequence, Finland has been able to sustain levels of debt and deficits well below the criteria of Maastricht. By 2013, the consolidated gross debt of the government was 56 per cent

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[231] IMF, ''Finland: Selected Issues'' (2014), 50.
[232] European Commission, '' Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', *European Economy Occasional Papers* 91 (2012), 129.
[233] See table 7 of chapter three.

while even during the crisis general government deficits did not exceed the 3 per cent reference value.[234]

The consolidation programme is a core element of the current government for 2011 to 2015 and is translated into a fiscal rule setting government spending limits. These expenditure ceilings cover 80 per cent of the central government budget. The exclusion of several items like unemployment assistance, housing allowances and interest payments are crucial to allow automatic stabilizers on the expenditure side to work. Programmes are formulated through a public agreement between coalition partners that is submitted to parliament as a government statement and thus relies heavily on political commitments.[235]

Although the experience with this framework has been positive, the previous chapter shows several institutional shortcomings in Finland. First, the fiscal rule index of chapter four (table 9) shows a relatively low figure in comparison with the other EU-15 countries. Although government spending limits are covered by a fiscal rule, neither balanced budget requirements nor limits to annual deficits are included. The fiscal rule also does not deal with the revenue side of the government budget and does not force a balanced budget during downturns. From here, the main technical work in setting the limits, as well as macroeconomic and budgetary forecasting and monitoring, is carried out by the Ministry of Finance, reflecting the shortcoming indicated in the table on independent institutions of chapter four (table 8). The decline of the medium-term budgetary framework strength can be related to the use of escape clauses initiated by the deterioration of the economic environment caused by the financial crisis. This framework is furthermore not legally binding, and thus rests on the commitment of the government.[236] Despite these shortcomings, the expenditure framework has ensured sufficient discipline and central government expenditures have been under control. Furthermore, the providence of macroeconomic projection by the Ministry of Finance have been proven to be prudent without negative budget surprises. [237]

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[234] See table 5 and 6 of chapter two.
[235] European Commission, ‘’ Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review’’, *European Economy Occasional Papers* 91 (2012), 129.
[236] European Commission, ‘’ Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review’’, 129.
[237] Ibidem, 130.

5.1.6: Challenges for the future and policy considerations.

The main ingredient for Finland's fiscal performance thus rests on the strength of political commitment between coalitions formed in the beginning of the new parliamentary term, complimented with a fiscal rule determining central government expenditures in combination with a multiannual framework. A budget balance rule is not in place. It would therefore be advisable to complement the existing expenditure ceilings with a budget balance rule formalised in legislation that can provide a robust correction mechanism in the case of an economic downturn.[238]

Unfortunately, this is currently the case in Finland, experiencing ever more difficult external circumstances, putting pressure on the political commitments who are most important for the formulation of the budget. As 2015 entails new elections for the Finnish government, polls indicate that an increase of dichotomy within the future coalition might be on the horizon, reflecting the current poor economic environment and a will to set aside current policy measures.[239] The need for stronger fiscal rules is therefore desirable.

Lastly, it will be hard for a new government to spend its way out of the recession. Government debt- and deficit levels are approaching the EU limits.[240] Further structural reforms are therefore needed and macroeconomic indicators need to be precisely monitored. Although the Ministry of Finance has a good history in the providence of these indicators, dispersed coalitions might put pressure on the deficit biases. An independent institution on the providence of macroeconomic projections and budgeting forecasts can therefore contribute to long-term stability, which is currently at stake. As J. Vartianinen, head of the Finnish Government Institute of Economic Research, states to Reuters in April of 2015; *'' We are not Greece but we are on the way there, that is quite shameful for a Nordic country."*[241]

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[238] European Commission, '' Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', *European Economy Occasional Papers* 91 (2012), 130.
[239] Reuters, '' Taste of its own medicine? Austerity overshadows Finland vote'', reuters.com/article/2015/04/12/us-finland-election-idUSKBN0N30JK20150412, consulted at 20-04-2015.
[240] Reuters, '' Taste of its own medicine? Austerity overshadows Finland vote'', consulted at 20-04-2015.
[241] Ibidem, consulted at 20-04-2015.

Chapter 5.2: Greece

It is been generally acknowledged that a root-cause of the current Greek crisis was not only the deterioration of its fiscal position, but also the opacity of public accounts.[242] Since the introduction of the Euro in Greece (2001) there have been several revisions of the government debt- and deficit levels. In October of 2009, the new government announces that the 2009 budget deficit was actually 12.9 percent, more than double the previously announced figure.[243] As a consequence, due to the erosion on credibility, financial markets reacted with a huge increase in Greek government bonds that made borrowing by the Greek state impossible.[244] In what way can we link the negative budgetary outcomes of Greece with the strength of their domestic fiscal framework?

5.2.1: The fiscal framework of Greece until 1993.

According to Alogoskoufis (1995), member of the Hellenic Parliament from September 1996 until October 2009, the post-war Greek economy had displayed two faces like the Roman god Janus. Prior to 1974, economic growth was second only to Japan among the OECD countries, with inflation rates at or below those of its partners. As Greece moved from a dictatorship to democracy in 1974, growth rates began to slow and inflation shot up 15-20 percent.[245] Greek fiscal policy was mainly driven by political considerations until 1990. Government budgets were therefore subjected to little discipline and deficits and government debt soared.[246] When the Maastricht Treaty was signed, fiscal aggregates were far from satisfying any of the criteria. The General Government deficit stood at 11.5 percent at the end of 1991 and the government debt was 83.3 percent and rising.[247]

The adjustment to the terms of Maastricht was going to be difficult. First, there was a greater need for fiscal discipline. In the cabinet under the first Papandreou government (1981-1989), the individual ministries made proposals for their budgets. The balance of power thus

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[242] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', *Hellenic Observatory Papers* No. 48 (2011), 5.
[243] Reuters, '' Timeline: Greece's economic crisis'', reuters.com/article/2010/02/03/us-greece-economy-events-idUSTRE6124EL20100203, consulted at 20-04-2015.
[244] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', 6.
[245] IMF, ''Greece: Selected Issues'', *IMF Staff Country Report* No. 98/100 (1998), 7.
[246] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', 6.
[247] V.G Manessiotis and R.D Reischauer, '' Greek Fiscal and Budget Policy and EMU'', in *Greece's Economic Performance and Prospects,* ed. R.C Bryant et al. (Athens and Washington: Bank of Greece and The Brookings Institution, 2001), 132.

represented a classic case of *fiefdom*.[248] Stronger ministers represented the big spending ministries such as defence, health and education. Although there was a minister of finance present in the cabinet, he was generally considered as the tenth or eleventh most powerful minister in the government.[249] Budgets were therefore subjected to little discipline. This resulted in a government spending that was significantly higher than the average of the four most comparable EU Member States (Ireland, Portugal, Italy and Spain). [250] In addition, there was a pronounced political fiscal cycle. In election years politicians increased spending and revenue growth decreased. The latter can be explained due to the fact that taxpayers realised that tax laws were not enforced in election years.

The Greek government and their policies could further be described as inefficient. The labour market relied on the government on the providence of jobs (the number of jobs rose with an average of 2.29 percent per year in contrast to only 0.55 percent in the balance of the economy) whereas the wages were particularly high (spending on public employees accounted for 12.7 percent of GDP, ranking just behind Denmark and Finland). Also, schemes like the social security system were highly complex, inefficient and inequitable.[251] These inefficiencies where also visible on the revenue side, where the Greek government relied heavily on tax. Here, compliance has long been a problem for Greece's revenue administrators.[252]

This latter problem has been a paradox of Greek governance. While Greece has shifted from an authoritarian regime to a liberal democratic structure, the political culture is traditionally marked by clientelism, rent-seeking and corruption. This culture has put a severe constraint on reform initiatives, particularly on politically sensitive issues, such as reforms on pension, health or labour systems. Major parties have been accused in a succession of scandals, and there is a long history of corruption with favours.[253]

Fortunately for Greece, 1993 marked a turning point in Greek economic and European policy. The climate for enhancing fiscal discipline improved.[254] Two factors were in particular

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[248] M. Hallerberg, *Domestic budgets in a United Europe: Fiscal governance from the end of Bretton Woods to the EMU*, 110.
[249] Ibidem, 110.
[250] V.G Manessiotis and R.D Reischauer, '' Greek Fiscal and Budget Policy and EMU'', 105.
[251] Ibidem, 107.
[252] Ibidem, 114.
[253] K. Featherstone, ''The Greek sovereign debt crisis and EMU: A failing state in a skewed regime'', *Journal of common market studies* Vol. 49:2 (2011), 196.
[254] B. Herz and A. Kotios, '' Coming Home to Europe: Greece and the Euro'', *InterEconomics* Vol 35:4 (2000), 1.

important. First, when a new government came into office in 1993, it became increasingly evident that past economic policies had failed. The new ruling socialist party (PASOK) therefore gave up old fashion Keynesian style policy. Second, due to a high popularity of the idea that Greece could participate in the EMU and a dominant pro-European sentiment, policy change became easier to bare.[255]

5.2.2: How did Greece manage to reach the Maastricht criteria?

With a new socialist government in 1993, a first phase of convergent policy was initiated (1994-1997). The introduced policy mix however, can be characterized as inconsistent and inappropriate.[256] Budget centralization did not occur due to a chronically ill prime minister (A. Papandreou).[257] The government started with an adjustment policy that was based on higher tax revenues, high interest rates and a real devaluation of the Drachma. Still, on the other hand, the government continued with its expansionary income policy and did not cut real consumptive public expenditures. Also, structural reforms necessary to improve the supply-side of the economy were postponed. While there was some improvement in the macroeconomic performance, the policy mix was incapable to bring Greece in line with the convergence criteria of Maastricht.[258]

After three years A. Papandreou was replaced by K. Simitis who pledged to meet the Maastricht criteria. Simitis merged the responsibility of the ministries of Economy and Finance under one person, Y. Papantoniou. On paper, this new minister now had the final word on all ministry budgets and thus could make cuts in spending where necessary. He started by freezing public wages, cuts on subsidies and was set out to close loopholes that allowed individual ministries to overspend their assigned budgets. Most importantly, he also started enforcing taxes. This resulted in a revenue increase of personal taxes which increased with 20 percent in 1997 and another 27 percent in 1998. The increase in tax revenues was also visible on the corporate income tax, increasing with an impressive 57 percent in 1998.[259] Lastly, the Greek central bank was granted independence, thereby fulfilling one of the EMU

[255] B. Herz and A. Kotios, ‘’ Coming Home to Europe: Greece and the Euro’’, *InterEconomics* Vol 35:4 (2000), 170
[256] B. Herz and A. Kotios, ‘’ Coming Home to Europe: Greece and the Euro’’, 171.
[257] M. Hallerberg, *Domestic budgets in a United Europe: Fiscal governance from the end of Bretton Woods to the EMU*, 111.
[258] B. Herz and A. Kotios, ‘’ Coming Home to Europe: Greece and the Euro’’, 172.
[259] M. Hallerberg, *Domestic budgets in a United Europe: Fiscal governance from the end of Bretton Woods to the EMU*, 112.

requirements. At the same time, the Drachma was further devaluated with 12.3 percent relative to the European Currency Unit (ECU).[260]

On paper, the consolidation efforts seemed to work. The budget deficit was brought back to -4.0 percent in comparison with -10.1 percent in 1995. In 1998, the budget deficit was comfortably below the convergence criteria of Maastricht.[261] The debt ratio also declined to 104.4 percent, and although this was strictly not under the reference value, it was confirmed as 'sufficiently diminishing and approaching the reference value at a satisfactory pace'.[262] Inflation also fell from 23.3 per cent in 1990 to 3.9 percent in 2000 due to the 'hard drachma' policy.[263] Consequently, the European Commission and European Central Bank concluded that Greece fulfilled the convergence criteria by the spring of 2000.[264]

Nevertheless, although it seemed that the consolidation policies were successful, the Greek government admitted in 2004 that deficit figures were manipulated.[265] Although M. Hallerberg (2004) speaks of a certain 'Maastricht effect' in the case of Greece[266], he did not foresee that the political imperative to join the euro were so strong, that the Greek government engaged in fraud and 'creative accounting' in order to meet the criteria as soon as possible.[267] It is therefore difficult to assess whether or not the improvements of the fiscal policy were genuine. But the Greek example was not unique. As it turned out, several countries like France, Italy and Germany all engaged in different forms of creative accounting in order to polish up fiscal results.[268]

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[260] B. Herz and A. Kotios, '' Coming Home to Europe: Greece and the Euro'', 171.
[261] M. Hallerberg, *Domestic budgets in a United Europe: Fiscal governance from the end of Bretton Woods to the EMU*, 112.
[262] Vox CEPR's Policy Portal, '' The politics of the Maastricht convergence criteria'', voxeu.org/article/politics-maastricht-convergence-criteria, consulted at 21-04-2015.
[263] As part of the convergence program, the Bank of Greece engaged in a foreign-exchange policy known as the "hard drachma" policy. Source: E. Seyler and J. Levendis, '' What was the role of monetary policy in the Greek financial crisis'', *South-Eastern Journal of Economics* Vol. 11:2 (2013), 118.
[264] B. Herz and A. Kotios, '' Coming Home to Europe: Greece and the Euro'', 172.
[265] BBC news, '' Greece admits fudging euro entry'', news.bbc.co.uk/2/hi/business/4012869.stm, consulted at 24-04-2015.
[266] M. Hallerberg, *Domestic budgets in a United Europe: Fiscal governance from the end of Bretton Woods to the EMU*, 112.
[267] BBC news, '' Greece admits fudging euro entry'', news.bbc.co.uk/2/hi/business/4012869.stm, consulted at 24-04-2015.
[268] J. von Hagen and G.B Wolff, '' What do deficits tell us about debt? Empirical evidence on creative accounting with fiscal rules in the EU'', *Studies of the Economic Research Centre* No. 38 (2004), 7.

5.2.3: Did fiscal governance in Greece improve after the implementation of the Euro?

As Greece adopted the euro on the first of January 2001, GDP growth started to pick up speed (see figure 3). Still, fiscal imbalances were never effectively brought under control. The most fundamental reason has been the weak institutional framework of budgeting and tax administration.[269] As fiscal consolidation started to lose momentum in the Eurozone after the implementation of the Euro, Greece engaged in its old tradition of expansionary fiscal policy. Although Greece's real GDP expanded at an average of 4.2 percent between 2000 and 2007, it was mainly driven by a rapid increase in domestic demand whereas the overall contribution of the external sector being on average, negative.[270] The results of the expansionary fiscal policy over the first years of the SGP can be seen in the deficit tables 3 and 5 of chapter two, where Greek deficits surpassed the reference value continuously during the SGP period.

So how can the high deficits of Greece be explained? Most important, it's because of the incompetence of the government to control expenditures and to collect budget revenues. The Greek fiscal system had a poor mechanism of setting up the budget and lacked systematic monitoring of its implementation, despite the minor institutional reforms of the 1990's.[271] According to the OECD (2008); *'' As in many countries, the Greek budget lacks strong top-down procedures, does not cover all government expenses, and has a very detailed input focus.''*[272]

The Greek budget preparation was to a large extent a bottom-up exercise, where ministries enjoy a large decree of freedom to propose spending wishes with little incentives to reallocate or prioritize spending.[273]Although the parliament has a powerful constitutional role in voting the state budget (also by Ministry), mechanisms to follow up budgetary execution and monitor developments on public expenditures and revenues were not in place. Also information about healthcare, the social security system and local government appeared only in a fragmented manner or was largely missing.[274] Coherent information systems that enable the production of detailed overviews regarding the total public revenues and –expenditures were absent, resulting in the lack of a unitary budget. As of 2009, the government budget was

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[269] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', *Hellenic Observatory Papers* No. 48 (2011), 8.
[270] E. Athanassiou, '' Fiscal Policy and the Recession: The Case of Greece'', , 364.
[271] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', 8.
[272] I. Hawkesworth et al, '' Budgeting in Greece'', *OECD Journal on Budgeting* No. 3 (2008), 9.
[273] I. Hawkesworth et al, '' Budgeting in Greece'', 10.
[274] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', 8.

based on some 14.000 separate 'budget lines' where each line represented grouped items of expenditure within parts of the public administration.[275]

Second, the government consistently based its fiscal forecasts on an optimistic outlook for the whole economy. Although a fiscal institution was established in 1959 (The Centre of Planning and Economic Research, KEPE), it did not had a formal role in the budgetary process. The government does not use the outputs and does not have to justify departures from KEPE's forecasts and assessments.[276] Thirdly, the government drafted the budget in November for the following calendar year only. It therefore misses budget implications that go beyond the yearly budgetary cycle. A medium-term budgetary framework therefore did not exist in Greece until 2010.[277]

Lastly, Greece has poor preforming tax administration mechanisms in place. Widespread tax evasions are common, therefore missing additional revenues. Much of the tax reforms that are introduced year by year usually involve changes of tax rates and tax bases, while structural weaknesses of the tax administration system remain intact.[278] Consequently, budget revenues did not its way into the public purse, while expenditures were not kept under control. Government revenue forecasts were inflated and expenditures underestimated. This was a consequence of the weak institutional framework.[279] As G. Kaplanoglou and V.T Rapanos (2011) write: *''Greece is a prime example of how poor fiscal governance, if combined with other negative factors such as the instability of global financial markets, can indeed lead an economy to the brink of financial collapse and at the same time create a systemic problem for a common-currency area as a whole.''*[280]

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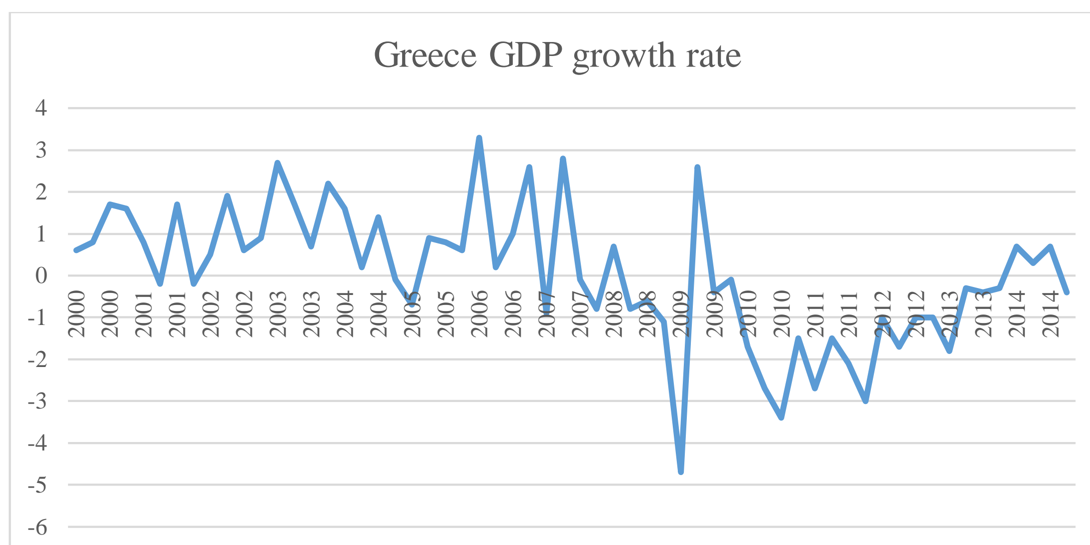
[275] Ibidem, 22.
[276] European Commission, ''Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', *European Economy Occasional Papers* No. 91 (2012), 18.
[277] E.J. Lundback, '' Medium-Term Budgetary Frameworks – Lessons for Austria from International Experience'', 29.
[278] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', 30.
[279] Ibidem, 20.
[280] Ibidem, 44.

Figure 3: Greece's GDP growth rate, 2000-2014.



Source: Tradingeconomics, tradingeconomics.com/greece/gdp-growth-annual, consulted at 22-04-2015.

5.2.4: Reforms after the outbreak of the financial crisis

The financial crisis pushed Greece far beyond the limits of the SGP. With an overall fiscal deficit of 15.5 percent and a public debt of nearly 130 per cent at end-2009, Greece had no option but to undertake a sizeable adjustment when capital inflows that financed them came to a sudden stop in early 2010.[281] Still, despite the challenging economic and financial situation, Greece's fiscal framework remains underdeveloped.[282] This does not mean however that structural reforms were absent after the outbreak of the financial crisis. A reform impetus has been created that has been particularly strong in the euro area countries that asked for assistance from the ECB and the IMF. Some of the following measures can therefore be linked to the obtained financial assistance.[283] The fact that Greece's fiscal framework remains under-developed can be contributed to the complexity of the current institutional framework and the time-consuming progress of reforms, especially considering the high dynamic

[281] IMF, '' Greece: Fifth Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Waiver of Nonobservance of Performance Criterion and Rephasing of Access; Staff Report; Press Release; and Statement by the Executive Director for Greece'', *IMF Country Report* No. 14/151 (2014), 4.
[282] European Commission, ''Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', *European Economy Occasional Papers* No. 91 (2012), 16.
[283] OECD, ''Economic Policy Reforms: Going for growth 2012'', oecd.org/eco/monetary/economicpolicyreformsgoingforgrowth2012.htm, consulted at 24-04-2015.

electoral situation in Greece which creates a highly volatile environment that makes it difficult for any government to complete reforms.[284]

A substantial reform effort was introduced with the passing of Law 3871/2010 on ''Fiscal Management and Responsibility''. First, this new law has introduced a medium-term budgetary framework (three-year) for the central and general government. The framework includes detailed fiscal targets, a reference to the use of macroeconomic assumptions on which fiscal forecasts have to be based, multiannual targets, etc. Secondly, a new top-down approach has been introduced for public expenditure. The Ministry of Finance will be able to impose a ceiling on the expenditure of ministries, local authorities and on social budgets.[285] These bodies are now required to draft annual budgets and communicate with the General Budget Accounting Office on a monthly basis. From here, the General Budget Accounting Office have to submit to the Parliament and press in order to enhance transparency.[286] Thirdly, new laws are implemented on the reform of the Social Security System (Law 3863/2010), National Health System (Law 3868/2010) and the Local Government and Regional Administration (Law 3852/2010), which should contribute to further cost savings.[287]

However, despite the considerable progress, important challenges and risks are still ahead with regard to the achievement of fiscal targets. Most importantly, this is a consequence of the lower than expected collection of revenues, mostly due to tax evasion. N. Artavanis et.al. (2015) write; *'' Using individual-level household-lending data across different credit products and samples, we conservatively estimate that at least 28 billion euros of income went untaxed in Greece for 2009. At the tax rate of 40%, the foregone tax revenues account for 32% of the county's deficit.''*[288] It is therefore necessary to reform the tax mechanism, especially with regard to combating tax evasion.[289] Although some reform measures have been implemented since the financial crisis, this problem is still very vivid in the Greek economy.[290] Key indicators on tax administration have improved in 2013 relative to 2012, but

[284] IMF, '' Request for Extended Arrangement under the Extended Fund Facility'', *IMF Country report* No. 12:57 (2012), 9.
[285] The Bank of Greece, ''Interim report 2010'', *Monetary Policy* (2010), 22.
[286] G. Kaplanoglou and V.T Rapanos, '' The Greek Fiscal Crisis and the Role of Fiscal Governance'', 27.
[287] The Bank of Greece, ''Interim report 2010'', Monetary Policy (2010), 22.
[288] N. Artavanis, A.Morse and M. Tsoutsoura, '' Tax Evasion across Industries: Soft Credit Evidence from Greece'', *Chicago Booth Research Paper* Vol 12:25 (2015), 36.
[289] The Bank of Greece, ''Interim report 2010'', 23.
[290] Reuters, ''Greek finance minister's letter to the Eurogroup'', reuters.com/article/2015/02/24/us-eurozone-greece-text-idUSKBN0LS0V520150224, consulted at 28-04-2015.

are still falling short of the targets due to political interference in operations and a slow roll-out of reforms to local tax offices.[291]

Further progress should also be aimed at the establishment of Fiscal Council or an Office of Fiscal Responsibility. Although Law 4270/2014 foresees the creation of an independent fiscal watchdog, it is never been activated and remains inoperative due to the lacking of management or staff.[292] This should further complement fiscal information on local governments as this remains very limited. Although the government has set expenditure ceilings for the state and deficit targets for various government sectors, there is still a lack of an adequate monitoring of intra-year budgetary developments for the government as a whole.[293] Lastly, there are currently no fiscal rules in Greece, which explains the (relatively) low score on the Fiscal Rule Index of chapter four. The small increase of this indicator can be contributed to the implemented MTBF with some binding ceilings on the expenditure side. Still, fiscal rules like a revenue rule for the general government are not in place.[294]

This is also the case for structural reforms, especially on the supply side. As the Greek economy boomed in the first decennium of the 2000's, real wage growth has consistently outpaced productivity gains, resulting in an eroded external competitiveness. Currently Greece is lagging behind on productivity enhancing reforms. Due to the political turmoil in 2011-2012, adjustment has been through recessionary channels (compression of real spending and income) rather than productivity gains. As a consequence, price declines in Greece have not been proportional with wage declines, reflecting rigidities in product and service markets.[295] Excessive restrictions remain that raise the cost of doing business and inhibit the establishment or expansion of larger firms, the minimum wage system is still problematic, and collective dismissals are de facto not allowed.[296] In sum, Greece should put a greater emphasis in bolstering the competitiveness and flexibility of the economy.

[291] IMF, '' Greece: Fifth Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Waiver of Nonobservance of Performance Criterion and Rephasing of Access; Staff Report; Press Release; and Statement by the Executive Director for Greece'', 7.
[292] Reuters, ''Greek finance minister's letter to the Eurogroup'', consulted at 28-04-2015.
[293] European Commission, ''Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review'', *European Economy Occasional Papers* No. 91 (2012), 16.
[294] European Commission, ''Fiscal frameworks across Member States: Commission services country factsheets for the autumn 2013 Peer Review'', 29.
[295] IMF, '' Greece: Fifth Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Waiver of Nonobservance of Performance Criterion and Rephasing of Access; Staff Report; Press Release; and Statement by the Executive Director for Greece'', 4-5.
[296] Ibidem, 19.

Chapter 5.3: Conclusion

In this chapter, two Member States are picked for an in-depth review according to the compliance results of chapter two. Here, Finland can be picked as a well-behaved Member State whereas Greece can be picked as a wrongdoer.

The 'Finnish miracle' can be contributed to the strong commitment of governments to follow-up a consistent consolidation policy as well as a set of relatively successful structural reform measures. As the Finnish economy experienced a severe recession in the beginning of the 1990's which can be summarized as *''a tale of bad luck and bad policies''*, the Finnish government of 1995 chased a new consolidation policy connected with both institutional- and structural reforms. From here, Finland followed an atypical pattern of industrial development transitioning from a nature-resource based economy into one that relies heavily on high technology and knowledge. Reforms were also implemented with regard to the Finnish fiscal framework. As from the 1990's, Finland had implemented a MTBF setting spending targets for individual ministers. Also lower governments in practice adhered to a balanced budget, reflecting a strong commitment-based government apparatus.

The current fiscal framework of Finland has been established in 2003 and is anchored around multi-annual expenditure ceilings, mirroring the previous fiscal framework of 1991. Although several elements that form a resilient fiscal framework were not in place, results suggests that governments tend to abide by the rules. This latter conclusion however may also be a fundamental weakness to the Finnish fiscal framework. As a consequence of an unfavourable external environment, Finland is currently undergoing an economic slowdown. This in combination with a shifting and volatile political landscape makes it questionable if the reliance on political commitment is sufficient enough to be sustainable on the long run. It is therefore advisable to complement the current fiscal framework with additional fiscal rules as well as an independent fiscal forecaster in order to enhance correctional- and monitoring mechanisms. Lastly, as a consequence of a lacking productivity growth, an ageing society and a decrease of competitiveness, structural reform measures should be implemented in order to boost economic growth.

Whereas Finland relies on a strong political commitment, the opposite is true for Greece. As Greece transitioned from a dictatorship to a democracy, the institutional framework mirrored a classic case of *fiefdom*. Greek fiscal policy was mainly driven by political considerations, resulting in overspending ministries and an ineffective down-top

approach on budgeting. Although some reform measures where undertaken on the road to the Euro, the government revealed that the Maastricht criteria were satisfied through fraud and 'creative accounting'. After the implementation of the Euro, the Greek government returned to its old course of expansionary fiscal policy while macroeconomic imbalances where persistent. The financial crisis exposed the unsustainable fiscal position of Greece, resulting in a sudden stop of capital inflows. As bankruptcy suddenly came closer, a reform impetus was created as Greece sought financial assistance. Greece had no other option but to undertake a sizeable adjustment.

Since then, several reform measures have been implemented in Greece. As from 2010, a medium-term budgetary framework is in place, setting multiannual targets for the government. Furthermore, a new top-down approach on budgeting is implemented, where expenditure ceilings have created for individual ministries and local governments as well as cost-saving policies for healthcare, the social security system and regional administration. Unfortunately, Greece's fiscal framework still remains under-developed. This can be contributed to the complexity of the institutional framework, the time-consuming progress on reforms and the current highly volatile political landscape. Current challenges lie in reforming the tax mechanism and structural reforms which are currently difficult to accomplish. The same is applicable for the implementation complementary fiscal rules and an independent Fiscal Council or Office of Fiscal Responsibility. Although for the latter an implementation law was passed in 2014, it is never been activated and remains inoperative due to the lacking of management or staff.

The case-studies of Finland and Greece adds strength to the outlined theory of the political economy of M. Hallerberg and co-authors, arguing for an appropriate budgeting procedure according to the country's political system. Successful periods of consolidation in Finland can be contributed to the strong commitment of politicians to abide by the rules, an early implemented MTBF with strong characteristics and a successive implementation of structural reforms which turned Finland from a country that relied on natural exports, to a country with a high skilled labour force and efficient tech-industry. The exact opposite is true for Greece. Here, fiscal policy was mainly driven by politics resulting in overspending ministries without a sufficient form of centralization of the budget. Although Hallerberg argues that Greece moved in the late 1990's from *fiefdom* to a *delegation* form of fiscal governance, the financial crisis has showed that a resilient fiscal framework is needed to be sustainable in the long run. This is both relevant for Greece and Finland. The financial crisis

might have an impact on the reliance of commitment in Finland, which makes the implementation of additional fiscal rules and a strong independent fiscal institution desirable. For Greece, the implementation of strong austerity measures imposed by its current financial lenders, have also contributed to a volatile environment. Although this might also indicate a well-functioning democracy, additional fiscal instruments will protect Greece for mistakes made in the past. A reform impetus might be created after the financial crisis, but it remains to be seen if current reform measures and those of the future will be continued in order to enhance Greece’s economic and fiscal position within the monetary union of Europe.

Chapter 6: General summary

Throughout the SGP-period, member states have been showing mixed results with regard to the fiscal rules stipulated in the Treaty of Maastricht. Although the fear of not being allowed to take part of the Euro was enough to create a consolidation impetus, this positive effect evaporated after the implementation of the SGP and the Euro. Consequently, the Pact has been reformed several times to address its flaws. Still, many member states adopted the requirements of the SGP on the surface while maintaining the legacy of past fiscal profligacy, weak domestic fiscal frameworks and the engagement in creative accounting and 'one-offs'. The consequences thereof can be seen in the aftermath of the financial crisis, where several countries now face painful austerity measures and structural reforms in order to prevent defaulting on a domestic level and the collapse of current the monetary system as a whole.

This research is aimed at providing answers on the question *why* member states have been showing mixed results under the same external constraints. Starting by analysing the results of the past, two explicit structural patterns of wrongdoers have emerged in the literature. During the first years of the SGP, especially the large countries (France, Germany and Italy) have shown non-compliance with the SGP criteria. This was also noticed by the European Commission in 2003, and they therefore advised the ECOFIN Council to start its corrective arm in order to correct their behaviour. The ECOFIN Council ignored the advice, mirroring a loss of credibility of the Pact due to the considerable political influence of these large countries. As a result of this 'compliance crisis', the Pact was reformed in 2005, introducing even greater discretion, leniency and political control into the procedures.[297] When the financial crisis hit, member states were 'distinctly ill-prepared'. Public finances started to worsen over the whole Euro area. This was especially the case for a second group of wrongdoers, conspicuously called 'the PIIGS', an acronym for Portugal, Ireland and/or Italy, Greece and Spain.

So why should the large countries have difficulties adhering to the rules of the SGP? The literature provides numerous reasons. Large countries have higher consolidation costs, experience slower economic growth, are less susceptible to peer pressure and have more bargaining power. While the political ownership of the SGP shifted to the smaller countries over time, they still had little influence with their peers. Moreover, small countries are more

[297] L. Schuknecht et.al., '' The Stability and Growth Pact, Crisis and Reform'', 10.

accustomed to peer pressure and political influence. They tend to suffer more from reputational costs and imposed fines when they do not comply. Also, high growth volatility and lower consolidation costs usually results in a stronger fiscal discipline. Over time, smaller countries performed better under the SGP than the large ones.

In contrary to the large countries, the PIIGS decided to replicate the fiscal policies of their more prosperous member partners rather than adjusting in real terms. The PIIGS were plagued with macroeconomic imbalances, slow economic growth rates, a loss of competitiveness and productivity, and rigid labour markets. Although the underlying root causes for their problems tend to differ between these member states, the all had one thing in common, an out of control expansion of government debt. They furthermore, just like their counterparts, engaged in creative accounting and 'one-offs' while maintaining procyclical fiscal policies.

The financial crisis has exposed fundamental weaknesses on a domestic institutional level. As a result, the SGP has been reformed again in order to tackle initial gaps in the EMU architecture. The first set of reforms entered into force at the end of 2011, also known as the 'Six-Pack' followed by a 'Two-Pack' and a 'Fiscal compact'. Where the SGP reform of 2005 called for increasing flexibility, these new set of rules are aimed at strengthening the adherence to the SGP trough the improvement of monitoring tools and EU's economic governance rules in order to reinforce economic coordination between member states. Still, scholars remain sceptical, especially regarding the seeming unwillingness of member states to transfer the necessary degree of sovereignty over macro-fiscal objectives to the European level. As it turned out, *'' important flanking policies to the fiscal exit will include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability.''*[298]

This raises the following question; can we relate the mixed compliance outcomes under the SGP with the strength of domestic fiscal frameworks? In the end, the literature stipulates a 'plethora of interrelated factors that can all act to feed the deficit bias and generate suboptimal fiscal policy'. European governments are all prone to deficit and debt biases that are likely to emanate from the democratic political process. Main root causes are the common pool problem, the use of pro-cyclical fiscal policies and the political cycle of a country, who

[298] The Council of the European Union, ''Press release'', Council meeting 2967 (2009).

can all feed the deficit and debt bias. Fortunately, research have also provided us with number of instruments and solutions to this problem.

Starting with an institutional approach derived from the theoretical political economy, von Hagen and co-authors argue that a decentralized or fragmented policy process leads to weaker fiscal discipline than a centralized one. The solution for a co-ordination problem in domestic budgetary procedures it thus 'centralization'. In order to achieve this, M. Hallerberg (2004) argues that political institutions are highly relevant. According to the electoral system, countries should engage in a 'delegation', 'contract' or 'mixed' form of governance, where countries using the contract form of governance, usually are associated with better compliance outcomes with the SGP. This is because in the contract approach, governments negotiate a 'fiscal contract' involving strict budget targets, thereby 'fitting snugly' with the SGP. Unfortunately, besides the work of von Hagen and co-authors, there is little research on the choice of governance. I therefore put an emphasis on the following instruments:

1) *Independent forecasters:* These institutions are regarded as promising by the literature. They can be the first line of defence against overly optimistic growth assumptions, fraud and creative accounting, and can mark-up reputational costs by setting transparent benchmarks. From here, I consider three important channels in order to be effective. First, the provision of independent analysis on fiscal policy issues. Second, The provision of unbiased inputs for the annual budget preparation. Most importantly, macroeconomic forecasts on which budgetary projections are based. And last, the issuing of regular assessments and recommendations relating to different aspects of fiscal policy. The use of independent forecasters is currently monitored by the European Commission.
2) *County-specific numerical fiscal rules:* Fiscal rules can provide a permanent constraint on fiscal policy and come in the following forms; budgetary balance rules, debt rules, expenditure- and revenue rules. Here, one of the most promising forms of fiscal rules are *expenditure rules*. These rules in particular have received increasing attention both by literature as well as the European Commission. The use of these rules is also monitored by the European Commission and compressed in an index for each Member State (FRI). The FRI is thus a single comprehensive score per country per year.
3) *The use of a medium term budgetary framework (MTBF):* Since a single year perspective provides a poor basis for fiscal planning, MTBFs can contribute to long term sustainable fiscal planning. This instrument can help to governments to extend

the horizon for fiscal policy making beyond the annual budgetary calendar. Although this is a fairly new concept, the use of a MTBF is currently required by EU law, and monitored in a MTBF strength-index.

4) *Structural reforms:* The economic crisis highlighted the existence of an important interaction in a monetary union between fiscal and structural policies at national level. Currently, the EU is facing slow economic growth, competitiveness problems and a deterioration of productivity levels. Here, supply-side policies can be especially effective in increasing the effectiveness of demand-side policies and help empower demand. Key indicators are therefore employment barriers and barriers to entrepreneurship. The OECD reports annually on these indicators in their 'Going for Growth' report.

In this research I have analysed the strength of these instruments based on summarizing indicators and whether or not they coincide with the structural results found in chapter two. The hypothesis is thus that wrongdoers should show weaker indicators on these instruments than their better preforming counterparts. Regarding the use of independent institutions, fiscal rules and MTBF's, I found that especially the PIIGS show relatively weak domestic fiscal frameworks. Between these countries, especially Greece is currently facing difficulties. After its transition to democracy in the 1970's, Greek fiscal policy was mainly driven by political considerations, resulting in overspending ministries and an ineffective down-top approach on budgeting thus representing a classic case of *fiefdom*. As the rest of the PIIGS, Greece relaxed its fiscal policies after the implementation of the Euro. It furthermore engaged in fraud and creative accounting in order to reveal rising levels of government debt and deficits. Not being sustainable in the long run, Greece had to admit forgery, sparking a succession of violent shocks spread out over the European continent.

In contrary, the small countries (the Netherlands, Luxembourg, Denmark, Finland and Sweden) show relatively strong scores. Finland and Luxembourg however remain outsiders. Luxembourg is still missing a MTBF whereas Finland lacked an independent fiscal forecaster until recently. This latter observation is especially odd, since Finland can be considered as one of the best preforming countries in the EMU. Still, according to the in-depth review, this success can be contributed to a firm MTBF implemented in the 1990's and the strong commitment of politicians to abide by the rules. The large countries showed mixed indicators, although Italy stands out. Where this country can also be associated with the PIIGS, Italy is the third largest economy in the euro zone. During the SGP-period Italy scored relatively

weak on the use of independent forecasters and fiscal rules in comparison with its large- and small counterparts.

Now that the dust of the financial crisis is currently clearing up, especially the southern countries are facing structural difficulties with their economies in general. The key indicators on structural reforms however show mixed results between all the groups. In the small countries, Belgium, Austria and Luxembourg all score relatively weak with regard to the OECD benchmark. The fact that structural reforms are also needed in the small countries is further exemplified by Finland. Due to globalization, Finland is currently facing more competition with regard to its tech-sector. It furthermore has to deal with an increasing ageing society, a lower productivity, high wages, a relatively high unemployment and an old-fashioned pension system. Structural reforms may be solution for long-term sustainability as it will be hard for a new government to spend its way out of the recession.

Between the large countries, especially France and Italy are still showing high levels of employment protection legislation and high administrative burdens to start-ups. Comparative levels can be seen for the PIIGS, although Ireland is relatively flexible. This 'Celtic Tiger' implemented a wide range of policies to foster productivity in the second part of the 20th century. As a result, Irish productivity growth consistently outpaced other advanced economies from the 1970's onwards. Still, while Irelands pre-Tiger supply policies may have been effective, it still lacked macroeconomic stabilization policies, turning them from a 'Tiger' into one of the PIIGS.[299]

So can we explain the mixed outcomes under the SGP by looking at the strength of domestic fiscal framework? Yes and no. This hypothesis can be confirmed for the PIIGS whereas the small countries show a more resilient framework in general. In almost all of the PIIGS, domestic fiscal frameworks were weak before the outbreak of the financial crisis. The in-depth review of Greece describes the consequences in detail. This case is a prime example on how a lack of constraint for policy makers and an inappropriate institutional setting, results in an increasing debt- and deficit bias while not being sustainable on the long run.

However, outcomes tend to be mixed between the large and the small countries. Within the large countries, Italy can be framed as a wrongdoer. Although Italy is also commonly referred to as one of the PIIGS, this hypothesis faces difficulties in explaining divergent

[299] K. Whelan, '' Ireland's economic crisis: The good, the bad and the ugly'', *UCD centre of economic research working paper series* WP 13/06 (2013), 2.

results of the other large countries. Both France, Germany and the UK have (almost) equally implemented fiscal rules, independent institutions and MTBF's, showing only marginal differences between the small countries. Thus, in order to explain the divergent results of the large countries, we must also focus on other explanations provided by the literature such as higher consolidation costs, political ownership etc.

Within the small countries, the hypothesis seems to apply more for the Nordic countries including the Netherlands and Luxembourg (although the latter is still missing a MTBF). Still, Belgium and Austria are definite outsiders, who can mainly be characterized by high government debt levels. In general, they have scored above average on the tested indicators. This is especially true for Belgium, who scores well on the fiscal rule indicator from the beginning of the 1990's onwards to the implementation of the Euro. From there, Belgium started to lose ground in comparison with the EU-average. Can this be contributed to adjustment fatigue due to Maastricht? Austria on the other side, scores relatively low on the fiscal rule indicator although it also had an independent fiscal forecaster and MTBF in place.

Lastly, due to the existing degree of political integration in the EMU, is internal adjustment rather than attempting to re-design the rules from scratch a more suitable way to bring about progress? Here, the answer is also ambivalent. The indicators on domestic fiscal frameworks show that since the implementation of budgetary rules on an EU-level, individual scores have increased. Furthermore, due to the financial crisis, the European landscape is becoming more volatile, which might have an impact on member states relying on commitment to abide by the rules. When commitment start to fail, fiscal instruments will be needed to constrain policy makers. Still, rules on a European level tend to be non-specific. Instruments need to be stipulated according to criteria as cited by Kopits and Symansky in order to be effective. This however, will be difficult. As L. Schuknecht et.al (2011) write: *'' The latest reforms continue to reflect Member States' unwillingness to transfer the necessary degree of sovereignty over macro-fiscal objectives to the European level.''*

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