Two policy topics

- Fiscal policy in the EU and the stability pact
  - are the rules falling apart?
- European unemployment
  - labour market reforms and pay-setting systems

Fiscal policy in the EU and the stability pact

- **The current rules**
- **The current fiscal policy situation**
- **How appropriate are the current rules?**
- **How well adapted are the current rules to the new EU states?**
- **Enforcement of the rules**
- **Can EU rules work?**

The current fiscal policy rules

- **Both in the Treaty and in the stability pact (Stability and Growth Pact)**
- **Maximum government budget deficit of 3 percent of GDP**

  - unless abrupt GDP fall (2 percent or 0.75 – 2 percent)
- **Maximum government gross debt of 60 percent of GDP**

  - or if the debt ratio is higher it should be falling ”at a satisfactory pace”
- **Excessive deficit procedure**

  - recommendation from the Ecofin Council

  - the Ecofin Council can give notice to a member state

  - deposit (maximum 0.5 percent of GDP initially, then maximum 0.3 percent of GDP)

  - the deposits can be transformed to fines
- **Medium-term fiscal objective of “close to balance or surplus”**

  - implicit long-term objective of zero net government debt
- **“Multilateral surveillance”**

  - stability (convergence) programs

  - early warnings
- **No-bail-out clause**

Net lending old member states (percent of GDP)

	2003	2004	2005
Austria	-1,1	-1,1	-1,9
Belgium	0,2	-0,5	0,7
Finland	2,3	2,0	2,1
France	**-4,1**	**-3,7**	**-3,6**
Germany	**-3,9**	**-3,6**	-2,8
Greece	-3,0	**-3,2**	-2,8
Ireland	0,2	-0,8	-0,1
Italy	-2,4	**-3,2**	**-4,0**
Luxembourg	-0,1	-2,0	-2,3
Netherlands	**-3,2**	**-3,5**	**-3,3**
Portugal	-2,8	**-3,4**	**-3,8**
Spain	0,3	0,4	0,6
Euro-area	-2,7	-2,7	-2,6
Denmark	1,5	1,1	1,5
Sweden	0,7	0,2	0,7
UK	**-3,2**	-2,8	-2,6
EU-15	-2,6	-2,6	-2,4

Source: European Commission (2004)

Net lending new member states (percent of GDP)

	2003	2004	2005
Cyprus	**-6,3**	**-4,6**	**-4,1**
Czech Republic	**-12,9**	**-5,9**	**-5,1**
Estonia	2,6	0,7	0,0
Hungary	**-5,9**	**-4,9**	**-4,3**
Latvia	-1,8	-2,2	-2,0
Lithuania	-1,7	-2,8	-2,6
Malta	**-9,7**	**-5,9**	**-4,5**
Poland	**-4,1**	**-6,0**	**-4,5**
Slovakia	**-3,6**	**-4,1**	**-3,9**
Slovenia	-1,8	-1,7	-1,8
EU-10	**-5,7**	**-5,0**	**-4,2**

Source: European Commission (2004)

Government debt old member states (percent of GDP)

	2003	2004	2005
Austria	65,0	65,5	65,3
Belgium	100,5	97,4	94,3
Finland	45,3	44,5	44,3
France	**63,0**	**64,6**	**65,6**
Germany	**64,2**	**65,6**	**66,1**
Greece	103,0	102,8	101,7
Ireland	32,0	32,4	32,6
Italy	106,2	106,0	106,0
Luxembourg	4,9	4,5	3,8
Netherlands	54,8	56,3	58,6
Portugal	**59,4**	**60,7**	**62,0**
Spain	50,8	48,0	45,1
Euro-area	**70,4**	**70,9**	**70,9**
Denmark	45,0	42,3	40,0
Sweden	51,9	51,8	50,5
UK	39,9	40,1	40,6
EU-15	**64,0**	**64,2**	**64,2**

Source: European Commission (2004)

Government debt new member states (percent of GDP)

	2003	2004	2005
Cyprus	**72,2**	**74,6**	**76,9**
Czech Republic	37,6	40,6	42,4
Estonia	5,8	5,4	5,3
Hungary	59,0	58,7	58,0
Latvia	15,6	16,0	16,1
Lithuania	21,9	22,8	23,2
Malta	**72,0**	**73,9**	**75,9**
Poland	45,4	49,1	50,3
Slovakia	42,8	45,1	46,1
Slovenia	27,1	28,3	28,2
EU-10	42,2	44,4	45,2
Euro-area	**70,4**	**70,9**	70,9
EU-15	**64,0**	**64,2**	64,2
EU-25	**63,1**	**63,4**	63,4

Source: European Commission (2004)

Motives for EU-level fiscal policy rules

1. **General need for fiscal discipline**

   - the establishment of EMU implied a unique opportunity to devise fiscal policy rules at the European level that could not be devised at the national level

2. **Stronger fiscal policy externalities (spillover effects) among countries in a monetary union**

   - other countries or the ECB might be forced to bail out insolvent government

   - fiscal theory of the price level: long-run solvency of government sector in the case of unsustainable fiscal policy is attained through ”jump” of the price level, which reduces the real value of outstanding government debt

   - expansionary fiscal policy in one country affects interest rates and the exchange rate for all countries in a monetary union

Fiscal policy rules should be:

- **Simple**
- **Appropriate**
- **Legitimate**
- **Verifiable**
- **Flexible**
- **Enforceable**
- **Not give rise to political conflicts**

Current rules

- **Simple: yes**
- **Appropriate?**

  - no theoretical basis for exact deficit and debt limits

  - inappropriate definition of debt: gross debt instead of net debt or net worth

  - why medium-term budget objective of ”close to balance or surplus” implying long-run objective of zero net government debt

  - actual and not structural (cyclically adjusted) budget deficit

  - government investment is not deducted from the deficit (no golden rule)

  - insufficient incentives for fiscal restraint in booms

- **Legitimate?**

  - rules that are perceived as inappropriate lose legitimacy

  - problematic with the EU as ”external enforcer”

  - fines worsen the deficit problem

- **Verifiable: yes**

  -because the rules are simple

- **Flexible?**

  - deviations should be ”exceptional, temporary and close”

  - GDP fall

  - But fines first after three years

- **Enforceable**

  -?????

- **Conflicts: yes**

  - sinners and non-sinners

  - big and small countries

  - protestant (Lutheran) and catholic countries

Reform proposal of the EEAG group

- **Relate the maximum deficit to the debt level**
- **If the main worry is about insolvency, the proper indicator is the debt ratio**
- **Lower debt should give the benefit of greater freedom of action of fiscal stabilisation policy**
- **Stronger government incentive for fiscal restraint in booms: visible gain if the country is moved to higher ”rung”**
- **The new EU countries have lower debt ratios than the old and would automatically benefit**

Table 2.8

Possible ways of conditioning the deficit ceiling on the debt ratio

Debt ratio (percent of GDP)	Deficit ceiling (percent of GDP)		
	Rule 1	Rule 2	Countries in the debt range
> 105	3.0	0.5	Italy
95 – 105	3.0	1.0	Belgium, Greece
85 – 95	3.0	1.5	
75 – 85	3.0	2.0	
65 – 75	3.0	2.5	
55 – 65	3.0	3.0	Portugal, France, Germany, Austria, *Bulgaria*
45 – 55	3.5	3.5	Netherlands, Sweden, Spain, *Hungary*
35 – 45	4.0	4.0	Ireland, UK, Finland, Denmark, *Slovak Republic, Poland*
25 – 35	4.5	4.5	*Czech Republic, Slovenia*
< 25	5.0	5.0	Luxembourg, *Estonia, Latvia, Lithuania, Romania*

Note: Accession countries in italics. These countries have been classified above according to their debt ratios in 2002. The incumbent EU member states have been classified according to predicted debt ratios in 2003.

Source: See Tables 2.2 and 2.9.

Golden-rule argument

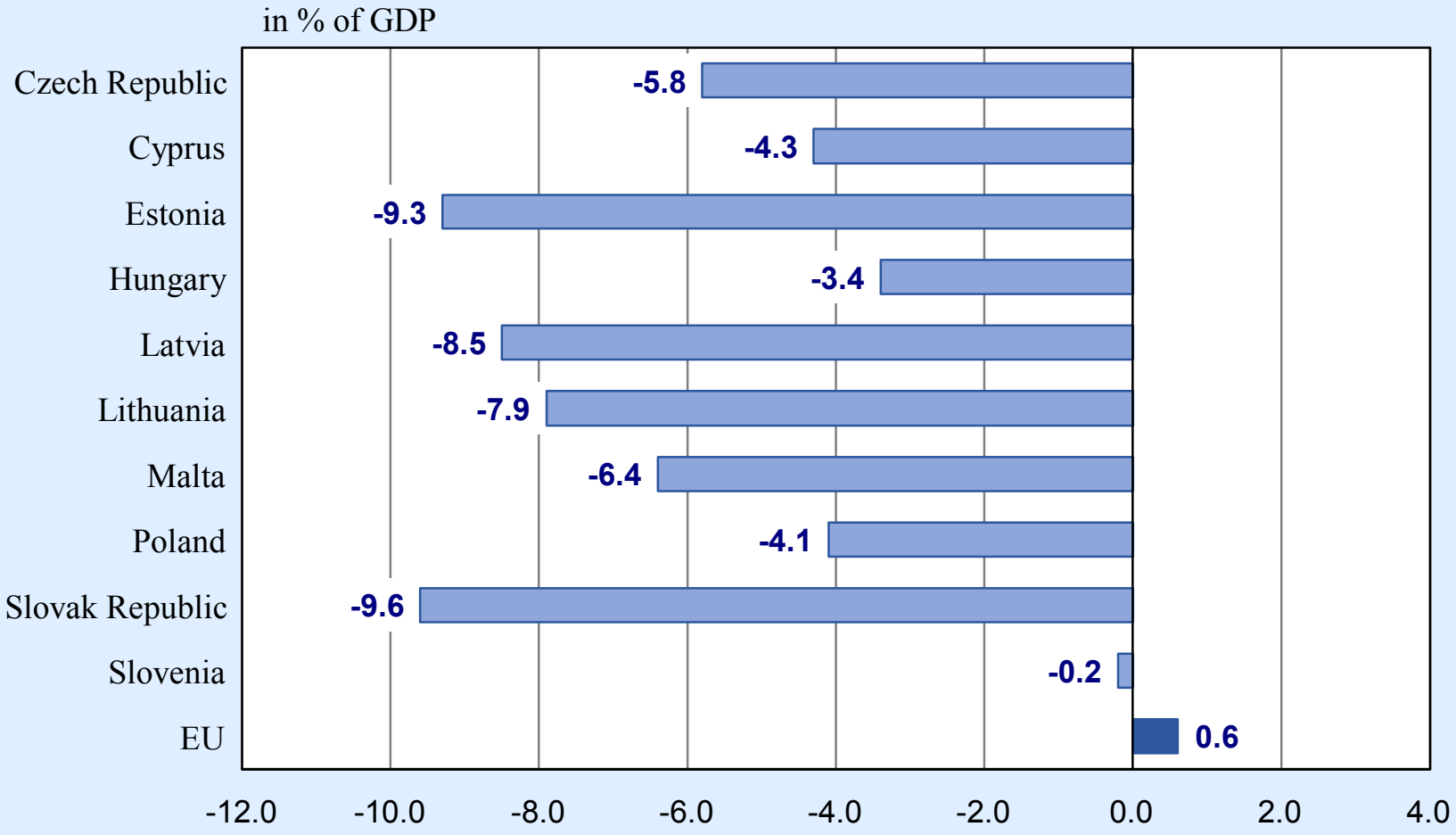
- **Higher deficit than 3 percent of GDP to allow for government investment**
  - **deduct government investment from the government budget deficit**
  - **required tax financing reduces government investment**
- **Counter arguments**
  - **all government investments do not give future benefits**
  - **creative accounting**
  - **tax cuts stimulating private investment?**
  - **tax cuts stimulating employment?**
  - **military spending?**
  - **investment in human capital (education)?**
- **Wrong signal in situation when demographic development requires repayment of government debt**

The situation of the new EU member states

- **Higher profitability of both private and government investment than in the old EU countries**
- **Exceptions for the new EU countries?**
- **Larger maximum deficit than 3 percent of GDP to the extent that it is covered by government investment as long as GDP per capita below certain level (60-70 percent of EU average).**
- **Risk of starting making exceptions**
- **But legitimacy also requires reasonable rules**

Fig. 5.5

CURRENT ACCOUNT BALANCE IN ACCESSION COUNTRIES
(average for the period 1997 – 2003)



Sources: EBRD Transition Report 2003; European Commission, European Economy Autumn 2003; own calculations.

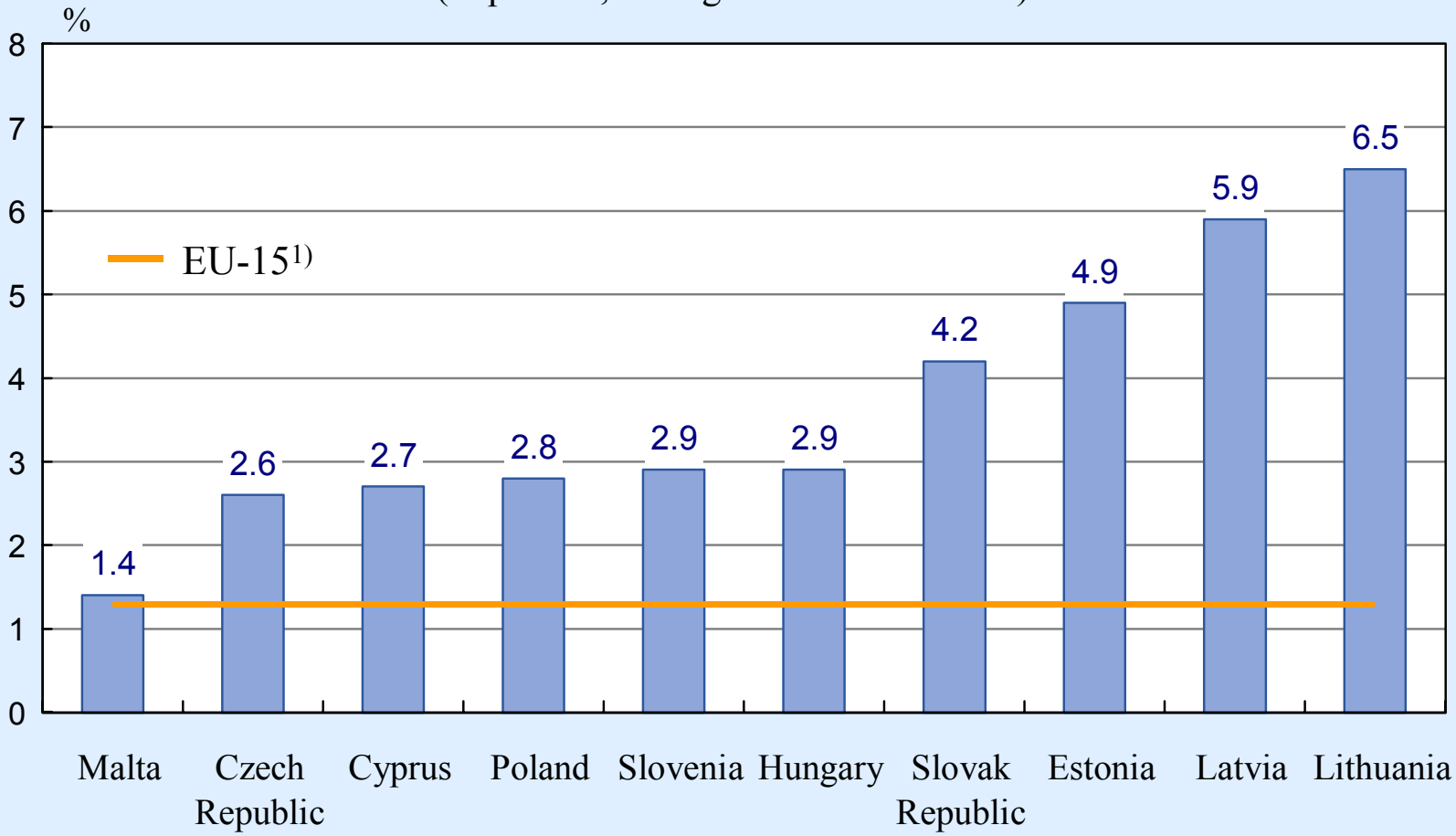
Government investment (percent of GDP)			
	2004	**2005**	**2006**
EU-15	**2,4**	**2,5**	**2,5**
EU-10	**3,0**	**3,1**	**3,1**
Private investment (percent of GDP)			
	2004	**2005**	**2006**
EU-15	**16,6**	**16,4**	**16,8**
EU-10	**17,5**	**18,9**	**19,8**

- **Higher real growth and higher inflation means larger reduction (small increase) of government debt ratio at given budget deficit**
  - **the ”catching-up hypothesis”: poor countries grow faster than rich countries**
  - **the Balassa-Samuelson argument: fast-growing countries have higher productivity growth in tradables sector, higher wage increases in all sectors, and therefore higher price increases for non-tradables and higher inflation in general**
- **Change in debt ratio = Deficit ratio – (Nominal growth rate of GDP) x Debt ratio**
- **Nominal growth of 7 percent and debt ratio of 45 percent reduces debt ratio by 3.15 percentage points if government budget is balanced**

Fig. 5.1

ECONOMIC GROWTH IN ACCESSION COUNTRIES

(in percent, average over 2002 – 2004)



1) EU-15: 1.3 %. Gross domestic product weighted with members gross domestic product of 2002 in US dollars.

Source: Eurostat, OECD, IMF, National Statistics Offices; 2003 and 2004: calculations by the Ifo Institute

Other changes that have been discussed

- **Rules for structural rather than actual deficits**
- **Theoretically more appropriate**
- **But many ways of computing structural deficits**
- **The true structural deficit is not verifiable**
- **Sanctions based on uncertain and disputable (disputed) calculations of structural deficits will not be perceived as legitimate**
- **Rules based on structural deficits will be unenforceable**
- **But one could try in a discretionary way to take ”large” output gaps into account**

  - large output gaps do not only arise because of abrupt GDP falls

  - large output gaps could also cumulate over time (Germany)

The enforceability of the rules

- **Lack of credibility for the sanctions**

  - insufficient legitimacy

  - fear of political conflicts

  - strategic behaviour on the part of finance ministers in the Ecofin Council

- **Depoliticising of the decisions on how the rules should be applied**

  - greater role for the Commission

  - right for the Commission to issue ”early warnings” itself within the multilateral surveillance process

  - more automatic excessive deficit procedure – proposals rather than recommendations from the Commission which would require unanimity in the Ecofin Council if they are not to be adopted

  - the European Court of Justice

  - independent Fiscal Policy Commission consisting of experts at the European level

  - but serious problems of legitimacy with depoliticising decisions at the European level

  - national decisions on stability programmes and on the government budget should be co-ordinate

- **Can fiscal policy rules at the European level really work?**

What does the current uncertainty about the stability pact mean for EMU entry for the new EU-countries?

- **Less strict convergence criteria?**
  - **but the fiscal policy rules were applied strictly as convergence criteria for the old EU countries**
- **The rules could be applied even more strictly as convergence criteria**
  - **the rules are credible only as entry criteria**
  - **therefore it becomes extra important that the new EU states have a sound fiscal policy position at least when they enter the EMU**

The best scenario for the stability pact?

1. **Ruling from the European Court that the Ecofin Council violated the rules**
2. **Continued deficits in Germany and France**
3. **The countries are fined**
4. **Changes in the rules first after that**

National decision-making processes

- **STEMU, Riksbanken, UK Treasury, EEAG**
- **Well-defined budget, debt and stabilisation objectives**
- **Transparent operational rules for how fiscal policy should be used to stabilise the business cycle**

  - size of output gap

  - which fiscal policy tools?

  - clarifications of which fiscal policy changes are temporary stabilisation measures and plans for their reversal
- **Calculations based on independent expert judgements**

  - Konjunkturinstitutet (National Institute of Economic Research)

  - Independent Fiscal Policy Council
- **Specific procedures when deficits or GDP gaps exceed certain levels (UK Treasury)**

- **Fiscal policy proposals from independent Fiscal Policy Council should be a normal part of the budget decision process**
- **Delegation of fiscal policy decisions with the objective of stabilising the business cycle**

  - independent Fiscal Policy Committee with clear objectives

  - variations of tax rates (VAT, payroll taxes, income taxes) within margins predetermined by Parliament

  - *ex post* evaluation with possibilities to fire committee that has not met its objectives (with qualified majority in Parliament)

  - escape clause giving Parliament the power to override decisions of the committee (with a qualified majority)

Today politically unrealistic proposals

- **But need for discussion**
- **Much more difficult to reform fiscal policy than monetary policy**

  - monetary policy has always been under weaker political control than fiscal policy

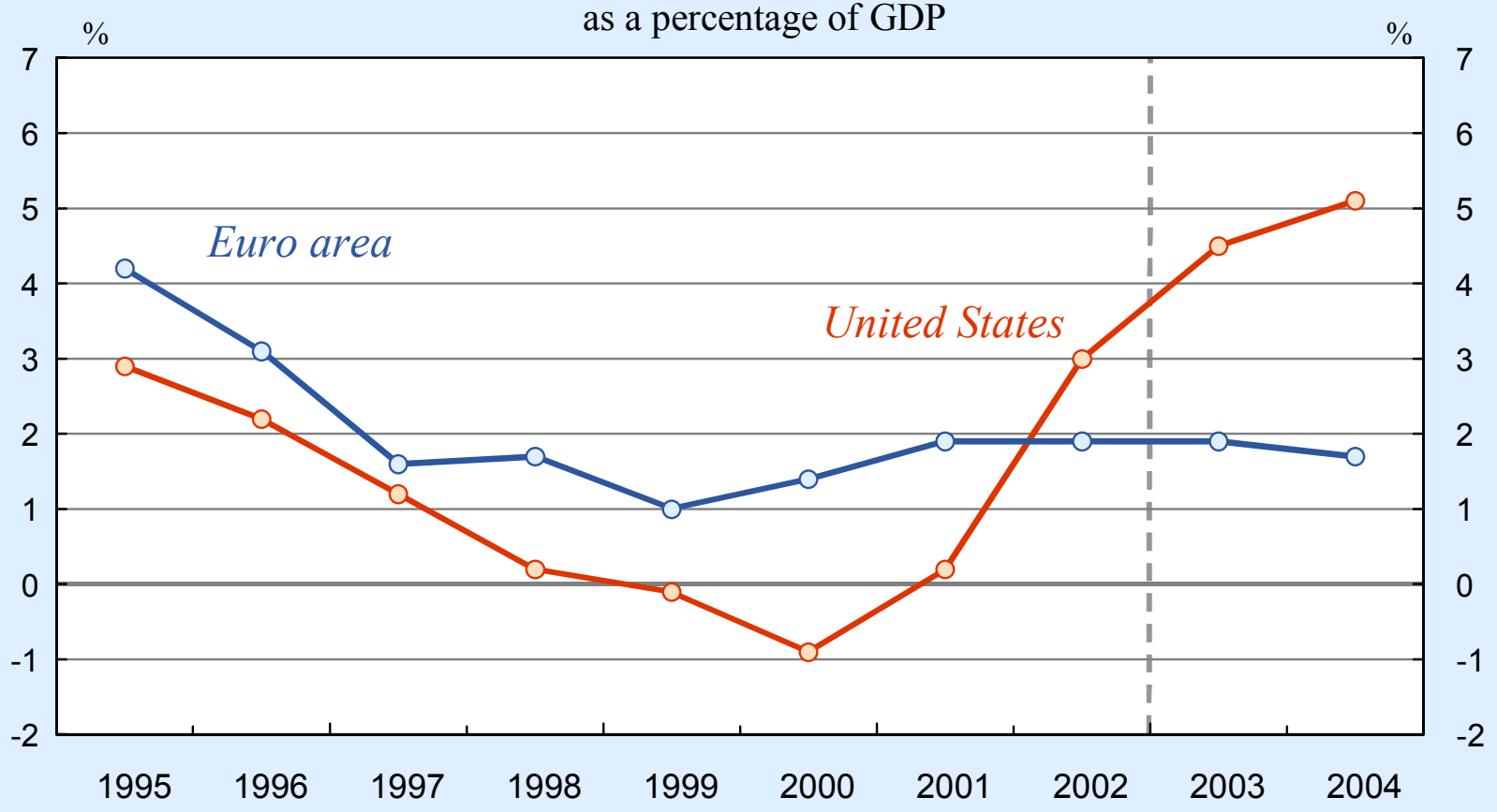
  - there were many practical examples of independent central banks (Bundesbank)

  - political control of tax/spending decisions is traditional cornerstone of parliamentary democracy
- **Much could be gained from forcing governments to be confronted in a regulated way with expert judgements and by requiring more of motivations for deviating from these judgements**
- **There appears to be a general trend throughout the world of weakening fiscal discipline: the US, EU, and to a smaller extent Sweden.**

Fig. 1.4

GOVERNMENT STRUCTURAL BUDGET DEFICIT IN THE EURO AREA AND THE UNITED STATES

as a percentage of GDP



Sources: OECD, Euro area; 2003 and 2004: Ifo forecast (December 2003).

The European unemployment problem

- **Large rise in unemployment in most Western European countries 1975-85**
- **Persistent unemployment: great problems reducing it again**
- **Contrast to the US where unemployment variations have been cyclical**
- **Unemployment increased much later in Sweden and Finland**
- **Some countries have been able to reverse earlier unemployment rises**
- **Others have failed**

Table 3.3

Unemployment rates under various bargaining regimes (ceteris–paribus differences to decentralised systems) in various studies[a)]

A: Studies finding a hump-shaped relationship between bargaining co-ordination and unemployment

	Study	Intermediate co-ordination	High co-ordination	Measure of bargaining structure[b)]
1	Zetterberg (1995)[c)]	2.6	- 1.5	Centralisation
2	Bleaney (1996)[d)]	3.5	- 2.1	Centralisation/ co-ordination
3	Scarpetta (1996)[e)]	0.9	- 12.0	Centralisation
4	Elmeskov et al. (1998)[f)]	1.3	- 2.4	Centralisation
5	Elmeskov et al. (1998)[g)]	1.2	- 4.4	Centralisation/ co-ordination
6	Elmeskov et al. (1998)[h)]	6.9	- 4.6	Co-ordination
7	Cukierman & Lippi (1999)[i)]	5.8	3.2	Centralisation
8	Daveri & Tabellini (2000)[j)]	5.8	- 7.2	Geographical[k)]
9	Nicoletti *et al.* (2001)[l)]	3.6	- 2.2	Centralisation/ co-ordination
	Average	**3.5**	**- 3.9**	

B: Studies finding a monotonic relationship between bargaining co-ordination and unemployment

	Study	Intermediate co-ordination	High co-ordination	Measure of bargaining structure[b)]
1	Layard et al. (1991)	- 4.7	- 10.4	Co-ordination
2	Zetterberg (1995)[m)]	- 0.4	- 2.4	Centralisation
3	Scarpetta (1996)[n)]	- 6.2	- 12.3	Co-ordination
4	Bleaney (1996)[o)]	- 2.0	- 3.9	Co-ordination
5	Elmeskov et al. (1998)[p)]	- 0.8	- 5.7	Co-ordination
6	Hall & Franzese (1998)[q)]	- 2.6	- 5.1	Co-ordination
7	Iversen (1998)[r)]	- 3.3	- 4.1	Centralisation
8	Nickell & Layard (1999)[s)]	- 4.6	- 6.0	Co-ordination
9	Blanchard & Wolfers (2000)[t)]	- 4.4	- 8.9	Centralisation
10	Belot & van Ours (2001)[u)]	- 2.6 (0)	- 5.2 (0)	Co-ordination
11	Belot & van Ours (2001)[v)]	- 1.9	- 1.9	Co-ordination
12	Nickell et al. (2003)[x)]	- 7.2	- 14.4	Co-ordination
	Average	**- 3.4**	**- 6.7**	

Table 3.4

Unemployment rates under various rates of union density and coverage of collective agreements (*ceteris– paribus* differences to 15% union density or coverage) in different studies[a)]

	Study	45%	75%	Explanatory variable
1	Layard et al. (1991)	2.5	4.9	Coverage
2	Scarpetta (1996)[b)]	1.8	3.6	Union density
3	Elmeskov *et al.* (1998)	0	0	Union density
4	Hall & Franzese (1998)	0	0	Union density
5	Iversen (1998)	0	0	Union density
6	Nickell & Layard (1999)[c)]	2.8	6.5	Coverage
		3.7	9.0	Union density
		6.5[d)]	15.5[d)]	Total
7	Nickell & Layard (1999)[e)]	2.4	4.8	Union density
8	Nicoletti et al. (2001)[e)]	2.1	4.2	Union density
9	Belot & van Ours (2001)[f)]	1.8 (0)	3.6 (0)	Union density
10	Belot & van Ours (2001)[g)]	4.7	9.4	Union density
11	Nickell et al. (2003)[h)]	0 (2.1)	0 (4.2)	Union density

Notes:

[a)] The table shows how much higher the unemployment rate is at 45% and 75% density or coverage rates compared to 15% density or coverage rates when other factors are controlled for.

[b)] Equation (2) in Table 2.

[c)] The equation explains the log of the unemployment rate. In the calculation of the effect on the unemployment rate, we have assumed that unemployment at 15% density and coverage rates is equal to the average rate of unemployment among the countries studied during the estimation period.

[d)] The sum of coverage/density effects.

[e)] The dependent variable is non-employment and not unemployment.

[f)] See footnote (u) to Table 3.

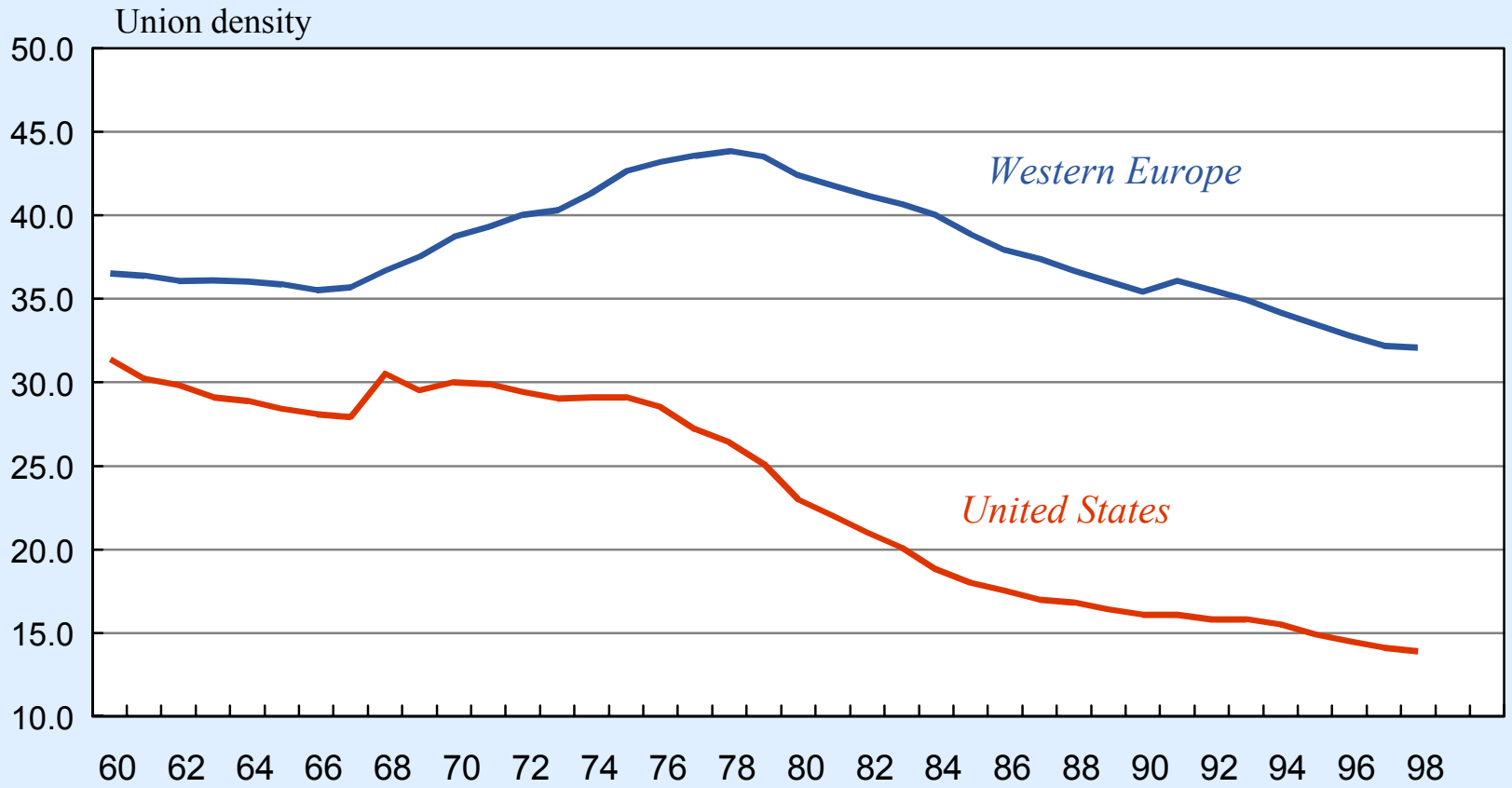
[g)] Equation (2) in Table 3B. The equation interacts various labour market institutions with each other (for example union density and co-ordination). The entries in the table refer to the effects of changes in union density under decentralisation. At higher levels of co-ordination there are no significant effects.

[h)] Equation (1) in Table 5. The figures not in parenthesis are long-run effects. The figures in parenthesis are impact effects. The regression equation interacts union density and co-ordination. The effects in the table are evaluated at the sample average of co-ordination.

Source: Calculations by the EEAG.

Fig. 3.1

UNIONISATION TRENDS IN WESTERN EUROPE AND THE UNITED STATES



Note: Union density (union membership relative to employment) for Western Europe is a weighted average of Austria, Belgium, Denmark, Finland, France, western Germany, Ireland, Italy, the Netherlands, Norway. Sweden, Switzerland and the United Kingdom.

Source: Ebbinghaus and Visser (2000).