

## An economic tale on the strict fiscal governance in the euro area

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### ABSTRACT

**B**udgetary outcomes, in terms of deficit and debt, can be seen as the result of a common pool problem. In democratic and mature economies there is a bias towards the easy temptation of debt financing. The outstanding debt of a country then reflects the accumulation of the budgetary indulgence of successive generations of policymakers. The degree of public tolerance on debt financing may vary across countries and is related to the level of civic capital. This paper demonstrates the negative correlation between debt levels and the reservoir of civic capital for a set of core countries of the euro area. National governments are thus not per se able to manage their public finances in an orderly and sustainable way. In such cases an 'exogenous' fiscal discipline by the authorities of the euro area can be defended. Numerical benchmarks and ceilings are the more tangible ingredients of the strict fiscal surveillance in the euro area.

A brief analysis of the conventional debt dynamics articulates the parameters which may be relevant to temper favourably the debt dynamics. It is shown that the numerical 3 pct. deficit criterion (to enact the excess deficit procedure) and the long term 60 pct. debt ceiling are internally consistent if and only if a specific 5 pct. nominal growth of GDP can be achieved. For other values of the deficit ratio and nominal growth the debt benchmark varies considerably. The uniform constraints neglect the differences in economic resilience of the member states (costs of ageing, explicit and implicit government guarantees, competitiveness, net private wealth...).

A major reluctance questions the adequacy of a balanced budget rule in the medium-term. It typically penalizes public investment outlays and growth enhancing categories such as research and development. Why not return to the golden rule which can be defended on theoretical arguments and which can show a track record of operational effectiveness if wisely applied?

**Keywords:** Fiscal Sustainability, Sovereign Debt, EU Budgetary Surveillance

**JEL Classification Code:** H61, H62, H63

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Thanks to Kristof De Witte for empirical assistance.





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## Introduction

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Politicians and budgetary policymakers still have to get used to the strict fiscal surveillance in the euro area. This paper addresses the substance and relevance of the fiscal governance by the European Commission and the European Council. First, is there a need for preventive and corrective actions by Europe? Are the national governments unable to manage their public finances in an orderly and sustainable way? If this is the case then it may be argued that an 'exogenous' fiscal discipline should be imposed.

The second issue investigates the relevance of the budgetary numerology. In principle a fiscal deficit of 3 pct. of the Gross Domestic Product (GDP) is deemed to trigger the so-called excess deficit procedure, which may result in an eventual fine. In the medium run the fiscal balance should land at an equilibrium in structural terms. And in the long run the debt level should converge to 60 pct. of GDP. Are these quantitative benchmarks adequate and are they supported by theoretical and empirical evidence?

## 1 The meaning of fiscal sustainability

Fiscal sustainability requires that at any point in time the interest payments on the public debt can be serviced. This boils down to a structural solvency. In the short run also liquidity should be ensured in the sense that the access to the financial markets is not a problematic hindrance for refinancing maturing principals.

The government budget constraint provides a conventional starting point such as in expression (1).

$$(1) \quad b_t = \frac{1+i_t}{1+g_t} b_{t-1} - pb_t + dda_t$$

The debt-to-GDP ratio  $b_t$  is linked to this ratio in the previous period  $b_{t-1}$ , taking into account events which happened in period  $t$ . The nominal (effective) interest rate is  $i_t$  and  $g_t$  is the growth rate of nominal GDP;  $pb_t$  refers to the primary budget balance as a percentage of GDP, i.e. the general government budget balance leaving aside the interest disbursements. For accounting consistency we also add an additional term  $dda_t$  which is often omitted and which will be clarified later on.

Deducting  $b_{t-1}$  from both sides from equation (1) and rearranging some terms we get equation (2).

$$(2) \quad b_t - b_{t-1} = \frac{i_t - g_t}{1 + g_t} b_{t-1} - pb_t + dda_t$$

The combined effect of three components determines whether the debt ratio increases, decreases or remains stable.

1. The interest-growth differential captures the snowball effect. If it exceeds  $g_t$  then the debt ratio will increase *ceteris paribus*. When  $i_t \leq g_t$  then the debt ratio is reduced or stabilized.
2. A deficit of the primary budget ( $pb_t < 0$ ) puts an upward pressure on the debt ratio as the second term then becomes positive. The opposite holds by a primary surplus.

3. The deficit-debt-adjustment-to-GDP ratio  $dda_t$  includes transactions which directly affect the debt level without being registered in the budget. For instance, a capital injection in a distressed private bank will increase the debt ratio. A sale of government assets will reduce  $b_t$ .

The solvency condition for the overall government budget can also be written as the intertemporal budget constraint (3).

$$(3) \quad b_{t_0} \leq \sum_{t=t_0+1}^{\infty} \frac{pb_t}{(1+r_t)^{t-t_0}}$$

Where the discount factor  $r_t = i_t - g_t$ . This means that starting from the actual debt level  $b_{t_0}$  the net present value of the future primary surpluses should be at least equal to  $b_{t_0}$ , given the interest-growth-differential and neglecting  $dda_t$ .

The intertemporal solvency condition suffers from several drawbacks. How should one treat uncertainty? Which figures should we plug in for the future interest and growth rate? What about the primary surplus so many years ahead? Isn't it naive to assume that a budgetary surplus can and will be achieved if needed? Intrinsically a primary budget requires high moral standards from the politicians of that time. They have to impose higher and unpopular taxes on that generation than what the citizens will receive in terms of public consumption and government transfers (government receipts are larger than expenditures).

From a public choice perspective it is clear that such a 'brave' attitude is not guaranteed. In fact it is at odds with the common pool problem, which often spoils the elaboration of a budget towards deficit spending. The outstanding government debt of a country can be viewed as the addition sum of the budgetary indulgence of successive generations of policymakers. A primary fiscal deficit is by definition the opposite of a surplus. The politicians in power are too lenient to cover the current public expenditures with regular contributions (taxes, social security contributions...). The deficit is then financed by debt obligations which in accumulation form the outstanding public debt of a nation.

The degree of public tolerance on debt financing may vary across countries. But in democratic and mature economies there is a generic bias to the easy temptation of debt financing. In economics this related to the well-known common pool problem. When a group of people can exploit a common asset there is a tendency towards an harmful overexploitation. An historical example is the common grassland in a rural village. When each and every farmer feels free to leave his cattle there, then after a time over-grazing is inherent with a loss for the community. The individual users are short-sighted and oriented towards their private benefit and less concerned for the negative external affects for the society as a whole.

Transposed in a budgetary context there is a tendency to increase the government expenditures for the benefit of specific groups which pay only a fraction of the budgetary cost via general taxation. However, other pressure groups also endeavor to gain particular advantages for their rank and file. A similar pressure also shows up at the revenue-side of the budget with attempts for tax exemptions, deductions... for the own group. Aggregating this selfish and myopic behavior, this variant of the common pool problem leads to an expansion of public expenditures, budget deficits and an increasing government debt (K. Shepsle and B. Weingast, 1981). The underlying explanation is that a given generation is unwilling to pay the full tax price for the collective comfort that they expect from their government.

In the relevant research it is revealed that this tendency is stronger when a society is more fragmented. A typical example is the operation of a coalition government with several political parties. Each coalition partner ambitions to favor its own constituency at the cost of the other parties and of the future generations. Other elements of fragmentation, next to political ideology, are ethnic diversity, cultural differences, the relative power of pressure groups... (T. Persson, 2002).

It should be clear that we envisage chronic 'unorthodox' deficit spending, making abstraction of public investment. This issue is taken up in the following sections. Also 'legitimate' deficits in times of war, natural disasters, or financial crises are left out. Keynesian smoothing of the cyclical movements of the real economy is surely allowed as temporary deficits are compensated with surpluses in better times.

## 2 Preconditions for a sustainable currency area

In economics an optimal currency area refers to a geographic area where several countries decide to share one single currency. The economic benefits of such a union should exceed its cost which will be discussed later on. Also some preconditions should be fulfilled in order to be successful as articulated in the seminal works by Mundell (1961), the originator of the idea.

More open economies with intensive exchanges of goods, services and capital, can reap more benefits from such a scheme. It is also recommended that the business cycles in the member countries fluctuate more or less in line with each other. In this case the central monetary authority can conduct an adequate monetary policy to lean against the wind and mitigate the fluctuations in real production. But in reality asymmetric shocks mostly prevail, e.g. a bad harvest in one country or a shift in demand away from the local production in another country. The monetary policy is then unable to address the particular requirement of each member separately. Two preconditions are then required to guarantee the viability of the union. Either labor mobility between the member countries or price and wage flexibility.

One should remember that in a currency union the member states abdicate their competence for devaluation or revaluation. The price of the currency can no longer be manipulated to restore economic imbalances between the members. This is a substantial cost for some members as we witness in the actual euro crisis. Fundamentally the concept of a currency union boils down to a commitment between countries with more or less similar production levels and earnings power. The economic basics need to be compatible but not identical.

Institutional economics, a relatively new strand in economics, emphasizes the role of civic capital in economic development and in the functioning of institutions. It is widely agreed that the economic performance of nations is fuelled by the endowment of natural resources and differences in the quantity and quality of human and physical capital. But also civic capital is instrumental. Civic capital can be defined as *“those persisted and shared beliefs that help a group overcome the free rider problem in the pursuit of socially valuable activities”* (Guiso, Sapienza and Zingales, 2010). The basic idea is that citizens who share cultural values based on respect and solidarity show higher standards of civic conduct. They require more accountability and integrity from the policymakers and are less tolerant of rent seeking and personal privileges by their elected representatives and public servants.

The sovereign debt crisis has bitterly revealed that there should also be adequate civic capital in the member states for the proper functioning of a currency union. This precondition is often neglected in the theory of an optimal currency area. And it turns out that the euro area now pays a high price for this neglect.

Let us reflect analytically on this statement. Why is it that in the standard economic theory sovereign debt was viewed as a debt instrument without a credit risk, i.e. the risk of a default? Indeed in finance the interest rate on long term government bonds is traditionally considered as the riskless rate. Two lines of reasoning usually supported this view: a monetary argument and a fiscal argument.

The monetary argument refers to the national central bank as a lender of last resort also for the government debt. The fiscal argument relies on the power to tax by the national government. A typical example is a one-off wealth tax. A country with a high public debt can in principle reallocate wealth from the private sector to the public by imposing a new and higher wealth tax. The budget surplus then will redeem the outstanding debt and reduce the debt ratio.

But now comes the tricky issue, as the Greek case openly demonstrates. Such a textbook prescription still has to be politically decided and administratively implemented. If a country lacks the necessary civic capital, then politicians will not be able to execute effectively such hard fiscal measures. The fiscal argument no longer holds in a society with e.g. corrupt politicians, a lame administration and a citizenry in disarray.

Oddly enough the monetary argument is less demanding for civic capital. This view, perhaps surprisingly, is well documented by Keynes in his writings on public finance and changes in the value of money (Keynes, 1923). *"A government can live for a long time...by printing paper money. That is to say, it can by this means secure the command over real resources, resources just as real as those obtained by taxation. The method is condemned, but its efficiency, up to a point, must be admitted... It is the form of taxation which the public finds hardest to evade and even the weakest government can enforce, when it can enforce nothing else"*.

In a country with meagre civic capital the government may be tempted to force the central bank to fund the fiscal deficit and refinance the maturing debt by printing money. As the money base and the supply of money expands one will be confronted with a higher inflation. This in turn will require a devaluation of the national currency. This vicious circle will ultimately lead to a lower standard of living and put an economic burden on the people, just as would have been the case with a full-fledged taxation. But as Keynes has pointed out, it is a form of taxation which even a weak government can impose and which hurts all citizens.

Returning to the euro area crisis it is evident that a member no longer can manipulate independently its money supply. This is the collective task of the European Central Bank (ECB), which is reluctant to buy directly sovereign debt from its members by printing money. This point is cleverly documented in a seminal paper by Paul De Grauwe (2011).

The international markets are well aware that the members of the euro zone are in principle cut off from the easy way out of monetary autonomy. They then focus on the credibility of the fiscal argument which is related to the level of civic capital. The credibility of debt sustainability then falls entirely on the fiscal argument, which is deeply dependent on the level of civic capital of a nation. In the previous years the Greek drama, with two digit interest rates, clearly illustrates the perception of an inadequate civic capital by the markets. And also the interest spread in other countries is correlated with the reservoir of civic capital in each country.

No wonder that the 'bazooka' statement of Mario Draghi in July 2013 in London has substantially reduced the interest rate spread government bonds in the euro area. The commitment by the ECB to buy sovereign bonds on the secondary market, whatever it takes, has revitalized the monetary argument as a vigorous instrument to counter 'irrational exuberances' in the markets. Consequently, the relative weight of the fiscal argument is somewhat downgraded as now again two weapons are in position.

The instrumental fundament of civic capital requires more investigation. Can civic capital be measured? How can we identify the members with inadequate civic capital? Such an examination may help to clarify why some members are more prone to a sovereign debt crisis and higher nominal interest rates.

### 3 The role of civic capital

In practice civic capital shapes the political, legal and administrative framework in which individuals interact to generate wealth. For empirical purposes it boils down to the institutional quality of a country. As we focus on budgetary policies and fiscal outcomes we envisage a concept of civic capital that addresses at least three dimensions.

1. Is there a legitimate government, democratically supported, which is able to make the adequate decisions?
2. Is there a public administration, endowed with competence and integrity, to implement on the field the political decisions with efficacy thus delivering value for tax money?
3. Does the citizenry show enough cooperation to comply with the political decisions without e.g. manifest fiscal fraud or forms of violent obstruction?

In our own research we favor the data on institutional quality that we borrow from the World Economic Forum (WEF). Each year the WEF publishes a global competitiveness report of some 140 countries and continues to be the most comprehensive assessment of its kind. It contains publicly available but also private survey data covering some 100 single indicators. These single indicators are then grouped in 12 pillars which support economic performance. The first pillar refers to the institutional quality of each country. It is a composite indicator which captures several characteristics. We list 10 of them:

- ▶ Are property rights, including financial assets, well protected?
- ▶ Is there diversion of public funds to companies, groups, individuals due to corruption?
- ▶ What is the level of public trust in the ethical standards of politicians?
- ▶ Is it common for firms to make undocumented extra payments or bribes connected with (a) imports and exports; (b) public utilities; (c) annual tax payment; (d) awarding of public contracts and licences; (e) obtaining favorable judicial decisions?
- ▶ To what extent is the judiciary independent from influence of members of government, citizens or firms?
- ▶ Do government officials show favoritism to well-connected firms and individuals when deciding upon policies and contracts?
- ▶ How would you rate the composition of public spending in terms of efficiency?

- ▶ How burdensome is it for business to comply with governmental administrative requirement (e.g. permits, regulations, reporting)?
- ▶ Are police services reliable to enforce law and order?
- ▶ Is the government policymaking transparent?

In table 1 the quality of institutions, as assessed by the WEF is reported as a proxy for civic capital. We limit our scope to 11 of 17 euro area members. The smaller countries with a share of less than 1 percent of the GDP of the euro area are omitted. These are: Slovakia, Slovenia, Luxembourg, Cyprus, Estonia and Malta (data for 2011).

Table 1: Civic capital and the source of the public finances

Country		Civic capital (a)	Debt level (b)	Fiscal balance (c)
Germany	GE	5,27	81,7	-1,3
France	FR	5,00	85,4	-5,9
Italy	IT	3,61	120,5	-3,8
Spain	ES	4,87	69,6	-6,6
Netherlands	NE	5,61	64,2	-4,3
Belgium	BE	5,03	97,2	-3,7
Austria	AT	5,24	72,2	-3,4
Greece	GR	3,52	162,8	-8,9
Finland	FI	5,98	49,1	-1,2
Ireland	IR	5,19	108,1	-10,3
Portugal	PT	4,20	101,6	-5,8

Sources: (a) Civic capital, World Economic forum (2012-2013).

(b) Debt level as % of GDP, European Economic Advising Group, 2012.

(c) Fiscal Balance as % of GDP, European Economic Advising Group, 2012.

In table 1 we also provide some data on the debt level and the fiscal balance of the selected sample of euro zone countries. These data are taken from the European Economic Advisory Group report on the European Economy (2012). Basically the debt level represents the accumulation of all past budget deficits. Countries with weaker civic capital will more easily give in to the interests of private pressure groups and pork barrel public expenditures. Additionally, the unwillingness to pay the full tax price for the public services irrevocably leads to large deficits and subsequently high debt levels. In figure 1 debt levels are related to institutional quality. Here we observe a strong negative relationship with a correlation coefficient of  $-0.87$ . Also here Greece can be identified as an unfortunate outlier.

## 4 Are the numerical rules relevant?

Three waves of criticism have questioned the relevance of the numerical fiscal rules initiated by the Maastricht Treaty, later on prescribed in the stability and Growth Pact (SGP) and recently refined in the sixpack, twopack and Fiscal Compact.

Around 1992 a first strand of literature, mainly from academia, revealed deep skepticism on the 'numerology' of Maastricht (see W. Buiters, 1993). Ten years later (2002), when Germany, France and Portugal violated the 3 pct. deficit limit, policymakers casted doubt on the wisdom of the SGP. Romano Prodi, then chairman of the European Commission, even murmured qualifications as "stupid".

The banking debacle of 2008-2009, causing a recession in the real economy, and subsequent the sovereign debt crisis, have fuelled a grim debate on the adequacy of the fiscal rules. Simplifying the many divergences, practitioners of budgetary policy, columnists and academics seem to have split in a Northern firm wing and a sleazy Southern club. Even Germany, which plays a pivotal role in this area, does not always speak the same language. Remember the dissident view of the German Council of Economic Experts in favor of the European Debt Redemption Fund and Eurobonds.

Let us briefly review the actual numerical targets. The general government deficit should remain below 3 pct. of GDP. Otherwise the excess deficit procedure (EDP) is enacted with a stricter surveillance and possible penalties. The benchmark for the debt level is 60 pct. of GDP or lower. But the most severe rule is a budget balance in equilibrium in the medium run. We elaborate on that later in the paper.

Is there some rationality between the 3 pct. norm and the long run ceiling of 60 pct.? On the theoretical level there is an internal consistency, as shown in appendix 1. Let nominal GDP, denoted as  $Y$ , grow with a trend rate  $g$  (roughly equally attributed to real growth and inflation). Assume for ease of exposition that the ratio of the fiscal deficit to  $Y$  is a constant  $a$ . It then follows that in a steady state the debt ratio will tend towards  $a/g$ .

I have the feeling that in the back-offices of the Maastricht Treaty a nominal growth rate  $g$  of 5 pct. a year was deemed achievable. Experiences of the mature economies in euro-land, based on historical data, showed that an average public investment accounted for 3 pct. of GDP. For capital projects debt finance is admitted as future generations of taxpayers also will benefit from the productive facilities. Therefore a deficit of 3 pct. could be defended for the medium run.

Plugging in these figures in the steady state formula one gets  $b = 0.03/0.05 = 60$  pct.

The well-known 60 pct. benchmark is thus consistent with the two underlying parameters  $g$  and  $a$ . But now comes the tricky issue in times of stagnation or even deflation. Given a gloomy forecast for the euro-zone, a nominal  $g$  of 4 pct. (2 pct. real growth + 2 pct. inflation) may even be too optimistic. In this case the steady state  $b$  is 75 pct. ( $0.03/0.04$ ). And in a more morose scenario of 3 pct. nominal growth the debt ratio will tend towards 100 pct.

We use the steady state formula as a didactical device to demonstrate the substantial sensitivity of the debt ratio. As the perception of the attainable growth rate deteriorates the debt ratio increases exuberantly. Also the fiscal deficit ratio  $a$  plays a vital role. Take as an example the optimistic scenario of a 4 pct. nominal growth of GDP. If the fiscal deficit ratio decreases from 3 to 2 pct. then the long run debt ratio will diminish from 75 to 50 pct. Let us go one leap further where the euro area aims at a zero deficit. In this case the remarkable result is a zero debt ratio in the steady state. Is this outcome desirable for the functioning of the financial markets and the society as a whole?

These exercises demonstrate that relatively small changes in the underlying parameters  $a$  and  $g$  yield great divergences in the outcome for the debt ratio. Consequently one may question the adequacy of the actual 60 pct. threshold. Furthermore, the euro-zone ambitions to lower the debt ratio (in member states where  $b > 60$  pct.) towards 60 pct. in 20 years time. Take for instance Belgium, where the debt ratio oscillates around 100 pct. The reduction trajectory is thus 40 pct. In a linear interpolation over 20 years this leads to a debt ratio decrease of 2 pct. a year. Take a country with a given debt level of 80 pct., then the debt reduction rate would be 1 pct. a year. However, a country with a debt level of 140 pct. would face a reduction rate of 4 pct. a year. For countries, which are really highly indebted, this would impose a formidable fiscal task. Focusing on some critical numerical parameters surely is instructive but may lead to recommendations which are not feasible on the field. A broader assessment may provide other insights. Such a larger scope is examined in the next section starting with the questioning of the adequacy of the balanced budget rule in the medium run.

## 5 What about the balanced budget in the medium run?

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Let us reflect a while on some behavioral consequences of the balanced budget rule as such. One can predict that this stringent rule will discourage the outlays for public investments. It implies that capital projects will have to be funded from current revenues. The costs of such investments are no longer spread over all the generations of the payers who benefit from these productive facilities. It is expected that such a rule delays and diminishes public investments and also will invite creative accounting. In fact one notices in almost all member countries incentives to finance public investment projects more and more via (sophisticated) off-budget structures. The present hype around public-private-projects fits into this scheme.

Another weakness is the limited flexibility to tackle fluctuations in the real economy. The euro-leaders are well aware of this shortcoming and understandingly the 'spirit' of the rule is now interpreted as a structural balance equilibrium. Cyclical fluctuations, e.g. measured as a deviation from potential output, are now taken into account. Also one-off measures, both negative and positive, are excluded from the nominal budget.

The balanced budget rule can be viewed from two angles. First, as a device to address the deficit bias, as explained by the common pool problem, and thus enhancing budgetary discipline. Second, the adequacy for managing macro-economic stabilization. Satisfaction on the first objective may be misleading. Indeed, fiscal adjustments may rely excessively on cuts in expenditures which generate less political resistance. Typical examples are public investment and growth-enhancing categories such as research and development. This concern is reflected in the so-called golden rule which is implemented in a dual budget, separating investment spending from current expenditures. It is worthwhile to reconsider this 'classical' financing rule.

It is often claimed that it is difficult to operationalize the golden rule. Indeed, the usual definitions leave elbow room for opportunistic interpretations to erode the rule. But the same applies to the balanced budget rule, and even with greater difficulties. How to agree on a correct assessment of the cyclical position at time  $t$ ? Even in retrospect it is arduous to estimate the output-gap analytically and empirically. Real-time management of cyclical fluctuations is thus prone to vulnerability and errors.

In our view, the European move from a nominal to a structural equilibrium, reflects an intuitive uneasiness of the policymakers vis-à-vis the balanced budget rule in the medium run. In this and the previous sections we have articulated some arguments to re-assess in depth this austere prescription.

## 6

## A broader economic view on fiscal resilience

The European Monetary Union (EMU) suffers from an institutional design which is atypical for a federalist setting. The EU-budget is very small (about 1 pct. of the EU-GDP) and is still lopsided to agricultural support. The bulk of public expenditures are conducted at the level of the nation states. Most decisions about taxes and spending remain thus at the national level. Earlier in the text it was pointed out that the 'new' fiscal surveillance contains strict and enforceable fiscal rules, often numerical caps, which in our view may be too stringent and certainly do not fit all sizes. Therefore also the general economic health status of a nation and its structural vulnerabilities should be considered.

The so called 'European semester' aims at addressing these issues. Next to a timetable for the first semester, it annually comprises an alert mechanism based on a scoreboard of a set of macroeconomic indicators. If needed the Commission will provide broad-based, in-depth reviews of economic, financial and public finance developments in the member states. Typical concerns are the cost of ageing (pensions and health care), the structure of industries and competition, the external current account and trade performances, rigidity in labor markets... Other items of interest are: the maturity structure and the denomination of government debt, reserves of government assets, explicit and implicit guarantees, the net financial wealth of the private sector... The European semester ambitions to coordinate ex-ante the 'insouciances' which may characterize some member states.

For the EMU to function properly fiscal surveillance alone is not sufficient. The broader economic stance and policies to promote financial stability, growth and social cohesion are also required. Or is it that after the Lisbon agenda, we also seem to have forgotten about Europe 2020? This implies that the economic policies in the member states cannot be conducted fully independently. They are subject to joint scrutiny and coordination. As a consequence at least some national sovereignty in economic policymaking is to be transferred to the supranational level such as the European semester ambitions.

## 7 Fiscal procedures and institutions

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Returning to the heavier fiscal surveillance, it is our feeling that there is more and more fatigue about the adequacy of stringent numerical caps. A case in point is the new structural budget equilibrium and a tolerated nominal deficit of 0,5 pct. of GDP. Also the surveillance of the debt criterion is less straightforward than that of the fiscal balance.

In recent years it has become quite clear that the macroeconomic performance of the member states, on average, is significantly hampered by the fallacy of composition. When a whole bunch of nations is involved in austere fiscal policy at the same time, than the global production level should suffer, as is observed in the euro-area, surely in the short run. The restrictive focus on the numerator (deficit) hurts the de-nominator (GDP) in such a way that the deficit and debt ratio hardly improve. Therefore we fully endorse the examination and surveillance of fiscal procedures and institutions in member states which are instrumental in promoting fiscal sustainability.

In the earlier sections of this paper we have emphasized the common pool problem as a metaphor for the bias towards budget deficits and debt accumulation. But myopia and free riding behavior vary greatly across nations and are negatively correlated with the level of civic capital of those societies. In this section we address some characteristics of the domestic fiscal frameworks.

Shortsightedness can to some extent be tempered by the obligation for multi-annual budgetary plans. Needless to say that any assessment requires the timely supply of relevant and reliable data. The accounting and reporting system needs to be adequate. In order to provide also valid forecasts a machinery of models and expertise is needed. It is essential that arrangements are in place which force the policymakers to look forwardly confronting them with the fiscal consequences of their policy choices.

Regular reporting with high standards of integrity and competence is also a necessary precondition. This may be achieved by the establishment of independent fiscal institutions. These non-partisan public bodies are entrusted with evaluating and advising budgetary activities. Their authority and credibility relies on their competence and concern for the common good. Admittedly the setting up of new fiscal institutions requires some time before becoming fully functional and gaining a solid reputation.

## 8 Summary and conclusions

Budgetary outcomes and the stance of the public finances can be seen as the result of a common pool problem. In democratic and mature economies there is a bias towards the easy temptation of debt financing. The outstanding debt of a country then reflects the accumulation of the budgetary indulgence of successive generations of policymakers. The degree of public tolerance on debt financing may vary across countries and is related to the level of civic capital. This paper demonstrates the negative correlation between debt levels and the reservoir of civic capital for a set of core countries of the euro area. National governments are thus not per se able to manage their public finances in an orderly and sustainable way. In such cases an 'exogenous' fiscal discipline by the authorities of the euro area can be defended.

A brief analysis of the conventional debt dynamics articulates the parameters which may be relevant to temper favourably the debt dynamics. It is shown that the numerical 3 pct. deficit criterion (to enact the excess deficit procedure) and the long term 60 pct. debt ceiling are internally consistent if and only if a specific 5 pct. nominal growth of GDP can be achieved. For other values of the deficit ratio and nominal growth the debt benchmark varies considerably.

In a recent IMF Working Paper (Debt and growth: is there a magic threshold, 2013) A. Pesatori, D. Sandri, and J. Simon use a novel empirical approach and an extensive dataset. They find no evidence of any particular debt threshold above which medium-term growth prospects are dramatically compromised.

Our main concern and reluctance questions the adequacy of a balanced budget in the medium-term. It typically penalizes public investment outlays and growth enhancing categories such as research and development. Why not return to the golden rule which can be defended on theoretical arguments and which can show a track record of operational effectiveness if wisely applied? Or is it that after abandoning the Lisbon agenda we also only pay lip service to Europe 2020?

On the other hand we convincingly favour formal budgetary procedures and institutional frameworks which are conducive to better fiscal outcomes. These are to be installed at the national level where necessary. Strong institutional frameworks visibly underpin the commitment to fiscal sustainability. Transparency and accountability, integrity in forecasting and reporting, can lend credibility to the consolidation efforts. The temptation of fiscal gimmickry is then better contained and reduced, which in turn is a prominent characteristic of the civic capital of a nation.

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