

# FISCAL DISCIPLINE AND CONVERGENCE OF THE EURO AREA CANDIDATES. CLOSER TO THE PERFORMERS OR TO THE LAGGARDS?

**Tatomir Cristina Flavia**

*Academy of Economic Studies in Bucharest, Faculty of International Business and Economics*

**Alexe Ileana**

*Academy of Economic Studies in Bucharest, Faculty of International Business and Economics*

*The objective of this paper is to examine how the current financial crisis has affected the fiscal discipline and convergence in the seven Central and Eastern European countries which have not yet joined the Euro Area (EA), namely Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania. In the first part, we emphasize the importance of fiscal discipline for the effective functioning of the European Monetary Union (EMU). In the second part, by exploring the current status of the literature in this field, we identify scarce theoretical and empirical research on the non-EA countries' fiscal discipline and convergence. In the third one, we briefly present the data and methodology used in the paper. We report the fiscal discipline of the non-EA countries by analysing their distance from the Maastricht criteria regarding the budgetary deficit and the public debt as shares of GDP in the fourth part. We also assess the fiscal convergence of the seven candidates for Euro adoption in order to understand whether they add to the strengths or to the weaknesses of the EMU, from a fiscal point of view, by employing two benchmarks: the EA core and the EA periphery. The sovereign debt crisis emphasized the asymmetry between core and periphery countries. It is of major importance to know if the EA candidates will exacerbate the fiscal imbalances by joining the periphery group of countries or by contrast, will promote fiscal discipline and sustainability alongside the core EA member states. The fifth part concludes. The non-EA group of countries has not experienced major fiscal imbalances in the last four years, but the efforts must continue in reducing the budgetary deficits and controlling the public debts. In times of crisis, the EA candidates achieved more convergence with the EA core than with the EA periphery, by reducing the distance from the EA core. This is due to a deterioration in the fiscal performance of the EA core states and not to an improvement in the non-EA group of countries. The result is not encouraging for the fiscal convergence given the fact that we would expect an improvement in the non-EA countries' fiscal performance in order to catch-up with the best performers of the EA and not the reverse. In terms of public debt, the fiscal convergence with the EA core would not be desirable, due to the high levels of public debt achieved by these countries.*

*Keywords: Fiscal Discipline, Maastricht criteria, Fiscal Convergence, Euro Area, Euro Area candidates*

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## **1. Fiscal discipline matters for the Euro Area**

In the context of the EMU, the fiscal discipline has always been in attention, since the monetary policy is given to a central supranational authority, which has the main goal to provide price stability in the medium term in the EA, whereas the fiscal policy is still within the hands of the

national governments. Moreover, the recent international crisis and the European sovereign debt crisis have relaunched the debate on an appropriate fiscal framework at the European Union (EU) level. There are different views on this matter. On the one hand, there are voices that support a fiscal union for the EA in order to become sustainable. De Grauwe (2006) takes this view further, advocating for a political union needed to ensure the success of the EMU. On the other hand, there are voices blaming extended fiscal powers for Bruxelles (Mckay, 2005).

The fiscal discipline and convergence is a precondition for the effective functioning of a monetary union, since the existence of divergent national fiscal policies may generate divergent macroeconomic adjustments in a monetary union. The risk of fiscal imbalances and their consequences on the stability of the single currency was a matter of concern for the EMU architects from the beginning. The solution to control the fiscal imbalances emerged in the Maastricht Treaty (MT) and the Stability and Growth Pact (SGP). The European countries have experienced more than a decade under the rules stipulated in the MT and the SGP, which set numerical limits on government deficits (3% of GDP) and public debt (60% of GDP). Although these numerical rules are attractive because they are predictable and transparent, EU countries experience shows that national states, taken individually, are not very effective in providing fiscal discipline. Moreover, in the last years some issues concerning the EA came at the surface: the lack of fiscal discipline, the unsustainability of public finances and the loss of fiscal rules credibility (Schuknecht et al, 2010).

In this paper, we define the fiscal convergence as the reduction of the gap between an irresponsible country from a fiscal point of view (countries with excessive prolonged budgetary deficits and/or public debts) and the best performers of the EA. In addition, the concept of fiscal discipline highlights the fiscal performance of a country in fulfilling the Maastricht criteria.

Our study is important for three main reasons. First, fiscal convergence and discipline has become a subject of intense debate after the introduction of the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (known as the Fiscal Treaty), which limits the structural deficit at 0.5% of GDP and requires automatic adjustment rules and penalties for countries exceeding the limits. Second, there are currently seven EU countries (except Great Britain, Denmark and Sweden, countries that benefit from the opt-out clause or temporary derogation from adopting the Euro) that must adopt the single currency sooner or later, which entails mandatory fulfillment of the nominal convergence criteria. Therefore, it is important to analyse their situation in order to understand whether they add to the strengths or to the weaknesses of the EMU, from a fiscal point of view. Third, the fiscal convergence in the non-EA countries is much less studied than in the EA.

## **2. Key findings in the literature up to present**

Theoretical studies on fiscal convergence are very limited in number. The only papers we know so far that developed a theory of fiscal convergence are Skidmore et al. (2004) and Onorante (2004). The model of fiscal convergence proposed by Skidmore et al. (2004) is based on the government spending convergence, specifically states with low levels of government spending will experience an increase of the budgetary apparatus, while states with high levels of government spendings will experience a decrease, thus leading to convergence in time. We can not employ this model in our paper, since the MT criteria refers to budgetary deficit and public debt, not to government spendings. In the model proposed by Onorante (2004), the fiscal constraints lead to a default coordination among states, characterized by lower deficits, lower interest rates and inflation rates under control. Joining the monetary union increases the fiscal activism, so it is preferable an ex-ante fiscal convergence both for the new members benefits and the stability of the monetary union.

As regards the empirical studies, there is poor work concerning the fiscal convergence in the EU Member States. Sanz and Velazquez (2003) test for the EU convergence in government spending

compared with OECD countries, showing that the EU countries converge to a fixed state faster than the OECD countries. Arestis, Khan and Luintel (2002) argue that an arrangement for fiscal sustainability is a necessity for an effective monetary union, by analysing the budgetary deficits convergence within the EA and between the EA and the U.S. deficits. The main results show the existence of fiscal convergence in most European countries, reaching the 3% of GDP target for budgetary deficit immediately after the launch of the Euro and the existence of lower fiscal shocks in the EA than in the U.S. Mongelli and De Bandt (2000) suggest, by analysing the fiscal convergence in the EA countries before the creation of the EMU, that the highest level of fiscal convergence in this countries was achieved in 1992-1995, recording a decrease after that. The heterogeneity in fiscal convergence and the lack of discipline in the EU countries was highlighted by Kocenda et al. (2008), by assessing the fiscal discipline of the new EU members with respect to EU15, between 1995 and 2005. Thus, the ability of the monetary union to provide fiscal discipline for its members is under question.

The novelty of our study consists of at least two main characteristics. First of all, such an analysis on the fiscal discipline of the EA candidates is missing in the literature, as far as we know. Secondly, there is no such work regarding the fiscal convergence of the non-EA countries with the EA performers and EA laggards.

### 3. Data and Methodology

We test for the fiscal discipline of the non-EA countries in the last four years of economic and financial crisis by analysing their distances from the convergence criteria as set in the MT: fiscal deficit up to 3% of GDP and public debt up to 60% of GDP. In addition, we complement this approach with an alternative way of measuring the fiscal convergence by reporting the non-EA countries performance to two different benchmarks: 1) the core of the EA represented by Austria, Belgium, France, Germany, Netherlands and Finland and 2) the periphery of the EA represented by Greece, Portugal, Spain and Ireland. For each benchmark we compute the average of the budgetary deficit/public debt expressed as percentage of GDP. We use annual data series taken from Ameco, one of the European Commission databases. The budgetary deficits and the public debts are expressed as shares of the GDP.

### 4. Main findings

Overall, the fiscal performances of the analysed countries were deeply affected by the crisis, both in terms of budgetary deficits and public debts. The austerity measures adopted by the national governments in order to achieve macroeconomic stability led to higher levels of deficits and debts especially in the EA core and periphery countries (Table no.1).

Table no.1: Fiscal performance of the non-EA, EU core and EU periphery countries

EU Member States	Budgetary deficit (%GDP)		Public debt (%GDP)	
	2008	2011	2008	2011
<b>EA core</b>				
Austria	-0.93	-3.44	63.83	72.19
Belgium	-1.25	-3.56	89.33	97.19
Germany	-0.06	-1.33	66.66	81.75
France	-3.33	-5.84	68.21	85.38
Netherlands	0.52	-4.30	58.46	64.25
Finland	4.30	-0.97	33.94	49.06
<b>Average</b>	<b>-0.13</b>	<b>-3.24</b>	<b>63.41</b>	<b>74.97</b>
<b>EA periphery</b>				
Greece	-9.80	-8.91	112.97	162.83

EU Member States	Budgetary deficit (%GDP)		Public debt (%GDP)	
	2008	2011	2008	2011
Ireland	-7.34	-10.29	44.35	108.12
Spain	-4.50	-6.65	40.07	69.59
Portugal	-3.64	-5.83	71.58	101.56
<b>Average</b>	<b>-6.32</b>	<b>-7.92</b>	<b>67.24</b>	<b>110.53</b>
<b>Non-EA Member States</b>				
Czech Republic	-2.23	-4.13	28.7	39.93
Latvia	-4.24	-4.20	19.79	44.8
Lithuania	-3.27	-4.99	15.5	37.75
Hungary	-3.71	3.62	72.88	75.88
Bulgaria	1.67	-2.46	13.69	17.49
Poland	-3.68	-5.59	47.11	56.74
Romania	-5.68	-4.86	13.41	33.95
<b>Average</b>	<b>-3.02</b>	<b>-3.23</b>	<b>30.15</b>	<b>43.79</b>

Source: AMECO database, European Commission, Authors' work

As regards the EA core countries, in 2008, when the economic and financial crisis started, they were characterized by budgetary deficits lower than the 3% of GDP limit, except France. The average of the budgetary deficits in this group was of 0.13% of GDP, the best performance being achieved by Finland, with a budgetary surplus of over 4% of GDP. Even though the budgetary positions were not worrying, the average level of public debt was above the 60% of GDP limit when the crisis hit. The four years of crisis led to an increase by over 3 percentage points in the budgetary deficit average (from 0.13% of GDP in 2008 to 3.24% of GDP in 2011) and by over 10 percentage points in the public debt average (from 63.41% of GDP in 2008, to 74.97% of GDP in 2011), putting pressure on the public finances in the EA core.

As regards the EA peripheral countries, the sovereign debt crisis emphasized the asymmetry with respect to the core countries. The root of the debt crisis is considered by the European leaders to be the fiscal indiscipline in peripheral countries. The EA periphery (commonly known as the PIGS countries) was hardly hit by the crisis, due to the fiscal imbalances recorded in 2008: the budgetary deficits average over 6% of GDP and the public debts average over 67% of GDP. The recent crisis worsened the fiscal positions in this group, increasing the budgetary deficit from 6.32% of GDP in 2008 to 7.92% of GDP in 2011 and the public debt from 67.24% of GDP in 2008 to no less than 110.53% of GDP in 2011.

In the non-EA group of countries, the fiscal imbalances were not so worrying when the crisis started: the average of budgetary deficits was 3.02% of GDP, while the public debt average was 30.15% of GDP. Regarding the budgetary deficit, Bulgaria was the only country that fulfilled the Maastricht criteria both in 2008 and 2011. The austerity measures adopted by the Bulgarian government have shifted the budgetary balance from a positive position in 2008 to a negative one in 2011. On the opposite side, Hungary improved its budgetary position from a 3.6% of GDP deficit to a 3.7% of GDP surplus in the last four years. However, the Hungarian success is only theoretical, being the result of an increase in the cyclical revenues by over 10% of GDP, obtained through the nationalization of the second pension pillar. In 2008, the year when the economic and financial crisis started, only the Czech Republic and Bulgaria fulfilled the Maastricht criteria regarding the budgetary deficit. In 2011, Hungary and Bulgaria managed to comply with the Maastricht criteria regarding the deficits. The rest of the non-EA countries were under the Excessive deficit procedure both in 2008 and 2011, with national budgets under pressure because of the more or less effective austerity measures adopted in order to counteract the negative effects of the crisis.

All the non-EA countries fulfilled the public debt criteria in times of crisis, having the advantage of low public debt levels when the international crisis started, except Hungary which violated the 60% of GDP limit for public debt both in 2008 and 2011. However, we can observe an increase in the level of public debt in the seven countries due to the loans contracted to achieve macroeconomic stability. For example, in the case of Romania, the increase in public debt was over 20 percentage points in the last four years because of the agreement with the international financial institutions – International Monetary Fund, European Central Bank and World Bank – but still under the limit imposed by the MT.

In terms of budgetary deficits, the non-EA countries achieved more convergence with the EA core than with the EA periphery, by reducing their distance from the EA core from -2.89 to 0 (Table no.2). This is not because of a significant improvement in the non-EA group, but rather because of a higher increase in budgetary deficits recorded by the best EA performers. Thus, the two groups attained similar budgetary deficit averages of 3.2% of GDP in 2011. The gap between the non-EA countries and the EA peripheral countries has widened in the last four years, from 3.3 in 2008 to 4.7 in 2011. This implies a better fiscal performance in the non-EA group, bringing these countries closer to the EA core.

Table no.2: Fiscal discipline and convergence in the non-EA countries – budgetary deficit

Budgetary deficit (% GDP)	Distance from EA core		Distance from EA periphery		Distance from the Maastricht criteria	
	2008	2011	2008	2011	2008	2011
Czech Republic	-2.1	-0.89	4.09	3.79	0.77	-1.13
Latvia	-4.11	-0.96	2.08	3.72	-1.24	-1.2
Lithuania	-3.14	-1.75	3.05	2.93	-0.27	-1.99
Hungary	-3.58	6.86	2.61	11.54	-0.71	6.62
Bulgaria	1.8	0.78	7.99	5.46	4.67	0.54
Poland	-3.55	-2.35	2.64	2.33	-0.68	-2.59
Romania	-5.55	-1.62	0.64	3.06	-2.68	-1.86
<b>Average</b>	<b>-2.89</b>	<b>0.01</b>	<b>3.3</b>	<b>4.69</b>	<b>-0.02</b>	<b>-0.23</b>

Source: AMECO database, European Commission, Authors' work

In terms of public debt, the non-EA countries achieved more fiscal convergence with the EA core, narrowing the gap by more than 4 percentage points and leaving the peripheral countries far behind. The distance from the EA periphery doubled in the last four years due to the surge in the PIGS public debts. However, we can not assess this as an economic success because all the countries analysed report higher levels of public debt.

Table no.3: Fiscal discipline and convergence in the non-EA countries – public debt

Public debt (% GDP)	Distance from EA core		Distance from EA periphery		Distance from the Maastricht criteria	
	2008	2011	2008	2011	2008	2011
Czech Republic	-34.71	-35.04	-38.54	-70.60	-31.30	-20.07
Latvia	-43.62	-30.17	-47.45	-65.73	-40.21	-15.20
Lithuania	-47.91	-37.22	-51.74	-72.78	-44.50	-22.25
Hungary	9.48	0.91	5.64	-34.65	12.88	15.88
Bulgaria	-49.72	-57.48	-53.55	-93.04	-46.31	-42.51
Poland	-16.30	-18.23	-20.13	-53.79	-12.89	-3.26
Romania	-50.00	-41.02	-53.83	-76.58	-46.59	-26.05
<b>Average</b>	<b>-23.59</b>	<b>-19.75</b>	<b>-37.09</b>	<b>-66.73</b>	<b>-29.85</b>	<b>-16.21</b>

Source: AMECO database, European Commission, Authors' work

## 5. Conclusions

In the context of the recent crisis, the non-EA countries made considerable efforts to achieve the fiscal discipline by fulfilling the Maastricht criteria. Their fiscal positions have not experienced major imbalances, but the efforts must continue in reducing the budgetary deficits and controlling the public debts.

In times of crisis, the EA candidates as a group achieved more convergence with the EA core than with the EA periphery, by reducing the distance from the EA core. This is due to the deterioration of the budgetary deficit in the latter group of countries. The result is not encouraging for the fiscal convergence given the fact that we would expect an improvement in the non-EA countries' fiscal performance in order to catch-up with the best performers of the EA and not the reverse. In terms of public debt, the fiscal convergence with the EA core would not be desirable, due to the high levels of public debt achieved by these countries. The EA periphery group remains by far the laggard in our analysis, increasing the fiscal gap both with the EA core and non-EA countries and running excessive unsustainable budgetary deficits and public debts.

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