EFR empowering your communications globally
The European Financial Review

How Robust is the Eurozone's Political Economy?

By editor1 • Aug 20th, 2013 • Category: Economics & Politics, Finance, New

By Richard Rose

On paper, the Stability Pact places clear obligations on national governments to reduce their annual deficit and debt, and to do so promptly or face big cash penalties. However, this technocratic agreement ignores the fact that each government is democratically accountable to its citizens as well as to the European Commission. This puts pressure on the European Commission to fudge the obligations it places on national governments in order to maintain the momentum for further European integration.

The eurozone is both an economic and a political construct. To survive it must be robust enough to withstand challenges from dissatisfied European citizens as well as from international market forces. However, the political assumptions on which the eurozone rests are vulnerable to popular pressures that can destabilise efforts to create a closer political as well as economic union among the European Union's member states.

The Powers of Technocrats
The intergovernmental Stability Pact that went into effect this January gives technocrats in the European Commission the power to demand that national budgets of eurozone countries achieve an annual budget deficit of no more than three percent of GDP and have a total debt of no more than 60 percent of GDP.[1] If a country deviates from these targets, the Commission can ask the Council to mandate a government to alter its national budget to conform to EC guidelines within a tight timetable. In June 2013, the Council recommended that seven countries–France, Malta, the Netherlands, Poland, Portugal, Slovenia and Spain–take corrective action by 1 October 2013, and notified Belgium that it had taken insufficient steps to reduce an excessive deficit.

National governments that have signed up to the fiscal compact are expected to enact national laws that limit their capacity to run big deficits on a recurring basis. The model law is that of Germany, but the economic situation in indebted countries is very different from that of Germany. Big deficits in eurozone countries have resulted from the failure to make structural reforms when Europe's economy was growing. This fault has sometimes been compounded by engaging in profligate public and private spending and borrowing.

> **"The eurozone is both an economic and a political construct. To survive it must be robust enough to withstand challenges from dissatisfied European citizens."**

In the past, many European governments managed their budget by using rosy scenarios that overestimated the growth in revenue and underestimated expenditure. Such over-optimistic forecasts led to ever-increasing debts and deficits that can no longer be financed by cheap euro-denominated borrowing. The Commission is now empowered to hold national governments to more realistic forecasts.

MORE FROM THIS CATEGORY

- Can the Euro Survive?
- How Robust is the Eurozone's Political Economy?
- China and Southeast Asia: Unbalanced Development in the Greater Mekong Subregion
- Trends in Market Microstructure
- The Much-Needed EU Pivot to East Asia
- 8 Steps for Managing Green Innovation in the Automotive Industry
- Beyond "Business as Usual" – A Truly Rational Approach to Smart Technology Implementation
- Alternative Investments and Benchmark Biases
- Can Good Governance Pre-empt Regulation in Financial Services?
- Management Lessons from the Emerging World: Seven principles that you can learn from the new Global Giants
- **Archive for 'Economics & Politics' »**

MORE FROM THIS CATEGORY

- In the Eye of the Storm: Europe's New Model of Unemployment Protection and the Economic Crisis
- How Robust is the Eurozone's Political Economy?
- The Concept of Luxury: A Global Phenomenon with Local Implications
- If We Build it, Will They Pay? How Accurate Predictions of Property Price Effects Can Help Realising Transport Infrastructure Projects
- Alternative Investments and Benchmark Biases
- A Radical Family Office: For The Ultra-Rich Who Want Optimum Financial Control
- Into the Shadows: How regulation fuels the growth of the shadow banking sector and how banks need to react
- Low Volatility Investing Revisited
- Can Good Governance Pre-empt Regulation in Financial Services?
- Europe Unhinged: What the Financial Crisis of 2008 Meant for the Integrity of the Eurozone
- **Archive for 'Finance' »**

The fiscal compact divides budget responsibility between EU institutions and national governments. The judgment that a national budget will run a bigger deficit than it should is made by Commission technocrats on the basis of their estimates of how much revenue the government will receive in the forthcoming financial year and what its total expenditure will be. Like all forecasts, both revenue and expenditure estimates involve assumptions about future economic activities. Because Commission calculations are only estimates, national ministers with far more information at hand can challenge the need for cuts by producing more politically congenial alternatives.

The margin for error in forecasting revenue is substantial, since every eurozone national economy depends in significant part on revenue from trade with other eurozone countries. Public expenditure estimates are vulnerable to alteration due to rising costs of open-ended entitlements such as unemployment benefit and health care, and on the cost of borrowing in international financial markets. Thus, any calculation of a government's budget deficit in the coming year is subject to a margin of error that can push the deficit further or closer to the 3 percent target.

If a government does not reduce its forecast deficit in line with Brussels' recommendations, the Commission may refer it to the Court of Justice of the European Union. If the Court decides that a national government has failed to meet its obligations under the fiscal pact, it can impose a fine of up to 0.1 percent of the country's Gross Domestic Product, a sum that can be equal to hundreds of millions of euros. These strict obligations were accepted at a time of great distress on the grounds that the only alternative to giving power to technocrats was the disruption of both rich and poor national economies and possibly the breakup of the European Union.

The fiscal compact is designed to provide an economic solution to a problem of political economy. If it succeeds, it will have a profound political effect by transferring power to Brussels over budgeting, a central political function of member states.

Challenges From National Democracy

Political commitment to the fiscal compact is vulnerable to resistance at the national level of politics, where governments are accountable to national electorates. Unlike most EU decisions, which are narrowly confined and have at most an indirect effect on some European citizens, the fiscal compact addresses very visible political issues of economic wellbeing. Following EU recommendations will require cutting expenditure on social programmes that account for the bulk of public expenditure and that are regarded, according to the EU's doctrine of subsidiarity, as the prerogative of member states. Cuts may involve raising retirement age to the German level; lengthening queues or boosting charges for medical treatment; and increasing class size in schools. While such cuts may immediately meet demands of the Commission, they do not reflect the priorities of a nation's citizens.

The fiscal compact is less threatened by a shortfall of democracy at the EU level than by a surplus of democracy within member states.[2] The elected heads of national governments that participate in collective decision-making in the European Council are accountable to 28 different national electorates. For example, the President of France, François Hollande, was elected as the leader of a Socialist Party that is strongly opposed to budget cuts required to reach eurozone target. The Frenchman who signed up to the fiscal compact is his predecessor, whom the French electorate rejected. Hollande's problem of securing national consent to a budget calculated by EU officials is a challenge to Brussels too.

The great majority of Eurozone states have governments that depend on a coalition of parties to enact their annual budget. In every Cabinet the making of the budget involves conflicts between spending ministries and a ministry of finance responsible for financing the budget deficit. A British Treasury minister once reckoned that if he only won half the battles over the budget, his ministry would be destroyed, but if he won all of them then the government would be destroyed. The prime minister is responsible for seeing that the compromises made will preserve the coalition government he or she heads and help it to win re-election.

Sequencing the costs and benefits inherent in a budget is politically critical. In a political business cycle, governments are expected to front-end load benefits; the costs may be met after the next election or in the more distant future, if at all. The fiscal pact reverses the sequence: the costs of reducing deficits and debt comes first, regardless of the electoral calendar, and the benefits of doing so are neither immediate nor visible. Growth-oriented economists argue that giving priority to deficit reduction in the current climate will lead to economic stagnation or even bigger deficits. National MPs can thus invoke economic as well as political theories to justify voting against big spending cuts.

The Cyprus bank crisis illustrates the insensitivity of EU technocrats to national politics. Given the need for EU funding, the Cypriot government accepted in Brussels imposing losses on Cypriots with small deposits in its banks as well as on mostly Russian rich depositors. The agreement ignored the fact that while Russians don't vote, Cypriots do. The Cypriot Parliament promptly rejected the proposal and a new agreement had to be drawn up in which small depositors were protected from loss.

> **"A national government commits the whole of its population by signing an EU treaty, but it usually has been endorsed by just under half the nation's voters."**

National courts have powers too. Portugal's highest court struck down as unconstitutional a cut in civil servant benefits approved by the national parliament after negotiations with Brussels. The German Federal Court in Karlsruhe has shown its independence of Berlin by repeatedly warning that there are limits to the transfer of power and money to European institutions; it leaves vague just what these limits are. The 2011 UK Referendum Act creates a legal obligation on the British government to call a national referendum on any transfer of power to Brussels.

Technocrats responsible for managing the economy have no responsibility for managing national election campaigns. Nonetheless, they cannot ignore election outcomes. In an EU of 28 member states there will be up to eight or more national elections each year, and some are bound to occur in countries under pressure from Brussels to make big cuts in

MORE FROM THIS CATEGORY

- In the Eye of the Storm: Europe's New Model of Unemployment Protection and the Economic Crisis
- Corporate Climate Change Targets and the Low Carbon Economy: A Critical Assessment
- 'We Have Been Innovative from the Beginning'
- How Robust is the Eurozone's Political Economy?
- China and Southeast Asia: Unbalanced Development in the Greater Mekong Subregion
- Trends in Market Microstructure
- The Role of Third Party Logistics Providers (3PLs) in the Adoption of Green Supply Chain Initiatives
- The Much-Needed EU Pivot to East Asia
- Board of Directors Oversight of Leadership Risk
- Innovate the Way You Innovate
- **Archive for 'New' »**

Follow us on

their deficits. The June 2012 election in Greece made an anti-EU party, the Syriza Front, the second largest in Parliament. In the February 2013 Italian election, the anti-EU Five Star Party destabilised coalition politics; for months the Italian state was represented in Council meetings in Brussels by the caretaker government of Mario Monti, whose party had finished fourth with just 10 percent of the vote.

Limited Popular Commitment to more Integration

A national government can explain why 'we' have to make big spending cuts to meet eurozone goals, but their electorate can respond by asking: Who do you mean by 'we'? After all, we, the national electorate, were not consulted.

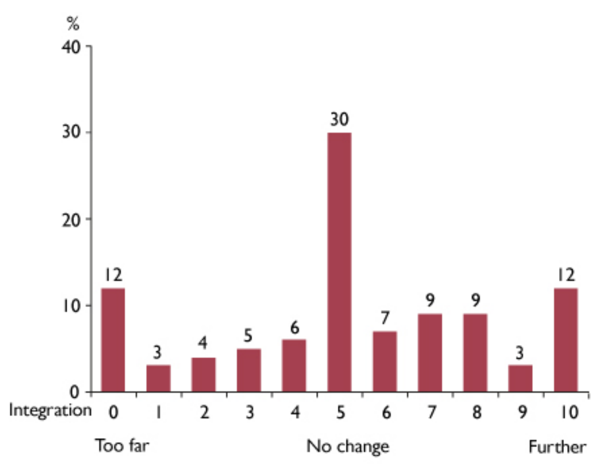
A national government commits the whole of its population by signing an EU treaty, but it usually has been endorsed by just under half the nation's voters. The Labour government that signed the Lisbon Treaty on behalf of Britain is an extreme example. It had gained office with only 35 percent of the vote and won only 29 percent at the election following soon after Gordon Brown signed the Treaty.

In most eurozone member states the government that agreed to join the eurozone has been long gone from the scene. Moreover, in a few years the national governments who signed the Stability Pact will have been replaced by another government. Even if a new government does not consider it feasible or desirable to repudiate the country's fiscal commitments, the political will is weak to defend what a predecessor has done.

Although EU treaties commit member states to advance toward an ever-closer Union, their citizens disagree about this goal. At the time of the last European Parliament election, two-fifths felt that European unification should be pushed further; three in ten thought it had gone too far; and an equal proportion more or less accepted the status quo. The figure shows the pre-eminence of those on the fence in their assessment of further integration (Figure 1). The swing group of Europeans is neither for nor against the principle of integration; it is pragmatically in favour of effective measures. However, the case for the Stability Pact is that it is needed to correct faults in the creation of the eurozone.

Figure 1. MEDIAN EUROPEAN FAVOURS LEAVING EU AS IT IS

Q 80. Some say European unification should be pushed further. Others say it has already gone too far. What is your opinion? Please indicate your views using a scale from 0 to 10.



Source: European Election Survey, 2009. Number of respondents in 27 countries: 27,069.

The European Parliament's role in eurozone policy is very limited. The 2014 European Parliament election will encourage new and populist parties to campaign against the stability pact and European integration as well. The outcome is likely to be an increase in the number of Members of the European Parliament who want less integration. However, pro-integration parties will continue to have up to three-quarters of MEPs or more, leaving anti-EU parties an ineffectual minority. This will encourage anti-EU parties to seek national votes on an anti-Brussels platform and press their government to be less cooperative with Brussels, as the United Kingdom Independence Party has succeeded in doing in Britain.

"A national government commits the whole of its population by signing an EU treaty, but it usually has been

BACK ISSUES

August 2013

- About
- Subscribe
- Archive
- Author Guidelines
- Industry Insights
- Gallery
- Advertising
- Contact Us
- Privacy Policy

endorsed by just under half the nation's voters."

Funding Effectiveness
EU institutions are now engaged in a battle on two fronts. Efforts to save the eurozone show some signs of success. No country has had to leave the group and 17 are now members. Moreover, eurozone governments in the countries with the worst financial problems have been able to continue financing their debts at lower rates of interest than at the worst of the crisis.

The big 'known unknown' of the European economy is whether it will soon be able to achieve sustainable economic growth. Economic growth generates additional tax revenue that painlessly reduces the budget deficit and the total national debt. It also avoids the Commission issuing unpopular recommendations to national governments. Current indications are that austerity policies are unlikely to deliver promised benefits in the immediate future. The stabilisation of the euro has been accompanied by economic stagnation rather than dynamic growth. The inability of austerity policies to deliver growth promptly is found in the United Kingdom as well as in eurozone countries.

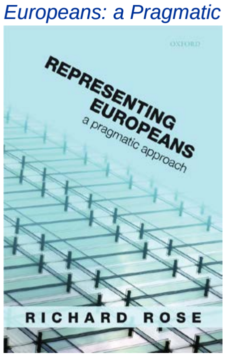
The Stability Pact has compounded difficulties by making targets so precise that they can easily be seen when violated. A demand for a heavily indebted eurozone country to achieve a deficit of 3 percent in the short term might make sense in a Superman comic strip but not in a no-growth Europe. The same is true of asking heavily indebted countries to reduce their debt to 60 percent of GDP. This will create evidence of failure. This could have been avoided if the targets had simply emphasised the direction of change. Getting a fiscally mismanaged country to reduce its deficit and debt would stop it continuing in the wrong direction while leaving open for annual negotiation the tempo at which satisfactory improvement is achieved. Moreover, it would be left to national governments to make the case in national terms for how much they cut, rather than be open to the accusation that they give priority to Brussels and Berlin rather than to their own voters.

"Austerity policies are unlikely to deliver promised benefits in the short term. The stabilisation of the euro has been accompanied by economic stagnation rather than dynamic growth."

When the first country is found to be in default of its eurozone obligations, the Commission and Council will have a choice between producing a fine or a fudge. There are clauses in the Pact that allow for cuts to be reduced in exceptional circumstances; however, if such a clause is regularly invoked it will undermine the credibility and authority of the stability targets. The EU will then have a choice between fining a large number of countries, publicly altering its targets, or trying to mask the limits of its technocratic capacity by fudging its demands on national governments.

The Commission can fudge demands on national governments by accepting that targets will be achieved later rather than initially planned. Member states cooperating with EU institutions have already been given extra years to comply in return for their complaisant behaviour. A rolling five-year plan has the advantage of setting a goal that can be routinely extended each year and thus need never be reached. Accepting such a fudge will undermine the authority of technocrats; however, it will also avoid a clash between national governments and the Commission over who best represents the claims of their citizens.

About the Author
Professor Richard Rose is Director of the Centre for the Study of Public Policy at the University of Strathclyde Glasgow and Visiting Professor at the European University Institute Florence. This article draws on his new book, *Representing Europeans: a Pragmatic Approach*, (Oxford University Press 2013).



References
1. For a convenient summary of main provisions of the Stability and Growth Pact and the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union, see 'Economic and Monetary Union and the Euro'. Luxembourg: Publications Office of the European Union, 2013.
2. See Rose, R. *Representing Europeans: a Pragmatic Approach* (Oxford University Press, 2013).

LEAVE A REPLY