Chapter Nine

Fiscal Policy in the European Union

Bardhyl Dauti
University of Tetova, Republic of North Macedonia
bardhyl.dauti@unite.edu.mk

Introduction

The European Union (EU, hereafter) Fiscal Policy represents an illustrative example of the increasing interaction between the sovereign EU member states' independent fiscal policy and the single authority of the monetary policy, promoted since 1999 by the European Union Central Bank, for achieving sustainable fiscal balance, sustainable development and sustainable growth. Therefore, sustainability as the focus of EU policy has been the subject of a lively public and academic debate (Collignon, 2012).

The European Council reached an agreement on the Stability and Growth Pact (SGP, hereafter) in June 1997, which clarifies the excessive fiscal deficit policies as anticipated by the Maastricht Treaty. After preliminary German suggestion for a Stability and Growth Pact (SGP), the debate in the European Union (EU) led to a double strategy: *The first strategy* requires an anticipatory, early warning system for detecting and adjusting the budget to ensure that the government budget deficit will not exceed the ceiling of 3 per cent of GDP. *The second strategy* requires an action for adjusting excessive deficits speedily, if they occur. Thus, countries should struggle for a balanced budget in the medium run (Heipertz & Verdun, 2003).

The SGP has met many conflicting considerations among economists, thus questioning the reasoning for checks and limits on countries' national fiscal policy in a monetary union. This chapter will attempt to examine the importance of the sustainability of fiscal policy for debt and deficit levels bearing in mind the EU framework. The chapter examines the necessity for budgetary guidelines in a monetary union from a political economy viewpoint. There are motives that may validate cer-

BY-SA G. Qorraj & I. Hashi (Eds.), *European Union and the Western Balkans.*
ToKnowPress · 2020 · https://www.toknowpress.net/ISBN/978-83-65020-33-8/159-178.pdf

tain fiscal policy rules because there is no assurance that governments will be able to control their deficits (Calmfors & Wren-Lewis, 2011). The first section of the chapter outlines the fiscal policy in the EU by focusing the analysis on the need for fiscal rules in the European Monetary Union (EMU) countries. The second section of the chapter reviews details of the SGP. The third section of the chapter outlines the European semester for economic and fiscal policy coordination. The fourth section outlines the implications of the EU fiscal policies for the Western Balkan (WB) countries and reviews some of the economic policies applied in the Western Balkan for approximating the region with the EU integration economic path.

The Fiscal Policy in the European Union

The role of fiscal discipline in a monetary union has a significant impact on a country's economic growth and other macroeconomic imbalances. The deficiencies of the monetary policy in the EMU due to its centralized status within the European Central Bank (ECB), in responding to country-specific shocks, made fiscal policy a pivotal element to better mitigate those shock, i.e. impacting the country's economic growth, inflation, budget deficit and government debt (Dabrowski, 2015; Hartmann & Smets, 2018).

Fiscal Displacement, Fiscal Autonomy and Fiscal Coordination

Based on the Maastricht convergence criteria related to fiscal discipline, according to article 127 of the Treaty of the Functioning of the European Union (2012) (TFEU, hereafter), the primary objective of the ECB has always been to maintain price stability. However, a constant growth of public debt may lead the central bank to use monetary policy to finance the government's budget deficit, thus, causing a state of fiscal dominance and making the central bank impotent in applying autonomous decisions and highly dependent on the fiscal position of the government, thus abandoning price stability. A constant rise in public debt may lead the central bank to applying monetary policy that would finance the budget deficit (Bordo & Siklos, 2015). Hence fiscal autonomy of the EMU sovereign countries is related to tax autonomy (taxing power of sub-central governments) and intergovernmental grants, aiming to better understand sub-central finance and intergovernmental fiscal relations (Blöchliger & Rabesona, 2009). With respect to tax autonomy, the most notable evolution is the increase in the 'discretion

on tax rates and tax reliefs' at the state level, the move towards more restrictive 'discretion on tax rates' category at both sub-central government (SCG) and state level, and the reduction of SCG power to determine their share in 'tax sharing arrangements' (Blöchliger & Rabesona, 2009). The role of fiscal policy coordination with a monetary policy is to provide sustainable economic growth in a context of price stability and external accounts as well as financial stability provided by interest rate and exchange rate stability (Laurens & De La Piedra, 1998). Fiscal policy coordination, on the other hand, is regarded as a critical tool for economic management by systematic monitoring of a country's fiscal policies between different levels of government that help achieving national goals in maintaining macroeconomic stability (Daniel & Davis, 2006).

The Need for Fiscal Rules in the EMU Countries

The convergence criteria related to fiscal policy applies in the EMU. Doubts about the effectiveness related to excessive deficit procedure as predicted in the Treaty, led to the proposal by the German minister of Finance (Waigel) for a stricter application on the rules for budgetary discipline.[1] After intense discussions, the European Council finally, with a force of law, adopted two council regulations and a resolution for the SGP, which does not have the force of law.[2] The regulations were related to the excessive deficit procedure and to surveillance.

According to the authors of the Maastricht Treaty, there is a necessity for a certain instruments to guarantee fiscal policies of the member states. The most convincing argument for the Stability and Growth Pact is that if public debt is anticipated to be on an unsustainable sequence, it may threaten price stability. As pointed by De Grauwe (1996) a high level of government debt may increase the inflationary bias. Following De Grauwe (1996), we can illustrate government budget constraint, as follows.

$$B_t = G_t - T_t + (R_t + \pi_t^e - \pi_t)B_(t-1), \quad (9.1)$$

[1] Germany, deeply attached to the concerns of price stability, proposed that under normal cyclical circumstances the budget deficit should not be higher than 1 per cent of GDP in order to create a safety margin below 3 per cent. It was also suggested that sanctions were to be imposed automatically, when the budget deficit exceeded the 3 per cent reference value.

[2] The resolution, which express political commitment, provides guidance to the council and member states on the application of the pact.

where B_t is the debt to GDP ratio, G_t is the primary government spending as a ratio of GDP, T_t is total tax revenue as a ratio of GDP, R_t is the real interest rate, π_t is the inflation rate and π_t^e is the expected inflation rate.[3] From equation (1), it follows that only the unanticipated component of inflation, $(\pi_t^e - \pi_t)$ affects the budget constraint. Setting $B_t = 0$, we obtain the debt to GDP ratio stabilizing condition, which, may be considered as a precondition for sustainable fiscal policy. It follows:

$$T_t = G_t + R_t B_{t-1} + (\pi_t^e - \pi_t) B_{t-1}. \tag{9.2}$$

Assuming rational expectations, we can write the sustainability condition as follows:

$$T_n = G_t + R_t B_{t-1}, \tag{9.3}$$

where T_n is the 'natural' rate of taxation given the level of spending, the accumulated debt, and the real interest rate. T_n is independent of inflation. Substituting equation (3) into equation (2), yield the following equation.

$$T_t = T_n + (\pi_t^e - \pi_t) B_{t-1}. \tag{9.4}$$

Based on these formulations, we expect that the unanticipated increase in inflation reduce the burden of the debt, in the same way, as it increases the output in the short run. The long run solvency constraint is similar to the natural rate of output growth. Assuming the authorities will tend to minimize the loss function, L of the form.

$$L = T_t^2 + A\pi_t^2. \tag{9.5}$$

Substituting equation (4) into equation (5), and assuming that the unanticipated component of inflation $(\pi_t^e - \pi_t)$, reach the equilibrium point of inflation rate π^*, it follows:

$$L = (T_n + \pi^* B_{t-1})^2 + A\pi_t^2, \tag{9.6}$$

where L denotes the loss function of the central bank and A denotes the coefficient of the inflationary bias measured by the terms of maturity of government debt. The equilibrium inflation rate becomes:

[3] We have written the nominal interest rate as the sum of the real interest rate and the expected inflation. From equation (1), it follows that only the unanticipated component of inflation $(\pi_t^e - \pi_t)$ affects the budget constraint.

$$\pi^* = \frac{B_{t-1}}{A(G_t + R_t B_{t-1})}. \quad (9.7)$$

This means that the debt to GDP ratio, denoted by the coefficient of B, affects the equilibrium point of inflation rate. Therefore, reaching a convergence to a low debt to GDP ratio reduces the risk potential for the EMU to face an inflationary bias.[4]

Although the ECB has a high degree of independence from the respective country government, it still may be forced to abandon the anti-inflationary policy. In case a specific EMU country gets into fiscal trouble, it is more likely to expect risk averse behavior from the potential investors within that country, by postponing the payments and hence sell their bonds. Accordingly, bond prices will start to go down and therefore the banks holding these lowered bond prices will find their capital reduced due to lowering pressures of bond prices, provoking the real and potential depositors to run away from the banking sector. This will increase the possibility of bailout and therefore make it very hard for the ECB to avoid getting involved (Eichengreen & Wyplosz, 1998).

Table 9.1 suggest that countries witnessing a rise in their government debt ratio also experience an expansion of government claims in bank portfolios. The first three columns of Table 9.1 show that in most countries the relative importance of banks, lending to government is not excessive. However, an additional safeguard that the SGP offers may be required on two grounds. First, EMU, may lead to more government borrowing and second, financial markets may not be able to discipline governments (Eichengreen & Wyplosz, 1998). The creation of a monetary union has contributed to the national governments following less sensible prudent policies, considering the following argument: Before the EMU, the country borrowing action was limited to the domestic capital market supply. The extra borrowing above the limit of the domestic market conditions would have exposed the borrowing country to the foreign exchange rate risk, thus causing potential losses for the respective borrowing country due to financial market speculations. With euro in the economic life of EMU countries, the capacity of the domestic capital market supply increases, which enables countries to in-

[4] According to De Grauwe (1996), by applying other forms of reducing inflationary bias like reducing the terms of maturity of government debt or issuing indexed debt the benefits of unanticipated inflation are reduced, and thereby the inflationary bias.

TABLE 9.1 Claims on Central Government as a Percentage of GDP and General Government Debt as a Percentage of GDP for Different Times in the EU and Non-EU Countries

Country	Claims on central government as a percentage of GDP			General government debt as a percentage of GDP		
	2000–2010	2011–2015	2016–2020	2000–2010	2011–2015	2016–2020
Euro Area	8.10	13.49	21.42	60.87	90.45	90.97
EU	7.65	12.17	19.28	60.61	85.51	85.37
United Kingdom	3.82	26.83	28.55	57.92	107.97	116.99
Switzerland	12.55	8.36	1.08	50.57	41.80	30.30
United States	20.18	34.80	39.99	91.17	134.37	136.24
Albania	34.80	29.34	26.19	58.83	67.52	73.14
Bosnia	−4.79	0.04	0.26	29.67	43.14	37.86
Kosovo	−14.40	−10.06	−0.22	4.82	9.46	13.10
North Macedonia	−2.23	5.00	9.06	32.89	29.73	37.41
Serbia	−0.97	2.53	6.48	69.76	49.04	58.02

NOTES Claims on central government include loans to central government institutions net of deposits, the values are weighted averages. Based on data from International Monetary Fund (https://www.imf.org), World Bank (https://www.worldbank.org) and OECD (https://www.oecd.org).

crease the borrowing activity without taking on any potential exchange rate risk pressure.

Stability and Growth Pact

The Stability and Growth Pact provides a working clarification of the Treaty's budgetary rules. It defines the actions for multilateral budgetary surveillance (preventive arm) as well as the conditions under which the excessive deficit procedure may be applied (corrective arm) (Heipertz & Verdun, 2010). The Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union. By requesting Member States to coordinate their budgetary policies and to avoid excessive deficits, it contributes to achieving macroeconomic stability in the EU and plays a crucial role in securing low inflation and low interest rate, which constitute essential assistance for providing sustainable economic growth and job creation (Heipertz & Verdun, 2010).

The main motivation of the Stability and Growth Pact is to guarantee sound budgetary policies on a permanent basis, thus, creating a space

for a long-term stability of public finances of the EMU countries (Dauti & Herzog, 2009). The Pact lays down the obligation for Member States to follow the medium term goals for their budgetary positions of 'close to balance or in surplus,' as defined under country-specific considerations.[5] SGP was adopted in 1997 by the European Council to institutionalize the deficit limit to three per cent of Gross Domestic Product, put down in the Treaty on European Union (TEU) for the Member States of the European Union, which participate in the European Monetary Union (Hepertz & Verdun, 2003). Officially, when the Council decides that an excessive deficit occurs, the country concerned is obliged to reduce its deficit below three per cent of GDP according to the recommendations of the Council or face sanctions at the end of a long drawn-out procedure[6] (Artis & Winkler, 1999). The purpose of the SGP was to strengthen the fiscal regime of EMU and make the existing fiscal rules of the TEU coherent, credible as well as rigorous and concrete, thus, not attempting to reduce potential ambiguities within the Treaty. There were two crucial reasons for the creation of SGP, *an economic reason* endorsed by the need for maintaining a budgetary discipline, which is a subordinate policy resulting from the framework of the fiscal provisions in the Maastricht Treaty and *political reason* ascribed to Waigel memorandum,[7] grounded on the observed need to secure a Germanic perception of 'fiscal stability culture' for the future EMU (Artis & Winkler, 1999).

The conditions for applying the excessive deficit procedure (EDP) are governed by the Article 126 of the TFEU.[8] The purpose of the EDP is to prevent excessive deficits and to guarantee they are quickly resolved in line with the amended SGP standards. EDP is triggered by the deficit

[5] Adjusting to such positions will allow Member States to deal with normal cyclical fluctuations without breaching the 3% of GDP reference value for the government deficit.

[6] These ultimate sanctions are serious. They first take the form of a non-interest-bearing deposit with the Commission of 0.2% of GDP and a variable component linked to the size of the deficit. Subsequently, the deposit is converted into a fine if the excessive deficit has not been corrected after two years.

[7] In case the concerned EU country is not capable of meeting the SGP requirement related to 'fiscal culture stability,' in relation to balanced budget or allowing for a marginal surplus over the medium term, whereas the original proposal suggested only a medium term deficit of one per cent of GDP, Waigel proposed automatic sanctions to be replaced by a politicized process.

[8] Based on the protocol No 12 of the TFEU (2012), the Council Regulation (EC) No 1467/97 (1997) and the Regulation (EU) No 1173/2011 (2011).

criterion or the debt criterion. *Deficit criterion* is triggered if the general government deficit is higher than the reference value of 3 per cent of GDP at market prices. *Debt criterion* is triggered if the general government debt is higher than the reference value of 60 per cent of GDP and the annual debt reduction target of one twentieth of the debt in excess of the 60 per cent threshold has not been achieved over the last three years (European Central Bank, 2019). Based on article 126 (11) of the TFEU, the EDP also provides sanctions in cases of non-compliance using a fine, consisting of a fixed component (0.2 per cent of GDP) and a variable component (up to a maximum of 0.5 per cent of GDP for both components taken together) (European Central Bank, 2019). The maximum fine may not exceed 0.5 per cent of GDP. Table 9.2 shows the general government deficit in the selected EU and EMU countries.

Table 9.2 shows that potential sanctions are not negligible, but in relation to the state's expenditures, they are almost 'peanuts.' However, a country will not be fined in case of 'exceptional circumstances'[9] and may avoid any sanction, if partner countries agree, in the event of a fall in GDP of between 0.75 and 2 per cent (Herzog, 2004). In general, the data presented on Table 9.2 confirm no evidence of excessive deficits (ED) above the tolerated limit of 3 per cent of GDP, for the group countries of the European Union and European Monetary Union, during the two periods, 2000–2010 and 2011–2015 and the years onward on estimated basis (2016–2019) and projected basis (2020–2022). However, as concern to individual EU countries, the results with respect to exceeding the tolerated limit of fiscal deficit of the 3 per cent of GDP, were worsening for Norway, on average basis, during both periods (2000–2010) and (2011–2015) and individual years (2016 onward).[10] In addition, for the period (2011–2015), Spain and Slovenia, on average, could not perform well in terms of sustainability of public finances, recording excessive level of fiscal deficit above the reference value of 3 per cent of GDP.

The hypothetical deposits that would have been paid by the selected

[9] If the deficit is caused by an unusual experience out of governing of the national authorities, or if output has fallen by more than 2 per cent.

[10] The case of Norway is not sensitive to its assessment in relation to the policy of fiscal deficit, based on the TFEU provisions, because the country is not a member of EMU. For the sake of comparison with the EU and EMU countries, the table also shows the data for some other non-EU and non-EMU countries, like Switzerland, United Kingdom, Israel and United States.

TABLE 9.2 General Government Deficit in the EU, Euro Area (EMU), and the Selected Non-EU Countries

Country	(1)	(2)	2016	2017	2018	2019	2020*	2021*	2022*
Euro Area	−2.84	−3.08	−1.47	−0.93	−0.46	−0.62	−0.87	N/A	N/A
EU	−2.83	−3.48	−1.67	−1.04	−0.68	−0.81	−1.05	−0.89	−0.86
Austria	−2.61	−2.09	−1.53	−0.82	0.18	0.67	−0.38	−0.09	0.10
Belgium	−1.37	−3.45	−2.36	−0.69	−0.79	−1.95	−1.45	−1.22	−1.35
Czech Republic	−3.84	−2.12	0.71	1.52	0.91	0.27	0.85	0.88	0.73
Denmark	1.60	−1.39	−0.11	1.79	0.69	3.78	1.54	1.95	1.99
Finland	2.86	−2.22	−1.71	−0.65	−0.86	−0.96	−1.04	−0.88	−0.94
France	−3.57	−4.35	−3.64	−2.96	−2.29	−3.01	−2.97	−2.81	−2.77
Germany	−2.53	0.14	1.16	1.36	1.84	1.52	1.47	1.55	1.59
Greece	−7.97	−8.39	0.54	0.73	1.02	1.52	0.95	1.06	1.14
Hungary	−5.89	−2.99	−1.81	−2.43	−2.12	−2.07	−2.11	−2.18	−2.12
Island	−2.05	−2.33	12.43	0.59	0.79	−1.53	3.07	0.73	0.77
Ireland	−3.76	−6.54	−0.67	−0.32	0.12	0.52	−0.09	0.06	0.15
Italy	−3.29	−2.98	−2.4	−2.44	−2.21	−1.61	−2.16	−2.12	−2.02
Luxemburg	1.93	0.95	1.92	1.32	3.07	2.43	2.18	2.24	2.48
Netherland	−1.54	−3.09	0.02	1.26	1.37	1.72	1.09	1.36	1.39
Norway	13.18	10.48	4.06	5.21	7.79	6.22	5.76	6.19	6.48
Poland	−4.74	−4.25	−2.39	−1.49	−0.24	−0.69	−1.22	−0.91	−0.76
Portugal	−5.58	−6.27	−1.94	−2.96	−0.35	0.08	−1.29	−1.13	−0.67
Slovakia	−5.47	−3.47	−2.58	−0.94	−0.99	−1.35	−1.46	−1.19	−1.25
Spain	−2.05	−7.72	−4.31	−3.02	−2.48	−2.86	−3.17	−2.88	−2.85
Sweden	0.98	−0.83	1.01	1.42	0.83	0.51	0.94	0.92	0.81
Switzerland	0.05	0.16	0.24	1.12	1.26	1.42	1.01	1.21	1.22
United Kingdom	−3.58	−6.24	−3.28	−2.42	−2.25	−2.31	−2.57	−2.39	−2.38
Estonia	0.62	0.36	−0.41	−0.72	−0.52	0.08	−0.39	−0.38	−0.32
Israel	−3.49	−2.96	−1.44	−1.12	−3.56	−3.94	−2.51	−2.78	−3.21
Slovenia	−2.77	−6.71	−1.92	−0.06	0.74	0.52	−0.18	0.25	0.33
Latvia	−3.07	−1.95	0.15	−0.78	−0.81	−0.57	−0.52	−0.67	−0.64
Lithuania	−2.89	−3.11	0.23	0.45	0.59	0.26	0.39	0.43	0.42

NOTES Column headings are as follows: (1) average 2000–2010, (2) average 2011–2015. General government deficit is measured as a percentage of GDP. All OECD countries compile their data according to the 2008 System of National Accounts (SNA 2008). * Data for the years of 2020, 2021 and 2022 is based on projection values, calculations based on 4 years moving average, starting from the yearly period 2016–2019. Based on data fromm OECD (https://www.oecd.org).

EMU countries, in case of applied penalties due to EDP, would have been higher for Germany, followed by France, Italy and Spain, during the two observed periods on average basis (2000–2010), (2015–2019), as well as during the years of 2016 onwards (Figure 9.1).

With respect to the SGP fiscal sustainability criteria of the debt to

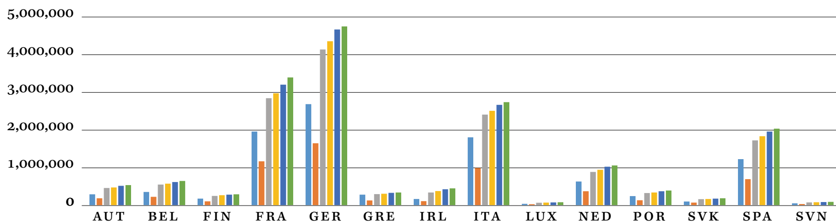

FIGURE 9.1 Maximum Expected Sanction Fee (0.5% to GDP) within the Stability and Growth Pact, in Million Dollars for Selected EMU Countries (light blue – 2000–2010, orange – 2011–2015, gray – 2016, yellow – 2017, blue – 2018, green – 2019)

NOTES This indicator is based on nominal GDP on millions of US dollars (current PPPS). This indicator is less suited for comparisons over time, as developments are not only caused by real growth, but also by changes in prices and PPPS. The calculations on two yearly periods (2000–2010) and (2015–2019) are based on average value. Based on data from OECD (https://www.oecd.org).

GDP ratio, which is tolerated up to 60% of GDP (Mathieu & Sterdyniak, 2003), the pact sets out a medium-term objective, for the purpose of reaching budgetary positions 'close-to-balance or in surplus' and implementing yearly stability programs which are subject to evaluation and recommendations by the Commission of the European Union. The Commission usually advise reaching price stability in EMU countries. In other words, the EMU needs a disciplining mechanism, like the SGP, accounting also for the country's sovereign fiscal policy, in order to react to potential idiosyncratic and asymmetric shocks (Herzog, 2004).

Several authors have been involved in the discussion of the two-category reform of the SGP, *radical reforms and moderate reforms* (Herzog, 2004). Radical reforms within SGP, point to the necessity for fundamental changes of the fiscal policy framework in Europe, leading to more centrally coordinated fiscal policy (Buti et al., 2005). Moderate reforms highlight the changes to a new target structure based on the current pact (Balassone & Franco, 2001; Buiter & Grafe, 2003).

With respect to debt criterion, the results shown in Table 9.3 confirm a worsening trend for Austria, Belgium, France, Greece and Italy followed by Portugal and Spain, all of them showing excess values of the debt/GDP ratio above the tolerated limit of 60% in relation to GDP. In addition, based on group countries, both EU and EMU, during the second decade, have shown failing results of the debt/GDP ratio, thus confirming a sensitive case with respect to the sustainability of European public finances.

TABLE 9.3 General Government Debt as a Percentage of GDP in Selected EU, Euro Area (EMU), the Non-EU Countries and Western Balkan Countries

Country	(1)	(2)	2016	2017	2018	2019	2020*	2021*	2022*
Euro Area	60.87	90.45	94.63	91.42	88.66	89.17	90.97	90.05	89.71
EU	60.61	85.51	89.22	85.92	83.21	83.1	85.36	84.40	84.01
Austria	75.5	97.27	102.53	96.55	90.95	88.89	94.73	92.78	91.84
Belgium	110.44	121.62	127.67	120.87	117.65	120.22	121.61	120.09	119.89
Czech R	32.82	53.15	47.43	43.33	39.74	37.81	42.08	40.74	40.09
Denmark	50.01	58.01	55.11	52.54	50.82	51.41	52.47	51.81	51.63
Finland	46.94	66.45	75.61	73.16	69.77	69.71	72.06	71.18	70.68
France	81.37	113.84	123.67	122.94	121.36	123.96	122.98	122.81	122.78
Germany	69.62	84.75	77.22	72.79	69.59	68.23	71.96	70.64	70.11
Greece	118.14	166.45	189.4	192.75	199.1	200.24	195.37	196.87	197.89
Hungary	69.61	98.21	98.75	93.07	86.52	83.25	90.42	88.31	87.12
Ireland	41.62	116.55	84.92	75.74	74.38	68.82	75.96	73.73	73.22
Italy	116.79	141.65	154.55	152.23	146.83	154.61	152.12	151.36	151.20
Luxemburg	20.6	29.76	27.87	29.65	28.84	29.96	29.08	29.38	29.32
Netherland	59.95	79.02	77.63	70.87	66.03	62.46	69.25	67.15	66.22
Norway	47.03	36.42	44.26	44.66	45.34	46.68	45.24	45.48	45.69
Poland	53.29	67.16	73.01	68.72	66.76	63.43	67.98	66.72	66.22
Portugal	81.87	137.49	144.31	143.19	137.32	136.3	140.28	139.27	138.29
Slovak R	46.02	62.34	67.74	65.56	63.47	63.36	65.03	64.36	64.05
Spain	55.51	102.98	117.33	115.78	114.51	117.33	116.24	115.96	116.01
Sweden	60.6	58.72	61.92	60.05	59.13	55.57	59.17	58.48	58.09
Switzerland	50.57	41.81	40.49	41.34	39.38	N/A	30.32	27.76	24.36
Great Britain	57.92	107.97	119.77	117.07	113.85	117.28	116.99	116.30	116.10
USA	91.17	134.37	138.21	134.82	136.37	135.69	136.24	135.78	136.02
Estonia	8.56	12.45	13.58	13.09	12.94	13.39	13.25	13.17	13.19
Israel	87.81	77.18	73.2	71.72	N/A	N/A	36.22	26.98	15.80
Slovenia	35.92	78.61	97.21	88.99	83.02	80.91	87.53	85.11	84.14
Latvia	22.13	48.18	49.72	47.03	45.65	47.14	47.38	46.80	46.74
Lithuania	29.02	50.14	50.89	47.11	40.67	44.55	45.78	44.50	43.88

NOTES Column headings are as follows: (1) average 2000–2010, (2) average 2011–2015. General government debt-to-GDP ratio measures the gross debt of the general government as a percentage of GDP. It is a key indicator for the sustainability of government finance. Changes in government debt over time primarily reflect the impact of past government deficits. * Data for the years of 2020, 2021 and 2022 is based on projection values, calculations based on 4 years moving average, starting from the yearly period 2016–2019. Based on data from OECD (https://www.oecd.org).

In general, participation in the EMU depends on the flexibility of fiscal policy, achieved targeted fiscal policies within the SGP framework and the assessment of the Maastricht criteria in relation to speeding up the nominal convergence toward EMU approximation path (Dauti

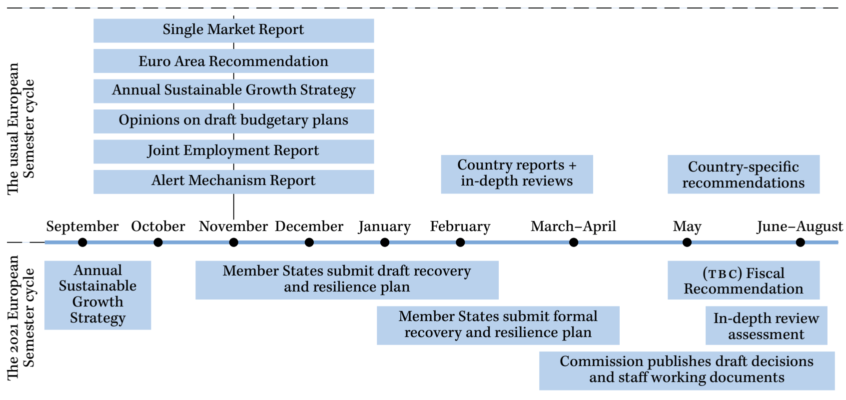

FIGURE 9.2 The Projected Cycle of European Economic Semester During 2021

NOTES Adapted from European Commission (2020a).

& Herzog, 2009; Dauti & Emini, 2019). The SGP recommends the requirement for perceiving the Maastricht criteria even after EMU membership and provides rather explicit guidelines for the course of deciding whether an EMU member country runs an excessive deficit or not. However, the SGP leads to a situation in which the new countries may refuse to participate in the EMU due to the lack of fiscal performance in terms achieving lows fiscal deficits. Empirical findings suggest that new entrant country into EU usually possess low government debt at early stage ending up with high level of fiscal deficit latter on, thus, obstructing the catching – up process of the new entrant countries to European levels (Tujula & Wolswijk, 2004; Nickel & Vansteenkiste, 2008; Agnello & Sousa, 2009).

European Semester for Economic and Fiscal Policy Coordination

Coordination of national budgetary policies is an important part of the economic governance framework in the Economic and Monetary Union. The European semester provides a framework for the coordination of economic policies in the EU by allowing the EU member countries to discuss their short run economic and budget plans and monitor the achieved progress of the stated plans throughout the year. Figure 9.2 shows the projected European semester cycle during 2021.

Due to the global pandemic crisis provoked by COVID-19, the euro area experienced a recession in the first part of 2020. The relevant institutions within European Central Bank (ECB) and the EU govern-

ments applied certain monetary and fiscal policy interventions with the aim of protecting jobs, refreshing the liquidity in the private sector, mainly the service sector, and supporting recovery in order to prevent the firms from bankruptcy. At the same time, the public health policies were addressed to strengthening the national health sectors for enhancing the capacity of the health institutions to deal with the pandemic. Based on the council recommendation on the economic policy of the euro area by the European Commission (EC), the Union took exceptional action plans by pushing short-term emergency measures, including the Coronavirus Response Investment Initiative (CRII) and CRII+ packages, proposing a major recovery plan which will use the EU state aid guidelines and activate the general escape clause of the Stability and Growth Pact, a conclusion endorsed by the economic and financial affairs council configuration (ECOFIN).

Based on the Council Recommendations on the economic policy of the euro area, the recommendations for the euro area during 2021 and 2022 were in the direction of improving the socio-economic flexibility of the EMU. The identified risk that could potentially threatened the socio-economic welfare of the EMU, based on the staff-working document (SWD) (Gortsos, 2020), of the European Commission program is related to the divergence risks in the labor market. The unemployment divergence in the euro area is largely due to differences in labor market institutions across countries and one of the main drivers of cross-country differences is youth unemployment within EMU (Boeri & Jimeno, 2015; Gortsos, 2020).[11] This course undermines the enlargement process of the EMU, and, hence, increases the risk potentials for macroeconomic and financial instability[12] by exerting downward pressure on wages and incomes and weakening of the international role of euro (Slavova, 2008; Bertola, 2008). Based on the Council Recommendations of the European Commission, the 2021 Draft Budgetary Plans, including the assessment of fiscal policies for the euro area can be summarized as follow (European Commission, 2020b):

[11] Based on the projections of the European Commission, dispersion in youth unemployment rates had remained high already before the COVID-19 crisis with youth unemployment still above 30% in 2019 in some Member States (Greece: 35.2%; Spain: 32.5%).

[12] Based on the projections of the European Commission, GDP growth in the euro area is forecast to decline by 7.8% in 2020 and to rebound by 4.2% in 2021 and by 3.0% in 2022 (European Commission, 2020b).

- Despite the forecasted growth in 2021, the recovery is expected to differ among EMU member states, making the economy to run below its potential due to uncertainty and potential risks, which remain high.
- The Draft Budgetary Plans point to an aggregate headline deficit of almost 6% of GDP and a debt-to-GDP ratio of around 100% in 2021, broadly in line with the Commission's 2020 autumn forecast.
- EMU member states have responded with significant fiscal measures in answer to the pandemic (4.2% of GDP in 2020 and 2.4% of GDP in 2021). Most emergency measures have been oriented to compensating workers for their wage decrease or wage loss and compensating firms for their income loss, due to lock down measures and social distancing and supply chain distortions (3.4% of GDP in 2020 and 0.9% of GDP in 2021). Other measures, such as indirect tax cuts or extra public works, have focused more broadly on supporting the economic recovery (0.8% of GDP in 2020 and 1.5% of GDP in 2021).
- Member States should avoid withdrawing fiscal support shortly. The mix of large output losses and downside risks calls for continued fiscal policy support in 2021.

The projected cycle of the economic recovery during the year of 2021, in a post-pandemic situation, is expected to come into life, thus, bringing the euro area closer to the optimum currency area and improve the transmission mechanism of monetary policy, thereby, strengthening the economic resilience and convergence of EMU member states. Further gains could also arise from completing the Banking Union and Capital Market Union and from strengthening the international role of the euro, which will be important to ensure Europe's financial and economic autonomy (Messori, 2020).

EU fiscal Policy and Implications for the Western Balkans

Fiscal policy in the EU is crucial for sustainability of public finances which on autonomous basis, within the individual EU countries, is manifested through efficient use of taxation in the direction of preserving reasonable level of fiscal deficit and national debt, in line with the SGP requirements related to 'fiscal culture stability.' The relevance of fiscal policy is also essential for maintaining reasonable

TABLE 9.4 Macroeconomic Indicators in the Group Countries of EU, EMU and WB region

	Average 2000–2010			Average 2011–2019			2020		
	EU	EMU	WB	EU	EMU	WB	EU	EMU	WB
(1)	17.94	17.27	19.25	20.24	19.47	20.82	18.13	17.45	15.22
(2)	47.44	47.49	34.88	47.91	48.37	36.89	54.93	55.71	40.50
(3)	44.74	44.65	33.19	45.94	44.27	34.14	45.22	45.60	32.58
(4)	1.77	1.43	4.24	1.61	1.29	2.60	−7.60	−8.26	−6.90
(5)	n/a	8.80	18.25	n/a	10.11	21.88	n/a	8.88	18.59
(6)	0.21	−0.25	−10.67	2.76	2.22	−7.35	2.35	1.90	−7.90
(7)	67.72	71.29	38.62	84.75	89.11	47.01	95.35	101.1	57.70
(8)	−2.70	−2.84	−1.65	−1.97	−2.10	−2.75	−9.71	−10.11	−7.93

NOTES Row headings are as follows: (1) tax burden – tax revenue (percentage of GDP*), (2) government expenditures (percentage of GDP), (3) government revenues (percentage of GDP), (4) GDP growth, constant prices (percentage change), (5) unemployment (percentage of labor force), (6) current account deficit (percentage of GDP), (7) general government gross debt (percentage of GDP), (8) net lending/borrowing under EDP (percentage of GDP). Based on data from International Monetary Fund (https://www.imf.org) and World Bank (https://www.worldbank.org).

trend of growth prospects in the Western Balkan countries,[13] enlightened through transmission channels of fiscal policy. The explanation is that the expansion of fiscal policy through investment stimulation will lead to growth prospect of WB transition economies, mainly via second round effect of investment increase on disposable incomes, and, therefore on consumption and economic growth. The improvement in growth prospects means new jobs, new income for households and thereby an increase of tax receipts for the budget, which helps to future increase in government spending. Table 9.4 outlines some of the main indicators of fiscal policy and macroeconomic environment in the EU, EMU and WB countries.

The data presented on Table 9.4 confirms the weak performance of all indicators during 2020, obviously due to disturbing effects of COVID-19 crisis, for the three group of countries (EU, EMU and WB). The real sector in the WB countries, suffered considerably, leading to economic slowdown and an increase of unemployment, thereby, ham-

[13] Western Balkan countries are Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia.

pering the efforts of WB economies to catch up in terms of real convergence with the EU countries.[14] In regards to external conditions, the high current account deficit in the WB countries of −7.90 percent in relation to GDP is a signal that WB countries may have been involved in a problematic deficit,[15] hence, making the reveal economies of the region to be highly dependent on imports.[16] The fiscal indicator, which indicates the government's success in collecting taxes, is tax burden[17] (tax revenue as a percentage of GDP). For the WB countries, tax burden is 2.91 percentage points lower than the EU countries and 2.23 percentage points lower than the EMU countries, indicating the potential presence of some degree of tax evasion in the WB countries and underground economy, which hides the potential tax receipts. With respect to 'fiscal culture criteria,' fiscal deficit reached its pick in 2020 for the three group of countries (WB, EU and EMU) above the tolerated limit of 3 per cent. This evidence indicates the distressing effect of the pandemic, forcing countries to postpone the collection of the taxes from the real sector in the name of anti-COVID-19 policies, thus damaging the national budgets, which, in the following periods, leads to an increase in borrowing activities of these countries, hampering their fiscal sustainability position by increasing the government debt. In the pandemic year of 2020, the government debt exceeded the tolerated limit of 60 percent for the EMU and EU countries, whereas, the WB countries reached their limit.

With regard to budgetary performance in individual WB countries

[14] On the demand side factors, the main contributors to growth slowdown, during the pandemic year of 2020, were the reductions in gross fixed capital formation, net exports, private and public consumption and investment. On the supply side factors, industrial output and construction activity were mostly negative in Albania and Bosnia and Herzegovina (European Commission, 2020b).

[15] This is a case where countries spend more on exports rather than available domestic production.

[16] When a country has a deficit, it must find a recovery method. Deficits are reduced through the inflow in the capital account potentially arising from the increase in the sales of assets, foreign currency and increase in the level of FDI. However, a current account deficit is not automatically a bad thing in case a certain country is importing the necessary inputs to produce an output, with an intention to export the outputs in the future, thus, potentially creating current account surplus, which would be attractive investment opportunity for foreigners.

[17] This ratio is relevant from macroeconomic perspective because reveals the government success in collecting taxes and the perception of tax burden for contributors.

TABLE 9.5 Macroeconomic Indicators in Individual WB Countries

	Average 2011–2019						2020					
	AL	BH	MN	NM	KOS	SER	AL	BH	MN	NM	KOS	SER
(1)	20.2	22.6	20.0	18.6	19.4	21.5	18.8	20.2	18.1	17.0	17.7	19.2
(2)	29.4	43.7	46.0	31.7	28.1	42.4	32.9	45.5	50.0	35.2	33.3	46.1
(3)	26.3	43.2	41.0	28.7	25.9	39.8	24.5	32.7	39.6	27.4	26.3	38.0
(4)	2.5	2.2	2.8	2.5	3.6	2.0	−7.5	−6.5	−12.0	−5.4	−7.5	−2.5
(5)	14.5	24.3	n/a	25.5	26.9	18.2	11.8	19.0	n/a	20.2	27.7	13.4
(6)	−9.0	−5.8	14.4	−1.8	−7.1	−6.0	−11.7	−4.4	14.2	−4.7	−6.0	−6.4
(7)	68.9	40.7	64.4	36.8	12.4	58.9	83.3	38.9	90.8	50.3	23.4	59.5
(8)	−3.1	−0.6	−5.0	−3.0	−2.2	−2.6	−8.4	−5.8	−10.4	−7.7	−7.0	−8.1

NOTES Row headings are as follows: (1) tax burden – tax revenue (percentage of GDP*), (2) government expenditures (percentage of GDP), (3) government revenues (percentage of GDP), (4) GDP growth, constant prices (percentage change), (5) unemployment (percentage of labor force), (6) current account deficit (percentage of GDP), (7) general government gross debt (percentage of GDP), (8) net lending/borrowing under EDP (percentage of GDP). Based on data from International Monetary Fund (https://www.imf.org) and World Bank (https://www.worldbank.org).

during the observed period 2011–2019, as Table 9.5 shows, they all recorded fiscal deficit to GDP ratio of less than 3 per cent and debt to GDP ratio below the tolerated limit of 60%, with the exception of Albania and Montenegro which exceeded the tolerated fiscal and debt limits only marginally. However, during the pandemic year of 2020, both Albania and Montenegro were the worst-case scenario with regard to sustainability of public finances, exceeding the tolerated limit of fiscal deficit by 5.1 and 4.7 percentage points, respectively, and debt ratio by 23.3 and 30.8 percentage points, respectively.

Reviewing the data on the individual WB economies, presented in Table 9.5, we can deduce that the biggest problems arose from the real sector (GDP and unemployment). The relative growth rate of GDP for the WB countries, ranging from 2.2 to 3.6 percent, is insufficient for the WB region to catch up in terms of real convergence with EU countries. Unemployment is also relatively high for WB countries, ranging from 14.5 percent in Albania to 26.9 percent in Kosovo. External positions in many WB countries, as shown in Table 9.5, remained weak, making the WB countries less capable to cope with the competitive pressures within the EU countries.

From the forward-looking perspective, the Western Balkan countries face substantial structural challenges as they struggle to fine-tune their national fiscal policies in line with the EU agenda in order to make

their economies capable of meeting the competitive pressures within the EU. Efforts in the WB countries directed at maintaining deficit and debt levels at reasonable levels, aggravated by different factors like population aging, costly pension schemes, migration and youth unemployment, may be unsuccessful. This situation leads to potential increase in expenditure pressure. Therefore, the WB countries are persistently exposed to the need for fiscal consolidation as their approximation paths to the EU integration process reach the satisfactory level.

References

Agnello, L., & Sousa, R. M. (2009). *The determinants of public deficit volatility* (ECB Working Paper No. 1042). European Central bank.

Artis, M. J., & Winkler, B. (1999). The stability and growth pact: Trading off flexibility for credibility. In A. J. Hughes, M. M. Hallett, S. E. Hutchinson, & H. Jensen (Eds.), *Fiscal aspects of European monetary integration* (pp. 157–188). Cambridge University Press.

Balassone, F., & Franco, D. (2001). *EMU fiscal rules: A new answer to an old question?* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2094456

Bertola, G. (2008). *Labor markets in EMU: What has changed and what needs to change* (Economic Papers 338). Publications Office of the European Union.

Blöchliger, H., & Rabesona, J. (2009). *The fiscal autonomy of sub-central governments: An update* (OECD Working Papers on Fiscal Federalism No. 9). OECD Publishing.

Boeri, T., & Jimeno, J. F. (2015). *The unbearable divergence of unemployment in Europe* (CEP Discussion Paper No. 1384). Centre for Economic Performance.

Bordo, M. D., & Siklos, P. L. (2015). *Central bank credibility: An historical and quantitative exploration* (NBER Working Papers No. 20824). National Bureau of Economic Research.

Buti, M., Eijffinger, S., & Franco, D. (2005). The stability pact pains: A forward-looking assessment of the reform debate. In R. Neck & J. E. Sturm (Eds.), *Sustainability of public debt* (pp. 131–160). MIT Press.

Buiter, W. H., & Grafe, C. (2003). Reforming EMU's fiscal policy rules: Some suggestions for enhancing fiscal sustainability and macroeconomic stability in an enlarged European Union. In M. Buti (Ed.), *Monetary and fiscal policies in EMU: Interactions and coordination* (pp. 92–156). Cambridge University Press.

Calmfors, L., & Wren-Lewis, S. (2011). What should fiscal councils do? *Economic Policy, 26*(68), 649–695.

Collignon, S. (2012). Fiscal policy rules and the sustainability of public debt in Europe. *International Economic Review, 53*(2), 539–567.

Consolidated version of the Treaty of the Functioning of the European Union. (2012). *Official Journal of the European Union,* C 326.

Council regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure. (1997). *Official Journal of the European Communities,* L 209.

Dabrowski, M. (2015). *Monetary union, fiscal, and macroeconomic governance.* Publications Office of the European Union.

Daniel, J., & Davis, J. M. (2006). *Fiscal adjustment for stability and growth.* International Monetary Fund.

Dauti, B., & Emini, E. (2019). Economic challenges of North Macedonia's bridging toward European Union, with focus on real and nominal convergence. *Economic Vision, 6*(11–12), 31–41.

Dauti, B., & Herzog, B. (2009). *Economic convergence between Macedonia and European Monetary Union Member States: The five Maastricht criteria* (MPRA Paper No. 21222). Munich Personal RePEc Archive.

De Grauwe, P. (1996). The economics of convergence: Towards monetary union in Europe. *Weltwirtschaftliches Archiv, 132*(1), 1–27.

Eichengreen, B., & Wyplosz, C. (1998). The Stability Pact: more than a minor nuisance? *Economic Policy, 13*(26), 66–113.

European Central Bank. (2019). *Convergence Report.*

European Commission. (2020a). *Aligning timing: 2021 European Semester cycle.* https://ec.europa.eu/info/sites/info/files/26-10-2020_semester_slide.jpg

European Commission. (2020b). *European economic forecast: Summer 2020 (Interim)* (Institutional Paper No. 132).

Gortsos, C. V. (2020). The response of the European Central Bank to the current pandemic crisis: Monetary policy and prudential banking supervision decisions. *European Company and Financial Law Review, 17*(3–4), 231–256.

Hartmann, P., & Smets, F. (2018). The European Central Bank's monetary policy during its first 20 years. *Brookings Papers on Economic Activity,* (2), 1–146.

Herzog, B. (2004, 24 June). *Stability and Growth Pact and its institutional inconsistencies* [Conference presentation]. Second Pan-European Conference, Bologna, Italy.

Heipertz, M., & Verdun, A. (2003). *The dog that would never bite? The past and future of the stability and growth pact* (MPIfG Working Paper 03/12). Max Planck Institute for the Study of Societies.

Heipertz, M., & Verdun, A. (2010). *Ruling Europe: The politics of the stability and growth pact.* Cambridge University Press.

Laurens, B., & De La Piedra, E. (1998). *Coordination of monetary and fiscal policies* (IMF Working Paper 98/25). International Monetary Fund.

Mathieu, C., & Sterdyniak, H. (2003, 3–5 July). *Reforming the Stability and Growth Pact: Breaking the ice* [Conference presentation]. EcoMod2003, Istanbul, Turkey.

Messori, M. (2020). *Europe's debate on fiscal policy: Too much yet too little* (CEPS Policy Insights No. 2020-08). Centre for European Policy Studies.

Nickel, C., & Vansteenkiste, I. (2008). *Fiscal policies, the current account and Ricardian equivalence* (ECB Working Paper No. 935). European Central Bank.

Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area. (2011). *Official Journal of the European Communities,* L 306.

Slavova, T. (2008). A rank order and efficiency evaluation of the EU regions in a social framework. *Empirica, 35*(4), 339–367.

Tujula, M., & Wolswijk, G. (2004). *What determines fiscal balances? An empirical investigation in determinants of changes in OECD budget balances* (ECB Working Paper No. 422). European Central Bank.