Weaving the Basket: Elusive Fiscal Convergence in the European Union

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Abstract: The European Union has recently survived a debt crisis that threatened to destroy its single currency, the euro. The dominant narrative in the aftermath of the crisis has been the need for southern European convergence toward northern European standards of fiscal rectitude. In fact, a project to promote macroeconomic convergence has been in place since the early 1990s as part of the euro area regime, the Economic and Monetary Union (EMU). Despite the EMU fiscal rules' initial failures, its members have doubled down on the goal of fiscal convergence in the wake of the debt crisis. This chapter explores the nature of the rules of this regime, and examines how continuing flaws in these rules—in conjunction with the inherent tensions between a German-led push for convergence among countries with fundamentally distinct economic models—leave Europe's fiscal future in doubt.

Fiscal performance is like much else in Europe: the past hangs heavily in the air, ever poised to repeat itself. In ancient Rome, emperors used a *fiscus* ("basket" or "treasury") to collect and store revenues from the provinces—revenues used to sustain the empire in the face of internal instability and external attacks. Two millennia later another pan-European polity, the European Union (EU), is seeking to build a stronger *fiscus* to banish its post-2009 debt crisis. Will this new fiscal basket hold together, or will the European Union too fall prey to internal (fiscal) rot and external (speculative) attacks?

The European Union's debt crisis is surely reflective of problematic fiscal performance. Yet the prevailing tale of two Europes—a disciplined "core" of northern European countries and a frail "periphery" of primarily southern Europeans—is at best only partly accurate. This narrative captures real cross-national differences but obscures both the near-past fiscal difficulties of some northern countries and the extent to which southern countries' problems have been magnified by Economic and Monetary Union (EMU), the regime governing the euro. Rather than focusing on the debt crisis itself, this chapter examines the post-1990 fiscal regime in the "eurozone" and its goal to improve fiscal performance in peripheral eurozone countries such as Italy, Spain, and Greece. As it demonstrates, both the regime rules and the convergence toward fiscal orthodoxy they prescribed have been shaped by both the internal contradictions of the regime itself and the inherent difficulties in reconciling the irresistible force of German hegemony and the immovable objects of persistent "varieties of capitalism" in Europe.

Any analysis of fiscal policy coordination in the EU must begin from the understanding that, while the EU is a single polity, it is an *international* polity. Macroeconomic policymaking in the eurozone reflect the complexity of this polity: the subset of EU members that adopted the single currency, the euro, delegated monetary policy to the European Central Bank (ECB); fiscal policy, by contrast, remains primarily in national hands—and thus requires international coordination underpinned by rules. In this context, fiscal policy dynamics respond largely to international political and economic conditions; factors addressed elsewhere in this book—such as party alignments and international economic integration—are rather less germane. In an incomplete international polity such as the European Union, fiscal policy is closely associated with national sovereignty, and thus EU-level fiscal coordination, not to mention integration, is *hard*.

This chapter explores how EU member states have struggled since the mid-1990s to promote fiscal rectitude and safeguard the single currency regime. The first section briefly discusses the path *not* chosen: full economic union, in which governments would delegate much greater supranational fiscal authority to the EU—and thus sacrifice more sovereignty to solve the dilemmas of international coordination. The next section addresses the co-evolution of EU fiscal performance and the supranational rules its members adopted to promote convergence toward fiscal orthodoxy. The subsequent section considers both the design flaws in these rules as well as non-institutional explanations for EU fiscal performance, focusing on the uneasy balance between the power of dominant creditor states (notably Germany) and the persistence of diversity in the economic models of different EU countries. The chapter concludes with a consideration of the likely success of reformed fiscal rules adopted during the debt crisis within a continent whose citizens are increasingly skeptical about EU authority.

10.1 European Union fiscal authority

There are two distinct fiscal arenas in the European Union. The main focus of this chapter is the collective fiscal performance of the member states of the EU. Yet the EU has some fiscal capacity itself—though this capacity is quite low. By identifying the limits on the EU's supranational fiscal authority we can get an initial glimpse into the politics of fiscal coordination in Europe.

The European Union lacks the *sine qua non* of fiscal authority, the power to raise its own revenues through direct taxation. Brussels acquires revenues through voluntary transfers by member state governments, with seven-year budgets agreed through tough intergovernmental bargaining.[i] The EU does have some directly collected revenues drawn primarily from tariff duties levied on goods and services entering the EU's single market, and also draws revenue from a harmonized value-added tax and member state charges based on gross national income. The size of the EU budget is approximately 1 percent of total EU GDP, or €150 billion ($207 billion) for 2014. (As a basis of comparison, the United States, with an economy roughly the same size of the European Union's, had a (proposed) federal budget in 2014 of $3.8 trillion.)

The EU spends its relatively scarce resources quite differently from its member governments. It has a limited role in traditional areas of interest for national governments, such as defense, public health, and education. (Also, because it cannot borrow, the EU spends nothing on debt service.) Rather, the EU has focused its spending on two particular areas: the Common Agricultural Policy (CAP) and "structural funds," or aid to poor regions. Agriculture has long been the single biggest area of EU expenditure, primarily reflecting France's leading role in setting EU priorities in its early days. Agricultural expenditures were 41 percent of the EU budget in 2012, after peaking at 73 percent in 1984—with funds that once went to production and export subsidies now focused on price supports and "environmental maintenance."[ii] Structural funds, for their part, emerged in the 1970s as a means to promote solidarity within a growing community that included new members (e.g., Ireland, Greece) significantly poorer than the original six (West Germany, France, Italy, Netherlands, Belgium, Luxembourg). Structural funds are allocated to regions rather than countries, reflecting internal regional diversity of countries such as Italy—and allowing all member states to claim at least some structural funds for their poorer regions. Yet while both the CAP and (especially) structural funds are tangible forms of intra-EU solidarity, there has been little move toward a transfer union in which funds would be transferred automatically from Brussels to governments or households of member states experiencing the effects of cyclical economic downturns.

Indeed, it is the absence of a transfer union and the power of direct taxation that defines the limits of EU fiscal authority. While it is beyond the scope of this paper to explain these limits, certain conditions that help explain these limits are also relevant to international fiscal coordination in the EU. First, the European Union is not a state: despite their delegation of major policy areas to Brussels, EU members are sovereign states that remain reluctant to cede authority to the EU in areas of core sovereignty (taxation, defense) or that are politically sensitive (health, education). Second, EU fiscal affairs follow the standard dynamics of distributional politics: budgetary agreements reflect a compromise between net contributors to the EU budget (wealthier countries and/or those with small agricultural sectors), which seek to limit their transfers, and net recipients (poorer countries and/or those with larger agricultural sectors), which seek to maximize their receipts. The combination of all member states' continued defense of central sovereign authorities, and wealthier countries' incentives to avoid large, automatic transfers presents large and perhaps insuperable barriers to supranational control over an expanded EU budget, at least for the foreseeable future.

Indeed, distributional politics is central to understanding the rules the EU has adopted to manage fiscal externalities—the external effects of individual countries' taxation and spending choices—in the absence of supranational fiscal authority. In the EU generally but especially in the euro area, fiscal externalities are high: an individual state's fiscal expansion can benefit others through a stimulus of economic activity within the single market, but a state's unsustainable fiscal policy that produces a debt crisis—as with that in Greece in 2009—can threaten financial disaster for all. To understand fiscal performance in the EU—and to put the debt crisis in its proper context—one must appreciate the fact of high fiscal interdependence and the demand for, and difficulties of, rules and institutions to manage these externalities.

10.2 EU rules and fiscal convergence

A standard narrative of the EU debt crisis is that the 2008 global financial crisis exposed the unsustainability of peripheral and/or southern European member states' fiscal policies and ultimately necessitated a rescue by the more fiscally responsible northern European creditor countries.[iii] While this narrative has some basis in reality, it accurately describes the fiscal malpractice of only one country, Greece, and tends to obscure the strong fiscal performance of crisis-beset countries such as Spain and Ireland and the rather more checkered record of the purported fiscal paragon, Germany.

The EU established its own measures of fiscal performance in the rules it adopted to manage fiscal externalities in the eurozone. Thus we must first consider how these rules sought to socialize members to a specific definition of sustainability—and to promote convergence among all EU states (notably Italy) toward a German/northern Europe model of orthodoxy. Beginning in the early 1990s, EU members adopted a set of fiscal targets as well as procedures to promote compliance with them. Yet these EU rules formed an awkward regime: they created a different set of rules for members participating in EMU and those that did not (see Table 10.1 below), and for eurozone countries they created unbalanced macroeconomic policy authority between a supranational monetary policy (conducted by an independent ECB) and intergovernmental fiscal rules.

[TABLE 10.1 HERE]

This section first describes the rules adopted by the EU and eurozone to promote convergence toward a model of fiscal orthodoxy, from before the birth of the euro in the late 1990s to the adoption of tighter fiscal rules in 2011-2012. Then it briefly examines the actual fiscal performance of the EU, euro area, and a sample of member states during 1995-2013. Variation in member states' fiscal performance not only indicates the limited effect of EU rules but also calls into question the received wisdom about northern European rectitude and southern European profligacy.

EU fiscal rules, 1991-2012

The Maastricht Treaty (or Treaty on European Union, TEU), agreed in late 1991, contained both a provisional architecture for the EMU and the first foray into EU fiscal rules. Several articles of the treaty stipulated measures to protect the independence of the new European Central Bank and impose market discipline on countries that would use the euro, including articles forbidding monetary financing of national budget deficits and intergovernmental bailouts. The TEU also articulated precise maximum levels for budget deficits (3%) and public debt (60%)—two of the "Maastricht criteria" (or "convergence criteria") for countries aiming to adopt the euro—and created an "excessive deficit procedure" (EDP) to monitor and if necessary punish eurozone members that repeatedly exceeded the deficit target. Germany insisted on these articles' inclusion to ensure that countries with poor fiscal reputations, such as Italy, would be forced to converge toward more orthodox practices—and thus could not free ride on northern Europeans' fiscal credibility and pursue economic expansion through borrowing (Dinan 2010).

Over the subsequent two decades, including the first decade of the euro, these rules would be expanded and strengthened before being weakened, partially overturned, and then resuscitated (see Table 10.2 below). Here the focus is on two interrelated elements of these rules: the extent of the obligation they impose on member states, both to consult with the EU in making their budgets and to face punishment if they are in noncompliance; and the extent to which they delegate authority to both the European Commission (the EU's executive arm) and the European Court of Justice (ECJ) to undertake monitoring and punishment free from member state interference—specifically, via the intergovernmental European Council.

[TABLE 10.2 HERE]

The Stability and Growth Pact (SGP, 1997) drew on both the TEU and a 1995 German Finance Ministry proposal for a "stability treaty" to strengthen the EU's fiscal rules. The SGP formalized the 3% Maastricht ceiling for budget deficits, which facilitated monitoring and peer review. Through its "corrective arm" the SGP increased budgetary consultation with and monitoring by the Commission, and formalized the excessive deficit procedure to warn and if necessary punish member states (with fines) that breached deficit limits. The SGP's "preventive arm," for its part, was primarily advisory, entreating member governments to aim for balanced budgets over the medium term—thereby including a bit of flexibility regarding deficits with reference to the economic cycle.

Yet, as Heipertz and Verdun (2009) argue, the SGP proved merely "declaratory": the Commission lacked the independent authority to enforce compliance, as demonstrated when Germany and France breached the SGP's deficit targets in 2003 and 2004. In accordance with the wishes of the German and French governments, in March 2005 the Commission and member states agreed to soften the application of the excessive deficit procedure, moving the SGP away from *ex post* punitive measures and promoting more *ex ante* coordination and consultation regarding national budgets. This reform retained the basic goal of promoting fiscal sustainability but left the SGP toothless and weakened the Commission's position as an impartial enforcer of the rules.

In the context of a weakened SGP, the 2008 global financial crisis triggered a series of fiscal crises in the euro area. Panic began with Greece in 2009 and subsequently engulfed Ireland, Portugal, and Cyprus—and, more dangerously, threatened the solvency of two of the largest eurozone countries, Spain and Italy. The EU's institutional response to the crisis was, in effect, to destroy and rebuild the foundations of the existing regime. It rescinded key provisions of the TEU, overturning the "no bailout clause" by permitting intergovernmental rescues of governments facing imminent default on their public debt. Greece, Ireland, Portugal, and Cyprus have all drawn on the new funds—the temporary European Financial Stability Facility (EFSF) and then the permanent European Stability Mechanism (ESM)—created by EMU members to deter speculative attacks on eurozone government bonds and, if necessary, serve as a lender of last resort.[iv]

During the same period, EU and eurozone members pursued both EU legislation and an intergovernmental treaty to intensify fiscal coordination and strengthen EU institutions' oversight of national budgeting (see Buti & Carnot 2012). In late 2011 the entire EU membership adopted the "six pack," a set of six reforms that reinforced surveillance of member states' expenditures and debt levels (as well as more general macroeconomic imbalances), following an earlier measure to intensify *ex ante* coordination in national budgeting. At the same time, members of the eurozone adopted the "two pack," reforms involving a deeper level of fiscal coordination among countries using the single currency, including synchronized adoption of national budgets and enhanced monitoring by and consultation with the Commission. (Members must submit national budgets to the Commission for approval before national parliaments vote on them.) EU members simultaneously negotiated an international treaty, the Fiscal Compact, which required signatories to adopt national legislation and/or constitutional amendments enshrining a "debt brake" akin to the one adopted by Germany in 2009.[v] The compact enhanced the EU's capacity to punish fiscal profligacy by requiring a qualified majority of members to vote *against* punishment rather than for it—a change that would make the sort of deferral of punishment Germany and France had earlier engineered much more difficult.[vi]

Overall, the fiscal rules adopted during the debt crisis have essentially doubled down on the original rules in the TEU and SGP. They reasserted the underlying rationale to promote, or now *require*, convergence toward fiscal orthodoxy, especially in the eurozone but also the EU as a whole. The reformed rules reaffirmed the initial fiscal targets (3% and 60%) and strengthened the excessive deficit procedure, even as they intensified EU involvement in national budgeting processes—which Schimmelfennig (2014: 325) called "*ex ante* control over national budgets." And even though EU members rescinded the TEU's "no bailout clause," the ESM—essentially, a European IMF—possesses more intrusive mechanisms of EU authority over member states forced to seek financial rescue. Greece as well as Ireland, Portugal, and Cyprus essentially lost their fiscal sovereignty within the context of their bailout packages, forced to adopt reforms handed down by the "troika" (the EU, IMF, and ECB) or face the loss of loans to stave off default. So, after the demise of the SGP, members of the EU and eurozone greatly strengthened collective fiscal mechanisms to cope with the debt crisis—and prevent a future crisis—but did not delegate any significant authority to the EU to collect and distribute more of its own resources, and thus the eurozone regime remains unbalanced between supranational monetary *policy* and intergovernmental fiscal *rules*.

EU fiscal performance, 1995-2013

The very fact of the debt crisis could be seen as an indicator of poor fiscal performance in the EU—and of the failure of the fiscal regime to attain convergence toward orthodoxy. But if we consider a somewhat longer time horizon the picture is rather more complex. Prior to the global financial crisis, Italy—the country most clearly targeted by EU rules—was among the EU's most restrained fiscal performers, often running a primary surplus and reducing its debt-to-GDP ratio by roughly 18 percent. (See chapter 4.) Crisis-beset Ireland and Spain were, between 1995 and 2008, better fiscal performers than the "core" stalwarts Netherlands and Germany. In other words, not only was there variation in fiscal performance among EU member states but this variation did not clearly fit the pattern the framers of the EU's fiscal rules might have expected.

[FIGURES 10.1 AND 10.2 HERE]

Given the differences in the rules between the euro area and the full EU membership, a first question is whether fiscal performance was notably better (or worse) in the eurozone than the overall EU membership. As Figures 1 and 2 demonstrate, levels of gross public debt and budget deficits in the eurozone and EU27 tracked each other closely, with slightly higher levels of each in the eurozone. Indeed, the eurozone collectively never met the 60% debt target, and often failed to meet the 3% deficit target. Yet the eurozone's somewhat worse fiscal performance cannot simply be blamed on the weakness of the SGP. First, higher eurozone debt levels reflect the fact that three of its members—Belgium, Italy, and Greece—had the EU's highest levels of public debt (typically exceeding a 100 percent debt-to-GDP ratio) even before the launch of the euro in 1999, and did not see significant increases in debt levels until after 2008 (along with everyone else). Second, eurozone countries have had (slightly) lower budget deficits than the overall EU membership since 2005—notably, the year that Germany began to restore fiscal rectitude after years of large deficits—and has closed the gap in public debt with the EU27 from roughly 8% in 2002-8 to 5% since 2009. More generally, both groupings' finances were highly responsive to the economic cycle (see Table 10.3 below), with debt and deficits falling during years of economic expansion (2004-7) and growing during the depth of the global financial crisis (2008-9). Yet deficit reduction since 2010, particularly in the eurozone, has come not as a result of a strong economic rebound but rather of near-universal budgetary austerity.

[TABLE 10.3 HERE]

From the perspective of creditors and debtors in the eurozone debt crisis, we also see trajectories of fiscal performance that do not clearly fit the narrative of "responsible" creditor countries and "irresponsible" debtors. On the debtor side, Greece and Spain reached the brink of default as a result of very different economic and fiscal conditions. Greece, like Italy, was allowed to join the eurozone because its efforts at fiscal rigor in the late 1990s were moving its debt and deficits in the direction of compliance; unlike Italy, Greece did not seek to sustain compliance once it had been admitted—and thus its near-default in 2009 came after years of poor fiscal performance. By contrast, Spain reduced its debt-to-GDP ratio by almost half to 36% and accruing multiple budget surpluses before the bottom fell out of the housing market that had been fueling Spanish growth. So, while all countries could blame the onset of the global financial crisis for the rapid deterioration of their fiscal positions in 2008-9, only Greece faced default as a result of its own *fiscal* choices in the preceding years.

Meanwhile, the story of Germany's fiscal performance is by now well known. Bearing the burden of integrating the former East Germany, it struggled to meet the standards it had itself demanded of others in the SGP. Indeed, it was Germany's excessive deficits in 2002-4 that led it to demand a reprieve from punishment under the EDP and a reform of the SGP. Yet after 2006

Germany returned to its pre-1990s pattern of fiscal rectitude, putting it in a stronger position to demand such rectitude from its European partners after 2010.

In sum, fiscal performance in the EU does not necessarily accord with the prevailing narratives. The pre-euro narrative, which became the basis of the fiscal regime for the eurozone, was that strong rules were necessary—and likely to be effective—to force spendthrifts like Italy, Spain, and Greece to converge toward Teutonic rectitude. The post-crisis narrative reasserts the morality tale of the virtuous and unvirtuous, despite the fact that Greece was the only case of willful unvirtuousness and, again, Germany itself was for a few years in the camp of the unvirtuous. Nevertheless, we have seen universal austerity and an improvement in fiscal performance since 2009, especially in the euro area—though it is unclear whether austerity, with its growth suppressing effects, has aided or hindered the restoration of fiscal sustainability.

10.3 Explaining EU fiscal performance

Why did the convergence toward fiscal orthodoxy envisioned in the Maastricht Treaty and the Stability and Growth Pact not emerge? To start from the expectation that an *international* regime with limited enforcement powers could corral countries with distinct political and economic interests and circumstances toward fiscal conformity is to expect too much; fiscal coordination does not come easily. Nevertheless, institutions *do* matter. Explaining EU fiscal performance and cross-national variation therein requires consideration both of the flaws in the design of these rules and institutions and of the magnitude of the challenge any such rules faced in attaining fiscal convergence among a group of countries with quite distinct national economic models.

Rules and institutions

How much did the EU's fiscal regime affect its members' fiscal performance? It is difficult to say for individual countries. But an effective regime would have produced minimal cross-national variation in fiscal performance in the eurozone, and likely greater variation between the eurozone and other EU members—and these were not the outcomes this regime produced. Examining the flaws in the regime can help explain some of the variation, as well as the onset of the debt crisis. It also offers an opportunity for an initial evaluation of the 2011-12 reform of the rules intended to produce the fiscal convergence that the SGP did not.

The main structural flaw in the EMU was, and remains, the imbalance between the supranational monetary regime—in which monetary authority was delegated to the ECB—and the intergovernmental fiscal regime—in which member states coordinated, but ultimately retained national control over, tax and spending decisions.[vii] Though the regime was formally called the Economic and Monetary Union, the economic half was decidedly weaker with the previously noted absence of supranational fiscal authority as well as a minimal capacity to promote coordinated economic planning.[viii] Krugman (2011), for one, has argued that EU member states' decision not to delegate greater fiscal authority to the EU—specifically, to create a "transfer union" in which revenues flow automatically from economically successful to struggling states—inevitably led to the financial, and political, crisis in the eurozone after 2009.

Many implications follow from this imbalance between supranational monetary authority and intergovernmental fiscal/economic coordination. One is the extent to which it created a clash of incentives for member states between pursuing national economic interests and complying with EU rules. Because the eurozone is not, by most accounts, an optimal currency area,[ix] interest rates that are appropriate for one country might not be for others. During the 2000s, the ECB set rates that were too low for countries experiencing asset inflation (e.g., Spain, Ireland) and too high for those experiencing relative economic stagnation (e.g., Germany, France)—thus causing the former to impose tight fiscal policies to prevent overheating and the latter to pursue deficit spending to stimulate growth. In the absence of supranational taxation/spending authority, eurozone states facing economic stagnation at home and lacking other macroeconomic tools (monetary policy, currency depreciation) to combat it defied—and continue to have incentives to defy—strict limits on debts and deficits.

The design of the euro regime also produced two key credibility problems. The first involved the TEU's "no bailout clause," intended to protect eurozone countries from having to take on others' obligations and thereby to ensure that governments would be constrained by market discipline. But for such market discipline to be operative, bondholders needed to believe members would allow afflicted eurozone governments to default—which they manifestly did not believe during the first decade of the euro. According to Budi and Carnot (2012, 903), interest rate spreads demonstrated that bondholders viewed all eurozone government debt as equivalent and "basically treated all as risk free," assuming "the Union would anyway renege on the no-bailout clause, if needed, to avert a financial crisis." Moreover, the continued reliance on market discipline once the debt crisis erupted in 2009 created self-fulfilling prophecies for European countries (Gros 2012, 41). Markets believed Germany could finance its debt (at essentially any level), and thus it was able to do so because interest rates were low. Alternatively, markets lacked such faith in southern European countries, and as a result they faced higher interest rates—which made servicing their debts more difficult and thus default more likely.[x] Thus a perverse quality of the rules was that they built upon, and ultimately reinforced, the pre-1990s narratives of northern v. southern European fiscal practice that ultimately effectuated divergence rather convergence between the two.

The second credibility problem involved the EU's own enforcement of the excessive deficit procedure, the EU's mechanism to rein in fiscal "free riders" (excessive borrowing at reduced interest rates) in case market discipline failed. Part of the difficulty here rested in the nature of the punishment: fining a government for running an excessive deficit may compound rather than solve the problem. More fundamentally, it is politically difficult for EU institutions to punish rulebreakers. The Franco-German success in cajoling the European Council to excuse their fiscal sins in 2003-4 destroyed the authority of the SGP (and the Commission's role therein), not only in exempting them from the rules but in weakening enforcement mechanism applicable to all eurozone countries. But this episode belied an underlying reality: the EU has more leverage to ensure rule compliance when countries want to *join* a given regime—whether it is the Schengen Agreement, the eurozone, or the EU itself—than it does after they've joined. Following Italy's lead, Greece tightened its belt in the late 1990s in a bid to join the eurozone; once it was offered entry, in 2001, it could loosen it with far less fear of repercussions—even more so after the Franco-German actions.[xi] So, just as bondholders did not believe they would be punished by a eurozone government default, eurozone governments were given ample reason not to believe they would be fined or otherwise punished by the EU for fiscal profligacy.

The theory underlying the pre-2009 fiscal rules in the eurozone regime was that a supranational fiscal authority to match the ECB's monetary authority was unnecessary (or undesirable), and that a combination of market discipline and enforceable rules would ensure all eurozone governments converge toward fiscal rectitude. Despite the blow this theory suffered with the debt crisis, the main post-2009 reforms to the regime—the six-pack, two-pack, and Fiscal Compact—doubled down on its core logic. To explain this choice, we must consider the power of creditor countries (notably Germany) and the magnitude of their project to achieve fiscal convergence in Europe.

German hegemony and varieties of capitalism

At the end of the Cold War, many asked whether we would come to see a “German Europe” or a “European Germany.” The answer, it now seems clear, is both—or at least that is what German leaders have sought to achieve. The Germanization of European fiscal policy (or policies)—i.e., promotion of orthodoxy and market discipline, sometimes called “ordoliberalism”—has been a project since the Maastricht treaty, with all major rules (no bailout clause, SGP, Fiscal Compact, etc.) reflecting German demands in exchange for its own Europeanization (i.e., surrendering the deutschmark and monetary policy independence). Yet this Germanization of European fiscal policies was very much incomplete by the onset of the debt crisis, reflecting persistent differences in EU members’ fundamental economic models—most notably, differences between northern and southern European countries. Thus the capacity of reformed EU rules to induce convergence toward fiscal rectitude will depend in large part between the underlying struggle between the irresistible force of German (and creditor) hegemony and the immovable object of the varieties of capitalism practiced in Europe.

German hegemony, and its orientation vis-à-vis fiscal policy convergence, can best be understood with reference to two longstanding literatures. Hegemonic stability theory describes how an economically dominant state can create regimes that provide collective goods (such as financial stability) and also serve the hegemon’s economic self-interest (Kindleberger 1973, Krasner 1976). Liberal intergovernmentalism, for its part, offers an EU-specific theory of how powerful EU members create integrationist treaties or agreements if and only if their national economic interests align (Hoffman 1966, Moravcsik 1998). What these theories highlight is not only the extent to which Germany, as the economically dominant state in Europe, has spearheaded the creation of regimes reflecting its interest in fiscal and financial stability, but also how other EU members' persistent inclination to protect their core sovereignty and national interests limits the extent of Germany's capacity to induce (or compel) fiscal convergence.[xii]

The history of the EU and eurozone's rules promoting fiscal convergence, if not the extent of convergence itself, clearly reflects German economic interests (see Dinan 2010; Moravcsik 2012). During the first half of the 1990s, when Germany was negotiating the terms of the euro, it sought EU rules to substitute for the economic rigor it had imposed via the Bundesbank's dominance of monetary policy across Europe during the 1980s. Key eurozone fiscal rules—complete ECB autonomy from political influence (contra French desires), the prohibition of bailouts or monetary financing of national debts, the specific 3% and 60% targets for fiscal performance, and the formal procedure for punishing states that ran excessive deficits—were adopted Germany's insistence.[xiii] Alternatively, when these rules no longer served German interests—notably, the excessive deficit procedure in 2003-4 and the no bailout clause in 2009—it advocated their dismantling. Yet when the debt crisis struck and threatened a perpetual, ruinous cycle of bailouts, it insisted on a Fiscal Compact that mirrored the "debt brake" it had adopted domestically in 2009 and demanded extensive and intensive conditions for fiscal and other economic reforms in Greece, Portugal, and other countries receiving funds from the EFSF and ESM.

The sources of German preferences in promoting European fiscal rectitude (for the most part) via these rules are varied. Two apply to all EU creditor countries. First, they retain a clear national interest in preventing fiscal free riding—overborrowing by governments benefiting from

German and other creditors' financial credibility—and avoiding taking on the financial burdens of other governments. This self-protective interest helps explain not only the rules that have been adopted thus far but also why Germany, Austria, and others have refused to consider new mechanisms to achieve fiscal sustainability throughout Europe that might imply new burdens on their taxpayers, notably Eurobonds.[xiv] Second, German banks were, by 2008-9, among the most highly exposed to government debt in peripheral countries—with loans totaling $704 billion to Greece, Ireland, Italy, Portugal, and Spain by 2009—and thus defaults would threaten the stability of Germany's banking system.[xv]

The third, and least tangible, source of the orthodoxy preference is rooted in Germany's past. Germans' twentieth-century history produced a collective national *angst* regarding the dangers of both debt and inflation, both of which can result from fiscal profligacy (Langenbacher 2010; Newman 2010; Hall 2012) This *angst* was stoked by two existential commitments the Federal Republic made during the 1990s—to sacrifice the deutschmark and to reintegrate the former German Democratic Republic. Integrating the former GDR involved a real, and large, financial commitment by all Germans, particularly those in the south and west, so national leaders have ardently sought to ensure that adopting the euro would not force Germans to bear the financial burdens of other Europeans. According to Howarth & Rommerskirchen (2013), the Angela Merkel-led governments in Berlin have sought to project a German "stability culture" onto the Continent, promoting stability abroad in order to sustain it at home. That the German position has occasionally manifested in sermonizing about fiscal prudence—emphasizing the *moral* in moral hazard—reflects how deeply embedded is the national narrative of economic orthodoxy as perhaps the central pillar of the Federal Republic's postwar revival and rehabilitation.[xvi]

Hall (2012) offers a framework, based on his work in the varieties of capitalism literature, for understanding why Germany's economic power and preferences may not be sufficient to ensure fiscal convergence. The assumption behind the fiscal rules and broader economic reforms Germany and other creditor countries have promoted is that indebted southern European countries simply need to adopt a specific set of macro- and microeconomic reforms to attain market confidence and economic competitiveness—and thus to replicate their own economic models. As Hall notes, however, northern and southern European countries have categorically distinct economic models—the former oriented toward export-led growth, the latter toward domestic demand—and international constraints on macroeconomic tools are much more onerous on southern European countries. Because northern European countries' economies are largely export-driven, their governments use macroeconomic policy to sustain competitiveness rather than stimulate demand; in southern European countries, domestic demand—and occasional macroeconomic stimulus to support it—are central. The eurozone rules, which limited the scope for fiscal stimulus for governments that had already ceded control over interest rates and currency values, have removed the macroeconomic tools necessary to sustain the southern European model.

Post-2009 reforms to the fiscal rules have thus ratcheted up the pressures on Greece, Italy, Spain, and Portugal to Germanize not just their fiscal policies but their entire economic model. This model does not merely constitute a set of discrete, easily alterable policies to achieve desired economic outcomes; it is deeply embedded in these countries' social and even cultural relationships, and reflects particular constellations of political interests, bargains, and power. While the initial eurozone rules were not strong enough to fundamentally challenge the southern European model or to induce uniform fiscal responses—relative discipline in Italy versus reckless borrowing in Greece—post-2009 fiscal and economic reforms have cut deeper. The reforms have been wrenching for southern European societies, including massive public sector layoffs and youth unemployment exceeding 50 percent in Spain and Greece.[xvii] Thus they have inevitably sparked political backlash, both against national leaders that have accepted EU diktats and against the EU itself, producing gains for nationalist and extremist parties across southern Europe, including France.[xviii]

Convergence toward the northern European model and related fiscal rectitude must overcome not only political resistance to a one-sided distribution of the burdens of economic adjustment, but also fundamental questions about whether convergence toward a northern European model is desirable, given its likely implications if it is in fact realized. The status of "export-oriented" or "creditor" country can only be attained if there are "import-oriented" or "debtor" countries elsewhere. Within Europe, Germany and other creditor countries have achieved their status largely because Greece and other debtor countries have been major export markets; in 2012, Germany enjoyed a nearly €55 billion trade surplus with France, Italy, Spain, Greece, Cyprus, and Ireland combined.[xix] If debtor countries are reformed to become competitiveness-oriented creditors, current creditors must accept one or both of the following implications: they must either take in more southern European exports themselves to support this transformation, or the EU as a whole must become a mercantilistic trader in global markets to support a universal creditor orientation within Europe. The ongoing political and economic costs of macroeconomic rebalancing will continue to be felt, both in southeastern Europe and elsewhere.

10.4 Conclusion

The European Union's single currency regime was conceived, and ultimately still rests, on the premise that it is both necessary and possible to achieve fiscal coordination without real supranational fiscal authority. Yet despite the power and conviction of Germany to promote north-south convergence, the flaws in the prevailing regime and persistent, deep-seated differences between EU member states' economic models enabled the debt crisis and raise doubts about the post-2009 reforms to the regime. The burden of adjustment under the reformed rules has fallen squarely on debtor countries, reflecting to some extent their own fiscal problems and to some extent a failure among creditors to acknowledge how their own economic models (and banks) have contributed to underlying imbalances. Yet the European Commission did formally warn Germany in November 2013 about its excessive imbalances—in its case, an excessive surplus—which may suggest it will attempt to pursue a more balanced enforcement of rules than in the past.

The capacity of the existing regime to solve Europe's fiscal woes ultimately depends on the EU and its member states' responses to several interrelated questions. The first involves the superstructure of the regime and whether enhanced intergovernmental coordination is sufficient to solve the regime's credibility problems or whether greater supranational fiscal authority is necessary. There is little doubt that the reforms—including *ex ante* requirements of nationally-embedded "debt brakes" and submission of budgets to the Commission for scrutiny and *ex post* mechanisms for punishing excessive deficits and rescuing governments facing default—strengthen coordination. Yet the imbalance within the EMU regime, with intergovernmental fiscal rules juxtaposed to supranational monetary policy, remains. In the absence of supranational mechanisms such as collectivized debt obligations (i.e., Eurobonds) and automatic transfers between member states (i.e., a transfer union), both political and market actors will have some incentives to probe the extent of member states' commitment to these rules and, ultimately, the euro.

A second question, deemphasized in this chapter but a source of much debate in recent years, involves the definition of appropriate fiscal performance. The definition promoted by Germany and largely codified in the rules is one of Hayekian orthodoxy, involving a strong reliance on market discipline and generalized caution regarding deficits and debt, regardless of the economic cycle. From this approach, strong fiscal performance in the EU is linked almost exclusively with concerns about free riding and negative externalities—i.e., with the concern that fiscal laxity in southern Europe could impose undue burdens on more rigorous northern member states. The buy-in to this Hayekian logic has eclipsed a Keynesian logic, which defines appropriate fiscal performance in terms of the economic cycle: balanced budgets are appropriate during periods of economic expansion, but not during recession and the early stages of recovery. Keynesian critics of the EU's regime, most notably Krugman, have argued that a European economy facing stagnation and possibly deflation—a condition in which the burden of debt increases—should be aiming for larger fiscal stimulus and its attendant deficits, especially in countries like Germany, to offer the *positive* externalities of pro-growth policies. Europe has not been entirely lacking in stimulative fiscal policy—especially immediately after the onset of the global financial crisis—but Hayekian rules such as the Fiscal Compact have further institutionalized constraints on countercyclical fiscal expansion. The adoption of these rules in the face of more pro-Keynesian arguments made by governments in France, Italy, and elsewhere is a strong indicator of the institutionalized power of Germany and its creditor allies.

The imposition of Hayekian rules from above—which French analyst Philippe Legrain has referred to as "fiscal colonialism" in which "European Union institutions have become instruments for creditors to impose their will on debtors"[xx]—begs the third question, involving the democratic legitimacy of the EMU regime. Democratically elected governments must now have their budgets, documents encompassing national priorities for public action, scrutinized and approved by the European Commission before national parliaments may vote on them. If member states suffer a fiscal crisis, they face the fate of Greece and, to a lesser extent other peripheral governments: the almost complete loss of sovereign economic policy authority. As Levi (1988) has argued, legitimate fiscal authority ultimately lies in "quasi-voluntary compliance" with authoritative fiscal institutions. Can such compliance be seen as voluntary in the European Union today?

There is disagreement among scholars regarding the implications of the strengthening of the EMU fiscal regime for the European Union's "democratic deficit." Some have claimed the EU does not suffer from a significant democratic deficit, whether in general (Moravicsik 2004, 2012) or in their procedures for strengthening the post-2009 fiscal regime (Schimmelfennig 2014). Others see more troubling democratic shortcomings, whether as a result of continuing economic integration (Crum 2013) or of a growing elite-mass divide regarding Europe (Fogarty & Wallsten 2013). As noted by Hooghe & Marks (2009) and affirmed by the continuing rise of anti-EU parties, there is no longer a "passive consensus" among European citizens for ever closer union, which means that public skepticism becomes another significant factor standing in the way of national compliance with an intergovernmental fiscal regime. Under such conditions, a fiscal regime that can coerce but not raise or distribute revenue may become increasingly untenable, requiring EU member states to choose between a fully supranational EMU with both automatic fiscal transfers and enhanced mechanisms of democratic accountability or the abandonment of the single currency altogether. As goes the *fiscus*, so goes the empire.

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[i] Formally, the European Commission proposes the budget and the European Parliament must give its consent. But because revenues come predominantly from national budgets most of the political wrangling occurs in the intergovernmental European Council.

[ii] European Commission, “CAP expenditure in the total EU expenditure,” available at http://ec.europa.eu/agriculture/cap-post-2013/graphs/graph1_en.pdf (accessed 6 July 2014).

[iii] See, for example, Josef Joffe, “The euro widens the culture gap,” *New York Times*, 12 September 2011.

[iv] The Spanish government did receive roughly €40 billion from the ESM in 2013 to help capitalize its banks, but managed to avoid an official rescue—and thus avoided required reforms as a condition for the loan.

[v] Two EU members, the United Kingdom and the Czech Republic, did not sign the Fiscal Compact.

[vi] This reform was similar to that adopted in World Trade Organization in 1995. Under the WTO's predecessor, the General Agreement on Trade and Tariffs, punishment of a country adopting illegal trade restrictions had to be agreed unanimously—essentially allowing the would-be punished party to block implementation. Under the WTO, punishment is only deferred if there is unanimous agreement among members to defer.

[vii] For different versions of this claim, see among others Gros 2012, Moravcsik 2012, Delors 2013, Hall 2010, Schimmelfennig 2014, Buti & Carnot 2012, and Krugman 2011.

[viii] Jacques Delors, president of the European Commission from 1985 to 1995, proposed a plan for both increased EU economic coordination and additional tools to spur growth, but "this was not accepted. Instead, it was deemed sufficient to merely add the word 'growth' to the name of the Stability Pact…In reality, this was purely and simply a budgetary stability pact: no economic coordination; no instruments to stimulate, cooperate, or regulate" (Delors 2013, 175).

[ix] According to Michael Cembalest, a leading investment analyst at JPMorgan, all the world's countries beginning with the letter M would make a more appropriate currency union than the eurozone.

[x] Gros (2012, 41) notes that countries' fiscal status within the single currency zone may be riskier than outside. Despite the fact that Spain is overall in a better fiscal position than the UK, it faces higher borrowing costs and risks of a debt crisis. According to Gros, "The conclusion seems to be obvious: it is easier to service a high public debt by keeping a national central bank and one's national currency."

[xi] Between 1995 and 1999 Greece reduced its budget deficit from 9.2 to 3.2 percent of GDP, and its public debt from 97 to 94 percent of GDP. By 2007 its deficit had risen to 6.7 percent and debt to 107 percent—with neither figure coming close to the Maastricht targets in the intervening years.

[xii] Several northern European countries (notably Austria, Netherlands, and Finland)—which Schimmelfennig (2014) calls the "coalition of solvent countries"—have backed most German positions, particularly during the debt crisis.

[xiii] The German government did not get everything it wanted: in its proposed “stability pact,” fines for excessive deficits would have been automatic except if a country experiences an unusually deep recession with a greater than 2% contraction of GDP (Heipertz & Verdun 2009, 6).

[xiv] There have been a variety of proposals for Eurobonds, but all would imply the issuance of bonds whose servicing and repayment would formally be a collective EU (or, more likely, euro area) responsibility.

[xv] Bloomberg View, “Germany’s banks must assist in Europe’s cleanup,” 24 May 2012, available at http://www.bis.org/publ/qtrpdf/r_qa1203.pdf (accessed 12 July 2014).

[xvi] The Bundesbank has been an influential source of advocacy for orthodoxy. In July 2014 Jens Weidmann, head of the Bundesbank, declared that the ECB’s “expansive monetary policy should not last longer than is necessary,” and that, “if we pursued our own monetary policy, which we don’t, it would look different.” Axl Weber, who in 2011 resigned as president of the Bundesbank in protest at ongoing ECB stimulus, declared, “we put too much focus on solidarity, and insufficient focus on [Member States’] own responsibility.” Paul Carrel, “ECB interest rates too low for Germany, says Bundesbank chief,” *New York Times*, 12 July 2014; David Milliken, “ECB’s Weber says EU too focused on solidarity,” Reuters, 9 March 2011.

[xvii] Youth unemployment in May 2014 was 57.7 percent in Greece and 54 percent in Spain, as compared to 7.8 percent in Germany and 10.8 percent in the Netherlands. The eurozone average was 23.3 percent. Eurostat news release, “Euro area unemployment rate at 11.6 percent,” 1 July 2014, available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-01072014-AP/EN/3-01072014-AP-EN.PDF (accessed 12 July 2014).

[xviii] One notable exception to this trend in the 2014 European parliamentary elections was Italy, whose voters strongly backed their current center-left government.

[xix] Satyajit Das, “Germany’s economy isn’t as strong as Europe believes,” *Wall Street Journal*, 4 December 2013, available at http://www.marketwatch.com/story/germanys-economy-isnt-as-strong-as-europe-believes-2013-12-04 (accessed 12 July 2014).

[xx] Philippe Legrain, “Eurozone fiscal colonialism,” *New York Times,* 21 April 2014.