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Between fiscal discipline and economic recovery. The solutions problem

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Abstract. *In this study we proposed a comparative analysis of the effect of the measures taken in seven European countries, which were aimed the fiscal consolidation, in correlation with monetary policy and economic recovery.*
The selected countries have been systematized into two groups: first group includes states that have signed agreements with international financial institutions (Romania, Ireland, Greece and Portugal) and the second group contains countries which, even if not directly assisted in the international funding programs, have take a several adjustment measures (Italy, Spain and France). In the same time, we keep in mind during the analysis the trade-off between fiscal discipline and sustainable economic recovery.

Keywords: fiscal consolidation; economic recovery; adjustment measures; monetary policy; international funding.

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1. Introduction

At the end of 2012 and at four years after the eruption of the financial crisis, developed economies of the world continue to face the persistence of several negative effects, while developing countries, which have been for a long period of time the major source of growth for the global economy, began to be visible affected by lower export demand as the global demand started to decline.

Amid historical level of public debts of the United States, Japan and especially the European Union (EU), the fiscal adjustment affects economic growth and, in the case of Romania, the convergence and the catching-up process.

The severe recession, significant interventions in financial markets and fiscal stimulus measures have increased public debt at levels that have not been seen since the end of World War II. Decreasing public debt ratio at more "confortable" levels in terms of sustainability requires a broad and sustained adjustment, which is expected to reduce the aggregate demand in the coming years and, therefore, adversely affect GDP growth. In the US and Japan, conventional monetary policy support for fiscal consolidation is limited by the fact that interest rates are already at levels close to zero, while the aging population and the trend of weak growth provides a small space in absorption of falling demand. Also, as most advanced economies are in the process of adjustment, export demand will provide a little support to growth prospects in US, EU states and Japan.

On the other hand, consolidation can not be postponed indefinitely, states (even more important countries, such US and Germany) being under pressure from international rating agencies. In the Euro zone, although so far the largest debt increases have been recorded by few countries (Greece, Portugal, Ireland, Spain and Italy), they are considered a high risk for the Eurozone due to the potential contagion effects. Therefore, if in this fragile countries consolidations are avoided, there is a real risk of ratings downgrades or even default. Automatically, we can ask about what pace of fiscal consolidation is needed in these countries so that necessary adjustments be effective, but to preserve the growth prospect.

2. Literature review

Delong (2012) and Rendhal (2012) highlight a key issue, that in a liquidity trap period the duration and depth of the current recession are not exogenous, but depend on the extent to which the dynamic of current aggregate demand affects economic activity. Thus, given that states are facing fiscal consolidation measures

(tax increases and/or reduction of government spending), which in short-term generates a reduction in aggregate demand, a sharp rise in unemployment and under-utilization of capital, driving to adverse developments or unfavorable expectations about the future economic situation. The authors state that, as a low unemployment in the present increase the likelihood of a low unemployment in the future, a loss of jobs in the present do individuals anticipating lower revenues in the future, that make them to reduce their consumption both now and in the future. This vicious circle – where a reduction of the number of jobs generate expectations of a low employment in the future and, therefore, leading to lower consumer demand and a greater job loss in present – is a powerful and dangerous mechanism. The same idea is also supported by Traşcă, Popa and Dudian (2011), who consider that the challenge for the European economy is the way out from the vicious circle of unsustainable public debts, financial markets concerns and declining growth and jobs in some member states.

Giavazzi and Alessina (2012), who followed in their study the fiscal adjustments in the OECD countries in the last 40 years, have shown that:

- adjustments achieved through spending cuts are less recessionary that those made by tax raising;
- consolidation achieved by lowering spendings, accompanied by the right macroeconomic policies tend to be less recessionary or has a positive impact on future growth. Among the policies that could accompany fiscal consolidation may include: monetary easing, liberalization of goods and labor markets and other structural reforms;
- only spending based adjustments led later to a permanent consolidation of the government budget, at least in terms of stabilizing the public debt if not by reducing its share in GDP.

Devries et al. (2011) reached same conclusions in their study. If we compare the effects of different "types" of fiscal adjustments over the production and "confidence" of investors, it seems that adjustments made on the tax side not only did not achieve the proposed goals, but was unable to stop increasing the share of public debt in GDP. When the tax measures are announced, the confidence of entrepreneurs is sharply reduced, this fact being reflected in lower production.

Another reason for avoiding the adjustment measures on the tax (revenues) side is that countries with shares of revenues in GDP around or above 50% can not use such an instrument, being close to the Laffer's curve point of inflection. A study by Harald Uhlig and Mathias Trabandt (2012) shows that many European countries are sufficiently close to this point and any further increase in taxes will

lead to a relative reduction in tax revenues that will deepen even more the recession.

Also, Hall (2009), Woodford (2011), Christiano et al. (2011), Ahrend and others (2006) show that monetary policy position is an important determinant for the fiscal multipliers. The mechanism of financial crises and the contagion effects were analyzed and by Moldovan, Adam and Hudea (2010) in a study published in "Challenges of the Knowledge Society" review.

A study belonging to Batini, Callegari and Melina (2012), which focuses on the US, Euro area as a whole (customizing analysis and on two major countries from the European monetary union who need fiscal adjustments, France and Italy) and Japan, using autoregressive vectors methodology, shows that spending multipliers are significantly higher during on downward economic phase than in a growth phase (presented as increase/decrease rate of GDP). They also showed that spending multipliers (where spendings are defined only as public consumption and public investment) are significantly higher than fiscal multipliers (taxation is defined as the net taxes, namely the difference between gross taxes and transfers) during recession. Moreover, authors concludes that monetary policy does not seem to have a strong effect to offset the economic downturn, possibly because the reduction of interest rate wasn't very significant or fast enough in the analyzed timeframe to counteract the production decrease during periods of fiscal consolidation.

Other conclusions of the authors: the greatest effect of fiscal consolidation on production is observed in the first year after the shock and the implementation of fiscal consolidation during periods of positive output increases significantly reduce the impact on production. Evolution of public debt in the Euro area was analyzed and by Hrebenciuc (2010), his conclusion being that the region needs a better coordination in terms of public policy.

Our scientific approach starts from the analysis of the effects that austerity measures could have on economic growth in Romania and in two groups of countries from the Euro area. In the first group we analyzed Ireland, Greece and Portugal, three countries that because of financial and economic imbalances had to ask international aid from European Central Bank, International Monetary Fund and European Commission, and the second group includes Italy, Spain and France, countries that, even without an international aid, have taken severe fiscal consolidation measures to restore market confidence and to recover losses in competitiveness (Figure 1).

States that ask for international aid from international financial institutions:

- Romania - 20 billions euro (EC, IMF, WB)+ 2"precautionary" agreements
- Greece - 80 billions + 130 billions euro (CE, IMF, ECB)
- Ireland - 85 billions euro (EU, IMF)
- Portugal - 78 billions euro (EC, ECB, IMF)

States that have implement consolidation measures without being under international aid:

- France
- Italy
- Spain

Source: European Commission(1).

Figure 1. *Groups of analyzed countries*

When the European fiscal compact was signed by 25 states of EU (without Czech Republic and United Kingdom), 14 of 17 Eurozone member states were under Excessive Deficit Procedure (EDP). Just Estonia, Finland and Luxembourg had a deficit below 3% in that moment. Also, the other countries take the commitment to reduce fiscal deficit below 3% of GDP until the end of 2012 (Belgium and Cyprus) or 2013 (the rest of 12 states).

As the budget deficit reduction occurs in a bad time of consolidation with small space for fiscal policy, there are significant impediments to fiscal discipline. Also, the situation is complicated by the fact that the current sovereign debt crisis makes that indebted states not be able to refinance debts as they had planned and the financial markets are reluctant to borrow governments at "reasonable interest rates". Desire of concomitantly economic growth and fiscal discipline is a challenge that governments have not been able to solve so far.

3. Diagnostic analysis of countries included in the two groups

Spain – Spanish economic expansion lasted about a decade, from de middle of 90s to 2007. Subsequently, growth began to slowdown and, after 2007, boosted by the global economic crisis, internal and external vulnerabilities of Spanish economy have emerged to the surface. The state entered in a spiral of indebtedness, economic decline and skepticism about his capacity to recover. At the same time, high unemployment rate has been fueled by the fired workers from the construction sector and the banking system was badly shaked by disappearance of

euphoria from the real estate sector. Banking sector crisis led to the financial aid(2) requested from the Eurozone leaders, in the summer of 2012. At the EU summit, on 28-29 June this year, it was also decided relaxing the loan conditions for Spain and Italy, a decision that was received positively by the markets and can provide time for these two countries to adjust imbalances accumulated in the last decade.

Spanish growth model was based mostly on stimulating the domestic demand, especially construction and real estate sector, a model which, ultimately, proved to be unsustainable, being the premise of Spanish macroeconomic imbalances augmentation. Joining Euro area generated a significant reduction of the country risk premium, which produced two effects: on the one hand, the Spanish interest rates fell strongly and, on the other hand, capital inflows increased, slightly solving the problem of external financing for Spanish economy. Another important factor, in terms of public debt, is the government deficit, including the need for measures and instruments to help banks and several regions.(3)

Low capital cost, combined with several factors that have increased the demand for housing, and population growth due to immigrants who came to Spain led to a housing bubble that caused a sharp increase of prices and housing construction.(4)

Challenges in the banking sector, which emerged with the global crisis, continues to depress the economy through a number of channels, including financing costs and reducing the credit flow to non-financial sector. In particular, high exposure of the banks to construction and real estate sectors eroded the confidence of consumers and investors.

At the same time, foreign capital inflows and strong domestic demand pushed wages and prices, contributing to a steady deterioration in the competitiveness of Spanish economic. According European Commission, the difference between the wage growth (3.2%, annual average rate over the period 1996-2007) and low growth of productivity (0.4%, annual average over the same period) generated an increasing in unit labor costs (2.8% from 1996 to 2007, twice higher than the Euro area average). Furthermore, real exchange rate, based on the unit labor cost, strengthened between 1999 and 2009 by 16%, which negatively affected Spanish exports.

Portugal – Before financial crisis, during 2001-2008, annual average growth rate of real GDP of Portugal was only 1% per year, the second lowest growth rate in EU-27 after Italy (with a annual average growth rate of real GDP of 0.4% in same period). Comparatively, annual average growth rate during 1991-2000 was approximately 3% per year.

Moreover, potential GDP has been on downward trend since the late of 90s. In average, contribution of all potential GDP components (capital, labor and total factor productivity) decreased, the fastest decline being in terms of total factor productivity. Then, after 2005, there is a negative contribution of labor, a decline which has not been offset by an increase in capital factor or total factor productivity. A low labor participation highlights the issues of Portuguese labor market, the latter being in center of adjustments programs established with international financial institutions.

In terms of foreign trade, Portugal has lost export market share, especially in markets where are traded labor intensive goods (e.g. textiles). On these categories of goods Portugal was exceeded by emerging economies from Asia and Eastern Europe, countries with lower labor costs as main comparative advantage. Furthermore, as exports were mainly concentrated on a relatively small number of Euro area countries, the economic downturn of Eurozone generated a lower export demand from trading partners in region.

Another important element is the exports structure, dominated by sectors with low added value. From this point of view (the technological intensity of products), Portugal was exceeded by other eurozone countries, like Italy and Spain, and even some countries from Eastern Europe.

In the banking system, Portuguese banks coped well in first phase of economic and financial crisis, with a low exposure to toxic assets. An important element was the fact that Portugal has not experienced the housing boom that had, for example, Spain. However, since 2011, amid Europe's sovereign debt crisis, banks started to have financing difficulties from external markets, the cost rising significantly alongside the country risk premium.

From the perspective of public finances, public debt of Portugal has increased constantly. According European Commission, after joining Eurozone, government deficit was usually above the limit of 3% of GDP imposed by the Treaty, and the share of public spending in GDP increased during 1999-2010 by almost eight percentage points. Large structural budget deficits and low economic growth lead to an increase of public debt as share of GDP from 60% in 2004 to about 108% in 2011, and is expected to rise at 119% in 2012.

Italy – Italy's situation was similar to Portugal in pre-crisis period, Italian economy growing in average with 1.2% during 1999-2008, below the average growth rate of Euro area, pointing out the low rate growth of labor productivity and total factor productivity. The latter is on a downward trend since the late of

90s, indicating the failure of Italy in absorbing new technologies and the low ability of companies to innovate.

Probably the Italy's biggest problem is the high level of public debt, that exceeded 120% of GDP at the end of 2011, and is projected to reach 126.5% in 2012, the highest share in GDP among large states of the European Economic and Monetary Union. High public debt can have many negative consequences on economic evolution, the correlation between high public debt an low growth rates being strong. Likelihood that government will use tax increases or spending cuts, trying to reduce the debt ratio is very high, and this will reduce consumer demand at aggregate level. However, premium risk of a country with high public debt determines an increase also in the cost of capital for private sector. Banking system and credit conditions are also affected in a negative way.

Italian banks coped well than other European banks during financial crisis, thanks to prudent business model and the absence of excessive euphoria in real estate sector. However, amid a generalized increase of risk aversion and the deepening of sovereign debt crisis, Italian banks ability to have access on financial markets has been reduced due to higher financing costs.

Loss of competitiveness was the main factor behind de decline of Italian economy in terms of trade balance. After 1998, the balance of trade in goods and services has deteriorated significantly compared with other partners from the Euro area. According to the European Commission, between 1999 and 2011, nominal labor cost (ULC) rose on average with 2.3%, significantly higher than similar costs in countries such as Germany (+0.5%) or France (+1.9%). In Euro area, ULC rose by 1.6% during the same period. These differences, achieved in the evolution of ULC after adoption of the Euro currency, largely explain the profit rates reduction of Italian firms relative to the rest of Euro area, particularly in manufacturing sector, despite the fact that the development of production prices was relatively similar.

In the last decade, sectorial specialization of Italian exports remained stable and mainly focused on goods with a medium-low technology (textiles, metals, plastics). According to European Commission (2012), in this category of goods, the share of Italian exports on world exports has decreased considerably in 2000s. At the same time, the fact that only a small fraction of exports are focused to emerging markets (usually, only largest Italian companies have become more competitive on these markets), has adversely affected the share of Italian exports in total world exports. Thus, Italy is strongly dependent on markets from Euro

area and failed to benefit from powerful growth of emerging markets, especially those from East Asia, mainly due to the relatively small size of Italian firms which hinder their ability to cover higher entry costs related to the creation of new distribution networks and investing in intangible assets, such as patents and brand reputation.

According to data from the Italy's national statistical institute, in 2011, 42.6% of exports were directed towards the Euro area (56% to EU-27 member states) and 44% to states outside the EU (including North America – 6.8%, Middle East – 4.9%, North Africa – 2.9% and China – 2.7%).

Ireland – Ireland was considered a model for real convergence in the Euro area, gross national income per capita(6) increasing from 83% of the EU-15 average in 1996 to 113% in 2006. This increase was mainly driven by strong inflows of foreign direct investment, the significant increase of exports and improving labor productivity. Also, amid the expansion of domestic demand (especially construction sector), the participation rates rose and unemployment rates declined.(7) Despite these positive developments, the strong growth of Ireland in the pre-crisis period was based on unsustainable engines. Successful experience starting in the mid of 90s, in terms of growth and catching-up to the EU average, have contributed to an underestimation of risk, with fueled over-lending, overinvestment in physical capital and excessive growth of asset prices and consumption expenditures.

In this context, low real interest rates and relatively easy access to credit contributed to increasing real estate prices, while the indebtedness of households and companies rose sharply before the crisis, among the highest from entire European Union. Construction, particularly housing, were in the center of domestic lending boom, and between mid-90s and 2006 the growth rate of housing prices was one of the highest in the EU. The real estate boom was also sustained by other factors, such as favorable demographic trends, high rate of employment and strong wage growth, fiscal incentives for investment in housing and the rapid expansion of lending through banking sector.

However, external competitiveness worsened significantly during the domestic boom. According to the European Commission, the real effective exchange rate (calculated on the basis of unit labor cost) has appreciated by about 16% between 2003 and 2008, due to the higher wage growth rate compared to labor productivity.

Amid the international financial crisis, the consequences of sudden adjustments in the housing market spread then rapidly in the whole economy. From early 2007 until late 2010, house prices fell by 38% and transactions were frozen, GDP declined between 2008 and 2010 by 11% in real terms and by 17% in nominal terms, while the employment rate fell by almost 14% from its peak in the third quarter of 2007. The unemployment rate rose from 4.5% in 2007 to 13.5% in 2010, and the construction sector accounted about half of the decline in employment. The bubble burst affected most banking sector, where the government injected by 2011 over 46 billion Euro (29% of GDP).(8)

Full impact of financial sector support measures over de general government deficit was 22.7% of GDP in 2009-2010. In November 2010, the Irish authorities have requested financial assistance from IMF and EU, after markets looked distrustful to the government ability to manage internal imbalances. Thus, the government published the National Recovery Plan 2011-2014, which represented the starting point in negotiations of financial assistance program worth 85 billion Euro, from European Commission, European Central Bank and International Monetary Fund for the period 2010-2013. The key objective of the program was to restore financial markets confidence in the Irish banking sector and in Irish government.

France – For France, the second largest economy in the Euro zone, rapid losses in terms of market share in recent years have increased the current account deficit. From a surplus of 3.1% of GDP in 1999, the current account deficit has increased since 2005, reaching 2.2% in 2011. Balance of trade in goods is the largest part of the deficit; the market share of French exports was reduced by 19.4% between 2005 and 2010, one of the largest reductions in the EU.

Both cost-competitiveness and the non-cost competitiveness contributed to the deterioration of French export performance after 2000. Although the specialization of products and geographical orientation of exports had a negative impact, performance of French exports from costs perspective decreased. Compared with its trading partners, relatively rapid growth of nominal wages in France in the last decade, higher than productivity growth, led to a decrease of cost competitiveness of firms. However, most of the damage comes from the competitiveness of non-priced, especially the lack of innovation in the private sector compared to its main competitors. Another factor is the limited number of exporting firms.

Although several measures have been taken by the French authorities to counteract adverse developments both in terms of competitiveness through cost

and non-cost, there is little evidence of their impact on export performance. Policies have been implemented to limit the increase in labor costs, to support innovation and help exporting companies. In particular, initiatives to shift taxation from labor towards less distortionary sources, extending the tax credit on expenditure on research and efforts to develop links between research and industry (especially the competitiveness poles) are considered steps taken toward correct direction.

Public debt ratio deterioration over the past decade was due to persistently high deficits, reflecting the action of structural factors (including pension costs). The budget deficit remained above the three percent between 2002 and 2008, including an extended period in which the country has been in excessive deficit procedure, while growth in the period 2004-2007 would have allowed a significant adjustment in structural terms. According to European Commission (2012), the structural budget deficit fell by just 1% of GDP in this period.

Country's fiscal and budgetary position deteriorated during the crisis due to the action of automatic stabilizers and incentives decided by the government. Along with the decline in economic growth, these factors have pushed the deficit to over 7% of GDP in 2009-2010, and authorities began fiscal and budgetary consolidation in 2011. However, the country's public debt will continue to rise to 85.8% at end of 2012.

French households are less indebted than other EU countries. Debt dynamics in recent years was mainly due to housing market dynamics. At the same time, rising unemployment, which already puts pressure on household income and creditworthiness, is not expected to decline before 2013.

The unemployment rate, which fell between 2006 and 2008, began to grow in Q1 of 2008, leaving in 2010 and 2011 under the symbolic threshold of 10%. In terms of solvency, a high unemployment rate means, on the one hand, lower income households and, on the other hand, a lower bargaining power in wage bargaining context. Even though the unemployment rate in France is below the euro area average, the labor market is an important target for the government. French labor market segmentation has led to high risk occupation for “extreme categories' (workers with temporary contracts, young and low-skilled) in times of rising unemployment and reduced incentives for firms to hire when the economy recovers. Measures were taken to improve labor market flexibility.

Greece – Between 2000 and 2009 the average annual increase in real GDP of Greece was 4%, due to stronger domestic demand, especially consumption and

residential investment. The increase in real wages and the increase in lending – the latter being supported by financial sector liberalization and low real interest rates associated with the Euro – and the easing of fiscal policy contributed to economic growth. However, during the same period foreign trade contributed negatively to growth, the share of exports in GDP narrowing from 25 to 19%.

Like the other countries analyzed in this paper, real wage growth exceeded productivity gains over the past decade, reflecting in part the effects of increasing government wages. Therefore, the increase in unit labor costs eroded the country's external competitiveness. In the context of expanding domestic demand and deteriorating external competitiveness, current account deficit widened, reaching a maximum of 14% of GDP in 2008.

Regarding fiscal situation, after 2000 budgetary position of the Greek State has never been below the target of 3% of GDP required by the Treaty. In addition, fiscal targets have been repeatedly missed due to high public expenditures, tax evasion and overestimating revenues from taxes. Size of the government sector increased from 44% of GDP in 2000 to over 50% in 2009, pointing out the increasing social spending about 5% of GDP and tax revenue in the same period fell from 41% to 38% of GDP. Additionally, health and pension systems, unreformed, became a threat to the long term sustainability of public finances. Due to fiscal deficits and external imbalances, public debt and the external one increased significantly. According to Eurostat, public debt as a share of GDP increased from 103.4% in 2000 to 129% in 2009, while net external debt increased to 100% of GDP, from 45% in 2000. Note that most of the external debt is held by the government.

Romania **-** Romania recorded since 2000 significant growth rates, rates that later proved to be unsustainable. Although the degree of convergence has increased over the years, there were a number of internal imbalances which have increased over time. For example, although there were wage increases especially in the state sector, uncorrelated with productivity growth, labor market showed some rigidity and participation rate remained low.

Economic boom generated by euphoric domestic demand generated pressure on the trade deficit which widened from to five percent (in 2000) to 14% (in 2007). Economic boom has also been fueled by massive capital inflows, surplus averaging about 17% in 2004-2007 period. The euphoria of the previous years, represents the crisis origins, which permitted the contagion to Romania from global economic crisis when it had a significant budget deficit, inflationary

pressures, a growing and unmanageable current account deficit[9] and a lack of structural reforms which were needed to progress.

Although institutions showed no consistent management regarding the arisen crisis challenges, the lack of transparency in the implementation and the anticipation of certain decisions affecting the degree of competition and of efficient investment in the economy. Romania has passed the first part of the crisis relatively well, with a number of progresses in terms of strengthening overall macroeconomic framework.

Once the crisis felt in our country, Government adopted a series of macro stabilizing measures, calling in the same time for the help of the International Monetary Fund. These measures started to be implemented since May 2009 and were targeted especially on macro stabilization rather than structural side. For the beginning the budget deficit was reduced by controversial pro-cyclical measures (VAT increase from 19% to 24%, a spending cut which was not necessarily the equivalent of greater efficiency), the current account deficit was also reduced mainly due to significant decline in domestic demand, inflationary pressures were monitored and the exchange rate recorded low variations etc. Exposure of the main banks towards the banking system was kept at the same level through the Vienna Agreement which was also helpful, avoiding the risk of a banking crisis

The results of implementing a set of measures supported by multilateral programs of the International Monetary Fund, World Bank and European Commission began to be visible in 2011, when registering a growth of 2.2% in real terms sustained growth of exports and the recovery favorable agricultural year. However, the absence of structural measures reflected light made the recovery in 2011 could not be sustained for a longer period of time and prospects this year and next period is not optimistic.

Adjusting severe public sector and private sector double adjustment following adverse international context and domestic economic policy decisions have created hostile conditions to economic recovery phenomenon, a phenomenon found in correlation with austerity measures mentioned above. In a relatively short time horizon, the impact these measures have had an impact on aggregate demand as restricting its. This translates also into a lower tax base and lower tax revenues, which put pressure on the income received from the state budget and determines other measures to rationalize public expenditure.

In the medium term, fiscal consolidation has an effect on the aggregate supply through micro-level channels and structures are reflected in the work motivation,

saving and investing. So the Government decided that reforming the tax administration must become a priority. Are still a number of both internal and external risks regarding Romanian economy in the short and medium term. That internal risks are worth mentioning: political instability and further assuming fiscal and budgetary consolidation process and the adoption of key structural reforms, the upward trend in the number and volume of bad loans, ensuring the efficient financing needs for 2012 as and for the next period; absorption of EU funds, which was far from expected levels, the consequences of a poor agricultural year, corruption, etc.

Regarding external risks should be mentioned decrease in global aggregate demand, contagion in the banking system as a result of diminishing confidence in some banks reluctant to trust in the ability of national governments to access capital markets, etc.

In these circumstances fiscal consolidation and fiscal discipline remains a basic necessity, while sustainable economic growth is rather a wish right now. Measures taken in 2009-2011 aimed at ensuring macroeconomic and financial stability, and since current measures are desirable phenomenon constitutes a sustainable growth engine in the future. Main challenges that remain valid as increasing public sector efficiency and the implementation of structural measures to increase competitiveness and generate then convergence in real terms.

4. Reforms

Spending reforms

Reform of pension expenditure was particularly important part of consolidation efforts in most advanced economies, particularly in Europe. Reforms generally focused on increasing the retirement age and, in some cases, accelerating previous reforms (France, Greece, Ireland, Italy, Spain).

These reforms should support growth by increasing the size of the workforce in the medium term. Reforms have "tightened" also criteria for early withdrawal (Greece, Italy, Spain) have increased taxes levied high pensions (Greece, Ireland, Italy), reduced indexation (Greece, Italy) or have changed the way calculation of basic pension, increasing the period for which the salary is taken into account (Greece, Spain). These reforms have greatly improved the situation in the medium term finances of pension systems. In particular the 2010 reform in Greece is

estimated to have reduced the present value of pension expenditure between 2010 and 2050 by more than 160% of GDP in 2010 (FMI, 2012).

More advanced economies have introduced reforms of health systems, although in most cases they are not expected to have a dramatic impact on long-term spending trends. In Europe, reforms aimed especially pharmaceutical expenditure restraint (France, Germany, Greece, Ireland, Italy, Spain), which is only about 15 percent of total public expenditure on health.

Most governments, especially in countries with the greatest needs adjustment, implemented measures to limit public sector wage bill, an item that was a key component for the fiscal consolidations of the past, countries can be offered as examples in this respect are the Nordic countries (mid 90s).

Most European economies except France and Germany recently announced such measures. Categories of expenditure concerned in this regard were the social benefits, but policymakers seeking to preserve social justice through better allocation of social spending. At the same time, public investment registered large reductions in most economies, such as Italy and Spain. Even though many of these investments were ineffective a sharp decline in capital spending may prove costly in the medium term because of the negative impact on potential GDP.

Revenues reforms

On the revenue side of the budget, advanced economies have tried to focus on less distortive taxes such as indirect taxes and property. Most countries have increased excise duty and took steps to improve the level of tax revenue collection.

In Europe, many countries have increased their revenues either by increasing VAT rates (France, Ireland, Romania, Spain), or by broadening the tax base (Greece, Ireland, Portugal). Many countries have increased property taxes (Greece, Ireland, Italy, Portugal), which are expected to have a relatively limited impact on economic growth. Nevertheless, several countries, especially those needed to implement large adjustment programs, have had to adopt several measures to increase income and increasing taxes on labor and capital.

Increases in personal income taxes took the form of increasing the tax base (Greece, Portugal) and increasing marginal rates (Spain). Several states also increased corporate income taxes (France, Italy, Portugal) and capital gains (Ireland, Italy, Portugal), which may affect private investment (for more details see Annex 1).

Institutional reforms

To enhance their financial credibility, many countries have adopted measures to strengthen fiscal governance. In the European Union, the European Semester was created to facilitate coordination of macroeconomic policies. In several Euro area countries (Austria, Germany, Ireland, Italy, Portugal, Spain), law, even at constitutional level, now required to maintain a balanced structural fiscal positions in the medium.

In many countries there were new institutional arrangements to strengthen implementation and monitoring processes. Greece, Ireland and Portugal created a medium-term budgetary frameworks. Greece adopted a medium-term fiscal strategy, Ireland has established a three-year expenditure ceilings for each ministry, while the stability program of Portugal includes an indicative program spending cap. In addition, many countries have created independent bodies responsible for monitoring the implementation of fiscal policy fiscal rules, paying more attention to tax issues. In Ireland and Portugal fiscal councils were created in 2011.

Further analysis performed and watched a few key indicators to observe the effects of measures taken by elected governments (Spain, Portugal, Italy, Greece, Ireland and France), such as the growth rate of GDP, annual growth rates of exports and imports, unemployment rate, the growth rate of unit labor cost, public debt as a share of GDP structural deficit and budget deficit, the annual growth rate of domestic demand and the growth rate of investment. The table below summarizes the forecast by the European Commission by the end of 2012 of these macroeconomic indicators:

Table 1. *European Commission forecasts for 2012 regarding analyzed countries*

Indicator	GDP growth rate	Exports growth rate	Imports growth rate	Unemployment rate	ULC growth rate	Public debt (%GDP)	Structural government deficit (%PIB)	Government deficit (%PIB)	Domestic demand growth rate	Investment growth rate
Euro area	-0.4	2.5	-0.5	11.3	1.4	92.9	-2.2	-3.3	-1.8	-3.5
UE27	-0.3	2.2	0.1	10.5	1.9	86.8	-2.7	-3.6	-1.3	-2.2
Spania	-1.4	2.1	-6.3	25.1	-2.7	86.1	-6.3	-8	-4	-9
Portugalia	-3	4.3	-6.6	16.5	-4	119.1	-4.1	-5	-7.1	-14.1
Italia	-2.3	1.1	-7.2	10.6	2.2	126.5	-1.4	-2.9	-3.8	-8.1
Grecia	-6	0.8	-10	23.6	-8.6	176.7	-1.5	-6.8	-9	-14.4
Irlanda	-0.4	2.8	0.3	14.8	-0.9	117.6	-7.9	-8.4	-2.2	-4
Franța	0.2	2.6	0.8	10.2	1.6	90	-3.4	-4.5	0.4	0.3

Source: Autumn forecasts of European Commission, November 2012.

Thus, due to the measures decided by national governments, government spending cuts or tax increases, there is a sharp decline in domestic demand, especially in Portugal, Greece and Italy. In the EU-27 domestic demand (private consumption and government consumption) will decrease by more than one percent, while at the 17-nation Eurozone will be more pronounced decrease of 1.8% compared with 2011. In Greece, private consumption is estimated to be reduced by 7.7% to 6.2% and the government. Another State for the European Commission forecasts sharp drop in domestic demand of over 7% is Portugal. The only country that is projected a slight increase in domestic demand is France (+0.4%). Contraction in domestic demand is explained by high rates of unemployment in these countries to meet (25.1% predicted value for Spain, 16.5% in Portugal, 23.6% in Greece and 10.6% in Italy), leading the contraction of private consumption demand, and then the government announced spending cuts during 2012.

5. Conclusions

To lower public debt to GDP ratio will be required fiscal adjustments, which need to be maintained for a long time from now on. The main compromise is to ensure a fair distribution of the economic consolidation effects, in order to avoid tensions which are hard to manage, especially in terms of social component, or distortions that prevent economic recovery.

Fiscal policy, correlated in an appropriate way to monetary policy can create a balance between inequality and growth management if they are considering some future impact variables such as education system and the labor market as a whole.

Notes

(1) European Commission website – Financial assistance in EU Member States http://ec.europa.eu/economy_finance/assistance_eu_ms/index_en.htm.

(2) Spain requested financial assistance in June-July 2012 to support its banking system, which may rise up to 100 billion Euro.

(3) Spanish government created a liquidity fund up to 18 billion Euro to help indebted regions.

(4) According European Commission (EC), between 1996 and 2009, in Spain was created above 6.5 millions of new housing and prices almost have tripled between 1997 and the beginning of 2008. Therefore, the share of investment in construction sector in GDP reached 22% in 2006-2007, from de 15% in 1995, this sector accounting 14% of total employment in 2007, compared with 9% in the period before the expansion.

(5) Anglo-Irish Bank was nationalised in January 2009 (29,3 billion Euro), Allied Irish Bank received 7.2 billion Euro, Bank of Ireland 3.5 billions, Irish Nationwide Building Society 5.4 billions and EBS Building Society 0.9 billion euro.

(7) According Eurostat, between 1996-2007, employment rate raised from 62% to 73.8%, while unemployment decreased from 11% to 4.9%.

(5) Unit Labor Cost (ULC) represent raport between growth rate of wages and growth rate of labor productivity.

(6) Regarding Ireland economy, is important to note that, although economic growth is traditionally cuantified in terms of Gross Domestic Product (GDP), for this country Gross National Income (GNI) is more appropriate to measure economic growth. The difference between GDP and GNI is that, while GDP reflect economic activity in a particular territory, GNI measure the activity of national economic agents, regardless of their location. GNI represent GDP adjusted by the difference between income inflows from the external activities of national production factors and income outflows of internal activity of foreign production factors (for more details http://www.ipe.ro/RePEc/WorkingPapers/cs18_1.pdf, page 6). For Ireland case, this difference is significantly negative because of profit repatriations from multinationals. Thus, GNI is about 20% smaller than GDP and is more useful to measure the living standards in Ireland.

(9) Fueled by the expansion of credit to households.

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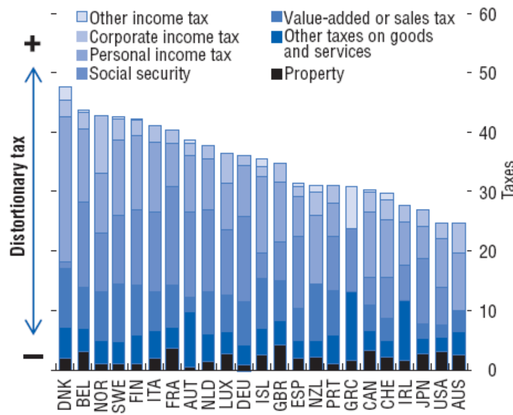
Annex 1

Decided measures on revenues and expenditures side starting 2009

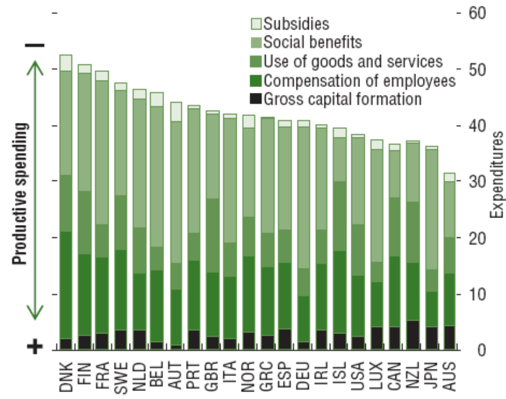
	Expenditure Measures							Revenue Measures							
	Public wage freeze/ reduction	Control of the size of civil service	Savings from pension-related spending	Savings from health care–related spending	Reduction in social benefits[1]	Reduction in public investment	Other expenditure measures	Increase in personal income tax	Increase in corporate income tax	Increase in capital gains tax	Increase in social security contribution rates	Increase in value-added or sales tax	Increase in excises	Increase in property tax	Improvement in tax compliance
Canada	✓	✓	✓			✓	✓[2]	✓			✓		✓		
France		✓	✓	✓			✓	✓	✓		✓	✓	✓		
Germany					✓				✓						
Greece	✓	✓	✓	✓	✓	✓	✓[2]	✓			✓	✓	✓	✓	✓
Ireland	✓	✓	✓	✓	✓	✓		✓		✓		✓	✓	✓	✓
Italy	✓	✓	✓	✓	✓	✓	✓[2]	✓	✓	✓	✓	✓	✓	✓	✓
Japan	✓	✓				✓	✓	✓			✓		✓		✓
Korea															✓
Portugal	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		✓	✓	✓	✓
Spain	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
United Kingdom	✓	✓	✓	✓	✓	✓	✓[2]	✓		✓	✓	✓	✓		✓
Romania	✓	✓	✓	✓	✓	✓	✓				✓	✓	✓		✓
Poland	✓	✓	✓		✓			✓		✓	✓	✓	✓		

Source: European Commission, IMF Report.
[1]Excluding pension and health care benefits.
[2] Savings from spending efficiencies.

Tax categories classified according to the degree of distortion



Tax categories classified according to the degree of multiplication



Source: IMF, Fiscal Monitor, October 2012.