Rebalancing the Fiscal Framework in the European Union:

Perspectives of Germany, France and Poland

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PREFACE

The economic crisis that began a decade ago has given impulse to economic governance reforms in the European Union. The most intense changes were in the fiscal sphere, i.e., the rules defining Member State leeway in budgetary planning, with a focus on tightening up the financial discipline and seeing to it that Member States, and especially euro area members, do not go beyond the caps imposed on the government deficit and debt.

The changes were by no means uncontroversial. As claimed by proponents, they led governments to begin taking a serious approach to the stability of public finances—a foundation for healthy economic growth—and bore fruit in the form of a European economic recovery starting from 2014. No significant overhaul is needed since the applied mechanisms have just started to work. Critics, on the other hand, argue that the restrictive rules have had the effect of prolonging the economic crisis, aggravating the debt situation and sharpening social problems, thus triggering the rise of populist and anti-European movements. The criticism goes further than that. The present fiscal framework, with its emphasis on discipline, makes it more difficult to pursue a coherent countercyclical policy in the euro area. In its current form, it cannot be coordinated with the monetary policy of the European Central Bank. Many also argue that the present fiscal framework has “technical” faults, too many criteria, is complicated, hard to project, and subject to over-politicised supervision, all of which affects the effectiveness and credibility of the whole system.

Proposals for changes that would “rebalance” the fiscal framework have cropped up for some time now, one of the most recent being put forward in November 2016 by the European Commission. Its centrepiece is for the system to include “fiscal goals,” i.e., levels of budget expenditures that Member States with space to spend should reach in a given year. That would provide a mechanism enabling a coordinated fiscal expansion at the euro area level and represent a revision of the current fiscal framework. But its consequences go would much further than that. Actually, this change could be added to the list of economic and political factors that could potentially define the evolution of Europe’s integration structure. In particular, the new fiscal framework may set the direction for the euro area’s future, and the dynamics of its expansion into new Member States.

If the “rebalancing” is accepted, the euro area may start turning into an economic bloc with more room for manoeuvre than before on the community level. Its fiscal competences would transcend the present priority of disciplining national governments towards pursuing a joint macroeconomic policy and intervening for economic stabilisation. It is evident that this process will be accompanied by a new round of arguments between proponents of liberal and more interventionist approaches to economic policy. Possibly, at the end of this road can be a fiscal union that would involve communitising risk and financial transfers, and moves towards greater power for supranational institutions.

The reform of the fiscal framework could also have an “external” effect by changing the present balance between the euro area and those Member States that are outside the single currency zone. Many of them perceive membership of the monetary union as too risky economically and contravening their preference for national sovereignty. From their viewpoint, those drawbacks still trump the advantages of belonging to a large economic area as well as the political and security benefits, which ensue from membership of the very core of the integration. The revised fiscal framework and the related evolution of the euro area could bring a new important element to these calculations and change the present equilibrium, either towards accelerated preparations for membership or a final decision on abandoning an integration project of such great depth.

Whether the fiscal framework is indeed redesigned, and the previously mentioned dynamics set in motion, will be contingent on the Member States’ preferences, i.e., their calculations of

costs and benefits from the new rules. The present report focuses on the economic components of those calculations and especially on who will contribute most to financing the expansion, who will benefit most from the stimulus, and who will find the new framework to be a challenge to their domestic interests and principles of economic policy. It can be assumed that interest in a new fiscal framework will be expressed by the Member States struggling with their own financial limitations, first and foremost those experiencing major problems with meeting the requirements of fiscal prudence. There will be supporters among Member States with small economies, limited room for increase in domestic demand, strong dependence on exports to the integrated area, and a tough economic situation. The prospect of fiscal expansion will also tempt countries whose variety of capitalism and competitiveness are better suited to thrive in conditions of a flexible—rather than principled—approach to macroeconomic stability.

This report seeks to analyse the German, French and Polish perspectives on a hypothetical revision of the fiscal framework and to find out if these countries would back the change. Their selection for analysis is by no means accidental.

Germany and France are the euro area's largest economies with a combined GDP higher than that of all its Member States taken together. The concurrence or conflict of their interests and preferences will seal the future of the fiscal framework and consequently may influence the direction of euro area evolution. It is as simple as that: if these two countries do not share a common stance, integration will stagnate, and if they do, the chances for perceptible acceleration will increase. As for Poland, among the Member States outside the euro area but still required to join it in the future, the country is the most populous Member State and has the second-largest economy. Poland's preferences may be decisive as to whether a separate integration platform emerges outside of the euro area, or perhaps the latter broadens gradually to include the entire European Union. The selection of Poland takes on added importance following the UK's decision to leave the EU and with it, an economy that has so far acted as a natural and strategic stabiliser for the area outside the monetary union. In these circumstances, the change in the fiscal framework, if its consequences prove to be highly beneficial for Poland, may become a factor that moves Poland's interests towards membership of the euro area.

The report comprises two parts. The first describes the European Union's existing fiscal institutions, the criticism they have received, and the proposals for their modification put forwards in autumn 2016. Part Two presents the Member States' preferences about a hypothetical rebalancing of the fiscal framework, based on which an analysis is provided of the German, French and Polish interests. The concluding part of the report includes answers to the questions posed in the *Preface*, which deal with (i) whether Germany and France have uniform—or, perhaps, divergent—preferences with respect to a revised fiscal framework; and (ii) whether Poland's economic features and preferences are of such a nature that it would become a beneficiary of the new framework if it were a member of the euro area. These answers will make up a point of departure for certain projections on the future directions of European integration.

This report is part of a research project, carried out by the Polish Institute for International Affairs in collaboration with the Konrad Adenauer Foundation in Berlin, and supported by the Polish-German Foundation for Science. Within that project, a conference was held in Berlin on 14 December 2016, attended by experts and representatives of government agencies from France, Germany and Poland, and devoted in large measure to the problems taken up in the present report.

FISCAL FRAMEWORK AND EUROPEAN INTEGRATION

Introduction

Fiscal policy is about choices the government makes with respect to its finances, especially when it comes to defining the sources and amount of revenue and the level and distribution of expenditures. In most of developed economies, these choices involve amounts equalling some 40–50% of GDP, which shows that fiscal policy can impact the economy in a major way, indeed. Even a small upward change in expenditure or a cut in taxes—referred to as expansionary fiscal policy—can get an economy out of recession. A reduction of spending and an increase in taxes—i.e., restrictive fiscal policy—can bring down inflation or lower the current account deficit. Expertise in taking countercyclical measures, that is, in correcting the course of the business cycle, is counted among the most important criteria when assessing the effectiveness of the state machinery.

This expertise is subject to numerous constraints stemming from the very nature of the economy. On the revenue side, the government is faced with the circumstance that a rising rate of taxation brings about a rise in treasury revenue only up to a point, after which tax receipts go down (following a Laffer curve). And when resorting to borrowing, the government must take into account investors' expectations and risk estimates, which will directly influence the price of capital. Conversely, on the expenditure side, a challenge is posed by what is called the spending multiplier, reflecting the impact of a change in government expenditure on changes in income. In certain conditions, it may turn out that a fiscal policy seeking to support the economy actually produces the opposite. This may happen when the government, by turning to the financial market to finance its expenditures, perceptibly restricts private business' access to capital (crowding-out effect) or when—additionally—government spending proves ineffective because of such things as pervasive corruption or inefficient bureaucracy.

Another constraint is that fiscal policy, far from being pursued in a vacuum, is interrelated with other economic policies, especially monetary policy. If the central bank's goal is absolute protection of the value of the currency, and if this goal is pursued by means of a steep increase in interest rates, then fiscal expansion may soon end up as nothing more than costlier access to capital for private consumption and investment. A similar outcome may be forced by the economy's external environment: changes in government spending may bring about currency rate fluctuations, changes in the current accounts balance and reversals in capital flows. These effects must always be taken into account by governments in their calculations.

The above-mentioned constraints are visible in economic and legal systems as rules limiting the room for manoeuvre by governments in fiscal policy. Over the past decades, another formal constraint has emerged and is most pronounced in Europe. Following intense economic integration and the interdependencies it creates, international rules and principles have been provided for guiding the fiscal policies of national governments of EU Member States—especially those in the euro area—which, consequently, face much stricter restrictions in determining important features of their own budgets.

Evolution of Fiscal Regulations in the Course of European Integration

It has been a long path to this point: fiscal policy became a topic of discussions in the European Community only when the first steps were being taken towards an economic and

monetary union.[1] But only the Maastricht Treaty of 1992 proved to be a game-changer, with Member States reaching agreement on the future single currency area and accepting the need to meet macroeconomic convergence criteria. These included fiscal discipline requirements, capping the budget deficit and public debt. In addition to that, the treaty stressed the very responsibility of Member States for their own debt through a "no-bailout" rule.

It was not possible, though, for fiscal integration to stop at that point. The upcoming monetary union, the members of which should still enjoy a great deal of fiscal autonomy, was exposed to a moral hazard problem.[2] This means that some governments purposely took a path of increasing expenditure and growing debt in the expectation that, in case of insolvency, the others will be left with no option but to bail them out, ignoring the rule against it in the face of potential wider economic and political dangers. The misgivings were augmented by the new monetary union's failure to fully meet the criteria of an optimum currency area,[3] which meant that the risk of financial upheavals resulting from diverse paths of economic growth could not be entirely ruled out.

As a result, the EU began building something that could be termed a "joint fiscal framework," which complemented national fiscal frameworks by adding to them more detail and, most importantly, by imposing more constraints. In other words, the sets of rules, procedures and institutions for national fiscal policies—from planning to implementation to monitoring—were merged with the institutions created at the integrated-area level.

The basis for the joint fiscal framework was provided by the Stability and Growth Pact of 1997, which required Member States to meet criteria on debt and deficit in the public sector (no more than 60% and 3% of GDP, respectively) or otherwise be forced to make arduous adjustment and face the risk of financial penalties. The pact gave rise to a great deal of controversy, some accusing it of constraining governments' pro-growth policies and introducing too much rigidity, said to be preventing more individualised approaches to challenges facing Member State economies.

The dispute escalated after 2000, at a time of weaker growth in the monetary union's largest economies, Germany and France, which led to a 2005 reform of the pact[4] that took the edge off its restrictive nature. In the longer run, though, that revision proved ill-fated. Connivance of the soft approach to fiscal criteria meant—as International Monetary Fund (IMF) experts put it—a failure "to build sufficient buffers [i.e., resources needed to pursue countercyclical policy] in good times [...]." Once the economic crisis arrived, many euro area countries had no means with which to support their flagging economies, nor were they capable of preventing deficits and debts from growing further. So, the previous failure "led to the need to tighten fiscal policies in bad times."[5]

The shock of the eurozone crisis caused deep changes in the fiscal framework, forcing—after a period of brainstorming and discussions[6]—a restrictive approach and a focus on fiscal discipline.

[1] Monetary integration was designed in the late 1960s and started a few years later with the coordination of exchange rates (the so-called currency snake), which was then replaced by the European Monetary System. In the 1980s, it contributed to the rising convergence of macroeconomic policies in the Member States.

[2] J. Alt, D.D. Lassen, W. Joachim, *Moral Hazard in an Economic Union: Politics, Economics and Fiscal Gimmickry in Europe*, Political Science and Political Economy Working Paper No. 5, 2012.

[3] For an overview, see: J. Jager, K.A. Hafner, "The optimum currency area theory and the EMU: An assessment in the context of the Eurozone crisis," *Intereconomics*, vol. 48, no. 5, 2013, pp. 315–322.

[4] M. Chang, "Reforming the Stability and Growth Pact: Size and Influence in EMU Policymaking," *Journal of European Integration*, vol. 28, no. 1, 2006, pp. 107–120.

[5] M. Andrle *et al.*, *Reforming Fiscal Governance in the European Union–Euro Area*, IMF Staff Discussion Note No. 15/09, 2015, p. 5.

[6] On the debate: M. Blyth, *Austerity: The History of a Dangerous Idea*, Oxford University Press, 2013, pp. 51–94. One of the texts particularly worth mentioning due to its political influence is C.M. Reinhart, K.S. Rogoff, *Growth in a Time of Debt*, Centre for Economic Policy Research, 2010, no. 7661. It claimed that high debt has a negative influence on growth.

Other Changes in EU-Economic Governance and Policies

Far from being isolated and scattered, the changes made in the fiscal framework were accompanied by a revamping of the entire system of the EU's macroeconomic governance. Towards the end of 2011, the European Semester came into being, bringing order to the monitoring and coordination of Member States' economic policies, and the Macroeconomic Imbalance Procedure (MIP) was set in motion, seeking to identify and correct developments that threaten economic stability, such as unsustainable private debt levels or extreme current account deficits. In October 2011, the instruments of financial aid to crisis-ridden Member States were systematised with the launch of the European Stability Mechanism. New unorthodox monetary policy tools were also used by the European Central Bank, which in mid-2012 declared the intention to save the euro area "at any price." This helped the euro area to recover and buy time to stabilise the economic situation. Work was also initiated on creating a banking union and a single supervisory mechanism for banks in the EU, the goal being to lower the risk of a financial sector crisis.

The first step came with what has been called the "six-pack" of late 2011, which was a set of six directives making it easier to impose sanctions on euro-area members in breach of budgetary rules. The same direction was taken by the "fiscal compact," a part of the new intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. It came into force in 2013,[7] also covering non-eurozone countries (except for the United Kingdom and the Czech Republic, which opted out). The fiscal compact requires signatory countries to write a balanced budget goal into their national laws, introduce independent monitoring bodies to form opinions on the budget, and convene summits of eurozone Member States. More changes, reinforcing supervision of eurozone states' budgetary policies, came in May 2013, with the "two-pack" regulation. They were all supplemented by significant changes to overall economic governance, which aimed at better preparing the EU and the eurozone for potential pressure (for more, see box). At the peak of this reform period, the fiscal framework had a much more sophisticated system of fiscal policy criteria and procedures to enforce their observance. The horizon of policy boundaries is still defined by the criteria of the highest allowable nominal budget deficit (3% of GDP) and public debt (60% of GDP). But the "daily business" is determined more by the preventive criteria, designed to provide early warning of fiscal problems and put the Member States on the track of fiscal prudence. The central place here is taken by the Medium-Term Budgetary Objective (MTO), which Member States should seek when planning their public finances. This is a structural indicator, adjusted for cyclical fluctuations and one-time spending and revenue items, and as such, presenting the actual tendencies of public finances. It is declared by Member States in the Stabilisation Programmes (eurozone members) or Convergence Programmes (others), and its level is revised at intervals not shorter than three years.

There are, however, more specific and detailed rules within these criteria that narrow the Member States' room for manoeuvre and should keep them on the discipline course.

First, the MTO path involves improving the structural balance by at least 0.5% of GDP a year (a more ambitious approach is required from Member States with high public debt). Second, with a view to improving MTO surveillance and compliance assessment, a limit was also introduced for permitted growth in public sector spending, which must not exceed the potential average annual economic growth as specified for the purpose of MTO calculations (unless exceptional revenue items emerge in the budget). Third, Member States were required to enact arrangements that prevent a structural deficit from growing higher than 0.5% GDP (or 1% GDP for Member States with debt lower than 60% of GDP). And fourth, a rule was added requiring a Member

[7] Precisely, in 2013 for 16 Member States and after progress in ratification in 2014 for all 25 signatories.

State with debt higher than 60% to cut it down every year by at least one-twentieth, or 5%, of the exceeded percentage points, above the reference value computed as the average of at least a three-year period (the 1/20th rule).

Compliance with these criteria is monitored and enforced using complex procedures, where the main actors are the European Commission, the ECOFIN council and the Member States. At the preventive level, they use reports, consultations and negotiations, as stipulated under the provisions of the European Semester. Sanctions can be imposed only on a euro-area member, and only in an exceptional situation. The rules are different at the corrective stage, where the main instrument is provided by a relatively rigid recommendation from the Commission and the Council as part of the Excessive Deficit Procedure (EDP). Failure to comply may entail sanctioning the Member State in question, such as cutting off structural funds or even slapping on financial penalties.

Controversies over the Current Fiscal Framework

Developed as part of the post-crisis reforms, the current profile of the fiscal framework is not without controversy. In fact, it is one of the most hotly debated areas of European integration, one where advocates and opponents of the restrictions imposed by the recent reforms have been clashing with each other.

According to the advocates, the restrictive fiscal framework in the euro area made it possible to stabilise the Member States' fiscal position. The EU-level rules proved to be of great help to many national governments by neutralising obstruction from the opposition and influencing changes in the mood of the public, which appreciated the importance of the fiscal sphere. Consequently, the eurozone aggregate fiscal deficit ran at an estimated 1.7% in 2016, and is expected to drop to around 1.4% by 2018. Public debt at 91.6% of GDP in 2016, is on course to fall to 89.2% by 2018.[8] If applied before the crisis, the rules would have probably prevented the sovereign debt crisis from happening.[9] And, some experts add, despite widespread opinions about the rigidity of the fiscal framework, there is sufficient interpretational leeway to allow fiscal expansion.[10]

Those in favour of the current institutions also argue that the fiscal rules, coupled with supply-side reforms and new governance framework, laid the groundwork for the recovery, the first signs of which emerged in 2015 without perceptible weakening ever since. In 2016, the eurozone's GDP rose 1.7%, employment was up 1.4%, and joblessness shrank to 10%,[11] despite labour supply growth and refugee inflows. Good news from the labour market is likely to be heard for years to come. In 2018 the unemployment rate is expected to drop 9.1% in the eurozone, and down to 7.8% throughout the EU.[12] What is needed now is to let all the hard-won reforms work and bear fruit without putting all that at risk with further fiscal integration.[13]

If the proponents of the fiscal course find reason to criticise the present institutional arrangements, they do so by pointing out the politicisation of surveillance and enforcement, and especially the dominant role of the Member States, which act as judges in their own cases and try

[8] European Commission, "Winter 2017 Economic Forecast," http://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/winter-2017-economic-forecast_en.

[9] C. Kamps *et al.*, *Would the Strengthened EU Fiscal and Economic Governance Framework Have Helped Signalling Sovereign Debt Crises?*, www.bancaditalia.it/pubblicazioni/altri-atti-convegni/2013-fiscal-policy/kamps.pdf.

[10] A. Truger, *Austerity, Cyclical Adjustment and the Remaining Leeway for Expansionary Fiscal Policies within the Current EU Fiscal Framework*, Institute for International Political Economy, 2015, p. 50.

[11] European Commission, *op. cit*.

[12] *Ibidem*.

[13] J. Matthes, A. Iara, B. Busch, *Die Zukunft der Europäischen Währungsunion. Ist mehr fiskalische Integration unverzichtbar?*, IW-Analysen Nr. 110, 2017.

to wrench concessions from the austerity rules. Suspicion is rife that a division has been emerging of those equal and some more equal, especially after a news report about France's informal agreements with the European Commission on soft treatment of the country's own infringements of the pact.[14] The most recent cause for criticism was provided in the summer of 2016 by a decision waiving sanctions against Spain and Portugal for failure to fulfil their commitments to fight excessive deficit, which Daniel Gros, director of the Centre for European Policy Studies (CEPS), called the "silent death" of the pact.[15]

Those on the other side of the dispute, the ones opposing the restrictive approach, argue that it unnecessarily prolonged the crisis by stifling demand and forcing governments to cut spending that otherwise could increase or help uphold their countries' economic potential.[16] They argue austerity should also be blamed for the rapid growth of unemployment and the rise of eurosceptic movements and populism, which have the potential to bring about the eurozone's fall.[17]

Also, satisfaction with the slightly better economic results for 2015–2016, though, should not turn into neglect of the euro area's obvious weaknesses and its future challenges. It is worth remembering that the GDP growth—still surprisingly low after such a long period of stagnation—was secured in highly favourable conditions marked by a weak euro, low oil prices and extraordinarily low interest rates. Furthermore, this growth is not going to speed up remarkably, staying around 1.4–1.8% in the coming years,[18] which hardly can be labelled a boom. And there is the risk that the eurozone economy will remain in this state (or even below) for a longer period, possibly reflecting the so-called hysteresis effect, in which the weaknesses of previous years result in demolishing so much knowledge and capital that the base for potential growth is eroded. Some economists also warn that Europe has been drifting towards a "secular stagnation,"[19] registering an excess of savings over investment and consequently suffering from weak demand that cannot be stimulated without changes in economic policy—and it the fiscal policy in particular.

Eurozone asymmetries provide yet another cause for concern and arguments in this direction. While Germany enjoys a good economic situation, Member States in Southern Europe are coping with high unemployment and recurring problems with their own financial sectors, as well exemplified by Italy. This division into core and periphery suggests that the recovery may prove fragile and be reversed by just a small external shock. The risk of such shocks materialising is not insignificant and are reflected in the rise of protectionist sentiments in the global economy, the impact of increasing oil prices, and the uncertain consequences of Brexit.

These are by no means the only arguments cited by advocates of a retreat from the cautious fiscal approach in favour of more expansionist action. One strong argument is that the ECB's monetary policy must not be the only factor defining the space for countercyclical measures at the supranational level. There can be no doubt that, thanks to Mario Draghi's unorthodox moves, this policy helped the economy out of the crisis and prevented an aggravation of public debt problems. But the room for a hyper-flexible policy is gradually being exhausted, as indicated by

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[14] C. Schubert, "Haushaltsdefizit: Geheimer Vertrag zwischen Frankreich und der EU- Kommission?," *Frankfurter Allgemeine Zeitung*, 18 October 2016, www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/haushaltsdefizit-geheimer-vertrag-zwischen-frankreich-und-der-eu-kommission-14485376.html.

[15] D. Gros, *The Silent Death of Eurozone Governance*, www.project-syndicate.org/commentary/eu-fiscal-rules-not-enforced-spain-portugal-by-daniel-gros-2016-08.

[16] See: C.L. House, C. Proebsting, L.L. Tesar, *Austerity in the aftermath of the Great Recession*, NBER Working Paper No. 23147, 2017.

[17] See, e.g., one of the most passionate critics of the austerity course, Blyth. Among economists very engaged in criticism against austerity are also Nobel Prize winners Paul Krugman and Joseph Stieglitz, as well as Thomas Piketty, the author of one of the most discussed books of the recent years, *Capital in the 21st Century*.

[18] European Commission, *op. cit*.

[19] An insightful publication on this topic: C. Teulings, R.E. Baldwin, *Secular Stagnation: Facts, Causes, and Cures*, Centre for Economic Policy Research (CEPR), 2014.

the projected increase in inflation from 0.2% in 2016 to 1.4% and 1.7% in the following years.[20] Thus, a second countercyclical engine—a fiscal one—must be started at the eurozone level.[21]

Last but not least, one could state that the focus on discipline and the reluctance to endorse expansive fiscal policy at the integrated-area level have also influenced a bit paradoxically the quality of the fiscal framework itself. The snag is that its universal principles clash with the complexity of Member States' economic systems and the need for a case-by-case approach. The reaction to this problem took the form of a multiplication of criteria—their number is higher than usual in full federations[22]—and also of exceptions and interpretative recommendations. This fosters neither system transparency nor credibility. These charges can be linked with experts' comments on the quality of the criteria themselves, and especially the MTO criterion, which is quite difficult to compute in a precise way. As was demonstrated by Masten and Grdovic,[23] the European Commission made wrong assessments of fiscal policy direction in 40% of cases, which could have forced Member States to take a pro-cyclical, tightening-up approach. Similar arguments were made by other experts, e.g., Bruegel (Claeys, Darvas and Leandro)[24] and the International Monetary Fund.[25] In their opinion, the fiscal framework is in need of radical simplification.

Towards Rebalancing the Fiscal Framework: Consequences for Integration

For some time now, there have been more and more indications that moderate critics of the current fiscal framework and the austerity course have the upper hand. Their influence has become more visible on the level of the European institutions, which devote more initiatives towards boosting growth and fighting unemployment. Towards the end of 2014, the European Commission announced a plan to stimulate investments in the EU (European Fund for Strategic Investment, EFSI, or the Juncker plan) and in following months pushed for a review of retrenchment-time regulations as well as recommended more flexibility in applying the rules. But a move of strategic importance came only in June 2015, with the publication of the Five Presidents Report,[26] which proposed to complete integration and create an economic, financial, fiscal and political union by 2025, to be achieved in three stages.

The fiscal sphere is among the most important areas covered in the paper. In addition to passages on the need for budgetary policy to guarantee public debt repayment capacity and make room for automatic stabilisers, it also contains this call: "[it] is important to ensure also that the sum of national budget balances leads to an appropriate fiscal stance at the level of the euro area as a whole."[27]

The authors referred to a situation in which national budgets could be "overwhelmed" and incapable of absorbing economic shocks, thus harming the whole euro area. Consequently, the currency union should have a fiscal stabilisation mechanism—but the document is more specific

[20] European Commission, *op. cit.*

[21] N. Roubini, *The Return of Fiscal Policy*, www.project-syndicate.org/commentary/shift-from-monetary-to-fiscal-policy-by-nouriel-roubini-2016-09?utm_source=project-syndicate.org&utm_medium=email&utm_campaign=authnote.

[22] M. Andrle *et al.*, *op. cit.*, p. 8.

[23] I. Masten, A.G. Gnip, *Stress testing the EU fiscal framework*, VOX, CEPR's Policy Portal, http://voxeu.org/article/stress-testing-eu-fiscal-framework.

[24] G. Claeys, Z. Darvas, Á. Leandro, "A proposal to revive the European Fiscal Framework," *Bruegel Policy Contribution*, no. 7, 2016.

[25] M. Andrle *et al., op. cit.*

[26] European Commission, "Completing Europe's Economic and Monetary Union. Report by: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz," 22 June 2015, https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf.

[27] *Ibidem*, p. 16.

on what the mechanism will not be rather than what it will be. It certainly should not lead to permanent transfers in one direction nor be seen as an instrument of income equalisation. Also, it should not provide disincentives to sound fiscal policy and structural reforms, or substitute for the European Stabilisation Mechanism in the implementation of bailout programmes. Its launch should be contingent on having reached a high degree of financial integration, economic convergence between Member States, and advanced coordination, or even alignment, of national budgetary policies. Also, its spending should be directed towards joint investments in the eurozone.

This proposal is repeated in successive documents, including a firm reference to it contained in the European Commission's release of mid-November 2016, coinciding with the opening of the European Semester. Commission President Jean-Claude Juncker then said that "the Commission is recommending a positive fiscal stance to support the recovery and the monetary policy of the European Central Bank, which should not bear the burden alone."[28] In practice, the Commission proposed that as part of preparations for the 2017 economic policy recommendations, Member States be divided into groups, in accordance with the capacity to increase spending. Those having problems with debt and fiscal balance should go on with "growth-friendly fiscal consolidation," i.e., stabilisation measures. But the Member States with fiscal space should take an expansionary stance, in the interest of the whole euro area.

The scale of this expansion was put by the Commission as 0.5% of GDP for the whole euro area—but only as guidance, not rigid instruction. Still, even a 0.3% expansion—while "insufficiently ambitious"—would nevertheless close the euro area's GDP gap by half. On the other hand, the upper limit of 0.8%, which would surely bridge the GDP gap entirely, could overheat the economies of some Member States and upset the stability of public finances.[29]

There remains the problem of enforcing an expansionary stance, and on this the Commission is quite enigmatic. It can hardly be expected that higher spending would come as a result of the application on Member States of the fiscal rules currently in force. If the point of departure were to be provided by the Country Specific Recommendations (CSR) adopted in July 2016, the result would be a moderately restrictive stance in 2017 and 2018, but not expansion.

In the absence of a dedicated instrument, the Commission proposed two lines of action. One is to "encourage" Member States with fiscal space to pursue expansionary policy by making it a "matter of collective responsibility and discussion in the Eurogroup." That could mean even stronger commitments made to other countries under the corrective arm of the pact to restructure one's own public finances.[30] Thus, the goal is to provide greater symmetry and avoid the impression that some Member States could free ride. As part of the other line, the Commission intends to emphasise the collective importance of the "expansionary stance," by linking discretionary public expenditure items with the EU's strategic goals in the fields of digitalisation, energy transformation, labour mobility and other areas requiring additional investments in coming years. This represents a clear link to EFSI, and especially to the ambitious plans for the Fund's build-up.[31]

The Commission's proposals did not elicit much enthusiasm on the part of many Member States. At a meeting in early December 2016, eurozone finance ministers rejected the idea of "expansionary fiscal targets." They only agreed that countries with the largest budget surpluses should step up their spending—but without setting specific goals and, most importantly,

[28] European Commission, "European Semester Autumn Package: Working for a stronger and more inclusive economic recovery," http://europa.eu/rapid/press-release_IP-16-3664_en.htm.

[29] European Commission, "Towards a positive fiscal stance for the Euro Area. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions."

[30] European Political Strategy Center, "Towards a Positive Euro Area Fiscal Stance. Supporting public investments that increase economic growth," *EPSC Strategic Notes*, no. 20, 23 November 2016.

[31] European Commission, *op. cit*.

"depending on country specific circumstances, while respecting the medium-term objective, the national budgetary prerogatives and national requirements."[32] Also, the newly appointed chief of the European Fiscal Board, Niels Thygessen, took a sceptical view of the Commission's "fiscal targets" and argued that the concept deserves more discussion and more analysis (saying, "that was surprising").[33] The strongest criticism came from advocates of financial discipline and of a continued conservative fiscal stance. Their position was lucidly expounded by the former EBC chief, Claude Trichet: "It is a little bit strange we are embarking on such recommendations when we know that the crisis of 2008 came from over-leveraging and we had a sovereign debt crisis."[34]

These reservations just signal the upcoming controversies in which arguments for fiscal responsibility and cautiousness will be confronted with statements that a monetary union cannot survive without a "balanced" approach on the macroeconomic level and more spending in order to support growth. Behind them, more fundamental fault lines will emerge. The first will divide proponents of a more liberal approaches stressing the importance of free markets and competition from interventionist ones claiming that a more active and redistributive state is essential for economic stability. It cannot be excluded that this discussion may indeed open the institutional "path departure"[35] on the integration level towards more financial risk-sharing, a transfer mechanism and even a common budget. The second fault line concerns the political area. A union heading towards a partial pooling of the fiscal area—the most intimate sphere of national sovereignty—would start resembling a state more than anything else in the history of integration in Europe. Opponents of this tendency will claim that the deficit of legitimacy is too striking for such a profound change.

How the issue of the fiscal framework and the possible fault lines it carries will be resolved could be decisive for the future of integration. If all members of the eurozone reach compromise and recognise their interest in moving forward,[36] the effect can be the formation of a very advanced core of the eurozone with a wide set of integrated policies at its disposal. However, if differences in interest and preferences prevail, the opposite direction may win and disintegration of the current monetary union becomes a more probable option in the next crisis.

The above-mentioned disputes may have also impact on integration in a broader sense and change the current equilibrium between the eurozone and the members of the EU without the common currency. Almost all of them have an obligation to join,[37] but there is no specific deadline to do it. Arguments for delay stretch from economic to political. The attractiveness of euro membership suffered during the crisis as the economies outside the area performed better with higher GDP growth and lower unemployment. These economies appreciate autonomy in setting up interest rates as well as influencing the exchange rate of their national currency. Apart from those reasons, another to stay out is a stronger national sovereignty bias and a clear reluctance to transfer very core competences to the supranational level. The steps towards fiscal integration could disturb this equilibrium and change the preferences of the non-eurozone countries. Some

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[32] "Finance ministers reject euro zone fiscal stimulus target", Reuters, www.reuters.com/article/us-eurozone-fiscal-expansion-idUSKBN13U1QU.

[33] "European Fiscal Board chief: Commission's analysis 'made a bit too quickly'," Euractiv, www.euractiv.com/section/euro-finance/interview/european-fiscal-board-chief-commissions-made-a-bit-too-quickly.

[34] "No sign of euro zone fiscal stimulus in 2017 borrowing estimates," Reuters, www.reuters.com/article/us-eurozone-economy-stimulus-idUSKBN1421G6.

[35] B. Ebbinghaus, *Can Path Dependence Explain Institutional Change? Two Approaches Applied to Welfare State Reform*, Max-Planck-Institut für Gesellschaftsforschung, 2005, p. 16.

[36] A joint fiscal stimulus is also one of the arguments discussed in the recent book by J.E. Stiglitz, *The Euro and Its Threat to the Future of Europe*, Allen Lane, 2016. See Chapter 9.

[37] This refers to Bulgaria, Croatia, Hungary, Czech Republic, Poland, Sweden, and Romania. Denmark and the United Kingdom take advantage of an opt-out from eurozone membership. However, after the Brexit referendum, the UK will abandon this status and Denmark has been tied to the euro since ERM II, which makes the latter much more closely integrated with the eurozone than its institutional status suggests.

of them may find it a factor pushing them to adopt the common currency sooner than later. For others, it may be a decisive reason to give up the wait-and-see approach towards the integration in the eurozone and invest their political resources in strengthening a platform of low-profile integration within the European Union, which will be mainly based on single-market access and a few joint policies.

EU MEMBER STATES AND THE EVOLUTION OF THE FISCAL FRAMEWORK

Introduction

The dynamics of the changes mentioned in the previous chapter depend on the preferences and interests of the EU Member States. Considering the potentially far-reaching consequences of the fiscal framework reform, they may have many reasons—support in the society, political philosophy, attachment to sovereignty and even international security considerations—to accept or refuse the shift. But at the core of them will be their fundamental economic preferences.

With respect to the eurozone, the preference comes down to whether the status of a member under the new rules benefits them from an economic point of view. This includes who will finance "joint" fiscal stimulus, or, in other words, who will be contributors under the new policy. Another issue is who will be the greatest beneficiaries of demand induced by joint fiscal expansion. A third problem refers to systemic consequences and has to do with whether the new, less-restrictive fiscal framework is in line with national stability bias, that is, with institutions that would foster policies such as a restrictive approach to inflation. The same set of issues applies to non-members of the eurozone, but in a different context. They will want to know whether the economic order under the revised fiscal rules would benefit them after entering the eurozone. In this sense, the new fiscal framework can become another important argument (along with, for example, the advantages and flaws of exchange rate flexibility or autonomous monetary policy) in the discussion of whether to join the monetary union or stay outside it.

These questions may be turned into a list of more detailed characteristics to make it possible to establish a profile of a Member State highly interested in the idea of rebalancing the fiscal framework. The detailed features are described next.

One is a Member State that has no "formal" fiscal capacities to spend more. It does infringe the Stability and Growth Pact, meaning that it failed to meet criteria on debt and deficit, and did so at least beyond a time horizon of a short-term downturn. If so, that state would not be a contributor for fiscal expansion, unlike those who comply with the criteria and thus—by definition—enjoy spending space in their budgets.

The second is a Member State with a small economy, which gives it asymmetrical benefits vis-à-vis large countries from a joint expansionary fiscal stance at the supranational level. A small economy usually has economy-of-scale problems with the production of public goods and consequently spends relatively more on this than larger economies, thus depleting resources needed for effective countercyclical policy. The problem is all the more pressing since the smaller economy's exposure to shock is greater than larger players, reflecting usually deeper trade specialisation and dependence on external markets.[38] Another asymmetrical benefit for small economies reflects the circumstance that commitments to fiscal expansion will be made based on universal criteria, such as the percentage of the budget space to be spent. This means, however, that in absolute terms smaller economies will contribute less than larger ones and, in practice, will not be able to support the latter to any perceptible degree. On the other hand, the fiscal stimulus generated by larger economies may prove to be of considerable importance for the smaller ones. Summing up, fiscal framework revision brings benefits to smaller Member States in the form of lower costs of maintaining macroeconomic stability.

[38] E. Cabezon, P. Tumbarello, Y. Wu, *Strengthening Fiscal Frameworks and Improving the Spending Mix in Small States*, IMF Working Paper, June WP/15/124, 2015.

The third characteristic is about a Member State that has limited capacity to stimulate economic growth by tapping internal sources other than public spending. This is especially true for household potential to increase consumer spending, which represents the weightiest portion of the GDP and which could contribute most to stimulating an upturn should fiscal problems emerge. The space for such "privatised Keynesianism"[39] narrows if households are burdened with high taxes (and the government, in fiscal trouble, cannot lower them), save little from current income, or are significantly indebted.

The fourth type is a Member State with an economy that stands the chance of reaping special benefits from fiscal stimulus in the euro area. The map of beneficiaries will be defined primarily by trade flows, through which positive demand effects will spread across the European single market. The greatest benefits can be expected by national economies with high levels of exports to other EU states and high export-to-GDP ratios. Interest may also be taken by Member States with a high current account deficit, which may be brought down by higher exports.

The fifth Member State type is one with an economy coping with structural problems, especially with long-lasting low rates of GDP growth and investment, and with labour market problems, as reflected by high long-term unemployment and joblessness among the young. External fiscal stimulus may—through high export dependency—lessen their pain and reduce the social costs of the possible reforms. This is an important point if we remember the argument frequently raised in discussions about reform effectiveness[40] that tough supply-side reforms and fiscal countermeasures, conducted simultaneously, can lead to political destabilisation and the government losing the next election.

And the sixth type is a Member State that has embraced such variety of capitalism that actors prefer a less restrictive stability bias. This argument draws on the distinction between liberal market economies (LME) and coordinated market economies (CME).[41] The characteristic features of LME include the dominance of a free-market approach to regulation of access to production factors as well as short-term "dynamic" contracts, where resources can be quickly moved to new uses. This creates favourable conditions for radical, disruptive innovations, and consequently for the emergence of entirely new products. From the macro perspective, this variety of capitalism easily enters the boom phase, after which may follow deep and long recessions. Consequently, businesses expect that the state will prove capable of pursuing a counter-cyclical policy, which means that LME economies may prove more inclined to create EU-level mechanisms of fiscal expansion.[42]

Different preferences will be demonstrated by businesses in a coordinated market economy (CME), where mesoeconomic mechanisms, such as corporations, unions, associations, or networks are more important than the market. The entire system is oriented towards stable, long-term conditions, with the attendant advantage of creating gradual innovations that improve the quality of mature-technology products. Expectations on the state concern stable macroeconomic conditions so contract terms and profit expectations do not have to be changed. CME businesses thus give preference to a state's financial discipline.

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[39] C. Crouch, "Privatised Keynesianism. An Unacknowledged Policy Regime," *British Journal of Politics & International Relations*, vol. 11, no. 3, 2009, pp. 382–399.

[40] It was discussed, e.g., during the Agenda 2010 reforms in Germany and explains why Schröder's government was not very enthusiastic about obeying the rules of the pact. It came back during a recent crisis in connection with the austerity imposed on Greece and other countries.

[41] Overviews: P.A. Hall, D.W. Soskice, *Varieties of Capitalism: Institutional Foundations of Comparative Advantage*, Oxford University Press, 2013; B. Hancké, *Debating Varieties of Capitalism: A Reader*, Oxford University Press, 2009.

[42] On the discussion of whether liberal capitalism is less or more prone to proactive stabilisation policy, see: B. Amable, K. Azizi, *Varieties of Capitalism and Varieties of Macroeconomic Policy: Are Some Economies More Procyclical than Others?*, Max-Planck-Institut für Gesellschaftsforschung, 2011.

Obviously, these two do not exhaust the diversity of capitalism's varieties, which may also include hybrid, mixed forms.[43] But these stay within the bounds defined by the two principal varieties and, depending on specific features, may tilt towards fiscal policy that is either proactive or stability-driven. These specific features may include the economic ideas, historical experiences and beliefs dominant in a given Member State, i.e., a group of factors sometimes referred to as a culture of stability. What also can be important here is the specific interest following from the status of either a structural, durable creditor or debtor in international relations. In the former case, the stability bias will be determined by the necessity to protect the value of assets, which translates into an aversion to any activities posing a threat to this. One such activity is expansionary fiscal policy, which may fuel inflation and bring down the claims' real value. The opposite is true of indebted economies.

Germany, France and Poland: An Analysis of Preferences

This section is devoted to the perspectives of France, Germany and Poland—the Member States whose interests with regard to the shape of the EU's fiscal framework may prove to be of key importance for the future of the internal design of the eurozone and its further enlargement.

Without France and Germany, the largest economies in the euro area and the strongest political muscle in EU structures, it would be quite hard to imagine any development of European integration mechanisms—and this obviously is also true of the chances of enforcing the proposal on a common expansionary fiscal stance. If the German and French preferences are in conflict, that rules out any compromise, the likelihood of change drops considerably. More than that, the differences might augur increasing dissonance within the euro area, which in the longer run even could bring an end to the monetary union in its current shape. And conversely, concordant preferences may define the direction of future integration. If this concordance is about keeping the fiscal framework's present restrictive nature, then the responsibility for the bulk of economic policies would likely stay with national governments. But if it is about accepting a common fiscal expansion, the euro area will likely move towards a quasi-federation model.

Poland is one of the EU members still outside the euro area but required to adopt the single currency in the future. Its preferences with respect to the Commission's proposals are worth looking into because the country is by far the largest of the members obliged to join the euro in terms of population and the second largest by economy (Sweden has a slightly higher GDP). Poland's position should become more important with the loss of the anchor of the non-euro area, the United Kingdom, and its political clout at the conclusion of Brexit (Denmark, another member with opt-out status is linked to the euro via ERM2 and is a relatively small economy). Poland's preferences on the fiscal framework may be among the factors that determine whether it joins the euro area in the foreseeable (though still very distant) future or stays out definitely.[44] In practice, this will be about answering the question of whether any separate and durable integration platform can emerge outside the euro area or, perhaps, is gradually absorbed by the euro area. Many other countries with the same formal status, such as the Czech Republic and Hungary, will be giving thought to this dilemma, too.[45]

[43] B. Hancké, M. Rhodes, M. Thatcher, "Introduction: Beyond Varieties of Capitalism," in: B. Hancké (ed.), *op. cit.*, pp. 12–16.

[44] The negative assessment of Poland's prospects of joining as well as the eurozone's chances of flourishing dominate nowadays. See, e.g.: S. Kawalec, E. Pytlarczyk, *Paradoks euro: jak wyjść z pułapki wspólnej waluty?*, Poltex, 2016.

[45] "Minister gospodarki Węgier nie wyklucza przyjęcia euro do końca dekady," *Rzeczpospolita*, 19 July 2016, www.rp.pl/Polityka/160719240-Minister-gospodarki-Wegier-nie-wyklucza-przyjecia-euro-do-konca-dekady.html.

Fiscal capacities

Proceeding from the criterion of compliance with Stability and Growth Pact provisions, which are decisive in determining contributor status under the "revised" fiscal framework, Germany is likely to rank among the countries least interested in the Commission's proposal. Having a budget surplus (see figures below), it is currently close to being a paragon of fiscal discipline, which has been achieved as a result of not only a satisfactory economic situation but also tough budgetary consolidation. As part of this consolidation, changes were made in the German constitution towards imposing a balanced finances requirement on the *Bundesrepublik* and its constituent *Länder*. Also, the country's structural deficit of 1.8% in 2010 improved perceptibly (actually turning into a surplus), and the public debt indicator is better than before, having fallen to 68.2% currently (see figures below, also for France and Poland). These numbers are all the more impressive considering just a decade ago Germany was among the Member States with the biggest problems, marked by frequent failures to stick to the deficit criterion and a rise in public debt, sometimes even exceeding 80%. That largely reflected the poor economic situation of the first half of the 2000s, when Germany was hit by stagnation and record-level unemployment and was the prime mover behind a push to water down the pact in 2005.

Germany's public finances do not look like they will turn bad for years to come. According to the European Commission's projections for 2016–2020, the country is expected to run a balanced budget. In terms of MTO, which permits a structural deficit of up to 0.5%, Germany is forecast to have 0.4–0.5% surpluses in both 2017 and 2018. Also, by 2020, its public debt is expected to drop to 59.1%, a level complying with the pact.[46]

The landscape is different in France, which in terms of its fiscal situation has for years lagged its Eastern neighbour. Until not long ago, the country's public finance deficits reached up to 7% as the recession drag was close to 3%. Only since 2012 has the situation gradually calmed down, leaving the country with capacity to reduce the deficit even in a downturn. The nominal deficit is expected to have reached 3.5% in 2016, and to register around 3% in 2017–2018, which, however, is close to infringing the pact and previously accepted commitments under the excessive deficit procedure (to comply with the pact by 2017 and reduce the deficit to 1.2% in 2019). Also fitting this pattern of a situation that is not satisfactory but gradually improving are data on the country's structural deficit, which several years ago was close to 6% but now remains at some 2.5%, and is required to go down to stay around this level in the next years. In order to improve, the French government has been taking retrenchment measures, seeking, for example, to slash public spending by €50 billion by 2017. But one would be forgiven to conclude that bigger hopes are being pinned on an economic upturn and a continuation of low interest rates rather than tough stabilisation treatment.[47]

France's problem transcends the bounds of annual fiscal balances and has very much to do with the size of its public debt. A decade ago, it only slightly exceeded the criterion of the Stability and Growth Pact (64.4% in 2006), but things since then have only worsened, with 96.2% posted in 2015. Fortunately for the French economy, it has never encountered problems with debt servicing or finding buyers for French bonds. It is not inconceivable, though, that a deep recession

[46] Council of the European Union, "Recommendation for a Council Recommendation on the 2016 national reform programme of Germany and delivering a Council opinion on the 2016 stability programme of Germany," *Official Journal of the European Union,* C299/19, 2016.

[47] Council of the European Union, "Council Recommendation of 12 July 2016 on the 2016 National Reform Programme of France and delivering a Council opinion on the 2016 Stability Programme of France," *Official Journal of the European Union,* C 299/114, 2016.

may spur the debt level out of control.[48] The latest forecasts data do not allow too much optimism: the public debt ratio is expected to run at around 96.5–97% till 2018.

The picture of Poland is moderately positive as far as the fiscal sphere is concerned, with both positive developments as well as certain weaknesses. On the one hand, as the only country of the three under review, Poland complies with the criterion on public debt, which in 2016 amounted to 53.6% (see figure 1). A potential cause for concern is that the Polish debt has been steadily rising, even despite favourable economic trends. As can be seen in the diagram below, the debt had already approached the 56% level, dropped for a short time as a result of moving Open Pension Fund (OFE) resources to the budget, and for some time now has been on the rise again. Expectations that it will decline again (to 50.4% by 2019 in previous assessments[49]) may prove unfilled: the Commission sees an incremental rise more probable now (see figure 2).

As far as the nominal deficit is concerned, the picture varied in recent years, with the worst performance seen in 2009–2010 when, under low economic growth, public budget deficits were in excess of 7%. The situation smoothed out after 2011, thanks to retrenchment and stabilisation measures taken under the excessive deficit procedure, which was ended in 2015, in step with deficit reduction. The situation should not be expected to worsen dramatically in the years to come, but still the public fiscal deficit is projected to run at around 3% of GDP, close to a point at which the next EDP can be launched. In addition to that the MTO objective, put as no more than -1% GDP, is unlikely to be reached. In 2016, the balance stayed at -2.8% and should hover around this number for the near future.

The risk of breaching the nominal criterium of the Stability and Growth Pact[50] is primarily connected with the—still unknown—effects of a perceptible increase in social transfers of new family allowances and the lower retirement age. In case of a downturn, they may easily translate into a higher deficit. There are also institutional factors that suggest taking a cautious assessment of the future fiscal position. Poland indeed has a "debt brake" written into its constitution, but detailed rules that should enforce it were weakened in recent years (e.g., the debt warning thresholds and expenditure rule). There is still no plan to create an independent fiscal council—a body that could strenghten a sound policy. And it is still very difficult to estimate how the budget will be affected by the government's further, ambitious development plans, providing for such things as increased spending on innovation, "re-Polonisation" of some financial institutions, and modernisation of the military. Markets did not fail to notice the pronouncement by the minister of finance to the effect that the criteria of the Stability and Growth Pact should be reassessed and rendered more flexible in view of the increased spending needed to meet these goals.[51] The government seeks to dispel possible misgivings about Polish public finances by stepping up tax collection (with success) and reiterating the finance minister's declarations about the primacy of fiscal discipline.

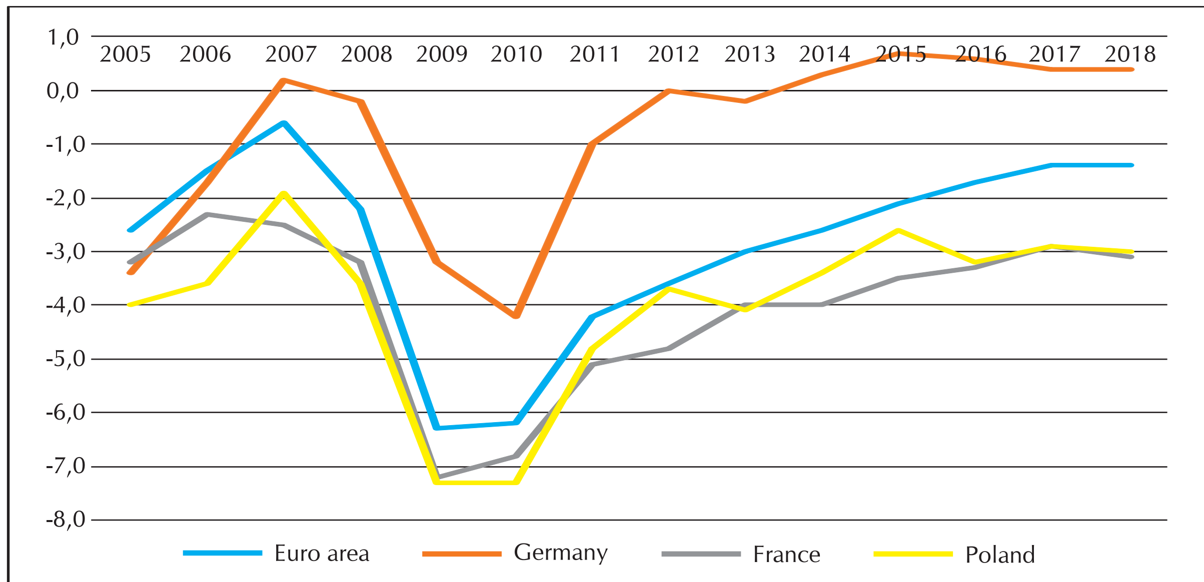
[48] B. Granville, *The French Disconnection*, www.project-syndicate.org/commentary/why-france-should-leave-the-eurozone-by-brigitte-granville.

[49] Council of the European Union, "Council Recommendation of 12 July 2016 on the 2016 National Reform Programme of Poland and delivering a Council opinion on the 2016 Convergence Programme of Poland," *Official Journal of the European Union*, C299/15, 2016.

[50] *Ibidem.*

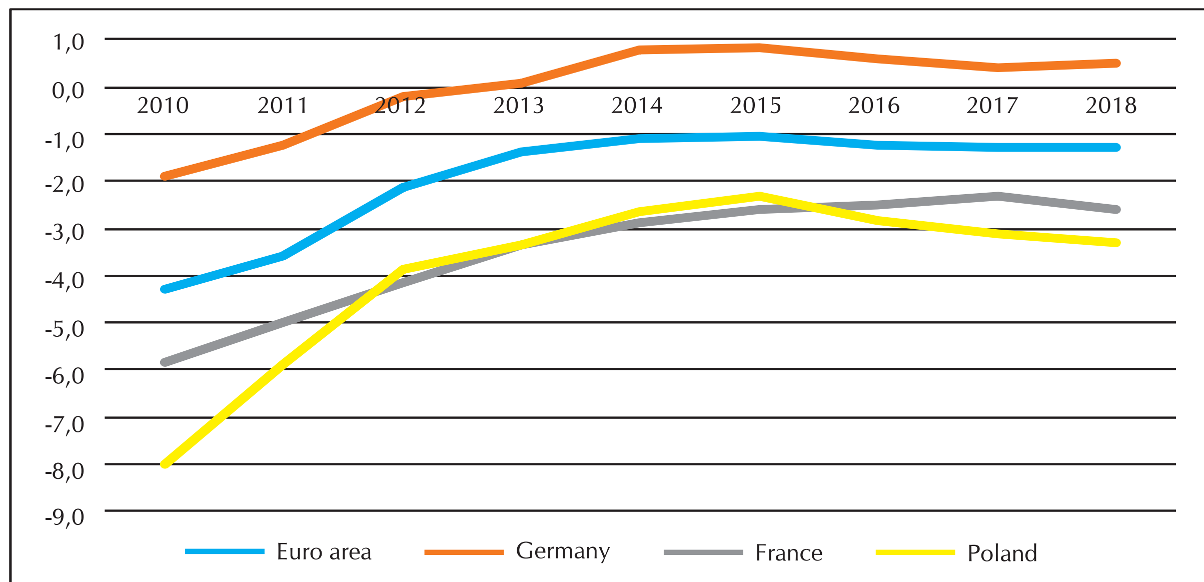
[51] G. Siemionczyk, "Mateusz Morawiecki nie chce do obowiązującego w Unii limitu deficytu budżetowego nie wliczać wydatków na obronność," *Rzeczpospolita*, 1 November 2016, www.rp.pl/Budzet-i-Podatki/311019942-Mateusz-Morawiecki-nie-chce-do-obowiazujacego-w-Unii-limitu-deficytu-budzetowego-nie-wliczac-wydatkow-na-obronnosc.html#ap-1.

Figure 1. General government net lending (+) / net borrowing (% of GDP) in Germany, France, Poland, and the euro area (19 countries), in 2005–2018*



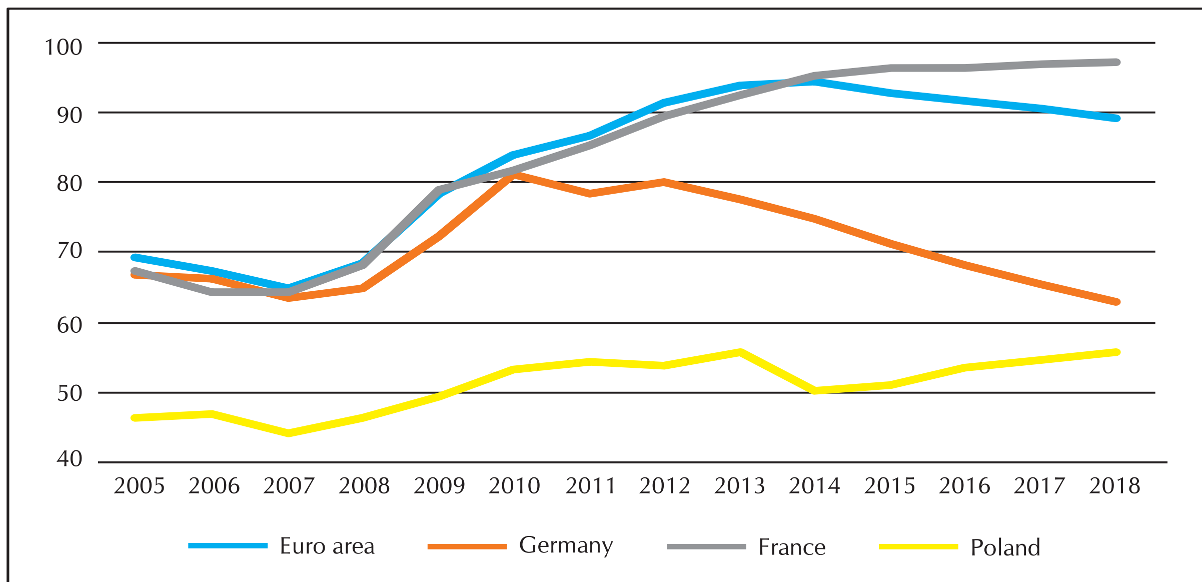
*2016–2018: forecast.
Source: European Commission, Economic and Financial Affairs,
Ameco database: http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm.

Figure 2. Structural balance of general government (% of potential GDP at current prices) in Germany, France, Poland, and the euro area, in 2010–2018*



*2016–2018: forecast.
Source: European Commission, Economic and Financial Affairs,
Ameco database: http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm.

Figure 3. General government consolidated gross debt (% of GDP) in Germany, France, Poland, and the euro area (19 countries), in 2005–2018*



*2016–2018: forecast.
Source: European Commission, Economic and Financial Affairs,
Ameco database: http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm.

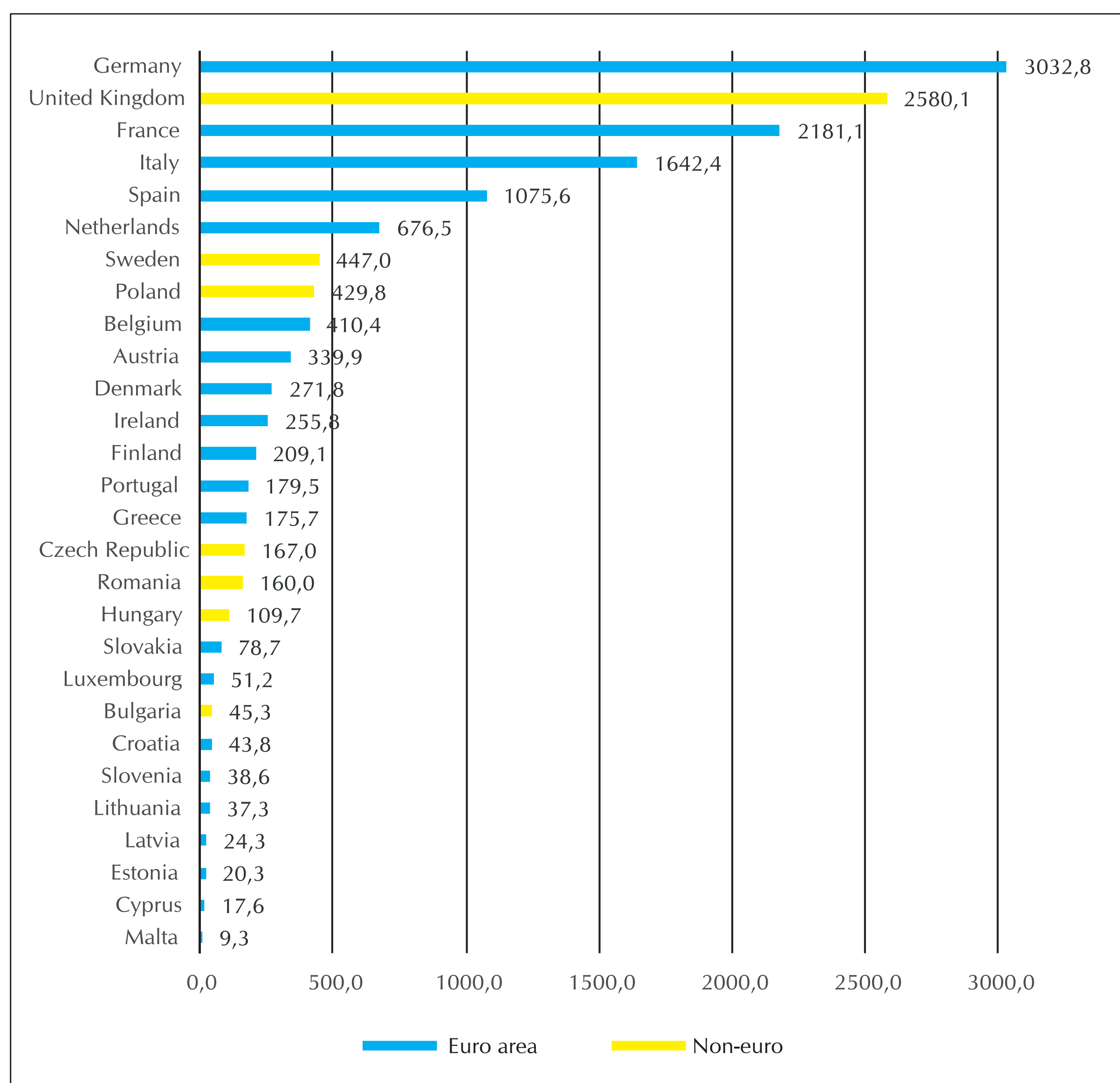
Size of the economy

Looking through the prism of the size-of-economy criterion, neither Germany nor France should be counted among enthusiasts of institutionalising fiscal expansion. Worth more than €3 trillion, the German economy represents more than 20% of the combined GDP of the EU and almost a third of the euro area (see figure 4). This means that Germany could end up being the largest payer for fiscal expansion should it be governed by universal rules. A glimpse of how big Germany's effort could be is provided by a Commission simulation based on current data. These figures indicate that seven Member States currently have space for expansionary fiscal policy: Estonia, Germany, Latvia, Luxembourg, the Netherlands, Malta and Slovakia. Together, they account for 37% of the euro area's GDP, but the figure for Germany alone is 29%, which leaves no doubt that the country would surely bear the brunt.[52]

France's economy is visibly smaller than Germany's, but with a GDP of €2.18 trillion, it comes second in the euro area and could potentially be a major payer for fiscal stimulus. Poland lags far behind the leaders: its GDP of €428 billion in 2015, equalling 4.1% of the euro area's economy, makes the country 6th in the monetary union. But the Polish economy can be expected to grow in successive years at a higher rate than the EU average, which would bring it closer to an 8–9% share, just after Spain.

[52] European Political Strategy Center, "Towards a Positive Euro Area Fiscal Stance: Supporting public investments that increase economic growth, *EPSC Strategic Notes*, no. 20, 23 November 2016, p. 6.

Figure 4. Gross domestic product at market prices 2015 (current prices) of EU members, in EUR billions

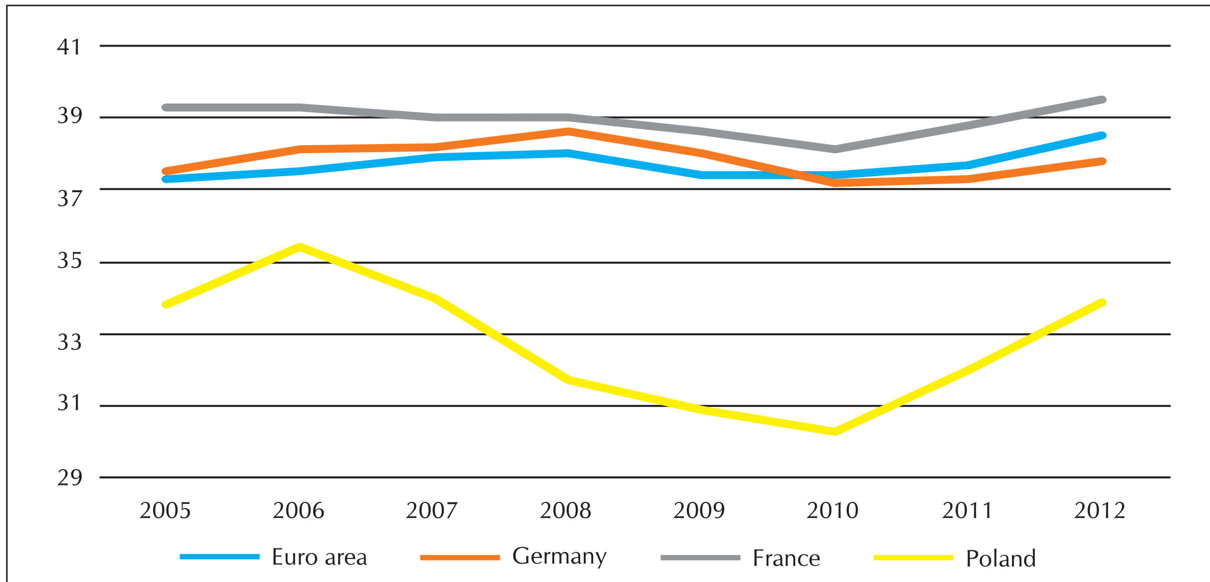


Source: Eurostat.

Spending potential of the private sector

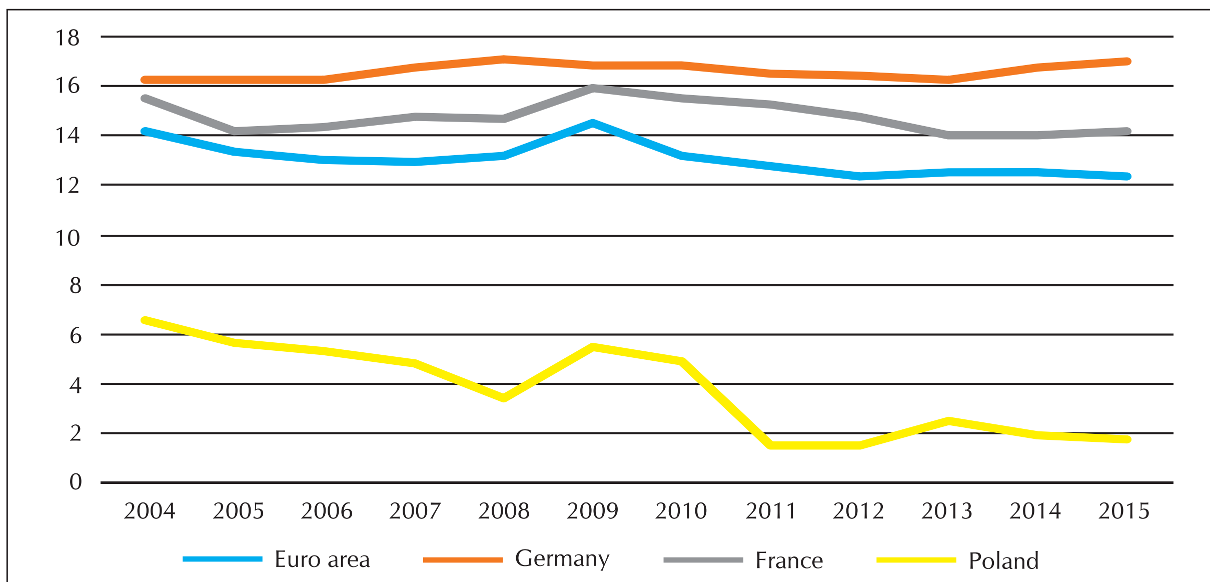
Among the three countries under study, Germany has the largest potential to mobilise household consumer spending to stimulate the economy. This potential is relatively least visible in the income tax rate, which at 37.8% (2012, according to Eurostat, see figure 5, also for France and Poland) is only a bit lower than the euro area average of 38.5%. But if in successive years Germany manages to quickly bring down its public debt to a level compliant with the Stability and Growth Pact, tax reductions can be expected and, with them, a strengthening of spending potential. Other factors, too, testify to the huge capacity the country has in this field, especially as regards households' high saving-to-income ratio, which in 2015 ran at 17%, or much higher than the euro area's average of 12.3% (see figure 6, also for France and Poland). Compared with other Member States, German households have accumulated relatively low debt and in 2015 it dropped to 82.2% of yearly income, down from over 100% in 2004 (when it exceeded the euro area average, see figure 7, also for France and Poland).

Figure 5. Ratio of taxes and social security contributions from employed labour income to total compensation of employees for Germany, France, Poland, and euro area (18 countries) in 2005–2012



Source: Eurostat.

Figure 6. Household saving rate (%) in Germany, France, Poland, and the euro area (19 countries) in 2004–2015

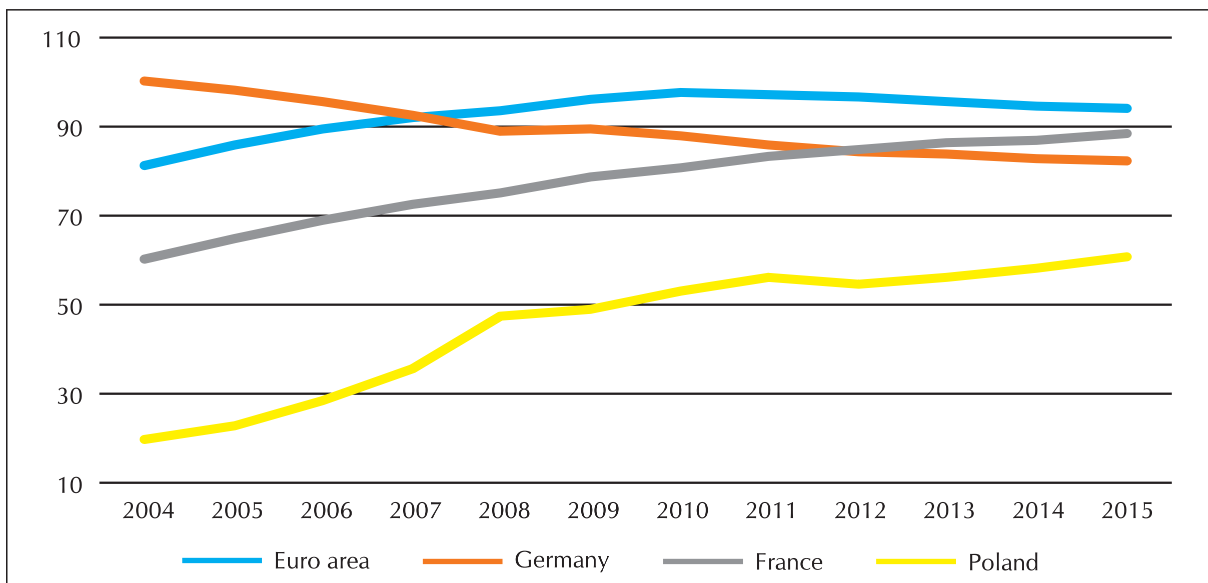


Source: Eurostat.

The French situation is less favourable, largely because of fairly high taxes and social insurance contributions (39.5% of GDP), which topped the euro area's tables in 2012. The picture is much better when it comes to households' savings ratio (14.4%), higher than the euro area's average. Household debt, at 88.3% in 2015, is close to the German ratio but unlike their neighbours to the east, the French have seen a steady rise in their indebtedness, which a decade ago was lower by some 25 percentage points (p.p.).

Poland is clearly different than Germany and France when it comes to mobilisation of household spending. The ratio of taxes and social insurance contributions is relatively low by European standards, at just 39.9% in 2012, and so is household debt, at some 60% of income. But the latter has seen a rapid growth indeed, after registering less than 20% a decade ago. Both of these factors could indicate households' considerable potential for consumer spending growth, were it not for their poor capacity to save. Only 1.77% of household income was saved in 2015, which obviously restricts the space in which households could spend more on consumption without going into debt.

Figure 7. Gross debt-to-income ratio of households (%) of Germany, France, Poland, and the euro area (19 countries), 2004–2015



Source: Eurostat.

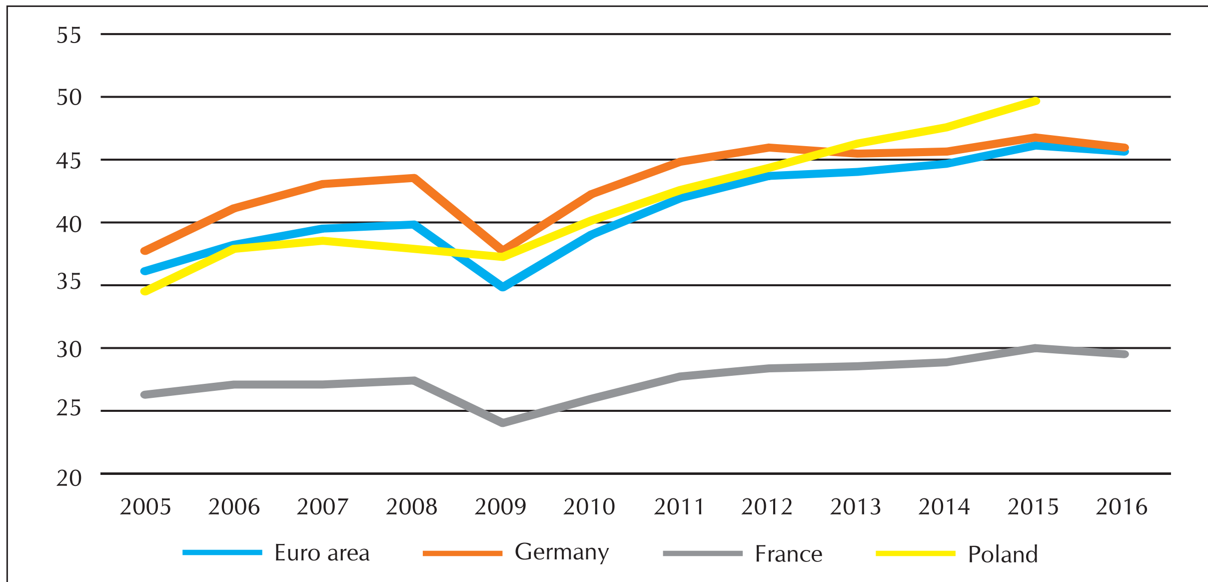
Trade volumes

Germany belongs to a select group of national economies that are both large and highly dependent on exports. Approaching €1.5 trillion in 2015, the country's foreign sales represented 47% of GDP[53] (see figure 8). The European Union markets were of key importance, accounting for more than 55% of German exports (figure 9). It is true that this proportion dropped 10 p.p. over the past decade, but that should be attributed to the poor condition of euro area economies. In a development of symbolic significance, France dropped to second on the list of Germany's export markets, overtaken by the United States. This does not change the fact that the close European neighbourhood remains the principal market for German companies, which is why a hypothetical fiscal stimulus at the euro area level could be expected to enjoy support from German companies.

The force of this argument, though, is blunted by the state of the current account—a criterion by which the German economy, with a surplus of 8.3% GDP (2015, see figure 10), comes out as extremely unbalanced. With some simplification, Germany exports much more than it imports, and for this reason the country has for years taken flak from many Member States, the European Commission and the IMF. As they see it, the pattern of German trade threatens the stability of the entire euro area and should be evened up through increased domestic spending. Fiscal stimulus outside German borders would only deepen this unbalance rather than latten it.

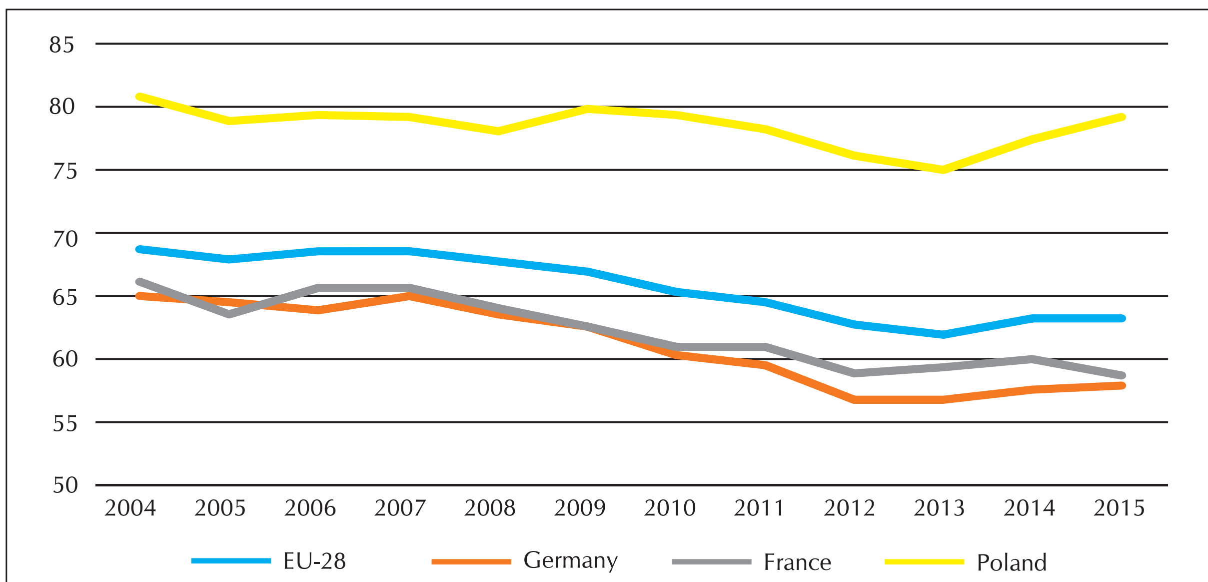
[53] The most recent data from 2016 confirm this pattern with €1.41 trillion of export.

Figure 8. Export of goods and services (% of GDP) of Germany, France, Poland, and the euro area (19 countries) in 2005–2016



Source: Eurostat.

Figure 9. Share of exports to EU (% of total exports) of Germany, France, Poland and the EU-28 in 2004–2015



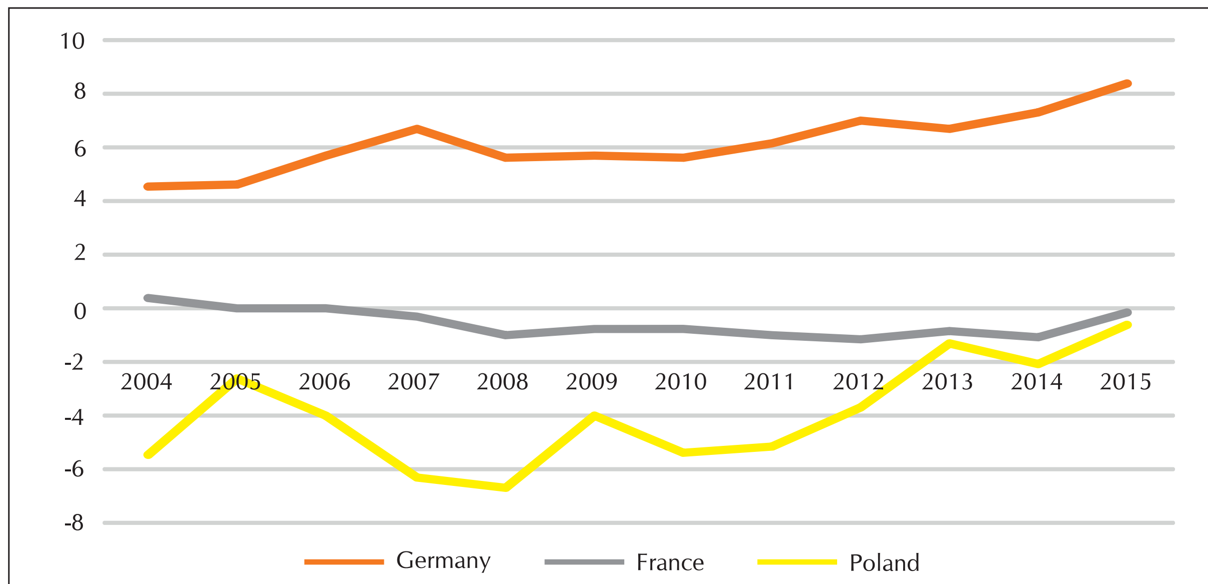
Source: Eurostat.

France's dilemmas are different. There, the proportion of GDP contributed by exports is lower—a "mere" 30%. And the European Union's share of France's foreign sales is around 60%, which is similar to the German ratio. For these reasons, one should expect that France will be less interested in a European fiscal stimulus, which would pass through a narrower conduit. Such an attitude should not be affected by the current account position, which in France is basically balanced, with deficits at 1% over the past decade (and dropping to 0.2% in 2015).

Poland's growing orientation to export is worthy of notice. Foreign exports' share of GDP has grown from less than 35% in 2005 to nearly 50% in 2015. This leap shows that Poland has

made good use of the changing competitive environment in the aftermath of the 2008 global economic crisis. With the EU accounting for as much as 85% of Polish exports, one could justifiably expect the country to have a positive stance on a hypothetical fiscal expansion in the euro area, with Poland would a clear beneficiary. An added argument could be provided by the current account position. While it is currently close to balanced (a deficit of just 0.6% GDP), large imbalances were recorded in the past decade of as much as 7% GDP.

Figure 10. Current account (% of GDP) of Germany, France and Poland, 2004–2015



Source: Eurostat.

Economic situation

A very important motive for supporting fiscal expansion is the overall economic situation and especially economic growth and labour market condition. But in terms of these particular criteria, Germany has little cause for backing the Commission's proposal, having seen healthy development over the past 10 years and especially against the background of the euro area's inferior performance. The country managed to overcome the protracted crisis of the early 2000s and move to recovery around 2005. That achievement was spoilt by the 2009 EU fiscal crisis, subsequent recession and state of near-stagnation around 2012, but in the years that followed, the economy managed to regain the path of growth, although not extraordinarily high but very stable (see figure 11, also for France and Poland). It should be added that the German economic development nowadays proceeds in a balanced way. This is visible in the gap between actual and potential GDP, which for the last couple of years has remained within -0.1% to -0.4%. For the coming years, forecasts see this trend continuing (see figure 12, also for France and Poland).

On the labour market, the picture is still better than with GDP. Thanks to the 2000–2005 reforms of Gerhard Schröder's cabinet (the famous Agenda 2010 and Hartz IV) Germany's employment scene is now more flexible and smoothly functioning. Joblessness dropped to a record low of 4.1% in 2016, which is 6 p.p. less than the euro area average (see figure 14 also for France and Poland). Confirmation of the labour market's exquisite condition also came from statistics on long-term unemployment (down from almost 5% in 2005 to just 2% in 2015, see figure 15 also for France and Poland) and the situation of young people (only 7.2% of those in the 15–24 age group were without work, less than a third of the euro area's proportion, see figure 16, also for France and Poland).

If there are any arguments on the German side for a looser fiscal stance, they should be associated with the weakness of investments, which for quite a long time have run one-fifth lower than the euro area average (see figure 13 also for France and Poland). This aspect has been under fire from many economists, believing that low investments weaken the chances for stable growth in the future.[54]

The economic situation in France is much more difficult than in Germany, even if not fully reflected in economic growth figures. Statistics show that except for 2009, when the country was hit by recession like the rest of the euro area, France did not experience a downturn on a scale like that of Europe's southern economies. However, what happened after 2011 can be called stagnation, with GDP growth around 0.2–0.6% and the output gap around 1.5%. Some improvement was seen only in 2015, possibly signalling that a better time is approaching. There might be a good basis for this: despite the sluggish growth phase, France stands out—also against the much economically stronger Germany—in terms of investments, which on average run at 2% higher than its eastern neighbour.

Compared to the growth figures, much greater cause for concern is the labour market: unemployment rose during the crisis from 7% to 10% and ran high even when the euro area as a whole saw gradual improvement. France's weakness is also reflected in the rate of long-term unemployment, which almost doubled between the beginning of the crisis and 2015 (from 2.6% to 4.3%). Young people in particular are in dire straits, with almost 25% of 15–24-year-olds—or more than the euro area average—unemployed in 2015. These figures are just the average: the reality is much worse among young immigrants, which explains to some extent the expansion of radical Islam. The poor situation on the labour market cannot be wholly explained away by sluggish growth. More convincing arguments speak of excessive regulation and high taxation of labour, but successive French governments, whether socialist or conservative, have shunned reforms in this area for fear of a public backlash. This is all the more reason why the government could take interest in a European fiscal stimulus that would speed up growth and help fight unemployment making painful reforms at least easier if not postponing them.

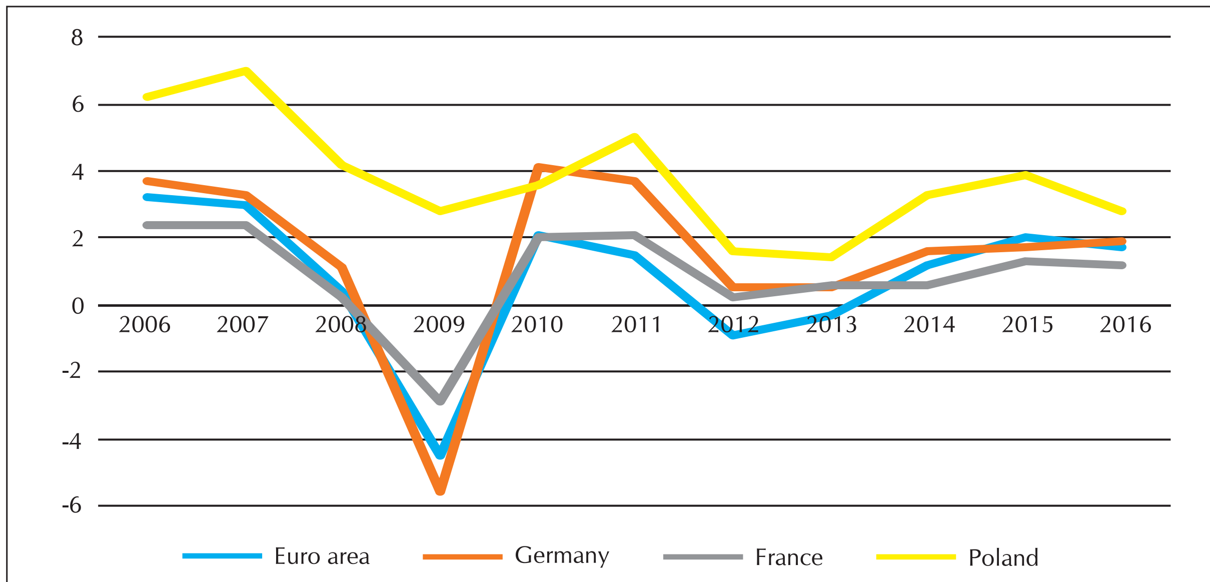
Poland has notched economic growth for much of the recent period despite the unfavourable external conditions (euro area crisis). Even in 2009, the worst year of recession in Europe, the Polish economy continued expanding—even if at a low rate—thanks to solid domestic demand and a weakening zloty, which prodded exports. Another slowdown in 2012 was fairly quickly overcome, with the rate accelerating to 3–4% till 2015 (with a slight cooling to 2.8% in 2016). From the viewpoint of the output gap, ranging between -1% and 0%, Poland's growth is balanced, even if a certain potential for acceleration is still there. This is especially true of investments, which comprise in Poland a surprisingly low portion of GDP compared to euro area countries—20% in 2015 and even as low as 18.5% in previous years. This is cause for concern when remembering that it was during a period in which Poland received substantial subsidies from EU structural funds. If this weakness persists, the Polish government may become more willing to back a more expansionary fiscal stance among the Member States.

The labour market is one more bright point among the generally positive data. Unemployment, which in the early 2000s was among the highest in Europe, fell to average just before the crisis, a result of better macroeconomic performance, labour market deregulation, and to some extent also mass emigration to other EU-countries. After a short period of worse joblessness figures, reflecting a weakening of the economy in 2012–2013, the unemployment rate began falling quickly, reaching 7.5% in 2015 and 6.2% in 2016, with few signs that the trend might reverse in the near future. Long-term unemployment, at 3% in 2015, is another indicator

[54] "Expertenkommission sieht weiteren Handlungsbedarf: 'Kapazitätsengpässe beseitigen, Überschüsse für Investitionen nutzen, soziale Investitionen und Digitalisierung vorantreiben'," Deutsches Institut für Wirtschaft, www.diw.de/sixcms/detail.php?id=diw_01.c.548705.de.

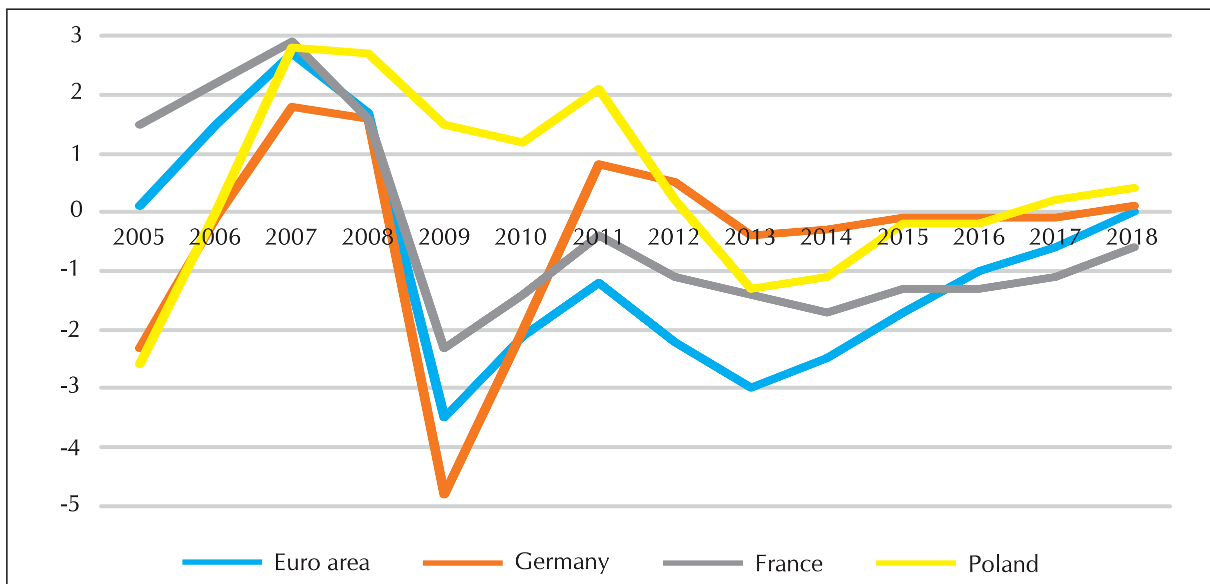
that dropped well below the euro area level. The plight of young people in the 15–24 age bracket remains a challenge. Unemployment in the group exceeds 20% (2015), and data indicate that it would grow rapidly if economic growth slows.

Figure 11. Real GDP growth rate by volume of Germany, France, Poland, and the euro area (19 countries) in 2006–2016*, as percentage change from previous year



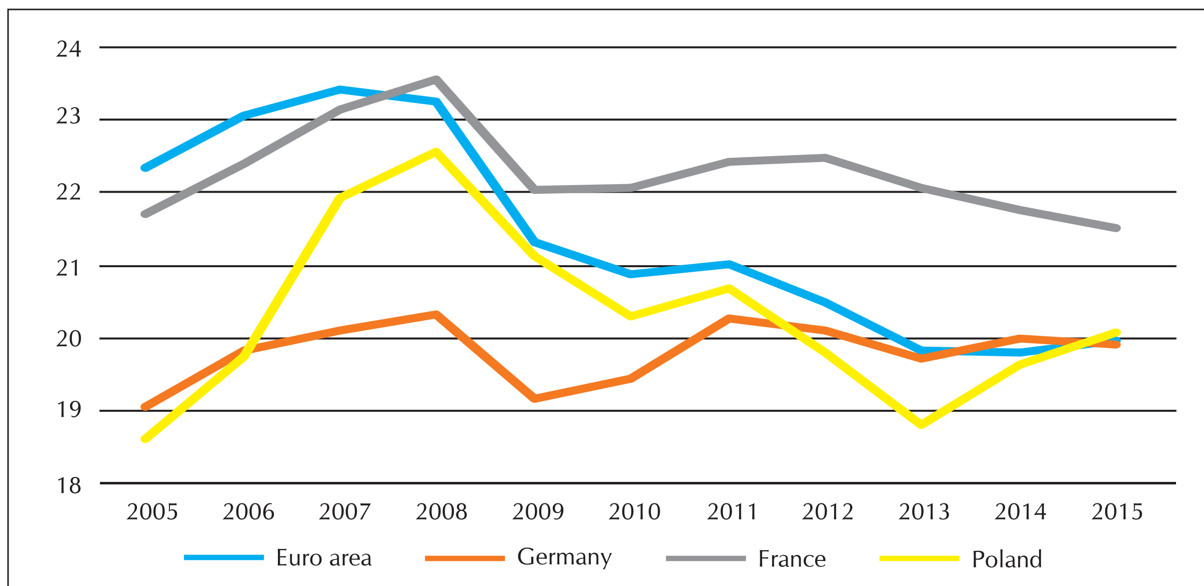
* For Poland 2016: forecast.
Source: Eurostat.

Figure 12. Gap between actual and potential GDP (at 2010 reference levels) of Germany, France, Poland, and the euro area (19 countries) in 2005–2018*, as a percentage of GDP



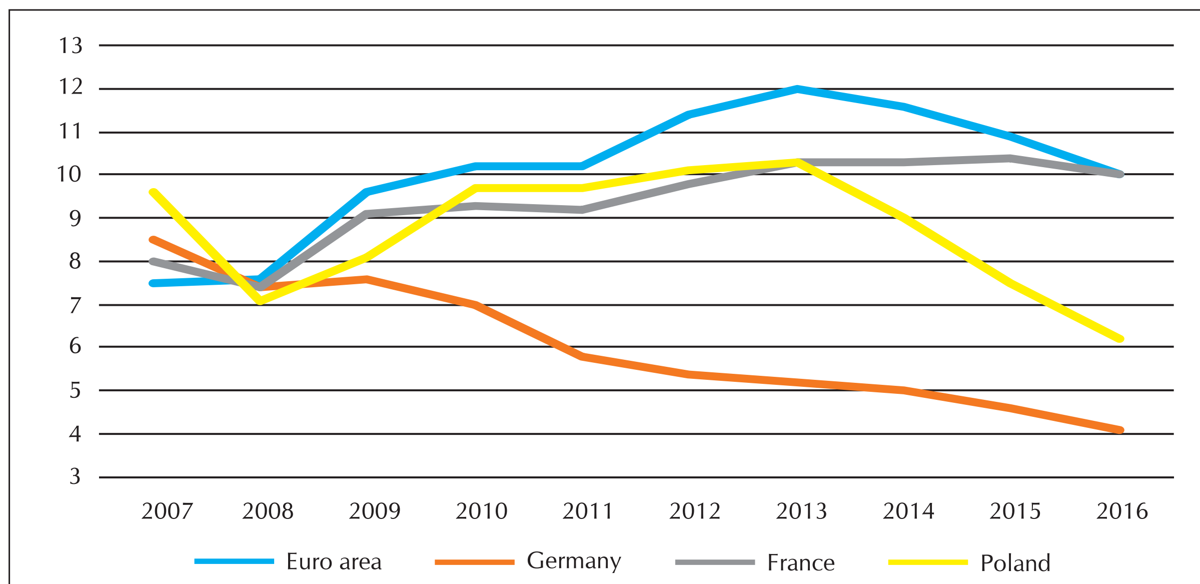
* Including forecast.
Source: European Commission, Economic and Financial Affairs,
Ameco database: http://ec.europa.eu/economy_finance/ameco/user/serie/ResultSerie.cfm.

Figure 13. Investment (% of GDP) in Germany, France, Poland, and the euro-area (19 countries) in 2005–2015



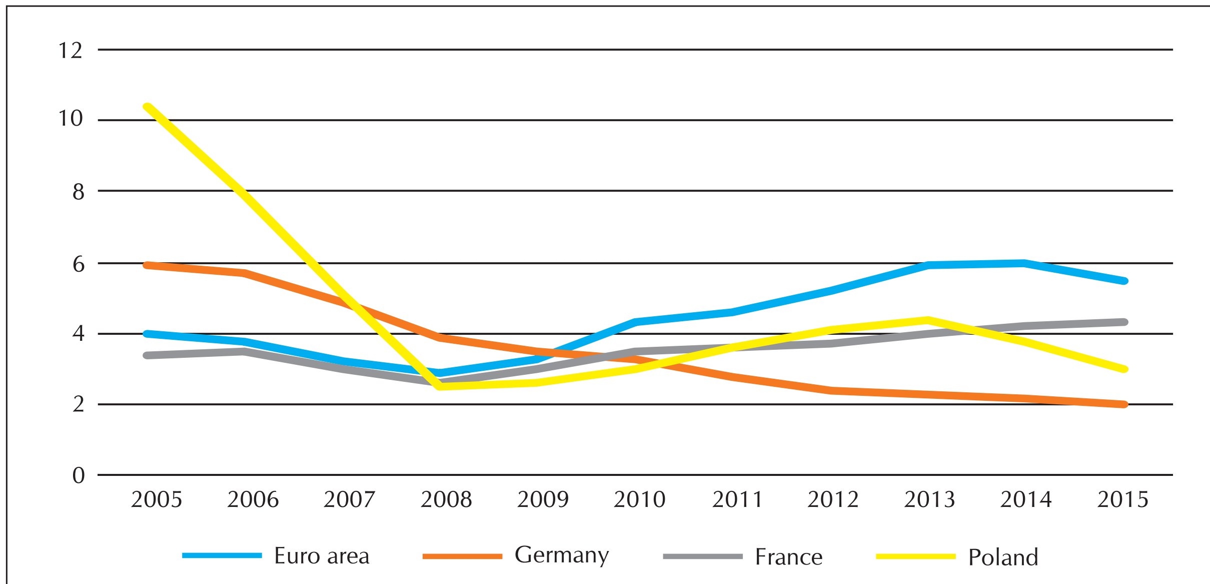
Source: Eurostat.

Figure 14. Total unemployment rates in France, Germany, Poland, and the euro area (19 countries) in 2007–2016



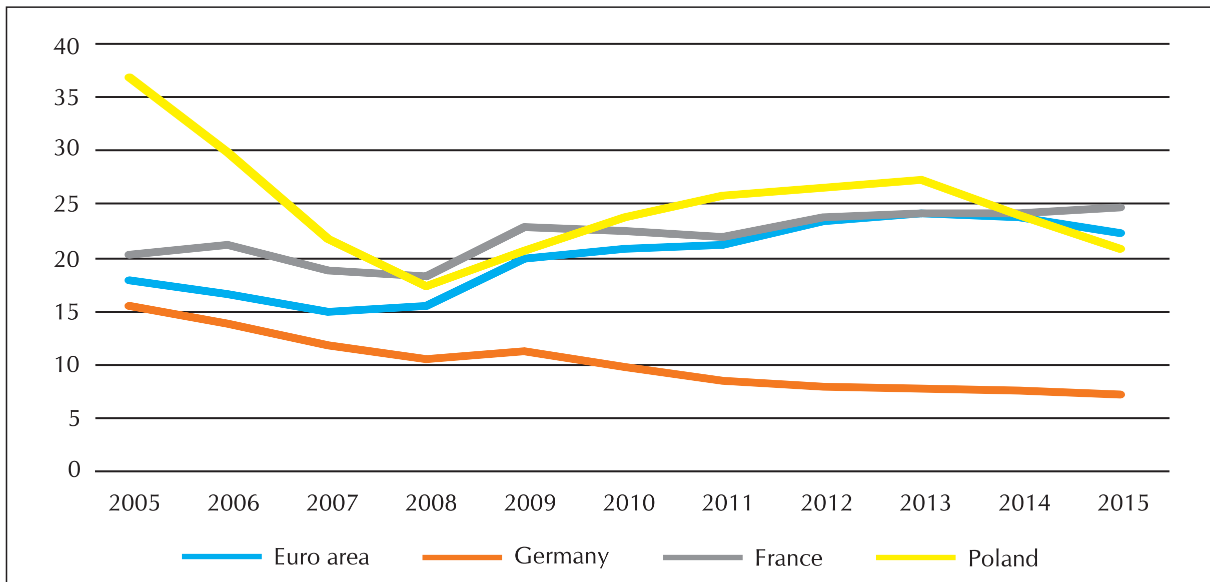
Source: Eurostat.

Figure 15. Long-term unemployment in France, Germany, Poland, and the euro area (19 countries) in 2005–2015



Source: Eurostat.

Figure 16. Youth unemployment rate (%) of active population aged 15–24 in Germany, France, Poland, and the euro area (19 countries) in 2005–2015



Source: Eurostat.

Stability bias

Germany

In the literature on the varieties of capitalism (see the introduction to this chapter), Germany is usually cited as a "pure" kind of coordinated market economy (CME). Its major feature is the dominance of a long-term business perspective that should translate into companies' preference for macroeconomic stability, including conservative fiscal policy.

This stability bias is solidly built into capital market institutions, where the foundation is provided by banks, with a special role played by relatively small public and cooperative entities. These are not pressed to maximise short-term profit to meet shareholder expectations, and therefore can focus on building stable financial relations with companies, providing them with capital needed for long-term investments. This pattern has strongly contributed to the expansion of small-to-medium enterprises (*Mittelstand*) and the prominent role they play in Rhein capitalism. Obviously, large commercial banks and a stock exchange are also part of the German system (see figure 17, also for France and Poland), but their weight is smaller than in LME economies. Orientation to the long term and stability can also be easily detected in the country's labour market institutions and arrangements, which include strong protection against firing of employees on full-time labour contracts (see Table 1), collective agreements at industry and company levels, and a tradition of co-decision-making by works councils. The logic these institutions follow is that a worker confident about employment stability and involved in management arrangements will be more eager to invest in his or her unique specific skills and their further deepening, which is key to improving products and upgrading quality. After 2000, Rhine capitalism's labour regulations and legislation on social provisions were liberalised, but the main thrust of these reforms was in the services sector and low-skilled labour not central to the nature of German capitalism. In fact, those reforms were like wrapping around the CME core a buffer of flexible and quasi-employment, with a view to curtailing long-term joblessness.

Due to these characteristics, supported also by vocational training and social insurance, Germany has developed strong competitive advantages in what is called "gradual innovation," i.e., improving, correcting and further developing technologically mature products, and hence its export dominance in engineering, transport equipment and chemicals.

The macroeconomic policy model supports this production regime because it is oriented to a restrictively understood stability, and thus helps companies with long-term planning. Its most prominent element has been the independence of the central bank, whose tasks have almost exclusively been confined to protecting the value of the currency. The strong stability bias is also reflected in fiscal policy, which after the reforms of 2009 is returning to a restrictive orientation after two decades of unification-driven expansion, including a debt brake (*Schuldenbremse)* at the federal and regional level.[55]

It is worth mentioning that Germany's stability bias has deep roots in historical experience, with the inflation of the 1920s remaining a compelling negative symbol and Ludwig Erhard's monetary reform from 1948 that launched a strong D-mark, a positive one. A powerful point of reference in economic thinking is still provided by ordoliberalism, a concept from the 1930s that combines a free market with a constitutional order preventing the concentration of power, designed as a counterweight against the "fiscal and monetary interventionism of the Third Reich."[56]

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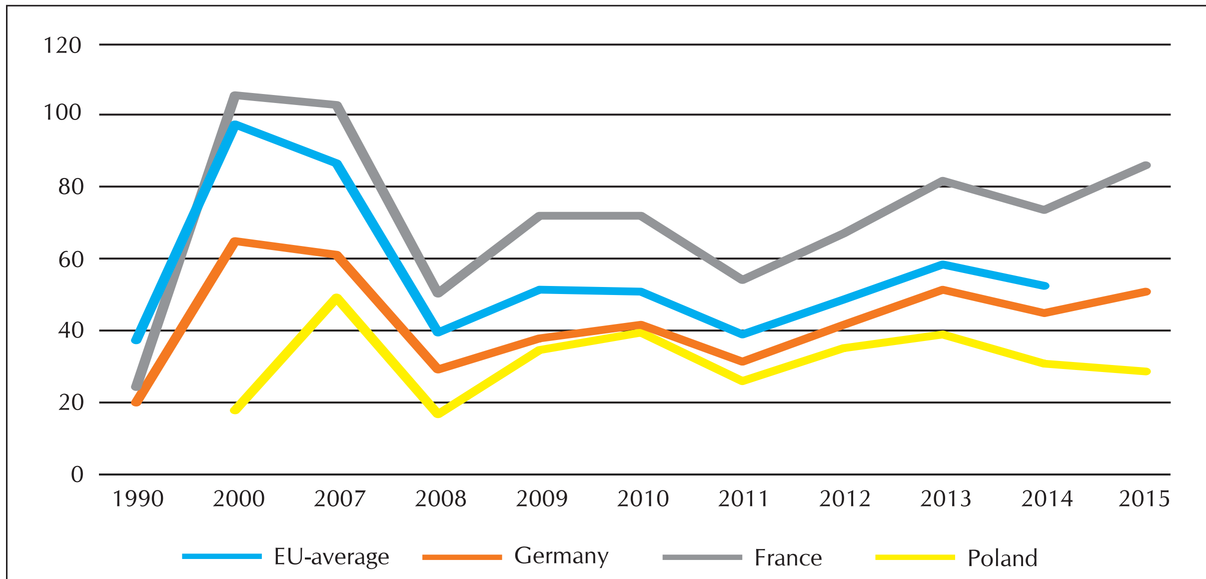
[55] "The debt brake in Germany—key aspects and implementation," *Deutsche Bundesbank Monthly Report*, October 2011.

[56] S. Dullien, U. Guérot, *The long shadow of ordoliberalism: Germany's approach to the euro crisis*, www.ecfr.eu/page/-/ECFR49_GERMANY_BRIEF.pdf.

Another backing for the restrictive stability bias is the federalism of the *Bundesrepublik*, where constituent *Länder* considerably narrow the fiscal space of the federal government.

Figure 17. Market capitalisation of listed domestic companies (% of GDP) in France, Germany, Poland, and the EU in 1990, 2000 and 2007–2015



Source: World Bank, Data Bank "World Development Indicators," http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS.

Germany's orientation on this is additionally cemented by a very practical issue: it is a creditor economy with an NIIP of +49% GDP, as registered in 2015 (after quickly rising from just 4.5% in 2004, see figure 18). It is visible particularly within the eurozone, where Germany has a €754.2 billion surplus in Target2 (a payment transaction system, data from December 2016, see figure 19).[57] It can thus be assumed that Germany's interests lie in international rules that would guarantee full debt repayment and preclude easy debt restructuring/reduction or depreciation via inflation. This is hardly an abstract problem. According to Leipzig economist Günter Schnabl, the German cumulative current account surplus in mid-2013 reached €1.663 trillion, and foreign assets €1.201 trillion, which means that €462 billion was lost in preceding years.[58] It transpires that an expansionary fiscal and monetary policy, potentially reducing debt's real value via inflation, would not be in the interests of the German economy.

[57] European Central Bank, Statistical Data Warehouse, http://sdw.ecb.europa.eu/reports.do?node=1000004859.

[58] M. Greive, "Kapitalabflüsse: 'Weltweit finanzieren unsere Ersparnisse Konsum'. Interview mit Prof. Gunter Schnabl," *Die Welt Online*, 1 January 2014, www.welt.de/finanzen/geldanlage/article123455116/Weltweit-finanzieren-unsere-Ersparnisse-Konsum.html; "Deutsche Direktinvestitionen im Ausland. Bestand, Entwicklung und ökonomische Bedeutung," Bundesministerium der Finanzen, www.bundesfinanzministerium.de/Content/DE/Monatsberichte/2014/09/Inhalte/Kapitel-3-Analysen/3-2-deutsche-direktinvestitionen-im-ausland.html; "Bestandserhebung über Direktinvestitionen," Deutsche Bundesbank, www.handelsblatt.com/finanzen/maerkte/anleihen/staatsanleihen-es-gibt-keine-sicherheit-mehr/6913712-all.html.

Table 1. EPL (employment protection legislation) indicator for France, Germany, Poland, and OECD members (average) in 2013

	Strictness of employment protection—individual and collective dismissals (regular contracts)	Strictness of employment protection—individual dismissals (regular contracts)	Strictness of employment protection—collective dismissals (additional restrictions)	Strictness of employment protection —temporary contracts
France	2.82	2.60	3.38	3.75
Germany	2.84	2.53	3.63	1.75
Poland	2.39	2.20	2.88	2.33
OECD—average	2,27	2,03	2.89	2,07

Source: OECD, "Protecting jobs, enhancing flexibility: A new look at employment protection legislation," in: *OECD Employment Outlook 2013: OECD Employment Outlook*, OECD Publishing, 2013, pp. 65–126, www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm.

France

The French stability bias is much less restrictive than Germany's, largely reflecting the differences in the variety of capitalism practiced in the country and which has taken an intermediate form between liberal and coordinated. In the literature, it is referred to as a state-led (or influenced) market economy (SME),[59] and its key feature is that the state corrects—or even replaces—the decision mechanisms that are typical of LME and CME (market, organisations, networks). Consequently, an SME economy can emulate equally well either of the two varieties and benefit from their specific economic advantages.

The chief characteristic of post-war French SME is the high degree of state involvement in the capital field, which is most evident in the concept of "national champions"—large, state-owned or co-shared companies, such as EDF nuclear reactors, SNCF railways, and Air France. It did change slightly when neoliberalism flourished in the world economy and many other states hastened to privatise state assets in the 1990s. However, the French government kept its stake in the companies and intervened in their favour. In 2014, the state held stock in 81 companies, including Alstom, Orange, and EDF, worth a total of €90 billion and giving employment to a combined workforce of 1.7 million (see table 2).[60] This is a policy line that comes with increasing controversy strengthened by the state having suffered quite a few failures. In the recent crisis-affected years it had to reconcile itself with a fall in the stock prices of many companies and to the necessity of directly supporting some of them (e.g., Alstom, EDF, Peugeot, CGG). As well, these companies have not always benefited from their strong links to officialdom. High state budget-spending needs often translated into high dividends being paid out, thus weakening companies' investment potential. Given these circumstances, calls have been made for the role of the state to be confined to such areas as holding only controlling pockets of shares and blocking hostile takeovers in sectors of strategic importance while supporting more medium-sized companies.[61]

[59] See: V.A. Schmidt, "Varieties of Capitalism: A Distinct French Model?," in: R. Elgie *et al.* (eds.), *Oxford Handbook of French Politics*, Oxford University Press, 2016; V.A. Schmidt, "French Capitalism Transformed, Yet Still a Third Variety of Capitalism," *Economy and Society*, vol. 32, no. 4, 2003, pp. 526–554.

[60] M. Stothard, "France: The politics of state ownership," *Financial Times*, 14 November 2016, www.ft.com/content/9be75d5c-a72e-11e6-8898-79a99e2a4de6.

[61] M. Stothard, "The state as shareholder: Raison d'état," *The Economist*, 28 June 2014, www.economist.com/news/business/21605921-other-countries-are-selling-state-owned-industries-france-trading-up-raison-d-tat.

Table 2. French government's ownership share (%) of selected industrial firms, 2014

Company	Industry	Share
SNCF	Rail services	100
RFF	Rail infrastructure	100
La Poste	Mail	100
Nexter	Defence equipment	100
Areva	Nuclear reactors	86.7*
EDF	Electricity	84.5
ADP	Airports	50.6
GDF	Gas and electricity	33.6
Thales	Aerospace / trains	26.6
Safran	Aerospace	22.4
Alstom	Power / trains	20.0**
Air-France-KLM	Airline	15.9
Renault	Cars	15.0
Peugeot-Citroën	Cars	14.1
Orange	Telecom	13.4
Airbus	Aircraft	11.0

* Includes stakes held by EFD and BPI.
** Proposal.
Source: "The state as shareholder: Raison d'état," *The Economist*, 28 June 2016, www.economist.com/news/business/21605921-other-countries.

Complementary to state involvement is the financial intermediation, whose structure is dominated by banking. But unlike in Germany, the French banking sector includes large entities ready to cooperate with the government in directing huge capital flows and conducting industrial policy. An important role is also played by the stock exchange, whose capitalisation considerably exceeds the corresponding data for the Deutsche Börse, thus demonstrating that French SME include successful institutions characteristic of LME (see figure 17).

The logic of interventionism is also visible on the labour market. A good example is the power of trade unions, which comprise only about 7.7% of wage and salary earners as members (2015, according to OECD),[62] but the collective agreements brought about by them are fully extended by the state to non-affiliated workers and employees.[63] It must be added that France's trade unions, unlike Germany's, follow a confrontational bargaining model rather than one of reconciliation, with a major focus on social demands than on co-determination. This lean on social aspects has been visible in other elements of labour market institutions, such as the protection against dismissal (particulary by temporary contracts, see table 1), working-time regulation, or the generous system of benefits. In recent years, these features have increasingly become a burden, which are reflected in the deterioration of the labour market. Hence, there has been a trend towards linking social programmes with the liberalisation of employment rules. More than a decade ago, for example, the government opted to a cut the weekly working hours to 35 in return for giving companies more freedom on hiring/firing and pay. In 2013, the flexibility was increased further, with labour granted a longer period for unemployment benefits.

Given such intense involvement of government in the economy's functioning, fiscal policy—as with monetary policy and exchange rate policy—plays a rather utilitarian role, subordinated

[62] OECD, OECD.stat, https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN.

[63] For an overview on this topic, see: M. Markezich, "Why is collective bargaining so difficult in the United States compared to its international peers?," Equitable Growth, http://equitablegrowth.org/equitablog/value-added/why-is-collective-bargaining-so-difficult-in-the-united-states-compared-to-its-international-peers.

to political priorities and torn between seeking to support state-controlled companies, boost competitiveness, and secure social rights. These priorities have made French politics less strictly focused on fiscal stability per se. They tend in general to take a holistic view that overall economic balance has the priority before macroeconomic prudence criteria. This means in practice that in times of crisis the economy should be propped up with additional spending and restrictions and harsh reforms should be undertaken during periods of economic prosperity. This is a different approach from the German one and France's membership of the eurozone has not dramatically changed it.[64]

These views are anchored in economic tradition and the rich landscape of ideas of the last few centuries. Despite having influential liberal philosophers, France is associated more with the vision of the active, overwhelming state of Jean-Baptiste Colbert, mercantilism, and public economic schools that paved the way for industrial capitalism and modern economic policy. Solid ground for government interventionism is also the unitary and centralised pattern of the French state, which has never faced the fiscal and organisational constraints characteristic of a federation. In addition to that, the vision of a social order in France grows from the heritage of the French revolution and is equalitarianism, which delivers arguments for redistribution and social interventionism. All these elements had contributed to the systemic orientation of post-war French republics. But there is also one more that should be mentioned because it links the trauma of WW2 to austerity. France's defeat by Germany in 1940 is partly blamed on a retrenchment programme of "super deflation" pursued by Prime Minister Pierre Laval,[65] which deprived the country of resources for proper preparation for war. The lesson learnt was that political priorities should never fall victim to economic corsets.

Last but not least, the less-restrictive stability bias of France can also be explained by the fact that it is not an extreme creditor in international financial relations. Unlike Germany's, France's NIIP position is negative, at -16% GDP, after deteriorating in the past decade from +8% in 2001 (see figure 18). Also, within the eurozone, its position according to Target2 accounts is balanced, with just a €13.8 billion deficit at the end of 2016 (see figure 19).[66] So France's position towards attempts to restructuring debt, "haircuts" or spending-driven inflation that may diminish the real value of debt can be much more accommodating that Germany's.

Poland

Establishing Poland's stability bias is quite a challenge, especially based on its identification with a particular variety of capitalism.[67] Against the traditional, mature systems in Germany and France, Poland looks at first sight as far removed from the basic LME-CME distinction. Problems are posed by the transformative and transitional nature of many of the country's institutional arrangements, some of which have been launched as transplant solutions tested in other market economies or designed on the EU-level while others have gradually evolved into their present shape.

Facing these analytical challenges Nölke and Vliegenhart described Poland and the other Visegrad Group members as "dependent market economies" (DME), i.e., economic systems that achieved considerable success and coherence in terms of their institutional pattern, as opposed to

[64] A very insightful juxtaposition of the German and French economic ideas is found in Ch. 4 of M.K. Brunnermeier, H. James, J.-P. Landau, *The Euro and the Battle of Ideas*, Princeton University Press, 2016.

[65] M. Blyth, *Austerity: The History of a Dangerous Idea*, Oxford University Press, 2013, pp. 200–203.

[66] European Central Bank, Statistical Data Warehouse, http://sdw.ecb.europa.eu/reports.do?node=1000004859.

[67] See an exhaustive analysis in: K. Jasiecki, *Kapitalizm po polsku: Między modernizacją a peryferiami Unii Europejskiej*, IFiS PAN, 2013.

the "cocktail capitalism" reigning in Romania and other countries in the region.[68] A slightly similar classification comes from Drahokoupil and Myant, who labelled the most advanced CEE models as "FDI-based" ones.[69]

DMEs enjoy a comparative institutional advantage in the production of relatively complex and technologically advanced consumer goods, reflecting the capital segment's saturation with foreign direct investment (FDI) and the economy's generally high dependence on external sources of financing. In practice, many domestic companies operate as entities in global supply chains of transnational corporations, thus enjoying access to foreign sources of financing and technologies. The logic of advanced FDI rules over the labour domain, too. Transnational organisations value employment flexibility and low labour costs, which translates into the weak presence of trade unions and rather limited state regulation, which means different patterns than found in other CMEs. On the other hand, labour-market relations are not as individualised and market-oriented as in the more liberal varieties of capitalism. This is because fairly advanced and globally integrated production requires a motivated and skilled workforce, as well as little exposure to strike actions that may disturb the value change. This leads corporations to offer constantly better working conditions, many incentives for employees included in the social contracts at the workplace level.[70]

How does stability bias emerge under this system? The dependence on external sources of capital enforces macroeconomic policy that is predictable and stability-oriented because investors need guarantees that the currency will not be devalued. Thus, an independent central bank pursuing a currency stability objective—not much different from the original German model—comes as an important element of DME governance. Also within this logic is conservative fiscal policy, sending to the outside world a signal of stable conditions for investment.

Such stability bias in Poland reflects the course of the country's transformation, which has been largely influenced by economic globalisation and regional integration. But it is worth looking into whether some deeper motives are at work here, stemming from historical experience and the dominance of certain economic ideas. At first sight, that bias could indeed be expected, given the numerous crises affecting stability in Poland in the 20th century, including post-World War I inflation (as devastating as in Germany), the huge debt accumulated under the communist leadership in the 1970s (leading to Poland's insolvency), and the late 1980s inflation that peaked at almost 600%. The socialist-era experiences surely influenced the determination of the post-1989 reformers to lay down the institutional groundwork for the present strength of the Polish currency. But with the passage of time, it looks like the threats of inflation and currency devaluation have been fading in Poles' collective memory, replaced by the costs of transformation, especially in the first half of the 1990s, as marked by fast-rising unemployment and a deteriorating social safety net for laid-up workers and villagers. This experience set the stage for increased state intervention and a less restrictive approach to stability.

There is a similarly equivocal picture when it comes to the dominant ideas that underlay Poland's attitude towards stability and, in a broader context, towards free markets and the role of government in development. In hindsight, the main challenge for Poland was how to catch up with the developed world and get out of the backwardness trap. In interwar Poland it was answered with the toolkit of state capitalism, which is understandable given the need to "stich up" the parts of the national economy previously separated by the borders of foreign powers. After

[68] A. Nölke, A. Vliegenthart, "Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe," *World Politics*, vol. 61, no. 4, 2009, pp. 670–702.

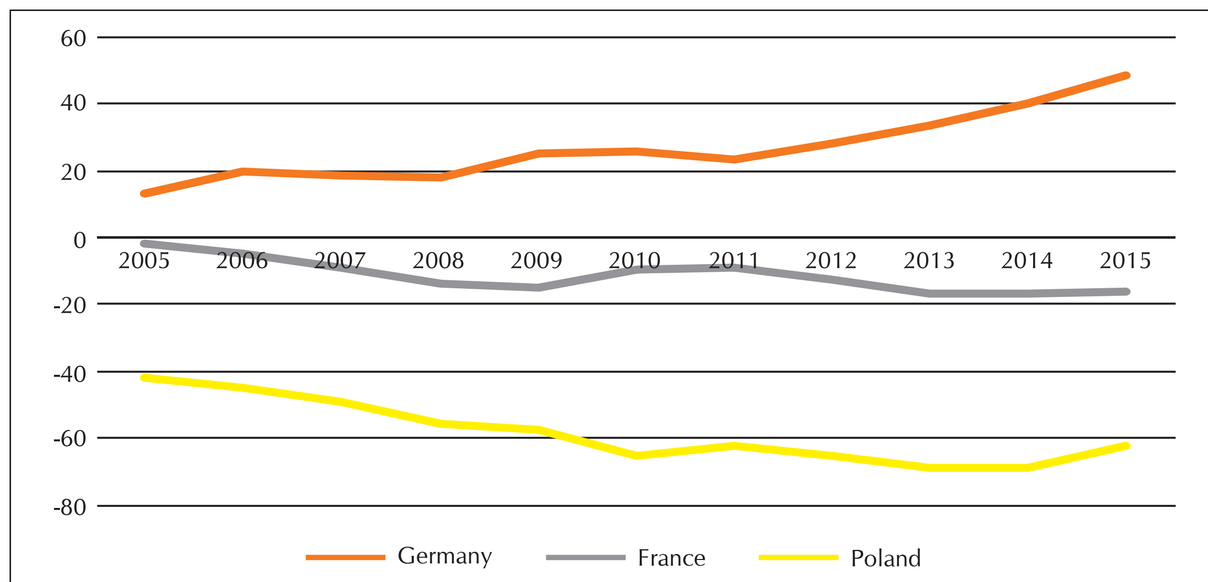
[69] J. Drahokoupil, M. Myant, "Institutionalismus jenseits der 'Spielarten des Kapitalismus': Transitionsökonomien in der vergleichenden Kapitalismusforschung," in: I. Bruff (ed.), *Vergleichende Kapitalismusforschung: Stand, Perspektiven, Kritik*, Westfälisches Dampfboot, 2013.

[70] A. Nölke, A. Vliegenthart, *op. cit.*, p. 685.

1945, there came a period of central planning, with only a marginal role left for what remained outside state control. And so it was only after 1989 that market-oriented ideas took hold, invoking the Washington Consensus and neoliberal concepts. Along with the vision of an open market with low entry barriers, a prominent position among these ideas was taken by monetarism and public choice theory—both critical of the government's role in the economy and both emphasising the advantages of a restrictive approach to public finances. It was strongly underpinned by the debt reduction programme, in which Poland received significant relief for its obligation to make market reforms and practice macroeconomic prudence. This liberal direction, which was the driver of development in the two decades after the collapse of communism, is now increasingly criticised. This is partly in response to the global financial crisis but also to the so-called "middle income trap,"[71] with questions seeking economic growth drivers other than low-cost labour. In this climate, proposals for the state to take a stronger role in the economy have been cropping up and attract the interest of the current government. This has not yet translated into a diametrically different approach to stability bias, but it will likely be somewhat revised in the face of new priorities (see previous comments on the fiscal capacities).

A certain amount of doubt on the question of whether Poland belongs to the very core of stability-biased economic cultures may be strengthened after one observes the development of the country's NIIP position. It is, like for most DMEs, negative, having deepened over the past decade from -40% of GDP to -62.3% of GDP in 2015 (see figure 18). Under normal economic conditions this high ratio may contribute to even more demonstrated orientation on stability, which is simply an instrument to attract further investors and service the debt. But if a severe crisis hits the economy, the interest in making the value of debt lower through inflation or other means can become higher, if not irresistible.

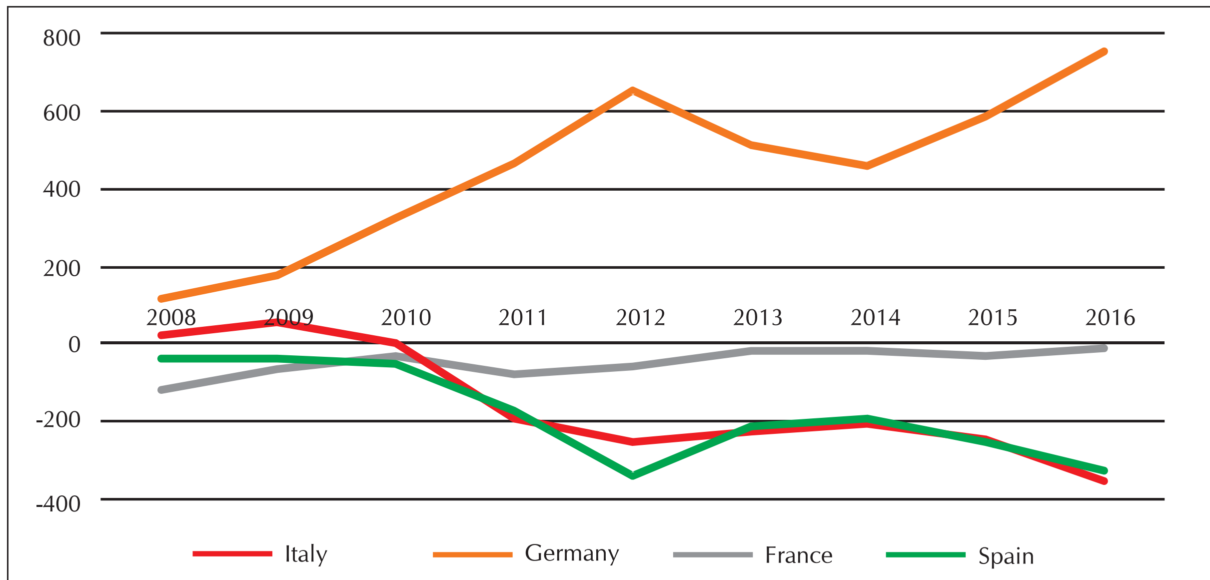
Figure 18. Net investment positions (% of GDP) of Germany and Poland, 2005–2015



Source: Eurostat.

[71] See, e.g.: "Trend: How Poland escaped the middle-income trap," Polityka Insight, http://zasoby.polityka.pl/politykainsight.pl/witryna/demo-analiza-makro1-en.html.

Figure 19. Largest economies of the eurozone and their Target 2 position in EUR billion, 2008–2016 (data from Q4)



Source: European Central Bank.

CONCLUSIONS

The following conclusions can be drawn from the analysis of the economic preferences of Germany, France and Poland regarding a broadening of the euro area's fiscal framework to include the possibility of joint fiscal stimulus.

First, Germany will be averse to this idea, which is understandable in light of its good fiscal position, which would automatically put the country in the position of an extreme contributor for fiscal stimuli. This argument is further strengthened by the circumstance that Germany is the continent's largest economy and its contribution would be incomparably higher than inputs from other Member States. Germany's interest in shared fiscal expansion is also mitigated by its favourable economic situation (as marked by stable growth and spectacularly low unemployment), status as an extreme creditor in international financial relations, and its variety of capitalism, where macroeconomic stability is highly prized. The only economic factor that could prod Germany towards support for coordinated fiscal expansion is its high dependence on exports to EU markets. Increased demand triggered by expenditures would likely translate into increased orders for German industry. However, this advantage would put the government into an even more awkward position towards its economic partners criticising the already huge German trade surplus.

Second, France is inclined towards supporting the expansive stance. The country's fiscal situation is rather unfavourable and it will take more years before the public-sector debt is brought down to a level commensurate with the Stability and Growth Pact. This long-term condition puts the country rather outside the group of hypothetical payers for the fiscal stimulus. Compared to Germany, France has more reasons to back the idea of spending, especially the plight of its economy, for years dogged by high unemployment and disappointing GDP growth. A joint fiscal stimulus also fits in with the French variety of capitalism, where state intervention is perceived not as market disturbance but as a move creating better conditions for growth. There are a few arguments that could deter France from common fiscal approach. One argument is the size of its economy: if it took a payer position, the country would make an asymmetric contribution to joint fiscal stimuli. Factors of neutral influence on the French preferences include the private sector's fairly high capacity to increase domestic demand and the economy's relatively low dependence on the European market, as reflected in the minute exports-to-GDP ratio.

Third, if Poland were a euro area member it would have problems responding unequivocally to the proposal of a coordinated fiscal stimulus because of its unclear fiscal prospect, which can make it both contributor and beneficiary. Other reasons may speak rather for supporting the idea. One is the GDP's high dependence on exports to European markets and another is the economy's size, which ranks in the middle. Poland also has a relatively low level of internal resources and high foreign debt, which means that any demand stimulus coming from outside may prove important to both the economy's stability and growth prospects. Additionally, for some time the Polish government has declared its development ambitions, which may possibly go hand in hand with the arguments propounded by the European Commission: growth and investment priorities catch up with financial discipline. Despite this, there still are factors that would make Poland more cautious: its well-balanced economic growth (GDP growth of up to 3%, unemployment falling for several years in a row) and its variety of capitalism rooted in the experience of transformation based on an attachment to fiscal prudence and market competition.

These economic preferences can contribute to some development paths in the process of European integration. First, it is more likely that the euro area's fiscal framework formula will remain unchanged, as defined by the requirement of fiscal stability. This results from major differences between Germany and France with respect to the institutionalisation of fiscal

expansion. The biggest one is about the roles to be played: Germany as contributor and France as beneficiary. There are important differences with respect to economic models and also the economic situation, which is much more difficult in France compared to Germany. With interests so wide apart, and given the high transaction costs of any institutional change in the euro area (time-consuming negotiations involving many actors), it would be hard to imagine progress being achieved over a short time. The euro area will thus continue focusing on fiscal discipline and market reforms, and as far as the promotion of fiscal expansion is concerned will confine itself to the European Union's recommendations to the Member States, coupled with the strengthening of the Juncker Plan (ESIF), which may turn into a permanent mechanism financed out of Member States' periodic contributions. Second, Poland's economic benefits and costs from a revision of the fiscal framework—considered as a would-be euro-member—is not entirely obvious, which means that the European Commission's proposal will not be a decisive factor changing Polish scepticism of putting in great effort to adopt the single currency. This wariness of the euro area will only be strengthened by the lack of German-French consensus.

This overall picture does not rule out changes that could emerge in the near future, altering the status quo and calculations of the parties concerned.

In the euro area, shifts in the economic situation could turn out to be such agents of change. In a moderate scenario, a downturn in Germany's economy results in the government showing more openness to expansionary fiscal policy. This is accompanied by a simultaneous improvement for other euro area members, as reflected not only in better GDP indicators but also in debt reduction. This makes interest more symmetric and finding consensus on fiscal commitments will be easier. In an extreme scenario, the crisis returns to the euro area and the southern economies suffer from a severe downturn. More active fiscal policy could not be avoided and the only alternative is a break-up of the euro area.

Change may also be occasioned by shifts in political priorities in both Germany and France. It can be expected that if the autumn 2017 election in Germany brings to power the Social Democrats, who favour a more active economic role for the state, favourable conditions can be provided for a new fiscal framework. This could be reinforced by the hypothetical victory in the French presidential election of a candidate embracing liberal economic reforms. France and Germany would thus meet halfway with their preferences, increasing the chances for political compromise on the future of fiscal integration. It could involve the acceptance of a new "expansionary" fiscal framework, coupled with the simultaneous acceleration of structural reforms.

This direction could also be enforced by external factors, especially a sharpening of economic conflict with the U.S., which for years has chastised Germany for "neo-mercantilism" and huge trade surpluses. The Trump administration could possibly opt to impose countervailing duties. It may be that launching fiscal expansion—reducing the surplus in trade with the U.S.—by the whole euro area, and especially by surplus countries such as Germany, would prove instrumental in satisfying the Americans.

This dynamic could coincide with changes outside the euro area, particularly in Poland, which could become much more open to monetary integration, especially if it were strengthened by the possibility of fiscal coordination.

This could be the case if tensions in Poland's fiscal policy heighten in response to increased social welfare spending and lower-than-expected GDP growth. In such circumstances, the scale of potential benefits from euro area-generated fiscal stimuli would widen. Another factor working in this direction could be Poland's gradual shift away from the aversion to join the eurozone. This could emerge, for example, with better economic performance of the monetary union's members in the upcoming years, as well as from a transition from an economy competing on costs towards

an economy competing on innovation. This would translate into a much lower dependence on currency devaluation as a way of responding to crisis, and a much greater openness to arguments for joining the euro area.

And finally, one should not forget that the entire pattern of detailed economic arguments can be simply overwhelmed by a very political dynamic. If in step with the current discussion on the future of the EU after Brexit, strong tendencies emerge towards shutting up wider integration in favour of creating close-knit integration circles, forces towards deepening the eurozone may simply devalue many of the differences in economic priorities described above. These tendencies can also become an argument for the Polish government to reassess the balance of economic and political benefits and costs from staying outside the integration mainstream, consider the possibility of accelerating its preparations for membership of the euro area, and start a wider public discussion on the preferred place of Poland in European integration structures. The rationale behind this is that the euro has never been just about economics but also politics—and this will become even more distinct in a Europe of "different speeds."

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In recent years, calls have been getting louder for a more expansionary fiscal policy in the euro area. This could happen, for example, by placing an obligation on Member States with space in their budgets to increase spending. If this direction is indeed taken, it can spell gradual but important changes in the integration structure. The euro area, currently focused on enforcing fiscal discipline on the national level, could start turning to joint approaches in stabilisation policy, with the stage open for competences moving to the supranational level. The changes can also influence the pace of euro area expansion if they prove alluring for non-members to ramp up their accession effort. The dynamics of these processes will be contingent mainly on Member State economic preferences. The present report looks into the perspectives on this of Germany and France, whose positions are key for the future of the euro area, and of Poland, one of the weightiest non-members of the monetary union and thus far determined to postpone the decision to join.

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