

Imperative of Economic Growth in the Eurozone

**Competitiveness, Capital Flows and
Structural Reforms**

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(Editors)

Vernon Series in Economics



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List of Abbreviations

ADF	Augmented Dickey-Fuller
AG	Advocates General
AGS	Annual Growth Survey
AIC	Akaike Information Criterion
AMECO	Annual Macro-economic Database
AMR	Alert Mechanism Report
ARDL	Autoregressive Distributed Lag
CABP	Cyclically Adjusted Primary Balance
CIT	Corporate Income Tax
CJEU	Court of Justice of European Union
CMU	Capital Markets Union
COFOG	Classification of the Functions of Government
CSR	Country-specific Recommendations
CT	Constitutional Treaty
DG Employment	Directorate-General for Employment
ECB	European Central Bank
ECI	Export Complexity Index
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EFSI	European Fund for Strategic Investments
EIP	Excessive Imbalance Procedure
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
ESF	European Social Fund
ETUC	European Trade Union Confederation
EU	European Union
EU-15	First 15 Member States of the EU
EU-19	19 Current Members of the Eurozone
EU-28	28 Current Member States

FE	Fixed Effects
FR	Fiscal Rule
FTT	Financial Transaction Tax
GDP	Gross Domestic Product
GNI	Gross National Income
HC	Heteroscedasticity-consistent
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
IR	Interest Rate
IRR	Interest Rate Shock
IV	Instrumental Variables
LSE	Least Squares Estimators
LTR	Long-term Interest Rates
MIP	Macroeconomic Imbalance Procedure
MT	Maastricht Dummy
MTO	Medium-term Budgetary Objectives
NATO	North Atlantic Treaty Organization
NPE	New Political Economy
OCA	Optimum Currency Area
OECD	Organisation for Economic Co-operation and Development
OG	Output Gap
OLS	Ordinary Least Squares
OMT	Outright Monetary Transactions
OPP	Observance of the Principle of Proportionality
PIGS	States of Portugal, Italy, Ireland, Greece and Spain
PIT	Personal Income Tax
PP	Phillips-Perron
RQMV	Reverse Qualified Majority Voting Procedure in the Council
SE	Standard Errors
SGP	Stability and Growth Pact
SIC	Schwarz Information Criterion
SME	Small and Medium-sized Enterprises
SNA	System of National Accounts
SVAR	Structural Vector Autoregression
TEU	Treaty on European Union

TFEU	Treaty on Functioning of the European Union
TFP	Total Factor Productivity
TI	Tradability Index
TS	Tradability Scores
TSCG	Treaty on Stability, Coordination and Governance
UK	United Kingdom
US	United States [of America]
VAT	Value Added Tax
VAX	Value Added Export
WIOD	World Input-Output Database

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Abstract

Ch.1, Growth and the Real Convergence in the Eurozone

(Lacina, Rusek)

Abstract: The mixture of the recent EU policies – mainly the “fiscal compact” and the OMT approach by the ECB – restored the nominal stability for the Eurozone and therefore preserved the common currency. However, the same steps resulted in a widening gap between the Northern tier and the Mediterranean countries. To address this issue – which is potentially a mortal threat to the Eurozone in its present configuration – the three policy options are available: A restoration of a real convergence, the Eurozone’s restructuring or a “muddling through”. The first two require radical policy steps which in the present political and economic climate are commonly considered unlikely. That leaves “muddling through” as the likeliest future approach. However, its inherent ad hoc nature breeds uncertainty, which, combined with a complacency stemming from the recent “successes” increases the possibility of a destructive future dynamics.

Ch.2, Does Baumol’s Cost Disease Produce Adverse Growth?

(Colombier)

Abstract: Based on a panel of 23 OECD countries this chapter shows that the government sector is partly contracted by Baumol’s cost disease. We provide empirical evidence that not only total government expenditure but also public expenditure on health, education and general administration are affected by Baumol’s cost disease. As we show, Baumol’s cost disease produces adverse consequences under a balanced budget rule such as a debt brake. Governments face a serious dilemma. Breaching the rule would certainly cause reputational losses for governments, which might affect their borrowing costs and therefore, the sustainability of public finances. Adhering to the balanced-budget rule means risking budget-crowding out of cost-disease affected public expenditure with an ensuing long-run deterioration of these services and/ or foregoing growth opportunities. Governments of the EU member states and EU policy makers should therefore revise the EU Fiscal

Compact to reconcile it with Baumol's cost disease. Additionally, we apply outlier-robust estimation methods, which are particularly suited to deal with the distinct heterogeneity of panel datasets.

Ch.3, Fiscal Union under Unsustainability of Public Debt

(Kutasi)

Abstract: Some EU members faced years of crisis in the first half of the 2010s with an excessive initial public debt, but several others had broad room for fiscal stimulus. However, the prolonged duration of the European economic depression expended public budgets, while exhausting stimulus policies and sovereign solvency. Meanwhile, one of the ways out of depression is a proposed centralization of the EU through fiscal union. Are the eurozone countries ready to participate in a risk pool in public finances? The study seeks to answer this question. The chapter presents the hypothesis that the sustainability of public finances deteriorated during the global and euro crisis in the majority of eurozone member countries and in the EU, and this phenomenon is discouraging the core countries from seeking the fiscal union. The analysis uses the Blanchard indicators of fiscal sustainability and the sovereign risk rating of the EURO-18 and EU-28 countries. The analysis presents as results a theoretical summary of fiscal sustainability, the development of fiscal sustainability in the EU member states, indicators of convergence or divergence of fiscal sustainability in the Community, and conclusions based on the indicators of the likelihood of a fiscal union.

Ch.4, The Principle of Proportionality

(Kasiewicz, Kurkliński)

Abstract: This is an attempt to assess regulatory impact with reference to a popular principle of proportionality. It undergoes large modifications; its interpretation is broadened and it gets adapted to the factual assessment of legislative processes. The principle of proportionality includes three significant elements: adequacy, necessity and proportionality *sensu stricto*. The proposed method in the law-making process comes down to three stages. The first one is interpretation of the subjective scope of at least three abovementioned components. The second stage consists in transformation of the adopted scope into clear and quite simple criteria. The third stage is attributing relevant measures to particular criteria. The proposed approach to regulatory impact assessment has been termed as the model of the

Observance of the Principle of Proportionality. The authors present the model assumptions, identify and particularize the criteria of main areas of the principle of proportionality and then determine its scoring methods. The final result of the chapter is a synthetic calculation: an ordered measure of the observance of the principle of proportionality for a specific regulation.

Ch.5, Fiscal Policy of the EU Countries in the Time of Crisis

(Kundera)

Abstract: In a situation as deep a crisis as 2008 the EU countries have carried out policy to restore macroeconomic equilibrium comprising various fiscal instruments. They have not opted for the classic methods of fight against the crisis by increasing public expenditure, but favored rather austerity programs to restore budgetary balance by increase taxes and reduce budgetary expenditure. Taking into consideration the economic consequences of these fiscal policy the main objective of this chapter is to examine the evolution of the budgetary revenue and expenditure in the EU member states during the economic crisis. On the basis of the statistical data the analysis shows the EU members significantly reshaped the tax structure during the crisis with noticeable shift from direct taxes to indirect taxes as a less harmful for economic growth. Increasing the consumption taxes in the EU members was accompanied by “fiscal devaluation” in direct taxation due to CIT rates reduction. Furthermore the economic crisis has influenced not only budgetary revenue in member countries, but also budgetary expenditure, where their share in GDP after a short-lived increase finally has been reduced. Empirical estimates for Euro Area have revealed that taxes changes appeared to imply lower multiplier than public spending, so tax increase usually entail lower effects on GDP and unemployment than austerity policy.

Ch.6, Inflation Expectations and Long-term Interest Rates

(Mirdala)

Abstract: Recent deflationary pressures and ultra-low interest rate environment in the Euro Area revealed fundamentally specific implications for the evaluation of monetary policy effectiveness. Redefinition of traditional views on price stability and the role of inflation expectations under near zero level inflation environment draws attention of increasing number of empirical

studies. Changing contribution of inflation expectations and expected real interest rates to the long-term interest rates determination represent one of the most important implications of the recent deflationary periods in the Euro Area. In the chapter we employ SVAR methodology to identify inflation expectations and expected real interest rates shocks and calculate variance decomposition and impulse-response functions of long-term nominal interest rates. Our research revealed considerable differences in the role of inflation expectations and expected real interest rates shocks in determining long-term interest rates between core and periphery countries of the Euro Area. The crisis period even intensified this trend.

Ch.7, Social Market Economy Leading the EU out of the Gridlock?

(Šmejkal, Šaroch)

Abstract: From the entry into force of the Lisbon Treaty, the EU has, among its constitutional objectives, the goal of achieving a highly competitive social market economy. At the same time, however, the EU has not been given any specific powers to actively develop its social policy, and having to cope in parallel with the economic and fiscal crisis, it has given preference rather to austerity than to social welfare. After more than seven years of legal force of the Lisbon Treaty there is still no clarity on how should the EU interpret the legacy of German post-war *Sozialmarktwirtschaft*; whether it should strive for its own economic and social “Constitution”, or whether it can try to fulfil the objective of social market economy through the existing instruments of EU law and policy measures. The chapter argues that some, rather partial, measures enacted by the EU would be desirable and feasible without creating a danger of over-regulation that would threaten the freedoms of the internal market or distort the existing division of powers between the EU and the Member States in the social field. The social market economy concept, being itself a compromise between the free markets and social welfare requirements, can act there as a guarantee that neither unbounded market freedoms nor socializing policies would dominate the EU.

Ch. 8, Revisiting Baumol’s "Growth Disease"

(Stöllinger)

Abstract: This chapter integrates the tradability index into a growth framework. This newly developed index captures the extent to which an

economy specialises in the production of tradable output. It can equally be interpreted as the predicted openness of a country given its economic structure. I embed the tradability index into a cross-country growth model to test a tradability-based variant of Baumol's growth disease. According to this hypothesis, countries that specialise in the production of tradable goods grow faster due to (i) higher productivity growth in tradable-goods producing sectors and (ii) the lack of demand constraints given the opportunities to sell on the world market. The prediction is confirmed for a sample of mainly European OECD and non-OECD countries though the impacts depend on countries' stage of development.

Ch. 9, Are Fiscal Rules Really Omnipotent? The Case of the EU

(Benczes)

Abstract: The reform of economic governance in the European Union has recently targeted four major areas: (1) strengthening fiscal discipline by tough fiscal rules; (2) establishing solid institutional mechanisms for an effective crisis management and resolution; (3) creating joint guarantee for national government debt; and (4) laying down the foundations of a fiscal union. The strengthening of fiscal rules has been the aim of both the so-called six-pack and the fiscal compact. As far as crisis resolution is concerned, the EU has created the European Stability Mechanism. Issuing joint guarantees on national debts did provoke harsh debates in the EU, but no real deal has been achieved yet on euro-bonds. The idea of a fiscal union, however, does not seem to be a short or medium term priority for most of European policy makers. In fact, there is no consensus on the very meaning of a fiscal union in the EU. In turn, this study critically evaluates the consequences of adopting stricter fiscal rules and it also reflects on the main concepts and ideas concerning a European fiscal union. In harmony with the literature, the chapter argues that rules could significantly contribute to the effectiveness of fiscal adjustments. More importantly, however, it can be also demonstrated that the most successful episodes were the ones where fiscal rules were adopted only *after* the start of the deceleration of the gross public debt-to-GDP ratios. In consequence, domestic rules were hardly the sole triggering factors of maintaining fiscal discipline; rather, they served as the key elements of a comprehensive consolidation package. It can be safely argued, therefore, that the most successful countries decided to adopt fiscal rules not because they wished to stop fiscal profligacy at some time in the future (as the most recently adopted fiscal compact envisions it), but because these countries

wanted to explicitly signal their strong commitment to fiscal discipline in the present. In other words, it is not fiscal rules (or a fiscal compact) *per se* what matters in delivering fiscal stability, but a strong political commitment and national ownership in particular. As far as the prospect of a fiscal union is concerned, the study provides a detailed analysis of both the expenditure and the revenue sides of national general governments and makes it clear that a fiscal union might not be a realistic scenario even in the longer future.

Ch. 10, Reforming the Eurozone: at Mercy of Politics

(Kudrna)

Abstract: The Eurozone was stabilized by the non-orthodox monetary policy of the European Central Bank as well as the set of reforms including the European Stability Mechanism and the Banking Union. At the same time, the institutional architecture of the Eurozone remains incomplete and requires introduction of some elements of fiscal and political union. While there is no shortage of recommendations for economic reforms, the most binding constraint is political. The Eurozone member states seem unable to agree on further reforms, even though they all agree that these are necessary. The result is a "muddling through", when the minimalist reforms are agreed upon at the latest possible moment and only under pressure of acute crisis. This chapter briefly outlines political economy constraints on alternative reform scenarios as well as some low-probability high-impact factors that could alter the Eurozone reform path. However, it concludes that the muddling through strategy is likely to remain dominant.

Introduction

Contributions in this volume explore the economic performance of the European Union, the underlying trends, and economic policies. Emphasis is placed on the post-2008 period – e.g. the “Euro Crisis” and its aftermath period. The experiences and the functioning of the European Economic and Monetary Union will be explored in the environment of twofold challenges of EU expansion (post-2004) and the increasingly globalized world economy.

European economic recovery appears to be taking hold. So is European crisis over? The acute phase of the crisis passed, however, the medium and the long-term issues remain to be answered. The current fiscal stabilization has been achieved, restoring the stability of the Euro. The policies of the “internal devaluations” are working, albeit slowly, to restore the competitiveness of countries most affected by the crisis. However, the growth remains at best sluggish. The medium and long-term outlooks remain highly uncertain, fomenting the social tensions and endangering the political stability.

The restoration of economic dynamism is increasingly perceived as the answer for the “European” future – economically, politically and socially. There is a broad consensus that dynamic structural reforms and the restoration of competitiveness on the scale of the global economy are the key answers to current European challenges. However, there are no answers yet to deeper questions: What do mean the structural reforms in particular? What is the role of capital flows? And what constitutes the improvement in global competitiveness?

However, the one thing appears to be obvious. Whatever the form of the fiscal and banking union(s), the transfer of resources is implicit (and seemingly necessary) for those unions if they are to provide the underpinnings for the current structure of the monetary union. This indeed raises the question of the governance of these unions – both fiscal and monetary. After all, the provision of resources implies an allocation – and it is hard to imagine that resources will be provided to the common pool (e.g. to the fiscal and banking union) unless the provider has some say with respect to the allocation of those resources. And that requires some form of common (e.g. centralized) decision-making procedures, in all likelihood exceeding the common understanding of *Acquis communautaire* as it exists today – e.g. some form of the effective political union.

Given the significant political content in deciding about taxes, expenditures and resource transfers (e.g. the fiscal and banking unions), some mechanism of the political governance involving the democratic processes appears to be necessary for these unions.

Contributors to this volume were selected to analyze various aspects of the processes of the Eurozone governance reform and (desirable) the growth. They provide a balanced and multifaceted look at the Eurozone's dynamics since its inception in general and in the last five years in particular. The issues analyzed include the discussion of the Eurozone dynamics, growth and reform, dilemmas associated with fiscal and banking unions and the interplays between the economic, legal and political. (More details are in the list of contents with abstracts below.)

The basic idea which connects all contributions is the analysis of the problems which affected the Eurozone in the past decade and the challenges and dilemmas the Eurozone will face in the coming years. The analytical approach which connects the arguments pointing out to the need for reforms in EU governance and policies with the discussions of the nature and feasibility of possible reform directions permeates all contributions. The research techniques vary, from the political economy approach of Rusek and Lacina (chapter 1) to the sophisticated economic analysis by several other contributors. And, indeed, authors in this volume cover a wide variety of the EU performance subjects, which they cover with a broad methodological flexibility.

The publication is the compilation of contributions of 11 authors from 7 countries – Austria, Switzerland, USA, Poland, Slovakia, Czech Republic and Hungary. The chapters are stylistically and content-wise independent, so that the reader may start with any one, according to an interest and preferences. To facilitate readers flexibility, the remainder of this introduction provides the short synopsis of each individual chapter.

In Chapter 1, Lubor Lacina, and Antonin Rusek explore the challenges, both internal and external the EU in general and the Eurozone, in particular, will face in the next decade or so. Most important of those will be a continuing rise of the emerging markets, with its asymmetric impact on the Eurozone member economies. This will only be exacerbated the increasing divergences between the countries on the Mediterranean littoral and the countries North of Alps (referred to subsequently as South and North respectively). (The essence of the problem is that the rise of emerging markets increases the competition on the consumer goods markets worldwide – e.g. in the area where southern European countries historically have – and still have – a strong, but weakening presence. However, the same phenomenon – the rise of the emerging markets – increases their demand for capital goods, historically

the strong area for the countries North of Alps, centered on Germany.) Finally, the demographic dynamics will exert influence over both the productivity and the fiscal positions.

To confront these challenges successfully, the restoration of growth is the imperative for the EU and the Eurozone's future. However, not any growth will do. The emerging markets challenge requires a growth based on the innovation and creativity (e.g. the increases in productivity), especially in the South. This type of growth improves competitiveness and should arrest and hopefully reverse the divergence tendencies. Moreover, its fiscal implications would help to address the looming demographic challenges – especially the rising expenditures on pensions and healthcare across the EU.

Based on a panel of 23 OECD countries Carsten Colombier shows that the government sector is partly contracted by Baumol's cost disease in chapter 2. He provides empirical evidence that not only total government expenditure but also public expenditure on health, education and general administration are affected by Baumol's cost disease. He points out that Baumol's cost disease produces adverse consequences under a balanced budget rule such as a debt brake. Governments face a serious dilemma. Breaching the rule would certainly cause reputational losses for governments, which might affect their borrowing costs and therefore, the sustainability of public finances. Adhering to the balanced-budget rule means risking budget-crowding out of cost-disease affected public expenditure with an ensuing long-run deterioration of these services and/ or foregoing growth opportunities. Governments of the EU member states and EU policymakers should, therefore, revise the EU Fiscal Compact to reconcile it with Baumol's cost disease.

In Chapter 3 Gabor Kutasi points out that some EU members faced years of crisis in the first half of the 2010s with an excessive initial public debt, but several others had broad room for fiscal stimulus. However, the prolonged duration of the European economic depression expanded public budgets, while exhausting stimulus policies and sovereign solvency. Meanwhile, one of the ways out of depression is a proposed centralization of the EU through the fiscal union. He asks whether the eurozone countries are ready to participate in a risk pool in public finances and seeks to answer this question. His argument presents the hypothesis that the sustainability of public finances deteriorated during the global and euro crisis in the majority of eurozone member countries and the EU, and this phenomenon is discouraging the core countries from seeking the fiscal union. His analysis uses the Blanchard indicators of fiscal sustainability and the sovereign risk rating of the EURO-18 and EU-28 countries. The analysis presents as results a theoretical summary of fiscal sustainability, the development of fiscal sustainability in the EU member states, indicators of convergence or divergence of fiscal sustainability

in the Community, and conclusions based on the indicators of the likelihood of a fiscal union.

The principle of proportionality as a new concept for the regulatory impact assessment is discussed by Stanisław Kasiewicz, Lech Kurkliński in chapter 4. There is an attempt to assess regulatory impact concerning a popular principle of proportionality. It undergoes large modifications; its interpretation is broadened, and it gets adapted to the factual assessment of legislative processes. The principle of proportionality includes three significant elements: adequacy, necessity and proportionality *sensu stricto*. The proposed method in the law-making process comes down to three stages. The first one is an interpretation of the subjective scope of at least three abovementioned components. The second stage consists in the transformation of the adopted scope into clear and quite simple criteria. The third stage is attributing relevant measures to particular criteria. The proposed approach to regulatory impact assessment has been termed as the model of the Observance of the Principle of Proportionality. The authors present the model assumptions, identify and particularize the criteria of main areas of the principle of proportionality and then determine its scoring methods. The final result of the chapter is a synthetic calculation: an ordered measure of the observance of the principle of proportionality for a specific regulation.

Jaroslav Kundera then analyzes the reform of economic policy coordination between the Euro Area member countries in chapter 5. He points out that Since 2008 the Euro Area has brought about the most severe crises, and the current situation in the Euro Area is far from stability. The crisis of the Euro Area turned out to be a crisis not only economies of member countries (Greece, Ireland, Spain, and Portugal) but also the crisis of mechanism of integration. To develop effective methods to combat the crisis and prevent future breakdowns present reform must cover not only the changes in the economic policy of the individual member states but also a mechanism for European integration. It is especially about the economic policy carried out at the level of the EU institutions that affects the economic policies of individual member countries. Hence the main goal of this chapter is to find an answer to the question, what changes should make the EU and its member countries to overcome the present crisis and prevent their occurrence in the future. Lessons are drawn from the current euro crisis to be such institutional changes within the EU, to ensure better coordination of economic policies between member partners.

In chapter 6, Rajmund Mirdala discusses the Inflation Expectations and Long-term Interest Rates in the Euro Area. He points out that recent deflationary pressures and ultra-low interest rate environment in the Euro

Area revealed fundamentally specific implications for the evaluation of monetary policy effectiveness. Redefinition of traditional views on price stability and the role of inflation expectations under near zero level inflation environment draws the attention of increasing number of empirical studies. Changing contribution of inflation expectations and expected real interest rates to the long-term interest rates determination are one of the most important implications of the recent deflationary periods in the Euro Area. In the chapter, the author employs SVAR methodology to identify inflation expectations and expected real interest rates shocks and calculate variance decomposition and impulse-response functions of long-term nominal interest rates. Research revealed considerable differences in the role of inflation expectations and expected real interest rates shocks in determining long-term interest rates between core and periphery countries of the Euro Area. The crisis period even intensified this trend.

Václav Šmejkal and Stanislav Šaroch ask whether the social market economy approach can lead the EU out of the gridlock in chapter 7. They point out that from the entry into force of the Lisbon Treaty, the EU has, among its constitutional objectives, the goal of achieving a highly competitive social market economy. At the same time, however, the EU has not been given any specific powers to actively develop its social policy and having to cope in parallel with the economic and fiscal crisis, it has given preference rather to austerity than to social welfare. After six years of legal force of the Lisbon Treaty there is still no clarity on how should the EU interpret the legacy of German post-war Sozialmarktwirtschaft; whether it should strive for its own economic and social “Constitution”, or whether it can try to fulfil the objective of social market economy through the instruments of EU law and policy measures. Authors argue that some, rather partial, measures enacted by the EU would be desirable and feasible without creating a danger of over-regulation that would threaten the freedoms of the internal market or distort the existing division of powers between the EU and the Member States in the social field. The social market economy concept, being itself a compromise between the free markets and social welfare requirements, can act there as a guarantee that neither unbounded market freedoms nor socializing policies would dominate the EU.

The empirical investigation of the tradability of output and the current account in the European context is the subject of inquiry of Roman Stöllinger in chapter 8. He put forward the hypothesis that increasing specialisation in the production of non-tradable output has a negative impact on the current account balance. To test this tradability hypothesis empirically, we proceed in two steps. Firstly, we develop a tradability index which captures specialisation patterns with regard to the tradability of output. Secondly, we embed the

tradability index into an empirical current account model for the full sample of European countries. We find strong evidence for a positive relationship between the current account balance and the tradability index in both the short and long run. The relationship is stronger for emerging economies in Europe than for developed countries. This finding has an important policy implication: the anxieties about "de-industrialisation" in many parts of Europe seem justified because the resulting loss of export capacity increases the risk of external imbalances.

Istvan Benczes asks whether in the EU context the fiscal rules are omnipotent. He stresses that The European Economic and Monetary Union (EMU) has an unprecedented institutional set-up for several reasons. Never before in modern history – in times of peace – have countries surrendered their sovereignty on monetary policy. No regional integration has succeeded ever before in reaching such a high level of complexity, with a supranational monetary authority at the centre. And never before has monetary policy been given up without the simultaneous introduction of a federal system of spending and taxation. No one has ever debated the fact that the design of the EMU is unique. By now, however, more and more commentators claim that its design was flawed or even that it was a total failure by institutionalising an asymmetry in the conduct of economic policy.

Finally, in the last chapter, Zdenek Kudrna discusses the problem of reforming the Eurozone in the light of the relationship between the economics and politics. The Eurozone was stabilized by the non-orthodox monetary policy of the European Central Bank as well as the set of reforms including the European Stability Mechanism and the Banking Union. At the same time, the institutional architecture of the Eurozone remains incomplete and requires the introduction of some elements of the fiscal and political union. While there is no shortage of recommendations for economic reforms, the most binding constraint is political. The Eurozone member states seem unable to agree on further reforms, even though they all agree that these are necessary. The result is a "muddling through", when the minimalist reforms are agreed upon at the latest possible moment and only under pressure of acute crisis. This chapter briefly outlines political constraints on alternative reform scenarios as well as some low-probability-high-impact factors (black and white swans) that could alter the Eurozone reform path. However, it concludes that the "muddling through" strategy is likely to remain dominant.

One technical note at the end of this Introduction. In discussing the dynamics of the different parts of both EU and the Eurozone, different authors in this volume use different terminology in reference to the same (or very similar) geographical entities. Editors respect authors choices. However, it may facilitate the readers better understanding if we point out the

commonalities connecting the terminology used by different authors. Namely, the terms South, Mediterranean, Mediterranean littoral, PIGS and EU (or the Eurozone) periphery all indicate the group of countries on the EU southern wing: Portugal, Spain, Italy, Greece, sometimes joined by Ireland (the latter depends on the actual context in the individual contributions). Similarly, the terms North, North of The Alps and core indicate the following states: Germany, Austria, Netherlands, Belgium, Luxembourg, and France, sometimes (again, depending on the context of individual contributions) joined by Finland.

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Growth and the Real Convergence in the Eurozone

Lubor Lacina, Antonin Rusek

1.1. Introduction

In the next decade or so, the EU in general and the Eurozone in particular will face a complex set of challenges, both internally and externally. Most important of those will be a continuing rise of the emerging markets, with its asymmetric impact on the Eurozone member economies. (Chen et al., 2012) This will only exacerbate the increasing divergences between the countries on the Mediterranean littoral and the countries North of Alps (referred to subsequently as South and North respectively). (The essence of the problem is that the rise of emerging markets increases the competition on the consumer goods markets worldwide – e.g. in the area where southern European countries historically have – and still have – a strong, but weakening presence. However, the same phenomenon – the rise of the emerging markets – increases their demand for capital goods, historically the strong area for the countries North of Alps, centered on Germany). Finally, the demographic dynamics will exert influence over both the productivity and the fiscal positions.

To confront these challenges successfully, the restoration of growth is the imperative for the EU and the Eurozone's future. However, not any growth will do. The emerging markets challenge requires a growth based on the innovation and creativity (e.g. the increases in productivity), especially in the South. This type of growth improves competitiveness and should arrest and hopefully reverse the divergence tendencies. Moreover, its fiscal implications would help to address the looming demographic challenges – especially the rising expenditures on pensions and healthcare across the EU.

In this context, the three issues emerge. The first and the most important one is the fact that the economic activities associated with the innovation and creativity are inherently riskier than the expansion of the existing business endeavors. That creates a funding problem. European financial sector, dominated by banks, is unsuitable to finance the new innovative but overall

highly risky business ventures, especially if those are undertaken by newly created firms.

The second issue relates to labor markets. The uncertainty associated with innovative ventures will be reflected in the need for flexible labor contracts, especially if these ventures are carried by the newly established firms. Moreover, the act of an establishment of a new enterprise faces complicated procedures in many, especially southern countries. Liberalization of the entry into professions and business activities, in general, is required to facilitate the desired economy of a growing productivity, e.g. the competitive and innovative economy.

Finally, the third issue is taxation. Increased uncertainty associated with the new enterprises constituting the new productive and innovative sector can be counteracted, at least partially, by designing a simplified (and perhaps even temporarily reduced) tax liability structure which would enhance the attractiveness of this sector for both the potential entrepreneurs and employees.

To address all three issues, actions on both the EU level and national levels are required. (Only the steps including the EU will be addressed here, but including the area where the EU and member states should act together in a coordinated manner.)

Venture capital firms are the key vehicle for the creation and financing of the new innovative companies which in turn are the essence of the dynamic, productivity enhancing growth. The actual funds for the venture capital come from existing financial establishments, technically termed the “limited investors”. (In the US these compose of the pension funds, university endowments, insurance companies, various investment and hedge funds, etc.) To be able to allocate a relatively small part of their funds to the high risk but high expected return venture capital, the “limited investors” need the continuous ability to diversify and hedge the rest of their portfolios – e.g. to optimize the overall portfolio’s risk-return configuration. This in turn requires the financial markets which are broad (in terms of the number of instruments available to trade), deep (in terms of the large number of instruments available with different risk-return characteristics) and liquid. The large and sophisticated US financial markets provide the environment in which both venture capital firms and “limited investors” strive.

The EU economy as a whole (even without the UK) is greater than the US, so theoretically it should be able to support the non-bank financial sector comparable to the US. However, despite the advances of the last 15 years, European financial sector remains dominated by banks. Relatively small non-

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