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The fiscal stance and economic coordination in Europe

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On the 30th of August, Governing Council of the ECB decided to lower the key interest rates by 25 basis points. May be this decision was the only available in view of the evolution of core inflation in Europe, but for reasons made clear below, it is not going to ease the fiscal debate in Europe. In his introductory statement, President Duisenberg said "under the present circumstances, the automatic stabilisers should only be allowed to work fully in those countries whose budget positions are closed to balance or in surplus". What should one think of such a position?

The Fiscal debate

The slowdown of growth in Europe, has had as a normal consequence an increase in "headline" deficits almost everywhere. This has given a pretext to the Commission for inviting some member States, namely Germany, France, Italy and Portugal, on the basis that they have been too lax in good times, to pursue a procyclical fiscal policy: they "have missed the opportunity of the recent favourable growth environment to meet the target of the Stability and Growth pact". Then one is left with the impression that if you do it wrong once, you are almost condemned to do it wrong for ever. This evaluation of European fiscal policy is also missing an important point: you can't evaluate economic policy without taking into account the initial conditions of the economy. There is a broad agreement that both monetary and fiscal policy have been procyclical for obvious reasons in the few years preceding the launching of the euro and that this procyclical episode has left the three "big economies" designated by the Commission with a mass unemployment problem and a negative output gap, which preclude a strongly restrictive fiscal policy at the outset of a new growth period. The return to a "normal" countercyclical policy will take more time, just because the European governments had it wrong (admittedly for good reasons, the Maastricht criterias) to begin with. And, above all, past errors are not justifications for present ones; so, to say the least, Member States are right when they declare that one could let the automatic stabilisers play. The debate will certainly gain in transparency if structural deficit figures instead of current ones are used. But that will also imply more confidence in the methods used to evaluate the output gap.

Much ado about nothing?

What is the extent of the problem? First, the fiscal deficit of the euro area is low and although forecasted to increase, it will still be less than 1% in 2001 (from –1,2% in 1999, 0.3% in 2000, -0.8% in 2001.) And of course the structural deficit which was –0.5% in 2000 will be according to the IMF of about -0.6% in 2001.) There is no reason to worry about these figures: neither about the level nor about the evolution of the deficit. It has to be remembered that in the US the deficit has turned into a surplus only in 1998-1999 after 6 to 7 years of expansion, and two years after a sizeable increase in potential growth. And the Congressional Budget Office has just forecasted a federal deficit of $9bn for 2001! It is thus hard to understand the big words used in the fiscal debate in Europe. Truly these figures are higher than those forecasted by the governments in their medium term fiscal programs, but the latter were conditional on hypotheses regarding the rate of growth which, at least for 2001, proved to be too high. There is no wonder then that actual deficit are higher than planned ones.

Should European governments be accused to have embarked on tax cut programs during a favourable growth context? As already emphasised, a procyclical fiscal policy in a period of quasi-stagnation, has meant for most European countries an increase in taxes and/or social contributions, leaving the economies when growth conditions turned to normal with an abnormally high tax burden as a ratio to GDP. This is a structural disequilibrium that governments had to address once the momentum of meeting the Maastricht criterias has been passed, and whatever the growth context. And that they did it in 2000 led by chance to the right timing, as these reforms will begin to sustain internal demand as from now, and hence may contribute to a reversal of the path of growth. So one of the arguments against the use of discretionary fiscal policy, that is the long and variable delay of implementing it, does not apply in this instance. Luck is not forbidden, as we have here an example of a structural fiscal policy which by chance has a countercyclical effect.

"Plus royaliste que le Roi"

On all these issues, the Commission seems to be more demanding than the ECB. The last monthly bulletin of the ECB (August) underlines the increased uncertainty surrounding economic growth in the euro area in the second half of 2001. But the editorial adds that fortunately (which is the way I understand the statement), "positive effects on euro area economic growth should stem from the impact of tax reductions in several euro area countries.." But the same bulletin contains also an article devoted to "Fiscal policies and economic growth". And here the position of the ECB is unambiguous. Stressing rightly the importance of fiscal policy for long term growth, it clearly concludes that for short term purposes automatic stabilisation has to be preferred to discretionary fine tuning. It also

asserts several times that fiscal policies in Europe are on the right track, e.g., p.52: “fiscal deficits have come down and sound budgetary positions have been achieved in the majority of euro area countries. The volatility of fiscal balances is much reduced and public debt is declining. There is no reason for complacency, and countries with imbalances remain, but major progress has been achieved compared with the situation only a few years ago.” Notwithstanding the reserve contained in the last sentence, this statement resembles much a congratulation to fiscal authorities which is sufficiently rare from a Central bank to be noticed.

The policy mix and discretionary fiscal policy

A new way of thinking about macroeconomic policy evaluation has emerged from events and research of the last two decades (see, e.g., John B. Taylor, 2000). In a nutshell, using a new “neoclasical synthesis” framework, and looking at what happens to the fluctuations of real output and inflation under alternative policy rules, the research concludes that the job of stabilisation is better left to monetary policy than to discretionary fiscal policy. The reasons are well known: the implementation lags are much shorter for monetary policy than for fiscal policy, monetary policy may be quickly reversed which is not the case for fiscal policy etc.. But this conclusion deserves two qualifications.

First, automatic stabilisers should be left to play their role, creating thus an element of certainty for the private sector. One just has to imagine the increase in uncertainty for private agents if discretionary fiscal policy is aimed at compensating the effects of automatic stabilisers to understand the strength of the argument. In addition, as set by Taylor, “The overall size of the actual changes in taxes and spending due to automatic stabilisers are frequently much larger than even the proposed discretionary changes. Both types of changes in taxes and spending impact aggregate demand, but the automatic ones are more predictable and work more quickly than the discretionary ones.” This statement is all the more true in Europe, where the level of taxes in proportion to GDP is higher and where the social protection system is more generous implying a greater automatic increase in social spending when unemployment increases.

Second, the conclusion is valid only if monetary policy does actively its job (see e.g. Creel and Fitoussi 2001). It is also and perhaps mainly because monetary policy was (in the US) systematically and strongly reacting to the cyclical state of the economy, that the “new normative macroeconomics” has emerged. Were monetary policy more passive or more constrained by its mandate, discretionary fiscal policy would have to come in. This is recognised by these new types of models especially in the case where the Central bank has to focus only on inflation and/or in the case of a fixed exchange rate system, not to say an unique currency. But, after all, these conclusions are well known: monetary policy should be the preferred instrument to fight common shocks, like a more or less general slowdown of growth, but fiscal policy should be activated to fight asymmetrical shocks or whenever a

common shock has asymmetrical effects. It also has to be activated if monetary policy is reacting too softly to common shocks.

Hence, the assignment problem can't be solved in Europe as easily as in the United States. But notice that in all cases, at minimum, automatic stabilisers have to be left to play their role. There is no justification in the economic literature, whatever its doctrinal inspiration, for a procyclical fiscal policy which is synonymous with not letting automatic stabilisers to play.

Economic policy coordination

As just underlined, there is no escape in Europe from discretionary national fiscal policies. A common monetary policy can't fit all euro area countries and something else is needed to perform the cyclical function, that is discretionary fiscal policy. To belabour the obvious -- a point which has been made in the early debate -- a country enjoying a boom will also, most likely, have a lower real interest rate than average, as if monetary policy were procyclical. And conversely, a country in the midst of a slump will be penalised by too high a real interest rate. When cycles are not synchronised, this problem arises automatically.

Thus, unsynchronised cycles, asymmetrical shocks etc.. imply to go beyond automatic stabilisers, and are powerful arguments not to restrain too much the room of manoeuvre of budgetary policies.

On the other hand, the plurality of national fiscal policies increases the opacity of the European policy mix, and the complexity of the job of monetary policy. So what are the pros and cons of economic policy coordination? By that I mean two things, the coordination between fiscal authorities *and* the coordination between the latter and the ECB. One is just left to guess how long the process of coordination will be. This length has to be added to the implementation lags of national fiscal policies to understand that stabilisation policies will have a hard time in Europe.

One can argue that in a common currency area, there is no need for coordination of national fiscal policies (Cf. J.P. Fitoussi, 1999; De Grauwe end Polen, 2000). A national expansionary fiscal policy will have two effects on other European countries: a trade effect and a financial effect. It is most likely that the first will dominate the second. The trade effect will not by definition be dissipated by nominal exchange rates movements, and if the expansionary country exhibits as a consequence, a higher rate of inflation, the trade effect will be reinforced by an increase in its real exchange rate (a lost in competitivity). The financial effect refers to the possible increase in interest rates, short and long, which may follow the increase in the euro area inflation rate and public deficit. But the inflation rate increase may be insignificant and it is probable that the public deficits in the others countries will be lower as a consequence of their induced expansion. It is thus unlikely that the two effects balance. The most probable outcome is that the other European countries will benefit from the expansion without having to bear any cost. At maximum, the increased deficit in the expanding country will be reflected

in its bond yields, as there is no chance of a bail out by the centre. One may even go as far as saying that the stability pact may lead to a restrictive bias in fiscal policy, as no country has interest in being the first mover, each having interest in others doing it. Another restrictive bias may arise from an increase in the dispersion of national public deficits around their European mean.

From this analysis, I conclude that in the euro area, not only will each country retrieve a full fiscal sovereignty, but this retrieved fiscal sovereignty will by no means be unfavourable to the other countries within the area, on the contrary. After all this is what the subsidarity principle is all about. There is another argument against policy coordination. Competition between fiscal policies may favour experimentation, innovation and the selection of best policies. But this argument should not be pushed too far: fiscal and social competition may have, and in actuality often have, adverse unintended results which may be harmful in the long run. They generally lead to a sub-optimal provision of public goods in sectors which are crucial for long term growth (education, health, infrastructure etc.., not to speak of social cohesion).

The arguments for coordination are of two kinds (Cf. P. Jacquet and J. Pisani-Ferry, 2000). First, only coordination may provide the public goods which are needed at the European level. Preserving the single market is a public good which implies fiscal and social harmonisation, as well as that of regulations. In this sense, budgetary discipline would also be a public good as it allows for a clear definition of the policy mix which, seen from outside Europe, is of the collective responsibility of member states. This type of coordination is called by Peter Kinnen, regime preserving coordination, as it allows for the continuation of the present regime.

The second kind of argument refers to externalities linked with national policies of the kind we have already discussed: for example monetary policy is geared towards the control of the average rate of euro area inflation. National policies including structural ones may influence this rate leading to a change of monetary policy adverse to other countries. To cope with these externalities, strategic coordination is required. But in view of the complexities of implementing such a coordination which in general implies discretionary policies, the temptation of adding new rules to constrain the policy maker may become too strong: for example a country experimenting a boom will be constrained to pursue a restrictive fiscal policy, and a country in recession an expansionary one, both discretionary. Notice that such a rule may conflict with the stability pact as it increases the dispersion of public deficits around their European mean.

An European level Tax?

National governments have to keep a policy instrument in their hands, otherwise what are they for? And how can they renounce this instrument if it is not clearly established that it will be used for the good by a higher level of government. In other worlds, the “Federation of Nation States”, has to become more of a federation if one wants national fiscal policies to be more severely constrained. That

would imply an increase in fiscal receipts at the level of the federation, and make the case for an European-level tax. Which tax it will be and for what associated spending are difficult questions which require a lot more scrutiny to be answered. It is obviously not a technical question, but a thoroughly political one, because it implies a new division of labour between the federation and national governments. One could nevertheless argue that the tax chosen should be a tax whose setting at the european level will avoid unfair and inefficient (because of negative externalities) fiscal competition, like corporate taxes and/or capital income taxes. The associated spending could also for the same reasons be devoted to social expenditures. Redistribution of this kind would help harmonising social conditions in Europe. One can also think -- as there is a strong need for a greater integration of the university system -- of spending on education and research, a sector which is crucial for the future of Europe and which has to be thought of at the European level.

Concluding remarks

The fiscal debate in Europe is putting the policy maker under too straight a jacket. Voices are heard saying that the cyclical increase in budget deficits should be prevented, recommending thus a procyclical policy! It would be better to avoid such a simplistic debate by reasoning with structural deficit figures.

In the European context, automatic stabilisers may not be enough and some room should be left for national discretionary fiscal policy. This is due to the impossibility of having monetary policy fit the situation of each country. But under present circumstances of a slowdown of growth in almost all European countries (accompanied by a decrease in inflation and an appreciation of the euro), research and experiences have shown that monetary policy would be the most adapted instrument … if used. If not discretionary fiscal policy would have to enter the picture. For example, as most European countries have decided on a pluriannual program of tax cuts, they can also decide in a coordinated way to implement the programmes on a shorter time span.

Under the present “Economic Constitution of Europe”, there are arguments against and for coordination of economic policies. From arguments made clear in the paper, coordination of fiscal policies is not necessary. Of course it would help understanding the policy mix of Europe if it were correctly designed and promptly achieved. But if it leads to rules constraining even more the policy maker, it would be undesirable. A much better solution is to move in the direction of a federation and to decide on a European-level tax.

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