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Fiscal Policy as a Stabilisation Policy Tool in the EMU

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The topic of my speech is how best to stabilise the domestic economy in the EMU in situations when cyclical developments differ fundamentally from those in other euro countries, or as we as economists like to put it, when a country is subject to asymmetric (country-specific) shocks that the common monetary policy of the European Central Bank will not react to. For Sweden this issue is a very topical one, as it is looking increasingly probable that we will join the EMU after a referendum next year. The issue is very topical for Denmark, too, as you have in effect already joined the EMU, though without taking up any seat in the Governing Council of the ECB, through your fixed exchange rate to the euro.

I shall base my talk on the recent work by a Swedish Government Commission with the somewhat awkward name of the "Government Commission for Stabilsation Policy for Full Employment in the Event of Swedish Membership in the EMU", which published its final report two months ago. The commission had the explicit task of analysing how to best stabilise the Swedish economy in the case of asymmetric cyclical developments relative to other euro countries in the event that we choose to participate in the EMU.

This is, of course, an old problem in the literature on optimal currency areas. This literature analyses several possible macroeconomic adjustment mechanisms that could substitute for the national monetary policy that is given up in a monetary union.

- One is *migration* of labour from countries in recession to booming areas
- A second one is *increased flexibility of nominal wages*, so that what economists term the real exchange rate, the relative price between the outputs of different countries, can be changed this way.
- A third adjustment mechanism is *fiscal transfers* among countries in the euro area in response to differences in the cyclical situation of the same type as occurs more or less automatically within federal states like the US or Germany
- A fourth possibility is an increased use of *national fiscal policy* as a stabilisation policy tool

Looking at these different possibilities, most economists agree. Mobility of labour among the euro countries may be increasing over time, but it is a very gradual process and will not play any significant role for macroeconomic stabilisation for a very long time to come. It may be the case that EMU membership strenghens the incentives for nominal wage flexibility, but changes are likely to be small and to be a very imperfect substitute for an own interest rate policy and exchange rate adjustments. This applies especially at the low rates of inflation, which mean that downward money wage rigidity is likely to be a binding constraint on the possibilities to lower relative wage costs vis-à-vis other countries in recessions that are deeper than abroad. As to cyclically motivated fiscal transfers among EU countries, they just do not seem politically feasible within a foreseeable future.

This means that the only macroeconomic adjustment mechanism that is left is national fiscal policy. So, I shall spend my time on discussing to what extent national fiscal policy can act as a substitute for a national monetary policy in the EMU.

When analysing the scope for fiscal policy, there are two basic apects:

- The first aspect has to do with the *technical effectiveness* of fiscal policy, that is whether fiscal policy has the power to influence aggregate demand and output
- The second aspect is the *political-economy* one of whether fiscal policy is likely to be used by policy makers in an efficient way.

I shall be rather brief on the first point. There exists a general discussion on whether fiscal policy is at all effective, based on the notion of *Ricardian equivalence*. The argument - as most of you know - is that tax reductions increasing the real disposable incomes of households will fail to raise private consumption and aggregate demand if they mean larger budget deficits; households will realise that their life cycle incomes have not increased, as they will have to pay for the deficit through higher taxes in the future.

Although the empirical research on Ricardian equivalence is not conclusive, there seems to exist a consensus that fiscal polices of the types that I described do have significant aggregate demand effects, although they may be considerably smaller than was believed in the past: fiscal-policy multipliers may be only around one or slightly larger.

Also, it is important to realise that even if Ricardian equivalence were to hold in the theoretical sense, it does not rule out the effectiveness of all types of fiscal policy. For example, a temporary deficit-financed increase in government consumption will still increase aggregate demand, because the direct demand effect will be larger than the fall in private consumption due to perceived future tax increases (the reason is that the reduction in private consumption resulting from the fall in life-time income will be spread over all future periods through consumption smoothing, whereas the whole increase in government consumption falls on the present period).

In addition, fiscal policies that change relative prices will have an effect also under Ricardian equivalence. One example is a temporary change in the VAT, which will change the relative price between consumption in different time periods, and thus create an incentive for households to reallocate consumption over time in much the same way as an interest rate change. Another example of such a fiscal policy is a reduction in payroll taxes, which will have an effect because it reduces the real labour cost of employers and depreciates the real exchange rate (that is reduces relative wage costs vis-à-vis other countries).

So, for these reasons I shall take it for granted that fiscal policy has an effect. The more difficult question is instead the political-economy question of whether policy makers are likely to use it in an effective way. To analyse that question, it may be instructive to first recall the macroeconomic policy regime that prevailed in most European countries in the 1970s and early 1980s.

These years were characterised by very serious stabilisation policy failures. Too expansionary monetary policy caused inflation. The problems were even worse for fiscal policy. Because it was not tightened enough in booms, there was a gradual weakening of government finances in almost all OECD-countries with dramatically increasing government debt as a consequence. This is illustrated in the diagram 1.

The stabilisation poliy problems of the 1970s and 1980s eventually led to radical changes in the stabilisation policy regime in most countries. One common reaction was the *delegation of monetary policy* to independent central banks, the idea being, as you know, that an independent central bank should be able to make more long-run considerations than governments more engaged in day-to-day politics.

Another change is that monetary policy has become the main stabilisation policy tool in most countries, whereas fiscal policy has come to play a less important role in this respect. This reflects the belief that independent central banks are likely to be more efficient in stabilising the economy than fiscal policy makers. In the 1990s, budget discipline was also strengthened in the EU countries, to some extent through national reforms of the budget process, but primarily through the fiscal policy rules at the EU level in the Maastricht Treaty and the Stability and Growth Pact.

The general problem, as I see it, is that macroeconomic stabilisation in response to asymmetric developments in the euro area will require an increased use of fiscal policy as a stabilisation policy instrument at the national level. This is a dilemma, because fiscal policy is for political-economy reasons an inferior stabilisation policy tool to monetary policy.

- An increased role of fiscal policy in stabilising the economy will mean that we to some extent return to a system where much of stabilisation policy is again under the direct control of the political sphere. This poses a risk that some of the problems with an expansionary bias of stabilisation policy that the delegation of monetary policy to an independent central bank were supposed to solve may reappear. Short-run political incentives may again come to play a much greater role in stabilisation policy.

- A second problem of fiscal policy has to do with the fact that it has also other central goals than stabilisation. Fiscal policy is also to a very large extent concerned with goals of income distribution and resource allocation. This poses a risk that the stabilisation policy aspects will not carry enough weight, and that stabilisation policy motives will be taken as a pretext for too expansionary fiscal policies in general.

- A third problem is the longer decision lags in fiscal policy than in monetary policy, which imply a large risk that policy measures will be badly timed. One reason is that it is technically much simpler to decide on changes in the interest rate than on changes in taxes and government expenditures. There is only one interest rate parameter for a central bank, but there are a number of taxes and government expenditures to change. And various tax and expenditure changes all have very different income distribution effects, which explains why the decision-making process for fiscal policy tends to become very drawn-out, as proposals on measures for reasons of stabilisation will always trigger long discussions of income distribution effects.

Looking at fiscal policy in the various EMU countries, there are worrying signs. There were great efforts to consolidate government finances in all EMU countries before the start of the EMU. But these efforts seem to have stalled. This is particularly evident in the large euro countries, Germany, France and Italy, where domestic political considerations seem to be much more important than the pledges to the common EU rules. It seems like the large EU countries have tried to uphold one set of rules for the smaller countries - I am thinking then of the early warning given to Ireland - but another set of rules for themselves. This is, of course, not sustainable in the long run. The recent treatment of Germany and Portugal, who did not receive the early warnings they should have had according to the Stability and Growth Pact, is an evidence of this. The discussion of loosening the fiscal policy requirements in the Stability and Growth Pact is another indication of the risk of a gradually weakening fiscal discipline in the EMU.

In my view, there are two basic flaws in the fiscal policy rules at the EU level. There is, of course, a need for prudent fiscal policies also in booms in order to stay away from the 3-%-of-GDP-deficit-level in recessions that can trigger sanctions according to the Excessive Deficit Procedure in the Maastricht Treaty. But these incentives are too weak, as the next recession is likely to be seen as very far-away in a boom and may be the problem of another government than the present one.

The other major flaw in the fiscal policy rules at the EU level is that the final evaluations of countries are made by politicians in the Ecofin Council. The finance ministers are likely to act in a strategic way and be very forgiving about the fiscal-policy deficiencies of their foreign colleagues, since they will know that they may soon themselves find themselves in similar situations and that they will then have to rely on the good will of the other ministers to escape embarassing criticism and possible sanctions.

So in my view, it is a mistake to rely on the EU to create the preconditions for sound fiscal policies. These preconditions must instead be created primarily at the *national level*. An appropriate way of doing this could be by adopting *a law on fiscal policy* that creates a well-defined framework for fiscal polilcy in much the same way as has been done for monetary policy in many countries, such as, for example, New Zealand, Sweden and the UK.

What should such a law on fiscal policy contain? Well, first it should define a *long-run sustainability target* for the government finances in the form of a budget target over the business cycle. The exact target should depend on a number of factors: the present debt situation, the requirements posed by the demographic situation and the size of automatic stabilisers (the "automatic" variations in tax revenues and government expenditures that are due to the cycle). Sweden, where the automatic stabilisers are very large because of a high tax share and generous unemployment benefits, and where future demographic developments will put a strain on government finances, has opted for a surplus target over the business cycle of 2 percent of GDP. The Government Commission, where I took part, advocated raising this target for the next ten-year period to 2,5 or 3 percent to create an even larger safety margin to the 3-%-deficit-limit in the Maastrict Treaty and thus more scope for fiscal stabilisation policy in downswings.

Given the long-run restriction of a sustainable government budget position, the short-run stabilisation policy target of fiscal policy should be to *stabilise the level of domestic economic activity* to the extent that this is not done through the monetary policy of the ECB. More precisely, the objective should be to counteract the emergence of large output gaps, that is large deviations between actual and potential GDP. In principle, this is the same as stabilising employment or unemployment around their equilibrium rates (the rates that are sustainable in the long run). But it may be better to formulate the objective in terms of output gaps than in terms of deviations from equilbrium unemployment, as it may be quite confusing for the general public with a fiscal policy that may at times try to prevent actual unemployment from falling (below the equilibrium rate), at the same time as structural policies are aiming at reducing (equilibrium) unemployment through various labour market reforms.

There are, of course, formidable difficulties of measuring the output gap in an exact way. Different techniques will give different results, so one will have to make a judgement based on a number of indicators, such as deviations from trend GDP, vacancies and shortages of labour, changes in inflation and wage growth, changes in the wage share of national income, and changes in relative wage costs vis-à-vis other euro countries.

I want to emphasise the special importance of one of these indicators, namely relative wage developments vis-à-vis other euro countries. The goal of counteracting large variations in the activity level should be *forward-looking* and apply both to the short term (1-2 years ahead) and to the medium term (2-5 years ahead). Wage developments relative to other countries is an important indicator of how present domestic output gaps relate to output gaps in other countries. But it is also a crucial indicator of the possibilites of stabilising economic activity in the medium term. The explanation is that higher wage increases than in other euro countries during a boom - which are not motivated by permanently higher productivity growth or permanent shifts in demand in favour of the country - lead to a real appreciation (higher relative wage costs), which because of downward nominal wage rigidity is very hard to reverse. If there is a large rise in relative wage costs , it may become impossible to stabilise economic activity in the longer run through fiscal policy without ending up with unsustainable budget deficits.

So, the conclusion is that relative wage (or price) developments ought to play a central role for national fiscal policy in the EMU. For a country outside the EMU with a flexible exchange rate as Sweden or the UK, the target of domestic stabilisation policy is the *absolute* rate of inflation; in the EMU the *relative* rate of inflation should instead be the appropriate benchmark. Fiscal policy should react quickly to tendencies to higher wage growth than in the other euro countries that are not motivated by permanent differences in productivity growth or relative demand shifts. Such a fiscal policy response pattern should also promote wage restraint in general, because it raises the "price" of high wage increases for unions and employers in terms of output and employment losses (more technically, the effective labour demand elasticity is raised).

A law on fiscal policy should also specify the conditions when discretionary fiscal policy action, that is active decisions to change taxes and expenditures, should be taken. The more often discretionary policy is used, the greater is probably the risk that fiscal policy is misused and gets an expansionary bias. This is an argument for using discretionary fiscal policy rather cautiously as a stabilisation policy tool. The general principle ought to be that discretionary action should only be taken in the case of *large* asymmetric macroeconomic shocks, whereas one should leave it to the automatic stabilisers to work when there are moderately-sized such shocks. At the same time, it is important that one does use discretionary policy when shocks are large, as automatic stabilisers by definition only moderate the developments taking place, but do not offset them completely.

A law on fiscal policy should try to define what are large macroeconomic shocks that motivate discretionary fiscal policy action. The Swedish Government Commission proposed proposed the definition of output gaps larger than plus/minus 2 percent of potential GDP. Applying Okun´s law, a change in the output gap of 2 percent of GDP corresponds roughly to a change in unemployment of 1 percentage point. How restrictive would such a rule be? Well in the Swedish case, the output gaps have been smaller than this for more than about half the time, as can be seen from diagrams 2 and 3, so such a rule would indeed put restrictions on fiscal policy. It could be seen as a parallell to the inflation targets of central banks in many countries, which are usually defined with a tolerance margin around a specific number (2 plus/minus 1 per cent in Sweden, for example).

I also believe it would be wise for Parliament to take a principal stand in advance on a number of fiscal policy measures to choose from if the need arises. The actual policy mix would, of course, have to be decided in the specific situation depending on the exact character of shocks. But still, such a preannounced list could help reduce decision lags in situations where discretionary action has to be taken. It could also reduce the risk that income distribution considerations take over stabilisation considerations in the concrete situation and lead to inappropriate measures being undertaken.

For political-economy reasons it is an advantage if stabilisation policy measures are broad and have so small income redistribution and allocation effects as possible. This makes it easier to reverse fiscal stabilisation measures in another cyclical situation. It is a precondition if measures are to be used symmetrically and temporarily over the cycle, which is necessary to avoid that stabilisation policies get an expansionary bias and have undesired long-run effects.

The measures pointed out by the Swedish Government Commission are perhaps not very sensational:

- Changes in income tax rates that apply equally to everybody, in the form of a specific *proportional* cyclical income tax or income tax rebate. This measure is subject to the Ricardian-equivalence critique, but not the other measures as I explained before.
- Changes in the VAT, which change the relative price of consumption between different time periods.
- Changes in pay-roll taxes, which affect the cost side of the economy as well as the demand side.
- Changes in government consumption (in Sweden through changes in government grants to the municipalities) and in government investment, which have a direct effect on aggregate demand.
- Internal exchange rate changes of the form that have been used both in Denmark and Sweden, that is, for example cuts of pay-roll taxes in a downswing, and simultaneous rises in income taxes or employee contributions to the social

security system in order to neutralise the effects on the government budget. This can be seen as a measure of last resort to use in a downswing when one does not want to increase the government budget deficit. It works very much lika an ordinary depreciation by depreciating the real exchange rate and accomplishing an expenditure switch from foreign to domestic goods.

Of course, policy makers can always deviate from such preannounced guidelines in a fiscal policy law as I have advocated. But the idea is to increase the political cost of doing so. Could one go even father? Well, there exists an embryonic international discussion on whether it would be possible to delegate fiscal policy to a *fiscal policy committee* of independent experts, in much the same way as has been done with monetary policy, in order to remove fiscal policy from day-to-day politics and secure a more long-term perspective.

The problem with this solution is that fiscal policy is intrinsically much more political than monetary policy, because decisions on individual taxes and government expenditures have large income distribution effects for well-defined and often well-organised interest groups. For this reason, it is very hard to see how one could delegate fiscal policy in general.

The issue is then whether one could delegate only the stabilisation policy part of fiscal policy . One way to do that could be to let a fiscal policy committee decide only on the budget deficit, which could be argued to have smaller income distribution consequences (and where the consequences apply more between generations than between various groups at a given point in time). Another possibility would be for Parliament to decide in advance the composition of policy packages (for example, 50 % income tax changes, 20 % payroll changes and 30 % increases in government consumption) and then let the committee decide the overall magnitude of the stabilisation package.

Could this be done? I am sceptical. It is difficult to decide the composition of a stabilisation package in advance without knowing the exact character of shocks. Deciding on taxes and government expenditures has also traditionally been seen as a centerpiece of parliamentary power. So it is unlikely that parliaments would delegate major fiscal policy action to such a committee.

The Swedish Government Commission proposed instead that one should set up a *fiscal policy council* of independent experts that should have no decision power, but be responsible for making recommendations to the government on fiscal policy measures that are motivated for stabilisation policy reasons. It would be a kind of beefed-up version of the Economic Council in Denmark or the German Sachverständigenrat, where the mandate should be more narrowly defined only to make stabilisation policy recommendations, but the powers in this respect larger. The council should provide a regular input into the budget process by producing a report on the cyclical situation of the economy - a parallell to the inflation reports of, for example, the Swedish Riksbank and the Bank of England - and make recommendations on the annual budget target and on specific tax and expenditure changes that are motivated by the cyclical situation.

According to the proposal, the council should have no decision-making powers. The government would not have to follow the recommendations, but if it chooses not to, it would have to present a written motivation to Parliament. This would give the council some "teeth", so that it could play an important role in defining the fiscal policy agenda. Another possibility, which I favour, but which was not proposed by the Swedish Government Commission, perhaps for rather obvious reasons, is to have the Minister of Finance take part in a "reversed public hearing" before the council of independent experts where he or she has to answer questions if the advice of the experts were not followed: a kind of "oral exam" in order to provide the general public with more information and thus to enhance accountability for fiscal policy.

Is this a good proposal? Will it work? One could perhaps say that the Sachverständigenrat has not helped much with fiscal policy in Germany. The Economic Council in Denmark has probably had more influence. It is not exactly clear to me why. Probably, the role of such councils depend a lot on the traditional roles economists have played in the debate and on the reputation and authority that such a council could build up over time.

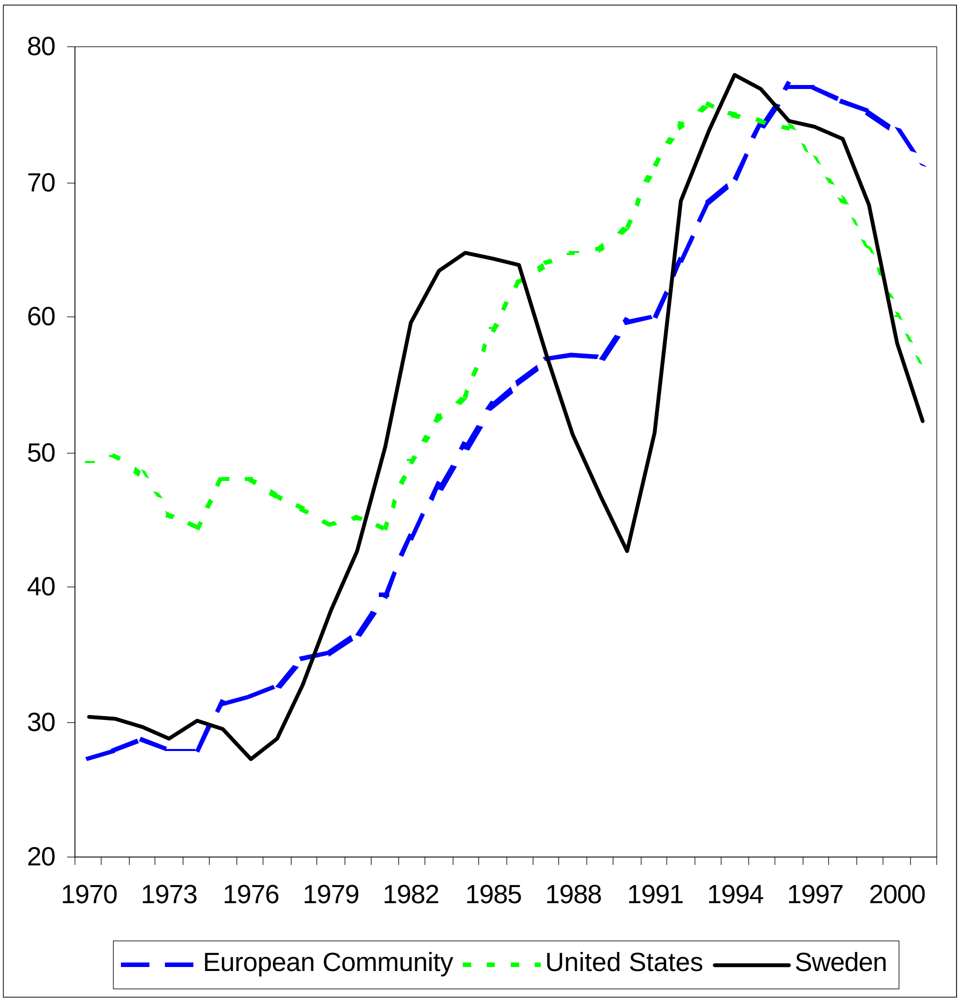
In the Swedish debate, politicians have not exactly applauded the proposal of a fiscal policy council. In fact, they have been quite hostile, seeing this as yet another attempt of economists to take over power from elected politicians. They seem to see the independence of central banks as a first step, and this as a second step. However, this type of criticism in my view rather strenghens the case for the proposal; if politicians thought it would make no difference, they would not be so opposed to it. The reason why politicians are opposed to it is likely to be that they fear that their freedom of action would be circumscribed, which is exactly the idea.

I am now approaching the end of my talk. I shall not make any long summary. I just want to repeat my main conclusion that if country-specific shocks continue to be important in the EMU, as I believe, then an increased burden will fall on national fiscal policy. If fiscal policy is to take on this role, one must create better preconditions domestically for fiscal policy as a stabilisation policy tool.

Let me end with a last remark on the EU? Which role should it play in this context? Not a very large one I would say. Multilateral Surveillance and the Stability and Growth Pact are fine, especially if one respects the rules that have been set up. But I see no role for more enhanced coordination of fiscal policies in order to stabilise the business cycle. Such coordination would have to rest on the existence of important spillover effects (externalities) among countries of fiscal policies, so that the policy in one country has a large effect on others. It is true that such effects exist, but we know very little about whether the net externalites are positive or negative when we add all effects together, and thus about in which direction coordination would change the fiscal policy stance. And if not even economists in a fiscal policy coucil would be able to tell this, how should politicians know how to use fiscal policy coordination. And if one does not know this, what should one have it for?

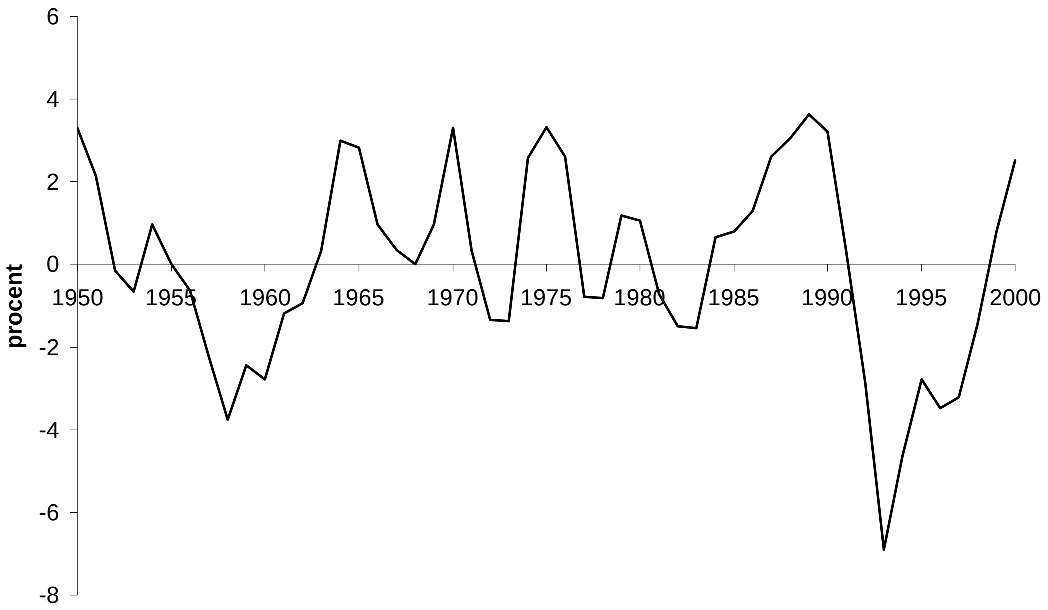
In addition, fiscal policy decision making at the EU level is likely to be quite inefficient, introducing further lags and inefficiencies into the decision process by adding yet another layer of decision making. Instead, it is important that individual countries are as free as possible to use national fiscal policies to stabilise asymmetric developments. So, we should think mainly about ways of improving the decision making process for fiscal policy at the national level.

Diagram 1: Government debt, percent of GDP



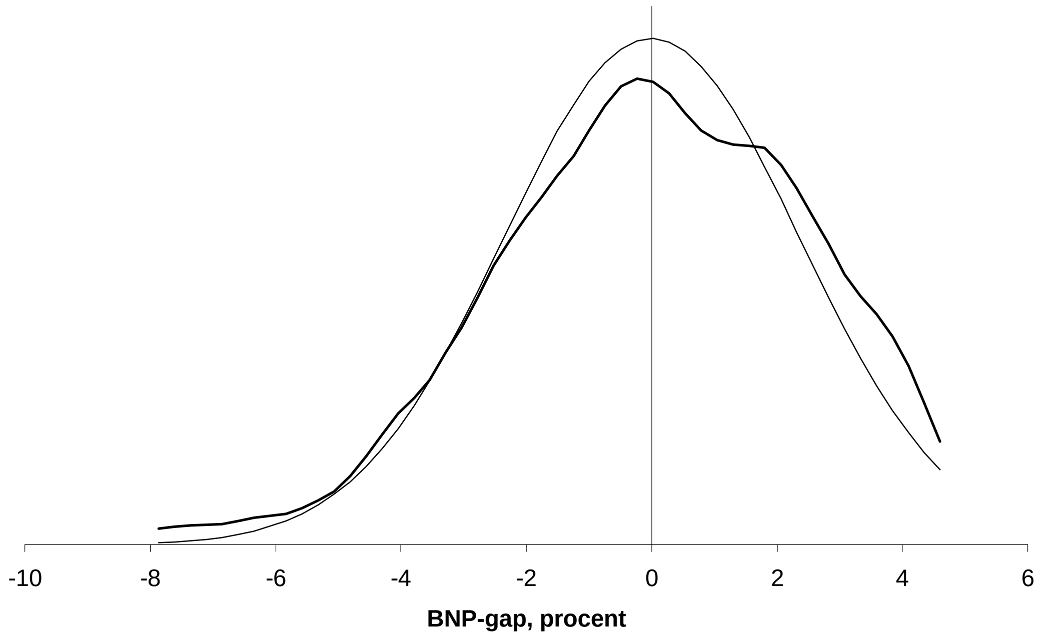
Source: Charles Wyplosz, "Fiscal policy: institutions vs. rules", bilaga 5 till Stabiliseringspolitik i EMU, SOU 2002:16.

Diagram 2: GDP gap in percent of potential GDP in Sweden, 1950-2000



Source: Henry Ohlsson, "Finanspolitik i en valutaunion", bilaga 4 till Stabiliseringspolitik i EMU, SOU 2002:16.

Diagram 3: The distribution of the GDP gap in Sweden



Source: Henry Ohlsson, "Finanspolitik i en valutaunion, bilaga 4 till Stabiliseringspolitik i EMU, SOU 2002:16.