SWEDISH ECONOMIC POLICY REVIEW 8 (2001) 3-14

Macroeconomic policy coordination in the EU: How far should it go?

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One of the basic questions facing the EU is how far macroeconomic policy coordination should go in various areas. This is a recurring theme in the discussion of economic policy in the EU, not least because the degree of coordination differs fundamentally among policy areas.

The monetary union implies a common, centralised monetary policy conducted by the European Central Bank. The fiscal policy stance is determined nationally, but is subject to common rules on government deficits and debts with the aim of ensuring budgetary discipline according to the Maastricht Treaty and the Stability and Growth Pact, as well as to looser forms of coordination centred around the Broad Economic Policy Guidelines. There is an ongoing discussion on the need to more closely coordinate fiscal policy stabilisation efforts among member states. There exists a similar discussion on tax policy, which remains an area for national policy making, although it is subject to some common rules restricting the freedom of action of national governments. Finally, some steps have been taken in the direction of coordinating structural employment policies, although these, too, largely remain a matter of national competence.

The issue of the appropriate amount of macroeconomic policy coordination formed the topic of a conference arranged in Stockholm on May 28, 2001 by the Economic Council of Sweden. This volume contains five of the papers presented at this conference together with the discussants' comments.

1. Monetary policy

The paper by *Richard Baldwin, Erik Berglöf, Francesco Giavazzi, and Mika Widgren* on *Eastern Enlargement and ECB Reform* discusses the possibili-

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ties to design an efficient decision-making process for monetary policy within the ECB, when the monetary union is expanded. The paper analyses the risk that monetary policy makers, adopting a national perspective, will choose policies that do not stabilise the aggregate inflation rate of the euro area, because the relative voting power of the Executive Board and the central bank governors of the core member states in the ECB's Governing Council will be diluted. This analysis is made under specific assumptions on which coalitions will be formed in the Governing Council, but still very clearly illustrates the potential problem of a *status-quo bias* in interest rate decisions. The authors also point to the risk of inconsistent and unpredictable decisions being made by a larger Governing Council than today.

The paper analyses the different solutions that have been proposed: *rotation*, *representation,* and *delegation* to a monetary policy committee. The authors are sceptical to the first two solutions. Rotation, together with reforms limiting the size of the Governing Council and long periods of office in the Council, will mean that each national central bank is "represented" rather seldom. Short periods of office instead imply a risk of unstable and inconsistent policies. With representation, (small) states would be lumped together in sub-groups, each selecting a representative. The problem with this solution is the difficult task of deciding on groupings and the (s)election mechanisms within groups.

The authors favour the third solution: delegation of monetary policy decisions to a small group of independent experts. This group could be the present Executive Board, perhaps augmented with outside non-executives. The main advantage of such a solution is that decision making is more efficient in a small group and that the lack of "national representation" makes it clearer than what is the case today that monetary policy makers should make aggregate Euroland considerations and not national ones. To address the problems of legitimacy and accountability of such a professional decision-making body, the authors propose that national central bank governors should form an advisory body, which is not allowed to vote on interest rate policy, but needs to be consulted.

2. Fiscal policy as a demand-management tool

Two papers in the volume analyse the scope for coordination of fiscal policies as a tool of demand management for stabilising macroeconomic fluctuations. The starting point for both papers is the combination of fiscal spillover effects (“externalities”) among countries and the interaction between fiscal and monetary policy at the EU level.

In the paper by *Roel Beetsma, Xavier Debrun, and Franc Klaasen* with the title *Is Fiscal Policy Coordination in the EMU Desirable?* demand spillovers via foreign trade play a crucial role. Such demand spillovers constitute a potential argument for fiscal policy coordination: for example, in the event of a common demand shock, the optimal fiscal policy response is larger under coordination than under non-coordination, because the positive effects of national measures on other countries will be taken into account. However, such fiscal policy coordination is not necessarily welfare-increasing in the absence of coordination between fiscal policy and monetary policy. This is an application of a well-known result from game theory, according to which cooperation between a limited subset of players may not be beneficial.

In general, the outcome of fiscal policy coordination depends on the nature of the interaction between fiscal and monetary policy as well as the type of macroeconomic shock. In the Beetsma-Debrun-Klaasen model, fiscal policy coordination is beneficial if fiscal policy makers can precommit the policy. This means that they can take the anticipated monetary policy response of the ECB into account, which allows them to influence monetary policy in the desired direction. In game-theoretic terms, fiscal policy makers, who coordinate their policies at the EU level, then act as Stackelberg leaders vis-à-vis the ECB. But in the absence of such precommitment, i.e. when aggregate fiscal policy and monetary policy in the euro area are determined simultaneously in a Nash equilibrium, the result is less clear-cut. For example, with symmetric demand shocks, the adjustment burden will be distributed between fiscal and monetary policy in an inefficient way. Because of the demand spillovers, fiscal policy will overreact when it is coordinated and, as a consequence, monetary policy will not react enough. With symmetric supply shocks, fiscal policy coordination is likely to aggravate the policy conflict between fiscal and monetary policy: if there is a negative such shock, fiscal policy aiming at stabilising output will become too expansive, whereas monetary policy aiming at price stability will be too contractionary. Somewhat paradoxically, fiscal policy coordination is most beneficial in the Nash equilibrium case when macroeconomic shocks are asymmetric. The explanation is that such shocks will not trigger monetary policy adjustments to the extent that the euro area aggregates are not affected. This means that no welfare losses arise because of the lack of coordination between fiscal and monetary policy responses.

Jürgen von Hagen and Susanne Mundschenk also analyse the joint problems of coordination of national fiscal policies and coordination of aggregate fiscal and monetary policies in the EMU in their paper on *The Political Economy of Policy Coordination in the EMU*. The authors point to the fact that the coordination problems arise because of the preoccupation of policy makers with short-term macroeconomic policy objectives. If policy makers were only concerned with the long-run perspective, the ECB price stability target and the long-run requirements on fiscal discipline embodied in the Maastricht Treaty and the Stability and Growth Pact would suffice as coordination devices. Because aggregate demand policies have no long-run effects on output, no policy conflicts are likely to arise between fiscal and monetary policy in this case. But in the short term, the situation is different, as fiscal and monetary policy then influence both output and inflation. Von Hagen and Mundschenk stress the risk that uncoordinated national fiscal policy makers, aiming at high output, will stimulate demand too much, thus forcing the ECB to adopt a contractionary monetary policy stance. The outcome is an inefficient combination of policies.[1]

Von Hagen and Mundschenk conclude that in situations with large marcroeconomic shocks, there is a need for enhanced coordination both between national fiscal policies and between aggregate fiscal policy and monetary policy in the euro area. At the same time, the authors argue that existing coordination mechanisms are too weak. The fiscal policy rules in the Maastricht Treaty and the Stability and Growth Pact have been designed to maintain long-run fiscal discipline, but do not aim at coordinating aggregate demand policies. In the authors' view, the Broad Economic Policy Guidelines are not focused enough on the specific needs for fiscal policy coordination in the euro area and involve too loose commitments. Also, the article argues that there is a lack of appropriate mechanisms for coordinating the joint fiscal policy stance of the EMU countries and ECB's monetary policy.

[1] If the ECB targets price stability unconditionally, fiscal policies will be unable to influence aggregate output in the euro area at all. Instead, fiscal policies can only affect the distribution of output between countries, so that governments become involved in a purely distributive game.

3. Tax policy

In his paper *Tax Coordination in the European Union: What Are the Issues?, Peter Birch Sørensen* analyses the case for coordination (harmonisation) of tax policies. The issue here is the social efficiency aspects of taxes.

Sørensen focuses on two types of taxes with mobile tax bases: indirect taxes and capital income taxes. In theory, it is possible to avoid that tax differentials among countries cause distortions to the location of economic activity. This requires that indirect taxes are levied according to the destination principle (i.e. in the country of final consumption) and capital taxes according to the residence principle (i.e. in the income earner's country of residence). However, because of monitoring problems in connection with cross-border shopping, some consumer goods are taxed in the country of origin rather than in the country of destination. Similarly, monitoring problems imply that the residence principle is difficult to apply in capital income taxation. Therefore, differentials in tax rates among countries tend to cause producer price differentials that lead to an inefficient allocation of production.

Sørensen's analysis provides strong arguments for harmonisation of both indirect taxes and the corporation tax, as well as for a systematic exchange of information on the capital incomes of citizens in the EU. The paper estimates the welfare gain of a harmonisation of capital income taxes within the EU to around 0.4 percent of GDP, but concludes that some countries will be winners and some losers from such a reform. Sørensen also analyses the welfare effects of a coordinated rise in capital income taxes that is used for lowering labour taxes, but here the results are very sensitive to the exact assumptions made.

4. Employment policy

The last paper in the volume has been written by *Richard Jackman* on *The Pros and Cons of a Common European Employment Policy*. The issue is the case for coordinating structural employment policies, i.e. the design of labour market institutions, such as employment protection, minimum wages, unemployment insurance, etc., among the EU countries.

Jackman sees several requirements for a common employment policy to be justified: the existence of significant spillover effects among countries, shared policy objectives, and a consensus on the appropriate means for achieving these objectives. On the whole, he remains very sceptical as to whether these requirements are fulfilled. He emphasises that the differences in labour market institutions among countries are likely to reflect "different national values" when it comes to the trade-off between generating jobs and protecting the interests of existing employees. A key conclusion is that the changes in the direction of more flexible labour markets that have occurred in Europe—albeit to different degrees in various countries—have weakened the case for employment policy coordination, because differences among countries in labour market regulations, providing the employees with various benefits, will be reflected in compensating differentials in wage levels to a larger extent than in the past.

5. Discussion

Which conclusions on the desirability of macroeconomic policy coordination can be drawn from the articles in this volume? My own conclusions are as follows.

On the one hand, there is a risk that the full benefits of European integration are not exploited because there is too little coordination in certain areas, with the consequence that spillover effects among countries are neglected. Here, a crucial analytical problem is to understand how enhanced coordination in some areas affects the benefits and costs of coordination in others. Such an analysis must, of course, focus on the consequences of monetary unification.

On the other hand, there is also a risk that coordination could go too far without a proper analysis of the case for it, just because enhanced coordination appears to be a politically natural next step in an ongoing integration process. It may also be tempting for politicians to signal the importance of particular issues by elevating them to the European level, even if this cannot be motivated by an improvement of the decisions.

When judging the pros and cons of macroeconomic policy coordination, the following general factors are crucial.

1. *The existence of spillover effects ("externalities") among countries.* Only if there are such spillover effects of policies in one country on others will the optimal policies differ between coordination and non-coordination. The choice of appropriate policies under coordination then requires that both the sign and the approximate magnitude of these "externalities" can be identified.

2. *The scope for ex post evaluation and monitoring* of the policies of individual countries. Unless the actual policies conducted can be effectively monitored ex post, coordination is difficult to sustain, as the incentives for free-riding will be strong.
3. *The efficiency of the decision-making process.* The decision-making process can be affected in several ways by coordination. Even if there are, in principle, gains from coordination, there may still be a net loss if the decision-making process is much more inefficient at the European than at the national level. This could occur through several mechanisms.
   - *Coordination costs* may be high, because agreement at the European level could require drawn-out negotiation processes that consume scarce decision-making capacity. This is especially the case if coordination involves complex decisions on a number of different policy parameters. As coordination of macroeconomic decision making has to involve the key national decision makers, an opportunity cost arises because there is less decision-making capacity left for other decisions (at the national level), so that the quality of these decisions may deteriorate.
   - *The quality of decisions at the European level could be lower than at the national level.* One reason is that decision making at the European level involves negotiations in a large and heterogeneous group, where each country representative has his own national constituency, and where "technical" judgements may play a smaller role than nationally. There is also the risk that decision lags become longer with coordination, because the number of decision makers involved increases. On the other hand, political blockings because of interest group pressure might arguably play a smaller role at the European than at the national level.
   - *Accountability* may be lower at the European than at the national level, because it becomes more difficult for voters to see who bears responsibility for decisions when these are the outcome of an international negotiation process rather than the sole responsibility of an individual national government. Such lack of accountability is likely to worsen the quality of decision making.
4. *The room for experimenting with different policies.* Even if conditions are similar in different countries, there is always a case for experiment-

ing with different policies in view of the uncertainty of the effects. So it may be important for the accumulation of knowledge of which policies work and which do not that there is enough diversity of policies among countries. In principle, coordination efforts can, of course, take this into account by focusing on comparisons of "best practice". But there is a risk that coordination leads to more uniform policies because certain views become dominating.

5. *The possibility to take the specific conditions in individual countries into account.* The potential benefits of coordination must be traded off against the risk that insufficient attention is paid to country-specific conditions. In theory, policies may be coordinated among countries in the sense that the spillover effects on others are taken into account, at the same time as policies are allowed to differ optimally depending on country-specific circumstances. In practice, coordination may cause a strong tendency towards similar policies, because this facilitates decision making. A parallel is the strong tendency towards similar wage increases and a compression of wage differentials that has characterised most systems of nationally coordinated wage bargaining.[2]

Obviously, these considerations apply differently in different areas of macroeconomic policy making. The centralised *monetary policy* in the EMU means that care is automatically taken of spillover effects, at the same time as the accountability is reasonably clear (although it would be even clearer if the minutes of the meetings of the ECB´s Governing Council as well as the voting records were published). On the other hand, there is just one monetary policy for the whole euro area, so there is no scope for taking the conditions in different countries into account or experimenting with alternative policies in different countries. The centralised decision making should make for a high quality of decisions, although the size and diversity of the Governing Council may emerge as a growing problem, as discussed by Baldwin, Berglöf, Giavazzi and Widgren in their paper.

When discussing *fiscal policy*, it is important to distinguish between coordination with the aim of maintaining long-run fiscal discipline and coordination of fiscal policy as a stabilisation policy tool. There is a strong case for the rules in the Maastricht Treaty and the Stability and Growth Pact, which have the objective of ensuring long-term

[2] See e.g. Calmfors et al. (2001), Ch. 3.

budgetary discipline. Here, it is clear that persistent excessive deficits in one member state have negative spillover effects on other states. Monitoring is also relatively simple. The need to observe the fiscal policy rules at the EU level have clearly helped to improve the national decision processes on budgetary policies by adding external monitoring as an additional counterweight to the forces working in the direction of lax fiscal discipline.[3]

In my view, the case for enhanced coordination of discretionary fiscal policy action as a demand management tool is, however, rather weak.[4] A first problem concerns the spillover effects. Although there exists a large literature identifying various such effects, there is no consensus on the net sign of these "externalities".[5] For example, the positive "externalities" of a fiscal expansion in one country on other countries due to demand spillovers via trade linkages can be counteracted by negative demand effects, because of an appreciation of the euro exchange rate and an increase in the interest rate, as well as by the negative externalities from terms-of-trade effects (which make the goods of a country where aggregate demand increases more expensive for consumers in other countries). If economists are uncertain about the sign of the net externalities, how are policy makers then to know in which direction the fiscal policy stance should be changed under coordination? This raises the question of what use there is of coordination if one does not know what to do with it.

There is also reason to doubt the efficiency of the decision-making process that enhanced coordination of fiscal stabilisation policy would entail. The coordination costs are likely to be substantial. One reason is that effective coordination would have to involve more than just agreeing on budget targets, as different changes in taxes and expenditures may have very different demand effects. As regards the quality of decisions, a well-known criticism against the use of discretionary fiscal policy at the national level to stabilise the economy is the existence of long decision lags. This problem is likely to be seriously exacerbated by efforts of coordinating fiscal policies among countries, because it adds an extra level of bargaining that must interact with the national processes. Coordination also dilutes accountability, as it be-

[3] See Calmfors et al. (1997) for a more extensive discussion.
[4] A similar judgement was made by the Swedish Government Commission on Stabilisation Policy for Full Employment in the Event of Swedish Membership in the Monetary Union (see Stabiliseringspolitik i EMU, 2002).
[5] See Andersen (2002) for a survey.

comes less clear who is responsible for the national fiscal policy stance when it is subject to coordination at the European level.

Finally, with a common monetary policy, there is a greater need for using national fiscal policy for stabilisation purposes in the event of asymmetric shocks. A coordination process that makes it more difficult to quickly adjust national fiscal policy to country-specific developments is therefore not desirable.[6]

In my view, the case for enhanced coordination of *structural employment policies*, i.e. the design of labour market institutions, is also weak. The arguments are similar to the ones above about coordination of fiscal policy as a demand management tool. As in that case, various spillover effects can be identified, but the sign of the net externality is unclear. On the one hand, labour market reforms in one country that reduce its wage costs will cause a reallocation of capital that harms other countries. But on the other hand, the reduced wage costs imply a terms-of-trade effect that makes the imports of other countries cheaper, which is beneficial to them. So again, it is difficult to know how coordination should affect policy.[7]

Another important argument is related to decision-making efficiency. Because labour market institutions differ fundamentally among countries, the coordination costs are probably very large. They will also be large because different judgements on the effects of various institutional changes are likely to be made in different countries, and because policy makers in different countries are likely to have very differing preferences on how to trade off job creation versus the protection of the already employed. There is also a risk that coordination of employment policies and attempts at formulating a common European policy are used by national governments mainly as an arena for domestically scoring political points: there is a strong incentive for governments to try to gain common acceptance at the European level of the policies that are already pursued domestically, in order to convince the national electorate of their appropriateness.

The argument about the benefits of experimenting with different policies in different countries would also seem to carry much weight in the case of structural employment policy. The reason is the difficulty in analysing the effects of various labour market institutions from time series data only. Much of our empirical knowledge about

[6] See Stabiliseringspolitik i valutaunionen (2002).
[7] See e.g. Fukushima (2002).

the effects of various labour market institutions derives from differences among countries.

A conceivable argument in favour of coordination of employment policy is that it might facilitate labour market reforms by adding external peer pressure in a similar way as the fiscal policy rules at the EU level helped strengthen the incentives for fiscal discipline in the 1990s. But it is as probable that the same interests that bloc labour market reforms at the national level will also assert themselves at the EU level. For example, it has been claimed that trade unions that have lost political power nationally are trying to make up for this by establishing a stronger influence at the EU level. To the extent that politicians see a need to strengthen the legitimacy of the EU and its institutions, it may be tempting to accommodate these attempts by involving unions in EU policy making to a larger extent.[8]

So the upshot seems to be that the arguments for further coordination of employment policies are weak. This is not to deny that there are gains to be had from the present "open coordination" in the employment field involving, for example, evaluation of national employment plans, comparisons of "best practice", etc. Nor is it to deny that there may be gains from coordinating the *timing* of various reforms that work to reduce wage pressures, because this would reduce the aggregate rate of inflation in the euro area and thus induce the ECB to cut interest rates. As a consequence, the positive employment effects of such labour market reforms would come more rapidly, which would serve to enhance the incentives for them.

As for *tax policy*, large social efficiency losses are obviously associated with differential tax rates on internationally mobile tax bases. The question is whether the best way to harmonise such tax rates is through tax coordination or tax competition. Here, the answer depends on one's view on whether there are important "distortions" in the political process determining tax policies. The paper by Peter Birch Sørensen and the comment by Hans Vijlbrief and Jan Koenan arrive at very different conclusions on this issue.

My interpretation of the reasoning above is that there is a strong case for rules at the EU level to ensure long-run budgetary discipline. There appear, however, to be much weaker arguments for more coordination of fiscal policy as a stabilisation policy tool and of structural employment policy. The case for coordination of tax policy is

[8] See Crouch (2000), Calmfors et al. (2001) Ch. 6, and Calmfors (2002).

more difficult to judge. However, as shown by the articles and comments in this volume, there exist very differing views on all these issues.

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