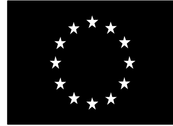
EUROPEAN PARLIAMENT



Directorate General for Research

WORKING PAPER

THE COORDINATION OF NATIONAL FISCAL POLICIES IN THE CONTEXT OF MONETARY UNION

Economic Affairs Series

- E-6 -

FOREWORD

At the request of the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy, this study has been carried out by the Economic Affairs Division of Parliament's Directorate General for Reasearch.

The objective is to provide Members of the Parliament, and others, with background briefing on fiscal policy issues arising from Economic and Monetary Union. The main conclusions are summarised in the final section.

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1. INTRODUCTION

The European monetary union coming into existence at the beginning of 1999 will have a particular feature "unique in history": "a single monetary policy coupled with a largely decentralized fiscal policy"[1].

At the time of the Maastricht Treaty, less attention was devoted to this aspect of the proposed system than to the initial qualifying criteria. As the day of decision drew nearer, however, worries also grew about the potential for conflict between the two policies. The proposal from the German Finance Minister, Theo Waigel, to add a "stability pact" to the existing Treaty provisions was one consequence of such worries.

Theoretically, conflict might be limited in a number of ways.

- There might be an increase in the Community Budget from its present level of about 1.2% of GDP to a level of around 7%, as recommended by the MacDougall Report in 1977. This would allow the congruent conduct of monetary and fiscal policies at Community level, and make possible significant budgetary transfers in the event of country-specific difficulties. Existing models indicate that Member States might then enjoy a very high degree of autonomy in their own domestic fiscal policies[2].

- National fiscal policies might be subject to fixed constraints, designed to prevent divergence from monetary policy objectives. The Treaty, indeed, already contains a number of such constraints in order to prevent any undermining of the stable money objective. First, the "excessive deficits procedure" (Article 104c and Protocol 5) sets "reference values" for national budget deficits (3% of GDP) and overall public debt (60% of GDP). Secondly, the Treaty also contains the three "golden rules" on deficit financing (Articles 104 to 104b): no privileged access to savings, no bail-out and no monetary financing.

- Finally, there might be voluntary coordination of national fiscal policies, both to handle cross-border spillovers and to make possible an "aggregate budgetary stance" for the Community as a whole. The framework for such coordination already exists, in part, in the "multilateral surveillance" procedure outlined in Article 103 of the Treaty, which has been in operation since 1990. This Article also requires Member States to treat their economic policies as a matter of "common concern".

Unfortunately, there are also major problems.

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[1] "Stable money - sound finances: Community public finance in the perspective of EMU" (*European Economy No.53, 1993)*

[2] See Chapter 3, “Public Finance in a system of multi-layer government” in *Stable money - sound finances*. See also “Macro-coordination of fiscal policies in an economic and monetary union in Europe”, by A. Lamfalussy, appended to the “Report on economic and monetary union in the European Community” (*the “Delors Report”, 1989)*.

1.1 Autonomy v. discipline

The very fact of monetary union will remove from national authorities several of the most useful instruments of overall economic policy, notably interest rates and exchange rates. In the event of asymmetric or country-specific shocks, therefore, the only significant remaining tool for stabilization will be fiscal policy. The scale of budgetary adjustments required may indeed prove to be even greater than would be the case outside a monetary union.

To what extent, though, should Member States be free to use even this tool ? The potential conflict between the need for national fiscal autonomy on the one hand, and the need for "discipline" and coordination on the other was certainly recognised at an early stage in the EMU programme. The Commission study *One market, one money* (1990)[3] provides some examples of both temporary and permanent country-specific shocks which would require stabilization through national budgetary policies.

On the other hand, the study took a somewhat restrictive view of where such policies would be justified. It rejected measures of short-term stabilization ("fiscal fine-tuning") as likely to produce "more sluggish adjustment in the longer term". Asymmetry would, in any case, decline as economic integration took place; and "wage-price flexibility" would generally constitute a better vehicle for adjustment than fiscal policy.

1.2 The objectives of fiscal policy

Beneath this conflict there also lie some more basic problems. To begin with, there is by no means full agreement, either theoretical or political, on the role of fiscal policy in the context of wider economic objectives.

The Treaty, it is true, sanctions the primacy of price stability, as well as the assumption that “fiscal consolidation” is essential to achieve it. There nevertheless remains a widespread suspicion that the price of low inflation and the reduction of budget deficits is higher unemployment;[4] and, in consequence, that the Maastricht fiscal criteria are inappropriate at a time when unemployment is high[5].

This is despite two decades during which any idea of a trade-off between inflation and unemployment has been very much out of fashion, and despite continuing assertions that "European unemployment primarily reflects structural problems"[6].

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[3] "One market, one money: an evaluation of the potential benefits and costs of forming an economic and monetary union" *(European Economy, No.44, October 1990)*

[4] At least as the rate of inflation approaches zero. See section 4.6.

[5] See, for example, the remarks of Fiat Chairman Cesare Romiti, reported in *The Times* on 26th August, 1996.

[6] European Monetary Institute Annual Report 1995

Similarly, there is a general belief that current levels of budget deficits and overall public debt are too high, and need to be reduced; and even that budgets should balance over the economic cycle. There are increasing warnings that the prospective level of pension payments in the next century requires most European countries to be aiming for budget surpluses today.

Yet there is less agreement about the practical consequences for individual Member States. As former Portuguese Prime Minister Anibal Cavaco Silva (1996) has pointed out,[7]

> *"the appropriate level of a country's fiscal deficit depends on its economic situation..... and factors such as the rate of private saving and public investment projects".*

In practical terms, as most politicians are aware, monetary union will only be acceptable to the general public if the effects on the *real* economy are seen to be beneficial - or, at the very least, not inimical.

Studies such as that carried out in 1995 for the European Parliament's special committee of enquiry into unemployment[8] have already warned that applying the Maastricht fiscal criteria - to say nothing of the even more stringent Stability Pact - could cost the EU a 0.25% loss of economic growth each year, and over a million fewer jobs by 2002.

To misquote William Jennings Bryan, the whole project will fail if, "the people of Europe are crucified on a cross of Euro-gold".

1.3 Monetary stability and democracy

Finally, there is the problem of creating a system "which permanently rules out fiscal misconduct as a political option for the future"[9]. Though there is no reason to suppose that the European Central Bank would ever be tempted to stray from the path of monetary rectitude - and it is protected by the Treaty from outside pressures to do so - the same cannot be said of finance ministers. These are responsible to national parliaments, which are, in turn, responsible to national electorates. If the people vote for a particular policy, who has the right to overrule them?

The so-called Eurosceptics are therefore not entirely wrong in warning of the inherent dangers to the European construction of a potential clash between the forces of democracy and the forces of monetary stability: the "imbalance", as *Bundesbank* Council member Otmar Issing puts it,[10]

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[7] *Financial Times,* Friday 3rd May 1996

[8] *The Employment Effects of the Maastricht Fiscal Criteria* by R.Barrel, R.Morgan and J.Pain (NIESR for the European Parliament, Working Document E2, 1995).

[9] The concluding words of Otmar Issing's recent paper, "Europe: Political Union through Common Money?" *(Institute of Economic Affairs, London, February 1996)*

[10] *op. cit.* p.2. The author is now a Member of the European Central Bank's Executive Board.

"between full economic and monetary union on the one hand, and rather rudimentary general political union on the other..."

This *political and institutional* dimension of the centralised monetary/decentralised fiscal policy dilemma requires addressing as much as the economic.

2. WHAT THE TREATY SAYS

The 1989-90 Inter-Governmental Conference on Economic and Monetary Union, which met separately from the general IGC. It was responsible for those parts of Maastricht dealing with EMU, and broadly accepted the need for some Treaty provisions covering fiscal as well as monetary policy. At the very least, the IGC recognised, there would have to be safeguards against a participating Member State running up a huge public debt, financing it by "printing money", and so debauching the entire system.

There was less agreement, however, on the best way of achieving such safeguards. One (majority) school of thought advocated specific Treaty limitations on the size of budgetary deficits, backed if necessary by sanctions. A second school argued that this was unnecessary: the *size* of budgetary deficits was less important than *how they were financed*. Given the right financial framework, market forces would provide the required safeguards against irresponsibility.

In the event, the authors of the Treaty adopted a "belt-and-braces" approach: the final text included the provisions advocated by *both* schools. were included in the Treaty. Limitations were placed on "excessive" deficits, so providing the belt. At the same time, the Treaty restricted the methods of financing *all* deficits ("excessive" or otherwise): the braces of the "golden rules" in Articles 104 to 104b..

The inclusion of effective upper limits on budget deficits, rather than reliance on market forces alone, reflected the opinion of the "Committee for the Study of Economic and Monetary Union", which published the "Delors Report" in 1989[11]. Market perceptions, it argued,

> "*do not necessarily provide strong and compelling signals and... access to a large capital market may for some time even facilitate the financing of economic imbalances...Market views about the credit-worthiness of official borrowers tend to change abruptly and result in the closure of access to market financing". Hence "the constraints imposed by market forces might be either too slow and weak or too sudden and disruptive*"[12].

2.1 The "excessive deficits" procedure (Art. 104c)

Accordingly, Article 104c of the Treaty enjoins Member States to "avoid excessive government deficits". It also empowers the Commission to "monitor the development of the budgetary situation and the stock of government debt in the Member States" in order to identify "gross errors". "Compliance with budgetary discipline" is judged against the 3% and 60% "reference values" fixed in the annexed Protocol 5 (see Diagram 1).

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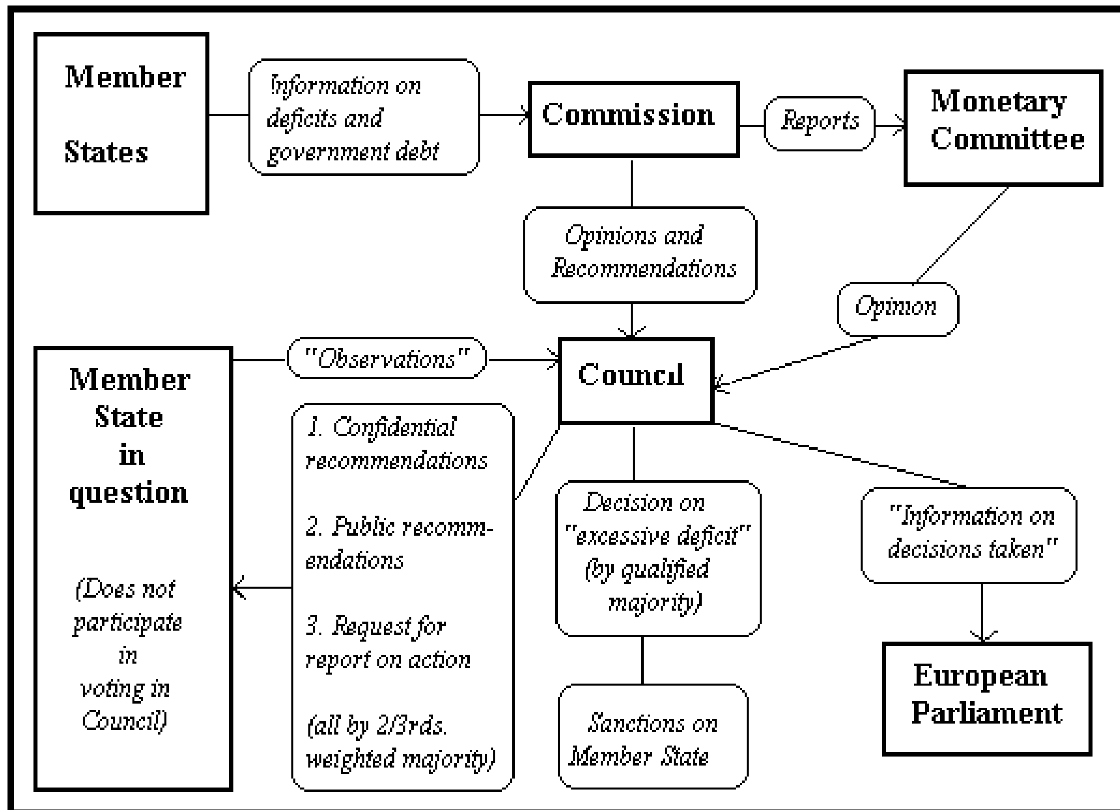
[11] "Report on Economic and Monetary Union in the European Community" *(Office of Publications of the EC, 1989)*

[12] *op. cit.* p. 24

Diagram 1: The "excessive deficits" procedure



Much discussion has already taken place as to how stringently these limits are to be interpreted - largely because the existence or not of an "excessive deficit" is one of the criteria for participation in the Single Currency under Article 109j. The procedure, however, is intended to form a permanent feature of EMU. Indeed it is entirely possible that it will apply with different degrees of flexibility to the *establishment* of the Single Currency and to its subsequent management.

The Treaty texts certainly provide scope for flexibility.

- The 3% ceiling applies to "planned or actual" government[13] deficits. These are calculated on the basis of the actual borrowing necessary on the capital markets - that is, the Public Sector Borrowing Requirement (PSBR) - rather than the statistical difference between expenditure and revenue, since the latter are defined in slightly different ways in different countries.

- It does not apply if *either* the ratio "has declined substantially and continuously and reached a level that comes close to the reference value; *or* "the excess over the reference value is only

[13] "Government" is defined in Protocol 5 as "general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts." Further information is given in the "detailed rules and definitions" adopted under Article 104c(14): i.e. Regulation (EC) 3605/93 of 22.11.93 (*OJ L332 of 31.12.93*). This Regulation also outlines procedures for the reporting of actual and planned deficits by Member State governments.

exceptional and temporary and the ratio remains close to the reference value".

- The 60% ceiling does not apply if "the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace".

- When deciding whether deficits are excessive, the Commission must take into account

    - "whether the government deficit exceeds government investment expenditure"; and

    - "all other relevant factors, including the medium-term economic and budgetary position of the Member State".

- The Monetary Committee (now the Economic and Finance Committee) gives its opinion, and the matter then goes to Council.

- The Member State concerned is at this stage able to put its own case.

- Finally, the Council, voting by qualified majority, decides whether an excessive deficit exists or not.

This decision taken, the Treaty outlines a possible scenario of increasing pressure on the offending Member State.

The Council would first make confidential recommendations for action. If this did not work, the recommendations would be made public. The next step would be a more explicit demand from the Council that the Member State take deficit reduction measures within a specified time-limit. There would be no right of appeal to the Court.

Continued failure to comply would trigger sanctions. The Member State might be required to "publish additional information, to be specified by the Council, before issuing bonds and securities". The European Investment Bank might be "invited... to reconsider its lending policy". The Member State might be required to "make a non-interest-bearing deposit of an appropriate size with the Community". Finally, fines might be imposed.

It is worth remarking that the Treaty envisages keeping these distasteful procedures very much "within the family": all action would be determined within the Council by the offending Member State's peers. Decisions there would by a majority of two thirds of the weighted votes of its members, *excluding* the offending Member State.

In the early stages, the details would be effectively secret. The only reference to the Parliament is the short provision that "the President of the Council shall inform the European Parliament of the decisions taken".

2.2 "Golden rule" one: no monetary financing (Art. 104)

One of the most effective ways to reduce the level of public debt as a percentage of national GDP is simply to inflate the currency. Governments have made use of this solution from the earliest days: emperors and monarchs found an apparently easy way out of their financial problems in repaying debts in debased or "clipped" coinage. Paper money has provided even greater scope for what Adam Smith described as the "avarice and injustice of princes and sovereign states"[14].

A number of conditions are nevertheless necessary for such "monetisation" of debt to work. The authorities concerned must enjoy a substantial degree of monopoly power in the creation and sanctioning of the currency concerned (it is no accident that the power to create money is considered a fundamental aspect of "national sovereignty" by those opposed to EMU).

Above all, however, the authorities need to exercise restraint. Up to a certain point, savers in the past appear to have tolerated the erosion of their savings in this way, even to the extent of accepting significantly negative interest rates. This has been because investors lending money to the state can at least be certain that they will be repaid the *nominal* value of the loan - if the state finds itself short of revenue to repay the loan, it can always create the necessary cash.

Beyond this point, however, the road to a complete collapse of public finances slopes steeply downwards. The certainty of repayment will no longer impress lenders, because the very act of repayment through money-creation will have made the nominal sum worthless by the time they get it.

The authors of the Maastricht Treaty decided to shut off the road completely. Article 104 prohibits "overdraft facilities or any other type of credit facility" with the European Central Bank or the Central Banks of Member States in favour of any Community body or national public authority or undertaking.[15]

2.3 "Golden rule" two: no privileged access (Art. 104a)

Governments facing a critical debt situation have found it useful, in addition to exercising monopoly power over money-creation, to exercise powers of coercion over domestic savers: for example, by preventing them from taking their savings out of the national jurisdiction (exchange controls), or by obliging them - or making it a "public duty" - to invest in government securities.

Article 104a of the Treaty therefore also limits the ability of public authorities to fund their deficits by "privileged access" to financial institutions. This is defined as "any law, regulation or other binding legal instrument" which:

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[14] *The Wealth of Nations,* Chapter IV, “Of the Origin and Use of Money”.

[15] These terms are defined in Regulation EC no. 3603/93 *(OJ L332 of 31.12.1993)*, which also provides for certain exceptions (for example, funds for managing foreign exchange reserves)

- obliges financial institutions to hold public sector liabilities; or
- encourages them to hold such liabilities by providing tax advantages.

The European Monetary Institute's Annual Report for 1994 observed that most Member States had already abolished "measures which could be construed as a form of privileged access". This had taken place in the context of the liberalisation of capital movements and of growing competition in the financial services sector.

Clearly, however, the provision does not entirely close down the ability of national authorities to "capture" domestic savings in order to finance public debt. Regulation 3603/93 specifically excludes from the provisions of Article 104a obligations for funding social housing, and the centralised funds of public credit institutions intended to ensure the financial security of savings schemes "designed for households".

Given that the encouragement of private saving, in particular through tax incentives, is a generally accepted objective, the absolute elimination of such schemes would be politically very difficult. However, their "privilege" effects *can* be largely removed by providing equivalent tax incentives for investment in the private sector[16].

2.4 "Golden rule" three: no bail-out (Art. 104b)

It might be thought that the operation of the "excessive deficits" procedure outlined in Article 104c would effectively prevent any Member State in the Euro area reaching a point where it could no longer fund its public debt. The Treaty nevertheless envisages that this might happen (perhaps because the financial penalties envisaged in the "excessive deficit" procedure themselves might precipitate a budgetary crisis.) What should then be done?

Article 104b covers such an eventuality. It provides that the Community shall "not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State.." The same rule applies *between* Member States.

In other words, if a country participating in the Euro area finds that it can no longer fund its debts, it will be allowed to default. Given this knowledge in the markets, any Member State approaching an unsustainable debt position will find its credit rating falling and be obliged to pay an increasing "default premium" on its borrowings.

However, the credibility of this "golden rule" has already been the subject of some doubt. Would the European Union really allow one of its Member States (or even a regional or major local authority) to repudiate "sovereign debt"? Such a default could have considerable spill-over effects, as holders of the debt in other Member States were themselves faced with insolvency.

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[16] As, for example, is the case with the various "PEP" schemes in the UK.

There would be pressure, both political and financial, to organise a "rescue package", or to soften the overall monetary stance and permit some monetisation.

Unfortunately, even a suspicion in the markets that the "golden rule" might be broken would largely nullify its effect. A Member State in a theoretically unsustainable debt position might nevertheless find itself still able to borrow, though at very high rates of interest, and at very short term. The *locus classicus* of this situation is the New York debt crisis of 1975, when the "bankrupt" City was able to continue operating by rolling over the mounting debts at shorter and shorter intervals.

The conclusion drawn by the Commission study *One Market, One Money*[17] was that at least two further "golden rules" might be needed:

- markets should have full information on the state of public finance; and
- the maturity of government debt should not be too short.

Even then, the study observed, "the record of markets in assessing the degree of government default risk is disputed".

2.5 Convergence (Art.109e, para 2)

Stage II of EMU began, on the 1st January 1994. In preparation for the move to Stage III, member States were then required do "adopt", where necessary, appropriate measures to comply with the prohibitions laid down in.... Articles 104 and 104a(1) - that is, "golden rules" one and two.

The same Article (109e) also laid down that each Member State should adopt "multi-annual programmes intends to ensure the lasting convergence necessary for economic and monetary union." In particular, these were to relate to "price stability and sound public finances". The Council has been required to assess the extent of convergence on the basis of a report from the Commission - again "in particular with regard to price stability and sound public finances".

After the January 1999, it is intended that the procedures should be strengthened:

- under the Stability Pact, those countries in the Euro area would be required to produce rolling, three-year "stability programmes" (see Section 3.1);
- under the most recent Commission proposals[18] those countries classified as "pre-in" would be required to submit new convergence programmes before the beginning of 1999, and to update them every year thereafter.

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[17] See page 111.

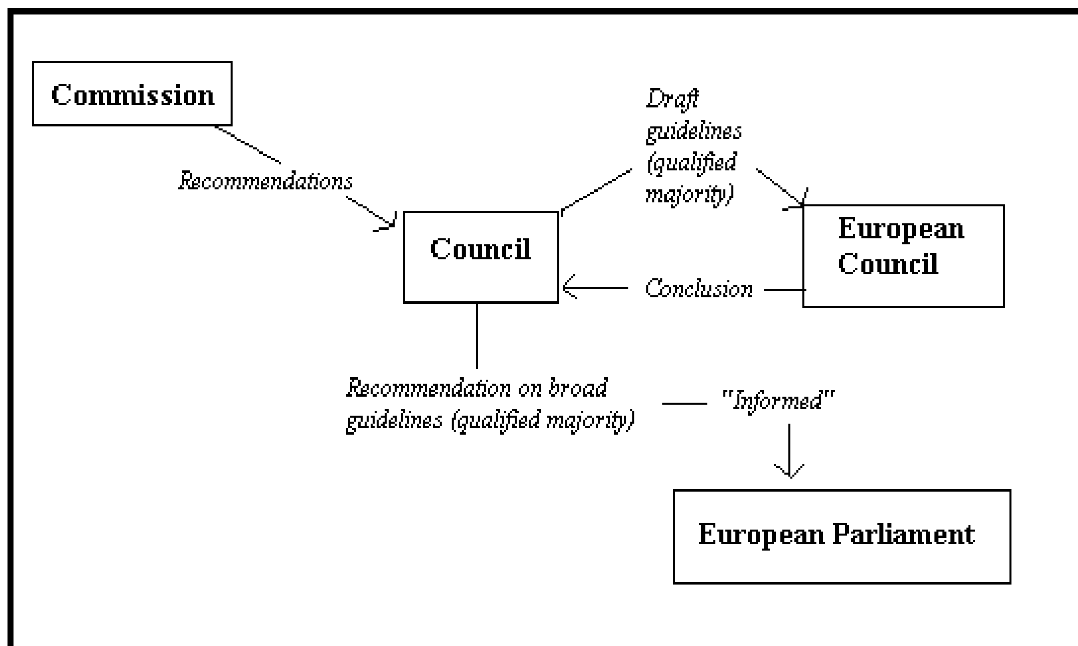
[18] "Reinforced Convergence Procedures and a New Exchange Rate Mechanism in Stage Three of EMU" *(Communication from the Commission to the Council, COM(96)498 final of 16.10.1996).*

The convergence programmes for the "pre-ins" would have to pay especial attention to the deficit and debt ratios, with a "clearly-specified multi-annual adjustment path." They would have to be in a common format so as to ensure a comparable standard against which to judge performance. The Council would then be required to complete its examination of each convergence programme within a month of its submission. The performance of each Member State would be monitored, and "major slippages" identified. The progress achieved by a "pre-in" towards its convergence objectives might be used as reference in deciding on the sustainability of that country's central exchange rate against the Euro within the new Exchange Rate Mechanism.

2.6 Policy coordination and "multilateral surveillance" (Art. 103)

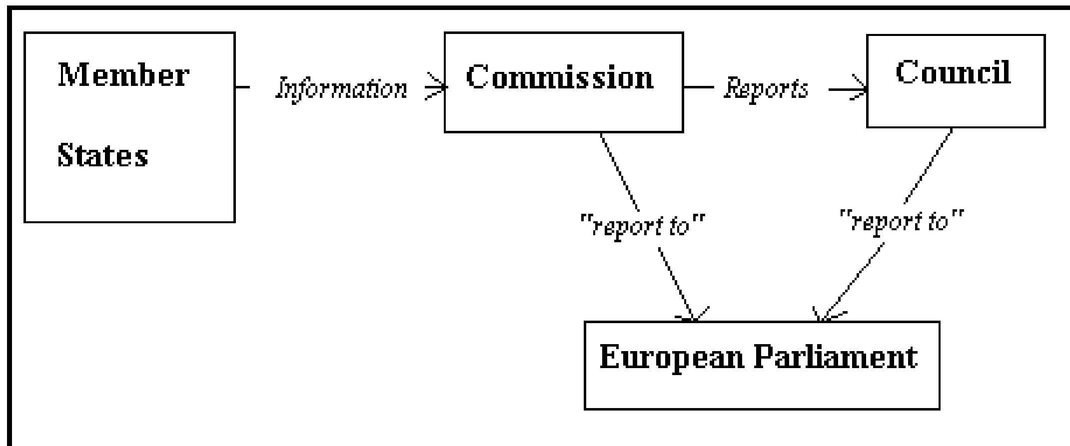
All Member States, under Article 103 of the Treaty, are under an obligation to "regard their economic policies as a matter of common concern", and to "coordinate them within the Council". Among the objectives is the "sustained convergence of the economic performances of the Member States".

Diagram 2: The "broad guidelines" procedure (Article 103.2)



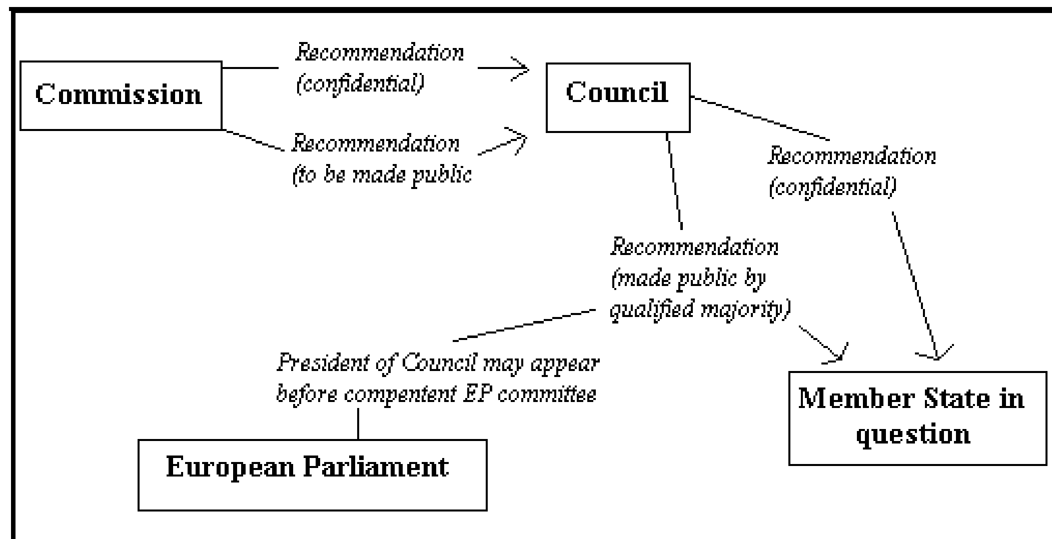
The Article also establishes a procedure for laying down "broad guidelines" for economic policy. On a recommendation from the Commission, draft guidelines are prepared by ECOFIN for consideration by the European Council (i.e. the Heads of State and Government). On the basis of the European Council's "conclusions", the Council can then vote a "recommendation", setting out the broad guidelines. The European Parliament is informed of any decisions (see Diagram 2). As part of this procedure, the Commission is empowered to act a kind of "clearing house" for information on Member States' policies. On this basis ECOFIN is operates a system of "multilateral surveillance" over economic developments (see Diagram 3).

Diagram 3: "Multilateral surveillance": monitoring (Article 103.3)



Where a Member State's policies are "not consistent with the broad guidelines", or where they "risk jeopardizing the proper functioning of economic and monetary union" the Council can "make the necessary recommendations" (see Diagram 4).

Diagram 4: "Multilateral surveillance" - admonition (Article 103.4)



The Council can also vote to make these recommendations public. In this event, the President of the Council may be asked to appear before the European Parliament's competent committee. Otherwise Parliament is only entitled to reports on "the results of multilateral surveillance".

In relation to the fiscal policies of Member States, multilateral surveillance appears to provide not only a *monitoring* procedure, but also an *admonitory* procedure to operate in parallel with the *disciplinary* "excessive deficits" procedure of Article 104c. The Broad Economic Policy Guidelines of June 1996, for example, take Member States to task because the strategy outlined in previous guidelines (notably fiscal consolidation) "has been implemented with insufficient vigour and credibility".

Once EMU Stage 3 has begun, multilateral surveillance will operate at two levels.

- The procedures already in operation for *all* Member States of the EU will continue, and provide one mechanism for coordinating the monetary, fiscal and general economic policies of the "in" and "out" countries. In particular, they will have the objective of helping the "outs" to achieve sufficient convergence to become "ins".

- At the same time, it is likely that much more intensive procedures will be required in relation to those Member States within the Euro area (see Section 3.1).

2.7 Financial Assistance (Art. 103a).

Article 103a, which has essentially been carried over from previous versions of the Treaty, provides a "catch-all" legal base for various measures in the event of a Member State getting into "severe difficulties caused by exceptional circumstances beyond its control". Paragraph 1 empowers the Council do decide unanimity upon"measures appropriate to the economic situation". Paragraph 2 similarly empowers the Council to grant, by unanimity, Community financial assistance; or, where the difficulties are caused by natural disasters, to decide by qualified majority. In the event of the later, the European Parliament is once again informed "of the decisions taken".

The relevance of these provisions to the conduct of fiscal policy is not perhaps direct (paragraph 1 refers particularly to difficulties arising "in the supply of certain products"). They are likely to be relevant, however, when a decision has to made upon a member State having a persistent "excessive deficit".

Depending upon the degree to which the circumstances are then considered "exceptional", the Member State might find itself in receipt of Community funding under Article 103a - or, finally, obliged to make a non-interest-bearing deposit, or even fined, under the provisions of the Stability Pact (see Sections 3.3.1 and 7.2.2).

2.8 Conclusions

The Treaty therefore contains, at first sight, a formidable array of instruments for ensuring that the fiscal policies of Member States are aligned with the EU monetary policy objective of price stability. A government intending to run a budget deficit must first run the gauntlet of the "excessive deficits" procedure. The "golden rules" then block a number of avenues for funding the deficit: the deficit cannot be monetized; financial institutions cannot be compelled or bribed to buy government bonds; and the markets will be wary of lending to a country where there is a risk of default.

Yet would all this be enough in the face of a government determined to follow an alternative policy? Such a government - particularly if it had a democratic mandate behind it - might accept the financial sanctions imposed by the "excessive deficits" procedure, and argue that they were

merely exacerbating the problem. Lack of belief in "no bail out" might still make it possible to borrow on world markets. It has been pointed out, for example, that the "no bail-out" rule does not prevent countries from coming to the aid of a Member State in difficulties through the purcahse of its debt in the secondary market.

In these circumstances, the other members of the Euro area would be faced with a difficult situation. There would be difficulties in obtaining a majority in Council for action of any kind. There would be difficulties in obtaining a majority in Council for action of any kind.

In effect there would be a choice between:

- relaxing the fiscal rules; and the same time, perhaps, putting pressure on the European Central Bank to permit some monetization of the deficit;

- organising a rescue package, or at least making substantial transfers of funds through one or other EU facility (see section 5.1);

- requesting the member State in question to leave the monetary union.

3. THE STABILITY PACT

In 1995 the German Finance Minister, Theo Waigel, put forward detailed proposals for strengthening substantially the excessive deficits procedure. Should a Member State overshoot the target deficit level - which, he suggested, might be reduced from 3% to 1% of GDP - a non-interest-bearing deposit would become automatic and obligatory (under Article 104c, paragraph 11, such a deposit is only an option, and is subject to a decision by the Council). The deposit would be refundable when the deficit fell below the target figure. If this did not happen within a specified time, no refund would take place - i.e. it would become a fine.[19]

ECOFIN and the Commission both gave the proposal immediate, though tentative support. A number of governments were said to oppose fixed targets, preferring a system of "auto-corrective" measures within a nine-month to one-year time-scale, and subject to Council decision.

In June 1996, however, ECOFIN formally decided[20] that the procedures of Article 104c needed to be strengthened, notably by setting "tight deadlines" for the various steps in the procedure, and by "establishing a presumption" that sanctions would follow the persistence of an excessive deficit. The Commission itself began work on a proposal of its own, which was presented to, and broadly approved by, an informal ECOFIN in Dublin on 21/22 September 1996.

The Commission's formal proposals were published on the 16th October 1996, and took the form of a Communication, together with two draft Regulations.

- The first of these covers *"strengthening of the surveillance and coordination of budgetary positions"*, and also implements some of the measures outlined in the Communication[21] on the new Exchange Rate Mechanism (see Section 2.5).

- The second deals with *"speeding up and clarifying the implementation of the excessive deficit procedure"*.

3.1 The Commission Proposals

The Commission's text for the Stability Pact does not entirely follow the original German proposal. The "reference value" for budget deficits remains at 3% of GDP; but this is "to be seen as an upper limit in normal circumstances". National budgetary policies should "create room for manoeuvre in adapting to exceptional and cyclical disturbances", while avoiding excessive deficits. Hence the medium-term budgetary objective is to be "close to balance or surplus": effectively a balanced budget over the economic cycle.

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[19] See European Parliament's EMU Task Force Briefing no. 18, *PE 166.309.*

[20] See Progress Report by the Council to the European Council in Florence: "Preparations for Stage Three of Economic and Monetary Union", *UEM 15, Brussels, 4th June, 1996).*

[21] "Stability Pact for ensuring budgetary discipline in Stage Three of EMU", *COM(96)496, 16th Oct. 1996.*

The Commission sees the Pact as a “twin-track strategy”, providing

- “preventive, early-warning system” for identifying and correcting budgetary slippages before they breach the 3% threshold; and
- a “dissuasive set of rules” to deter Member States from incurring, or failing to correct, an excessive deficit.

3.1.1 The “early warning” Regulation

The first element of this strategy would be a strengthening of the multilateral surveillance procedure (see Section 2.6). While those Member States not yet within the Euro area would continue to produce convergence programmes (see Section 2.5), each Member State participating fully in Stage 3 of EMU would present three-year, rolling “stability programmes”. These would contain:

- an “objective and adjustment path” for budget surpluses/deficits, and forecasts of the government debt ratio;
- the main official forecasts for growth, unemployment, inflation and “other important economic variables”;
- a description of the budgetary measures being taken to fulfil the stability programme; and
- “a commitment to take additional measures when necessary to prevent slippage from targets”.

The first stability programme would have to be submitted before the start of EMU Stage 3 on January 1st 1999. After that, the programmes would be updated annually, and be submitted “not later than two months after the presentation of annual budget proposals by a Member State government to its national parliament”.

The Council would then have two months (as would also be the case for the convergence programmes of those Member States still outside the Euro area) to examine a programme, and, if necessary, to recommend adjustments. The programme would also be examined by the Monetary Committee (which will have become the Economic and Financial Committee at the beginning of 1999). The procedures for confidential, but if necessary public, recommendations would then continue as provided would then continue as provided for under Treaty Article 103.

3.1.2 The “deterrence” Regulation: deadlines

The first purpose of this Regulation is to tighten up the deadlines of the excessive deficit procedure outlined in Treaty Article 104c. Accordingly:

- The Economic and Finance Council (ECOFIN) would have three months following the submission of budget figures by a Member State to decide whether an "excessive deficit" existed (Article 104c(6)), and to issue a recommendation (Article 104c(7)). Council would initially base its judgement on the "official public decisions" by the national government concerned. It would, however, reserve the right to reconsider if these decisions were not actually enacted by the national legislatures within a specified time limit.

- If ECOFIN decided after another four months that no effective action had been taken by the member State in question, it could make the recommendation public (Article 104c(8)).
- Failing action by the offending Member State within one month, ECOFIN could then issue a notice for the Member State to take deficit-reduction measures (Article 104c(9));

- If within another two months no satisfactory measures had been taken by the Member State, ECOFIN would, "as a rule, decide to impose sanctions" (Article 104c(11)).

- The total time between the reporting date for budgetary figures and any decision to impose sanctions would have to be less than ten months.

Diagram 5: the proposed Stability Pact

March	A	May	J	J	A	September	October	N	December	2 years later
Member States report fiscal data*		"Excessive deficit" established by ECOFIN, and recomm-endation made				Recomm-endation may be made public. Member States Report fiscal data*	Possible notice of "specific measures " by ECOFIN		Measures to be implemented by Member State. If not, non-interest-bearing deposit to be made	"Excessive deficit" to be eliminated. Otherwise deposit to be paid into the Community Budget

*Member States are required to submit data in March and September of every year.

3.1.3 The "deterrence Regulation": penalties

The second purpose of this Regulation is to quantify the deposits and fines provided for in Treaty Article 104c, and to make them obligatory. The non-interest-bearing deposits provided for under Article 104c(11) would consist of two elements:

- a fixed sum equal to 0.2% of GDP; and
- a supplement equal to 0.1% of GDP for every percentage point by which the budget deficit exceeded the 3% reference level.

These provisions would, however, be subject to two qualifications:

- ♦ There would be an upper limit of 0.5% of GDP; and

- ♦ If the excessive deficit were due to non-compliance with the government debt criterion (that is, the 60% of GDP reference value), only the fixed sum would be due.

If the deficit persisted two years later:

- ♦ the deposit would become a fine, and be paid automatically into the Community Budget;
- ♦ a new non-interest-bearing deposit would have to be made; and
- ♦ some of the other measures outlined in Article 104c(11) might also be imposed.

3.1.4 "Exceptional and temporary"

The draft Regulation also provides for possible derogations from this procedure if an excessive budget deficit is the result of "exceptional and temporary" circumstances. The Commission believes that this term "can be clarified to a degree". In the draft Regulation a deficit is defined as exceptional and temporary:

> *"when resulting from an unusual event outside the control of the relevant Member State and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn, in particular in the case of significant negative annual real growth".*[22]

There has already been some debate, however, as to the possible scope of the derogation. Those on the side of fiscal stringency have argued that there should be only limited room for interpretation - that is, that the system would be "rule-based" (see Section 7.2). The budgetary consequences of a major natural disaster, for example, might automatically be considered such a circumstance. There is less agreement on the extent to which political and economic developments might be included. The Commission has proposed defining a "severe economic downturn" as a 1.5% to 2% fall in GDP, but admits that "it is unlikely that all possible relevant situations can be covered explicitly".

3.2 The Legal Base

Theoretically, there are several ways is which a Stability Pact might be introduced:

- ♦ The Treaty itself, as amended at Maastricht, might be further amended so as to incorporate the Pact into Articles 103 and 104c. This would require subsequent ratification by national parliaments and, in some cases, electorates.

- ♦ Since the Pact would apply only to those Member States within the Euro area, those

[22] Draft Regulation, Article 1(2)

outside might be excluded from the decisions establishing it. The procedures would be equivalent to those establishing the Schengen area, and probably could not be agreed until after the start of EMU Stage 3.

- ♦ The Pact might be introduced through the provisions for secondary legislation contained in Treaty Articles 103(5) and 104c(14). In the first case the Council acts by weighted majority voting, and the European Parliament is involved through the "cooperation procedure" (Article 189c). In the second, Council must decide by unanimity, and Parliament is only able to give an "opinion".

The Dublin Summit of September 1996 accepted that the third of these options should be used. The Commission successfully argued that the Pact could be achieved within the context of the present Treaty; and that all Member States should participate in the decisions, whether the Pact would initially apply to them or not.

3.3 Arguments for the Pact

The surprising ease with which the Stability Pact has gained acceptance requires some explanation. At the time of the Maastricht Treaty negotiations it was generally believed that the excessive deficit procedure as drafted, together with the "golden rules" on financing deficits, would provide sufficient discipline in Stage 3.

The change of opinion, paradoxically, can be attributed to the extraordinary efforts that are being made to meet the 3% of GDP budget target in the qualifying year 1997. Following the reported refusal of the Spanish Government to join a "Mediterranean lobby" for softening the criteria, both Spain and Italy are now aiming to fulfil the 3% criterion à la lettre. In the case of Belgium, extraordinary executive powers have been invoked to adopt the 1997 budget.

The need to meet the convergence criteria in 1997 is clearly providing a powerful incentive to fiscal rectitude. However, the Treaty does not refer to fiscal figures for one year only, but to "sustainable convergence" (Article 109j(1)). This requirement was behind Bundesbank President Hans Tietmayer's warning on 7th October 1996 against the "breathless short-term effort" of some Member States to squeeze into the "first wave" of EMU Stage 3.

3.3.1 Creative accounting

One cause of disquiet lies in the details of some countries' 1997 Budget proposals. In the case of France, for example, reliance is being placed on a one-off transfer of the pension liabilities of France Télécom, which will have the effect of reducing the projected budget deficit by FF 37.5 billion, equal to 0.5% of GDP. Though the proceeds of privatisation are not supposed to be taken into account, sales of assets by two Spanish state-owned companies is enabling them to pay into the budget a "dividend" equal to 0.2% of GDP. In the case of Italy, some Lire 13,000 bn. of the 1997 budget package (one fifth of the total) is due to come from "treasury operations".

These measures have been widely criticised as "accounting tricks". Since the 3% criterion is defined in reference to the net borrowing requirement rather than the actual revenue and expenditure proposals, they are not strictly inadmissible. On the other hand, they will have no effect on budget deficits beyond 1997. Moreover, they have also created political tensions. Italian Prime Minister Romano Prodi, interviewed by the *Financial Times*[23], has observed that "if the French can get away with fiscal window-dressing, we can show them a trick or two as well".

3.3.2 Spending and taxation

A second cause for concern is reliance on cuts in capital, rather than current expenditure in order to meet the 1997 criteria. Such cuts are likely to constitute only a postponement of spending rather than a permanent reduction of spending levels. They can also damage the long-term prospects of the economy. This matter is examined in greater detail later (see Section 4.5).

The same is to some extent true of tax increases. "One-off" taxation, like the proposed "Europa-tax" on higher incomes in Italy, or the suggested "windfall tax" on privatised utilities in the UK, can obviously have no permanent effects on budget deficit levels.

Finally, the determination of the German government in particular to ensure that "3% means 3.0%, not 3.1%, not 3.2 or 3.5%"[24] is entirely credible when it is a question of a decision, at a particular point in time, on admission or non-admission to the Euro area. The situation could be different, however, once the hurdle has been cleared. The excessive deficit procedure - on the face of it strict - is subject to trade-offs in Council.

After 1999, indeed, the ironic situation might develop that those countries already within the Euro area might be tempted to relax their fiscal stance; but those still attempting to qualify would have to impose the most rigorous discipline. A Stability Pact would make certain that the efforts made to qualify were continued afterwards.

3.4 Problems with the Pact

As against this, there are a number of objections to the Pact.

3.4.1 The credibility of fines

Despite the precision of the procedure for penalising Member States with a persistent excessive deficit, there are reasons to doubt whether sanctions would ever, in practice, be imposed.

In the first place, the imposition of large fines - or even the requirement to make large interest-

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[23] Wednesday, 2nd. October, 1996.

[24] Reported remarks of German Finance Minister, Theo Waigel.

free deposits - on a country whose problem is an excessive public borrowing requirement can only make exactly that problem worse. Under the proposed penalty rules, for example, a country running a budget deficit of over 4% of GDP might be required to find revenue or savings amounting to another 0.3% of GDP in the following year, in addition to the 1% necessary to close the initial budget gap. In biblical terms, it will be "taking away from him that hath not, even that which he hath".

Secondly, the countries concerned are likely to be precisely those which are eligible for EU funding, where economic problems would in normal circumstances trigger extra rather than reduced payments. The tensions which attempts to reverse the flow of funds might create have already been demonstrated in the case of "cohesion fund" payments, which are dependent upon the four Member States concerned (Spain, Portugal, Greece and Ireland) adhering to their published "convergence programmes".

In the case of Spain, the planned deficit for 1995 was 5.8% of GDP; and initial figures for the year indicated that this target had been met. On this basis, the Commission saw no reason to suspend cohesion funds payments. The recently-elected Spanish Government, however, subsequently informed the Commission that the true deficit for 1995 was 6.6% of GDP, thus raising the question of whether cohesion funding should be suspended after all. The Spanish Government argued, reasonably enough, that the deficit was the fault of the previous government; and also that suspension of funding would undermine the confidence in financial markets of the current government's corrective measures. The Commission has also itself argued, in the case of Structural Fund payments, that cutting off funding could do long-term economic damage (see Section 7.2.1).

Finally, there is the possibility of Community funding for a Member State in difficulties under Article 103a, where everything will turn on the definition of "severe difficulties caused by circumstances beyond its control" (see Section 2.7). Presumably the same criteria would have to be applied here as in the case of "exceptional and temporary" under the Stability Pact.

Given such problems, it is not surprising that a number of those supporting the Stability Pact in principle have nevertheless compared it to a nuclear weapon: the idea of sanctions is so horrific that actual implementation must at all costs be avoided. The same problems of credibility apply as in the case of "no bail-out".

3.4.2 Objectivity of the criteria

The arguments surrounding the original German proposal turned to a considerable extent on whether the reference figure for the borrowing requirement should remain at 3% of GDP, as negotiated at Maastricht; be reduced to 1%, as proposed by Theo Waigel; or redefined in terms of a balanced budget over the economic cycle.

Such discussions, however, have lent such figures a false precision. Any ceiling whether of 3% or 1%, presupposes that accurate and compatible statistics are available for each Member State's annual borrowing requirement itself; and also its GDP.

Yet, despite the efforts of Eurostat and the EMI, this is not yet the case. Suggestions have been made in the case of Belgium and Italy, for example, that the debt-to-GDP ratio could be reduced from over 100% to something much closer to the Maastricht target of 60% simply by including extra transactions in the GDP - notably those in the "black" economy. Such a measure would, however, also enable both countries to meet the 3% budget target without any further fiscal discipline.

There is also a strong case for disaggregating each country's borrowing requirement so as to distinguish between borrowing for investment and borrowing to meet current expenditure (see Section 4.5). Were capital spending to be discounted, for example, France would currently be running a budget surplus.

3.4.3 "Ins" and "outs"

The difficulties of coordinating fiscal policies between those countries within the Euro area, and those classified as "pre-ins", "countries with derogation" or "outs", is examined later in this study (see Section 8.3). Few problems are likely under the Maastricht rules alone. Were fiscal disciplines to go further, however, there could be problems in maintaining a consistent definition of "excessive deficit". More seriously, convergence of two groups' economies could become more difficult. Differing constraints on fiscal policies could be expected to affect, not just nominal factors like inflation and interest rates, but also real factors like growth and unemployment.

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Finally, there is a much more fundamental consideration. The policies of the country running an "excessive deficit" might, in certain circumstances, actually be the correct ones. This issue is the subject of the next Chapter.

4. FISCAL DEFICITS AND PUBLIC DEBT

Behind the provisions of the Treaty designed to prevent a conflict between monetary and fiscal policies lie a number of assumptions which require closer examination.

The first - that monetary policy should be largely centralised, but fiscal policy remain largely devolved - has already been noted. It is nevertheless worth adding that, while the centralisation of monetary policy is inescapable in a currency union, the decentralisation of fiscal policy is a matter of political choice. A range of options exists for the allocation of functions and taxing powers among different levels of government according to principles of "fiscal federalism".[25] A choice in favour of a generally more centralised Union remains a possibility - though currently an unpopular one.

The second assumption has also been a matter of choice, though this is not always recognised: that existing or proposed provisions are designed to prevent fiscal policies clashing with monetary policy, rather than the other way round. This, in turn, is a consequence of the primary objective, written into the Treaty, of price stability.

Alternatives would have been possible: for example, a system designed to meet a full-employment or maximum growth objective. Fiscal policies would have been conducted accordingly by Member State governments; and the role of the monetary system would have been to provide the necessary liquidity.

4.1 Why fiscal discipline ?

A general presumption in favour of fiscal discipline, however, inevitably follows the primacy of monetary stability. If fiscal policy is lax - perhaps in an attempt to reduce high unemployment - monetary policy will have to be tightened to maintain price stability. Short-term interest rates will increase, with the result that:

- ♦ private sector investment will be squeezed, eventually leading to even higher rates of unemployment; and
- ♦ the cost of funding public debt will rise, so exacerbating the budget deficit.

The European Monetary Institute observed in its convergence report of November 1995[26] that the fiscal criteria were, therefore,

> *"not to be seen as constraints on the conduct of economic policy, but rather as a mechanism for preventing the recurrence of the experience of several countries in the*

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[25] The principles of "fiscal federalism" are examined in detail in the substantial *Economics of Community Finance (European Economy no. 5, 1993).*

[26] "Progress Towards Convergence", *(EMI, Nov. 1995)*

past where fiscal developments have affected confidence, increased risk premia on interest rates, and thus hampered the achievement of long-term, non-inflationary growth".

Moreover, as the development of global financial markets has increased the ability of governments to borrow through the issue of sovereign debt, it has at the same time vastly increased the disciplines of the market. Governments managing currencies believed to be "soft" must either take on exchange risks themselves by denominating their issues in Dollars, D-Marks, ECUs, etc., or pay an exchange-risk premium. Governments whose debt position is believed to be on the edge of unsustainability will also have to pay a default premium. Market judgements are aided by the credit ratings accorded to countries by Standard and Poor, Moody's, IBCA and other agencies.

Greater access to world financial markets is indeed one of the explanations for the large increases in public debt built up by most European countries during the 1980's and early 1990's. The consequent exposure to market disciplines is also one reason for the general belief that "fiscal discipline" is now required, defined as "the avoidance of an unsustainable build-up of public debt" *(One market, one money*).

This raises a key question: at what point *does* debt become "unsustainable"?

4.2 What is "sustainable"?

At a very basic level, it can be argued that *any* level of borrowing is sustainable, provided someone can be found to lend the money. If the terms are not to be prohibitively expensive, however, the lender must have reasonable expectations that the interest will be paid, and that the principal will also be repaid on maturity. Expectations that the principal will by then have lost some of its value, relative to alternative securities, will be reflected in the interest rates.

One would therefore expect high levels of indebtedness to be reflected in relatively high levels of long-term interest rates. The extent to which this is so in practice can be seen from Chart 1, which plots rates of long term interest against levels of debt for the fifteen EU Member States in 1994/5. It shows that.

Though there is a correlation, it is not a very strong one; and that in some countries (notably Belgium - see next section) do not for the trend-line at all. In 1995, indeed, there was a stronger correlation between the long-term interest rate and the level of budget deficit, as can be seen from Chart 2.

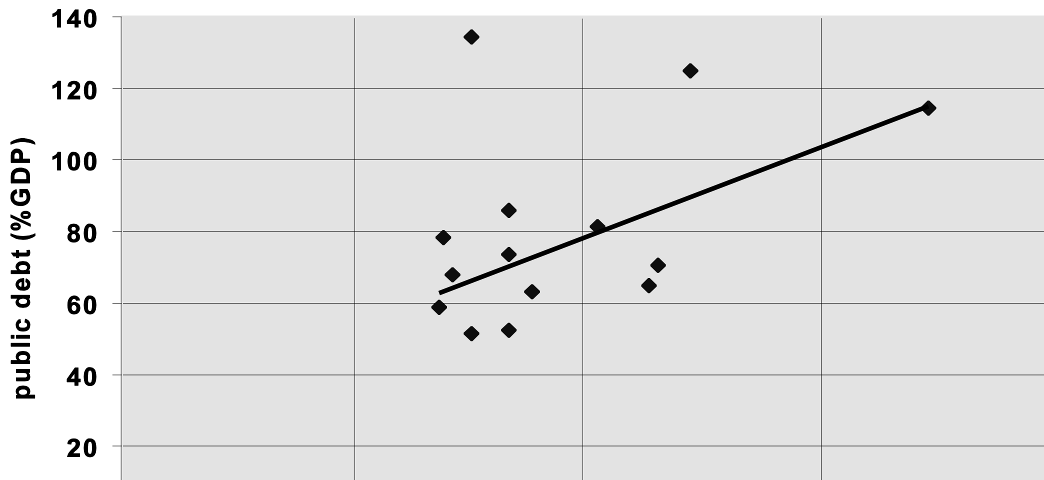

Chart 1: Government debt (as % of GDP) and long-term interest rates, 1994/5

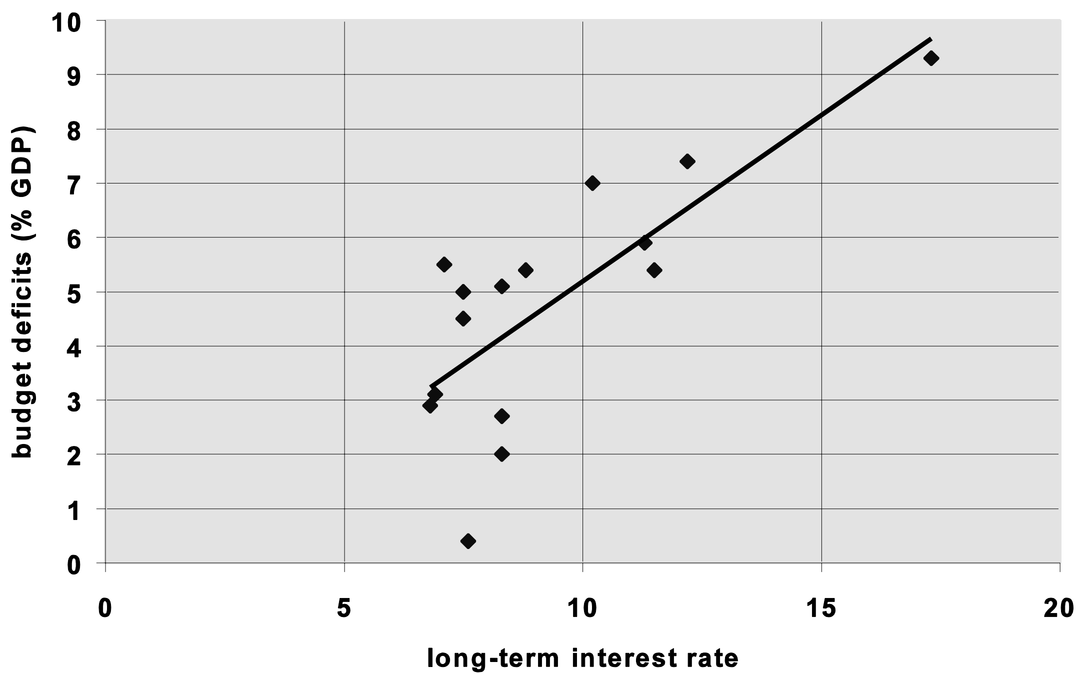

Chart 2: Budget deficits (as % of GDP) and long-term interest rates, 1994/5

Such figures indicate that the link between deficit, debt and rate of interest is not entirely straightforward.

First, a particular level of debt can be considered entirely sustainable if there is a primary budget surplus, year on year, equal to or exceeding debt-interest payments.

Secondly, where the debt is held domestically, a high level is perfectly compatible with external equilibrium. Though it is common to describe such a situation as "paying for past spending by mortgaging the future" or "placing a burden on future generations", this is an illusion from a macro-economic standpoint. An economy as a whole cannot be in debt to itself: it is merely a case of "taking money from the left pocket (the citizens as taxpayers) and putting it in the right (the citizens as savers)".

From the point of view of future generations, as the economics text-books point out, the critical factor is not so much the size of the debt as *the use to which the initial borrowing has been put*: i.e., whether the nation’s stock of productive capital has been increased or reduced. If public borrowing has the effect of "crowding out" private investment, the effect is inimical. If the effect is to mobilise private savings for otherwise unrealised capital investment, the effect can be beneficial (see 3.4).

Finally, the level of investment is itself a major component of the single most important determinant of sustainability: the level of economic growth. Put at its simplest, if GDP doubles, any given level of debt will be halved as a percentage of GDP. In more complex terms, sustainability is determined by the relationship between the levels of debt, of primary budget surpluses, of economic growth and of real interest rates.[27]

In consequence, "and contrary to the underlying reasoning of the Delors Report, the existence of

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[27] See "The arithmetic of budget constraints, Box 5.2 in "*One market, one money"*. "The initial debt must at most equal the present value of future primary surpluses, the discount factor being the excess of the real interest rate over the growth rate. This condition only holds if the real interest rate exceeds the growth rate. If not, growth wipes out any debt that can be issued."

A study by Prof. Charles Wyplosz at INSEAD has attempted to quantify these relationships. Assuming a real current rate of interest of 5%, the limit of sustainable debt was (as % of GDP):

	Maximum primary budget surplus tolerable					
	3 %		5 %		10 %	
Growth rate	0 %	3 %	0 %	3 %	0 %	3 %
Maximum debt	60 %	150 %	100 %	250 %	200 %	500 %

("Les implications budgétaires de l'union monétaire", *Obervations et disgnostiques économiques no.33, octobre 1990*)

deficits cannot be systematically taken to be a sign of indiscipline".[28] Moreover, in evaluating the sustainability of a country's fiscal position, the raw figures for budget deficits and public debt as percentages of GDP (e.g. 3% and 60%) are not the whole story - or even the most important part of it. Other relevant factors include:

- the extent to which the debt is funded by domestic savings;
- the average maturity of the debt;
- the underlying balance between capital and current spending; and
- the rate of economic growth.

4.3 The case of Belgium

The former President in Office of ECOFIN, Irish Finance Minister Ruairi Quinn, went on record[29] as stating that Belgium might become a founder member of the Euro area in 1999, "even if it failed to meet the economic convergence criteria required". It would indeed be ironic if the first effect of EMU were to be the break-up of a currency union that already exists: that between Belgium and Luxembourg!

On the face of it, there is little hope that Belgium can meet the 60% public debt criterion, even interpreted extremely loosely. In the last two years the percentage has fallen merely from 135% of GDP to 134.4%. The estimates for reference year 1997 was still around the 127%, even after the special measures taken in the draft Budget for that year. It is a charitable interpretation of the Treaty to consider that the debt is falling "at a satisfactory pace".

However, Belgium has much stronger arguments for inclusion in 1999.

Given such a weight of debt, one would have expected Belgium to be paying a substantial interest-rate premium. On the contrary: the long-term interest rate, at around 7%, is about one percentage point *below* that of the UK, whose debt/GDP ratio is mere 52.5%. Belgian short term rates are below 4%, and the Belgian Franc is stable.

For an explanation it is necessary to look at the structure of the Belgian Budget and of its public debt.

As far as the Budget is concerned, interest payments on outstanding public debt came to about 9% of GDP in 1995. Belgium has therefore necessarily run a substantial primary budget surplus in each of the last ten years.

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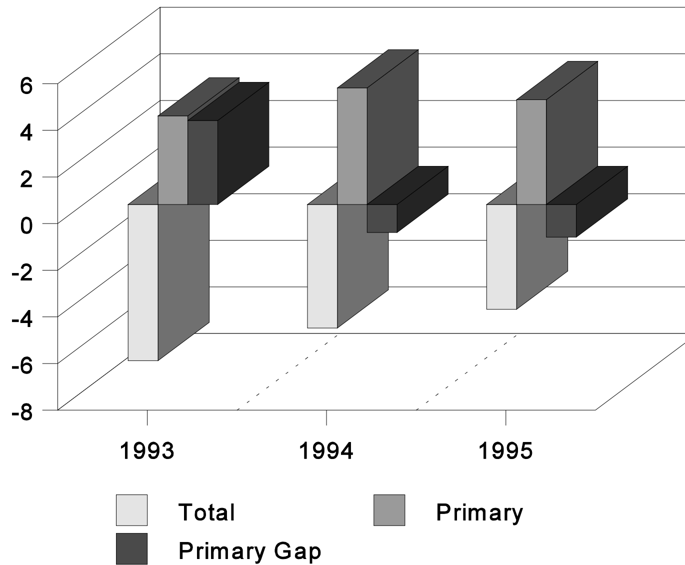
[28] Wyplosz, *op. cit.*

[29] See *Financial Times*, 14th. June 1996.

Chart 3. Belgian budget deficits, 1993-5



Source: Commission Autumn 1995 economic forecasts

Belgian economic growth, having been negative in 1993, has since been running at the rate of about 2% a year. In consequence, the primary surplus in 1993 fell short by some 3.6% of GDP of the total needed to stabilise overall debt (the "primary gap"). In both 1994 and 1995, however, the "primary gaps" were negative (at -1.2% and -1.4% of GDP respectively). In consequence the overall debt level fell.

At the same time, the savings ratio in Belgium is the second highest in the EU (after Italy) at over 20% of GDP. Of the BF10600 billion total of Belgian public debt in 1995, some 90% was denominated in Belgian Francs. Belgian residents held 77.8% of it, and non-residents the rest. Finally, over 80% of the debt was represented by medium or long-term loans and bonds; the rest by currency and deposits, bills and short-term bonds and other short-term loans.

In other words, the Belgian debt position has been sustainable because:

- ♦ it has so far proved possible to raise from Belgian taxpayers the necessary revenue to fund the payment of interest;
- ♦ a high proportion of the debt is denominated in the domestic currency, and held by Belgian residents;
- ♦ the domestic savings ratio is high; and
- ♦ the maturity of the debt is long.

The Belgian government is of course currently engaged on a programme of fiscal consolidation as part of the general EMU convergence agenda; and this is not merely in an attempt to meet, mathematically, the Maastricht criteria. The chief threat to the sustainability of the Belgian debt

position in the future will be doubts about ability of the government to raise the necessary revenue from Belgian taxpayers. "A Member State which was compelled to raise taxes without supplying a proportionate level of public goods, because tax revenues were devoted to the sole purpose of servicing the debt, could face the risk of large-scale migration of mobile factors of production."[30]

This is, of course, one example of the "spillover" effects which national fiscal policies are bound to have within an economic and monetary union, and which constitute a major argument for some coordination of the policies. The increased difficulties of funding large public debts would be one result of "fiscal degradation" (see 5.3).

4.4 Keynes and the role of deficits

The case against large budget deficits and high levels of public debt is that they will result in lower levels of productive investment (see section 4.1). It was a presumption of classical economics that the reverse also held: low interest rates - achieved though balanced budgets and low public debt - would stimulate higher levels of investment.

Keynes argued that this was not necessarily the case. Where there was a lack of effective demand, or when savers preferred to hold on to their money rather than invest it, reducing interest rates was like "pushing on a piece of string". The result would be recession and rising unemployment; and the correct government response was to increase public spending. This could be funded by increasing taxes (so ensuring that the proportion of the tax revenue which would otherwise have been saved was spent instead); or by deficit financing. The multiplier effects would result in increased national income and employment.

Budget deficits in times of recession are likely to occur, however, whether governments plan for them or not, since tax revenues will fall faster than cuts in public spending. The resulting stimulus to demand will raise national income, increase tax revenues and (provided public spending remains much the same) create a budget surplus, so damping down any inflationary pressures. These are the "automatic stabilisers". Over an economic cycle a government should therefore expect to borrow during the down-swing and repay debt during the upswing. Moreover, attempts to counteract the stabilisers - notably to reduce budget deficits in times of recession by increasing tax rates - can prove futile. Recent increases in the standard VAT rate in France, for example, have apparently resulted in *lower* total revenues.[31] The same may be true of Belgium

Attempts to *re-enforce* the stabilisers, however, can also be damaging. The EMI has pointed out[32] that in recent years there has been a trend increase in the ratio of public expenditure to GDP.

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[30] *One market, one money,* p.109

[31] The reasons are probably a combination of lower consumer confidence and increased efforts by companies to minimize tax bills. Evidence from the UK shows, in particular, a recent growth of tax planning in the complex VAT area.

[32] *op. cit.* p .22

> *"While the expenditure ration typically increased sharply during times of economic slowdown (as in the mid-1970s and 1980s and early 1990s), only partial correction tool place during periods of recovery... Although the revenue ration typically also increased over time, this could not fully offset the impact of expenditure growth on deficits".*

This "expenditure ratchet" effect has meant that "tax and spend" policies have fallen under a dark cloud in recent years, particularly as the proportions of national income taken in tax have approached the 50% level. In these circumstances, the "supply side" costs have outweighed any possible gain in productive investment. In addition, the recent examples of Denmark and Ireland have illustrated the opposite thesis: that increased growth is obtained from *reductions* in budget deficits.

The merits of deficit financing as a mechanism for stimulating economic recovery, however, remain arguable. One key factor, according to some recent research,[33] is the expected *future* level of taxation needed to finance the accumulating public debt; and hence the overall level of the debt itself. Where this is low, fiscal policy can have the traditional Keynesian effects; but where consumers/taxpayers know that debt levels are becoming excessive, increases in budget deficits have a *contractionary* effect.

4.5 Current and capital spending

Whether a budget deficit *per se* is the correct response to a recession can be debated. One consideration of great importance, however, will be the *composition* of the deficit - more precisely, on what the extra public funds are spent.

The automatic stabilisers discussed above tend to operate, not just through variations in tax revenue, but also through current transfer payments. In times of recession, current public expenditure will rise, notably on unemployment and other social payments. In this sense the mechanism consists of "borrowing long to pay short". When economic activity increases, such social payments should once again fall back. Other than through the operation of such cyclical factors, a systematic policy of borrowing to meet current payments is likely to prove as fatal for an economy as for an individual.

But what about *capital* expenditure? Though the proportion of corporate investment financed by borrowing varies between countries, it is not thought questionable for firms to finance new capital projects through bank loans or the issuing of bonds or equity. The critical factor is the expected rate of return.

To some extent at least, public investment projects can be thought of in the same way. Given that the true "burden" of public debt is not the sum involved, but the ultimate effect on the economy's productive potential, a budget deficit used to finance capital projects is different from one used only to meet current expenditure.

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[33] See "Financial Crises and Aggregate Demand: Can High Public Debt Reverse the Effects of Fiscal Policy?" by Alan Sutherland *(Centre for Economic Policy Research Discussion Paper No. 1246, September 1995)*.

It is, of course, true that a positive rate of return should be expected on such investment; and that it is generally extremely difficult to estimate rates of return on public projects. Except in the most extreme depression, there will be an element of "crowding out" of private investment, and there is always the risk that the rate of return on the public project will be lower than that on the "crowded out" alternative.

As against this, public capital expenditure will generally raise the overall level of investment, increasing national income through the multiplier effect. Whether the first, "micro" effect or the second "macro" effect is the more important will be a matter of economic and political judgement. The judgement of the EU Commission and the ECOFIN Council is that public spending should be redirected "to the greatest extent possible... towards productive activities such as investment in infrastructure, human capital and active labour market measures...."[34]

The wisdom of differentiating between public capital expenditure and current spending is also apparent from the different effects when the are *cut* in pursuit of "fiscal stabilisation". A number of recent studies[35] analysing the results of several such "stabilisation" policies have shown that:

- raising taxes is less effective that cutting public spending; and that
- cutting back on capital projects is less effective than cutting current spending.

The studies have also shown that a great deal depends on the *duration* of the policy. A short-term increase in taxation and a deferment of capital projects merely tends to *slow down* economic growth and increase unemployment. On the other hand, a sustained policy of pegging back current public spending eventually results in *increased* economic growth. The experiences of the Irish economy over the last fifteen years[36] here provide the most obvious practical example.

Considerable weight should therefore be given to the provision of Treaty Article 104c(3) which enjoins the Council to take into account "whether the government deficit exceeds government investment expenditure". Subtracting government fixed investment expenditure from the total of government deficits indeed gives a very different picture of the current position. On this basis, countries like Italy would not need to meet the convergence criteria by drastic cuts of capital projects, especially much-needed infrastructure (see Section 3).

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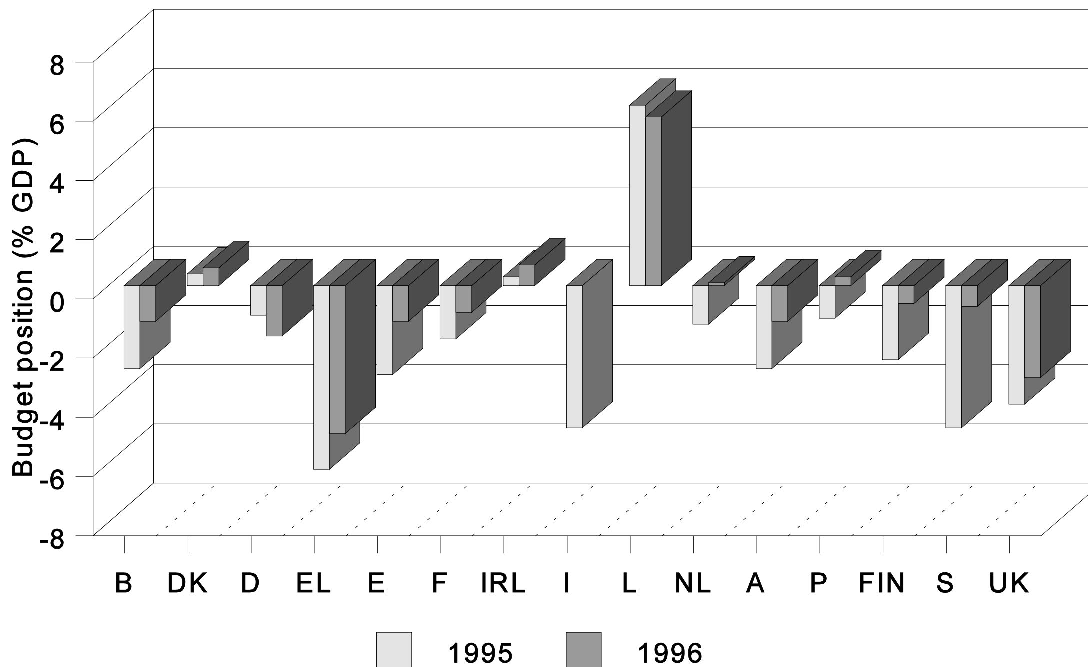
[34] See draft for the Broad Economic Guidelines, UEM 18 *(Brussels, 4th. June 1996).*

[35] For example, “Fiscal Adjustment: Fiscal Expansions and Adjustments in OECD Countries” by Alberto Alesina and Roberto Perotti *(Economic Policy, October 1995)* and “Non-Keynesian Effects of Fiscal Policy Changes: International Evidence and the Swedish Experience” by Francesco Giavazzi and Marco Bocconi *(NBER Working Paper no. 5332, November 1995).*

[36] see "The Economic and Financial Situation in Ireland: Ireland in the Transition to EMU" (*European Economy, No.1.1996*)

Chart 4: National budget surpluses/deficits, as a % of GDP, discounting fixed investment



Source: European Commission Report on Convergence in the European Union in 1996, Table 4.7.

4.6 Inflation and Unemployment

In the 1960's, the "Phillips Curve"greatly influenced discussions on economic policy. Using UK data for a period of almost a century, the economist Prof. A.W.Phillips suggested that there was a fixed trade-off between the rate of change of money wages and the rate of unemployment.[37] Policy-makers could choose the desired balance.

As rates of inflation began to rise in Western economies, however, it became clear that the relationship between unemployment and inflation was not fixed - or, rather, that there was no single "Phillips curve". The choice of higher inflation to reduce unemployment only worked when the inflation was *unanticipated*. The result was a "ratchet" effect: it took higher and higher levels of inflation to reduce unemployment to a given level - in other words, the Phillips Curve shifted to the right.

Instead of a trade-off between unemployment and inflation, policy discussions centred on the idea that there was a "natural" rate of unemployment which could not be reduced without rising inflation: NAIRU ("non-accelerating-inflation rate of unemployment").

[37] "The Relation Between the Rate of Change of Money Wage Rates and the Level of Unemployment in the United Kingdom, 1867-1957", *Economica,* November 1958.

Recent years have seen a determined and successful international campaign to reduce rates of inflation. As a result, the Phillips Curve for certain individual economies may now have shifted leftwards again - i.e. lower rates of inflation are now consistent with lower rates of unemployment. A sustained anti-inflation policy will gradually change *expectations* about inflation in the future, so bringing down long-term interest rates and lowering wage-demands.

It is possible to argue, however, that the Phillips Curve also shows symmetry. Just as attempts to reduce unemployment below a certain level will squeeze the curve rightwards (creating a higher level of inflation for any given level of unemployment), so attempt to reduce *inflation* below a certain level may also produce such a shift (leading to higher unemployment for any given rate of inflation) .

4.7 Zero inflation ?

A lively debate is indeed already under way in the United States about whether it is worth trying to reduce inflation below the current rates of around 3%. Robert Chote of the *Financial Times* recently summed up the state of research as follows:[38]

> *"Although numerous studies have confirmed that inflation impedes growth where it is high, there is little evidence that cutting inflation from the levels seen at present in industrialised countries will improve long-term growth prospects".*

A recent paper from the Brookings Institution has proved especially influential.[39] It argued that a reduction in the rate of US inflation to zero would permanently raise unemployment there from its current "natural" level of about 5.8% to about 7%. Another paper from Michael Sarel at the IMF has gone so far as to propose that "economic growth rates are maximised at an inflation rate of about 8%".
Finally, Paul Krugman, professor of economics at the Massachusetts Institute of Technology,[40] has advocated a long-run target of 2-4% inflation, which perhaps might be called "NAURI" ("non-accelerating-unemployment rate of inflation"). His thesis is that reducing rates of inflation towards zero does not merely involve a one-off sacrifice of economic growth and employment, but produces a permanent loss of productive potential and a permanently higher rate of unemployment. The costs of inflation, he argues, are "non-linear":

> *"i.e. 3% inflation does much less than one-third as much harm as 8%".*

Similarly, the "sacrifice ratio" is also non-linear. The loss of output and jobs in reducing inflation

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[38] *Economics Notebook*, Monday September 16th. 1996.

[39] "The Macroeconomics of Low Inflation" by George Ackerfhof, William Dickens and George Perry, *Brookings Papers on Economic Activity, 1.1996,* presented at a Symposium of the Federal Reserve Bank of Kansas City in Jackson Hole, August 31st. 1996. For the alternative view, see the paper presented there by Martin Feldstein of Harvard University.

[40] "Stable Prices and fast growth: just say so", *Economist,* August 31st., 1996.

from 3% to 0% would be far greater than from 6% to 3%.

There are a number of reasons why this might be so. The most obvious is that inflation can sometimes play a role in "pricing people back into jobs". Since *nominal* wage-rates are inflexible in a downwards direction, one way to reduce *real* wages is a rate of inflation higher than increases in the nominal wage-rate. Such a confidence trick cannot be carried out too often; but it perhaps justified when an economy requires an across-the-board reduction in incomes in order to become competitive. In the past, it has usually been the natural - and intentional - consequence of a currency devaluation.

Table 1: International consumer price inflation, year to August 1996

Austria	1.8
Belgium	1.9
Britain	2.1
Denmark	2.3
France	1.6
Germany	1.4
Italy	3.4
Japan	0.4
Netherlands	2.1
Spain	3.7
Sweden	0.3
US	2.9

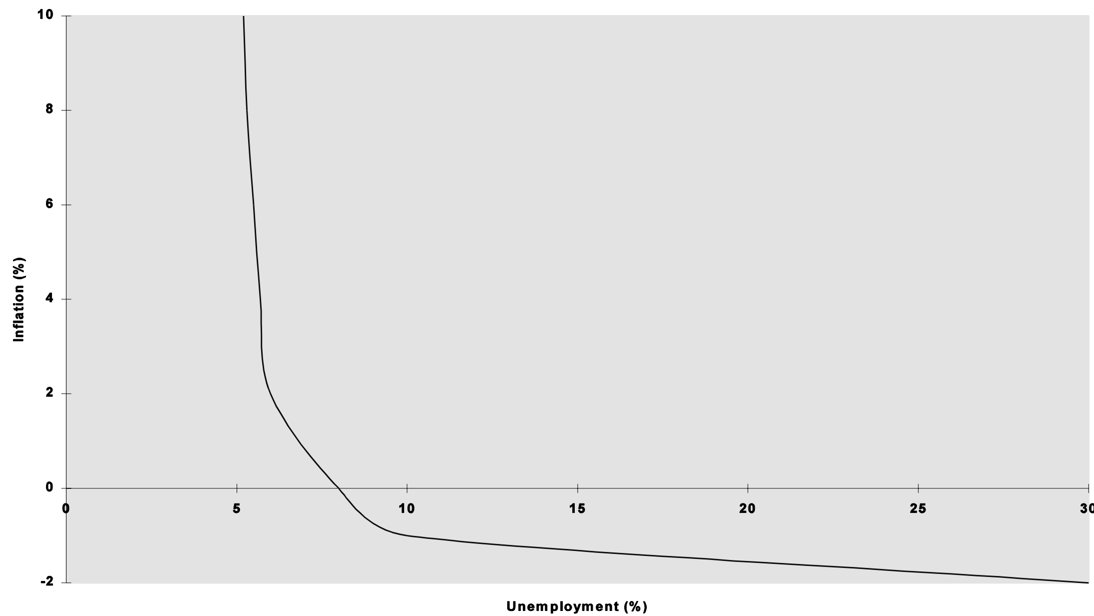
Source: "Economist" economic indicators

The problem faced by a number of countries within the EU could be the reverse side of this coin. Even if nominal wage-rates are stable, deflation can price people *out* of jobs.

Whatever the validity of such theories, inflation is most countries is already below 3% (see Table 1). More significantly, it is low in several countries where the most stringent retrenchment is under way in order to meet the Maastricht fiscal criteria: notably France. France also, however, has an unemployment rate which has risen from 8.8% in 1990 to 12.5% today.

If research in the United States is right, the Phillips Curve there - and possibly in most OECD countries - looks something like that in Chart 6. In such circumstances, "full employment" and "zero inflation" are equally dangerous objectives. Monetary and fiscal policies conducted either with sufficient laxity to achieve the first, or sufficient stringency to achieve the latter, could prove equally destructive.

Chart 6: A possible Phillips Curve



4.8 Conclusions: defining "stable prices"

The foregoing analysis indicates that the primary objective of EMU monetary policy - price stability - needs some clarification.[41] Rather than absolute stability of prices (that is, a zero rate of inflation), the aim of policy should be a *stable and low rate of inflation.* The rate should be at a level which tends to *maximise economic growth* and *minimise the rate of unemployment*.

Economic theory predicts that such a rate is attained when *actual* inflation equals *expected* inflation; and that this occurs when output equals potential national income: i.e. when there is no demand pressure on the price level. At this point, the long-run Phillips Curve is vertical: there is no trade-off between inflation and unemployment; and the rate of inflation remains constant, provided that it is accommodated by the appropriate monetary expansion.

[41] This is a separate issue from that also raised in the United States by the Boskin Report: namely, that existing statistics over-estimate the rate of inflation by failing to take account of quality improvements in the "bundle" of goods used to track prices.

5. THE CASE FOR COORDINATION

A number of arguments can be advanced for macro-fiscal coordination within a monetary union. In his paper annexed to the Delors Report[42], Lamfalussy mentions four: the need for "an appropriate fiscal policy for the union a whole"; the "need to avoid the disproportionate use of Community savings by one country"; a "possible bias towards lack of fiscal restraint"; and "the need for convergence in budgetary positions during the transitional period". *One market, one money* argued more generally that

> *"the mere creation of a monetary union requires.... long-term consistency between the common monetary policy and the fiscal policies of the Member States".*[43]

In the considerable body of literature which now exists on the issue, three arguments for coordination stand out:

- the "spillover" effects of a country's fiscal policies on the economies of others;
- the competitive effects of different patterns of taxation and public expenditure within the Single Market; and
- the need for a coherent "fiscal stance" to match the single monetary stance.

5.1 The externalities of fiscal policy

The case for coordination of national fiscal policies rests, in the first place, upon externalities and "spillover" effects: that is, the consequences of one country's policy for the economies of its neighbours. The extent of such effects will depend upon a number of factors, and in particular: the importance of trade links between the countries concerned; the exchange-rate *régime*; and financial market integration.

Various models exist[44], for example, outlining the consequences of a fiscal expansion in one country upon the economy of a trading partner. Where exchange rates are free to move, the initial effect of such an expansion can be a rise in domestic demand, coupled with a rise in interest rates, and an appreciation of the currency. This, in turn, can lead to an increased demand for imports with a consequent *positive* effect upon the trading partner's GDP. The initial boost to EU economies created by the unification of Germany provides a practical example of such an effect

This example also, however, illustrates some of the limiting conditions. The currencies of all Germany's main trading partners in the EU were at that time linked to the D-Mark through the EMS exchange-rate mechanism, which prevented an appreciation of the German currency. To

[42] *op. cit.*, footnote 3

[43] *op. cit., Chapter 5*

[44] e.g. the Mundell-Fleming model

maintain the ERM parities, other Member States were also forced to raise interest rates. In the end, the system blew apart in the 1992/3 crises.

Models of a similar fiscal expansion within a system of *fixed* exchange rates indeed show that the effects upon trade partners are *negative.* Increased borrowing in the expanding country disturbs the overall savings/investment balance; and the consequent rise in interest rates is communicated to other economies. The dampening of domestic demand there - both as a result of the higher interest rates themselves, and because of higher taxes to service public debt - will more than offsets any increase in exports.

In such circumstances, the potentially *inflationary* consequences of fiscal expansion in one country are matched by *deflationary* effects in its neighbours. But this need not necessarily be the case. The fiscal expansion might also be "accommodated" by the monetary authorities. Indeed, within the context of Monetary Union, the possibility of such an accommodation constitutes the main fear of those who argue most strongly for restrictions on national fiscal deficits. They highlight a number of points.

♦ Though the effects of "fiscal expansion in one country" within EMU might be negative overall, there are incentives for *any one country* to take such a step:

  i) within a monetary union, the danger that excessive fiscal expansion will lead to domestic currency depreciation will no longer exist;

  ii) a country facing debt-servicing problems might have expectations of assistance from other members of the union, particularly if its debt forms an important part of external portfolios;

  iii) even if such assistance were not forthcoming (or were prohibited by "golden rules") part of the burden resulting from such behaviour will be borne by the country's trading partners.

  Put another way round, "in the absence of coordination, no national government would be willing to deflate for the benefit of the Community as a whole".[45]

♦ In those states which do *not* receive any benefits from the fiscal expansion, and yet experience higher interest rates and unemployment, the political pressure for *monetary* expansion could be considerable. Within the EMU context, such pressure might successfully be brought to bear upon the European Central Bank, despite its independence. The result might then be a higher rate of overall inflation and a depreciation of the euro against the $ and other currencies.

In sum, uncoordinated fiscal policies could create a "bias towards lack of fiscal constraint". *One market, one money* concludes that correcting such "possible medium-term tendencies" is one of the two objectives justifying coordination.

[45] *One market, one money,* p. 118. Several quotations follow from pages 115-119 of this report.

5.2 The exchange rate of the Euro and the balance of payments

The other is the "the appropriate policy mix of the Community in the context of the world economy, particularly with respect to the common exchange rate and current account".

Under Article 109 of the Treaty, final responsibility for the exchange rate of the Euro in relation to non-Community currencies rests, not with the European Central Bank, but with the Council. The Article empowers the Council to "conclude formal agreements on an exchange-rate system"; or, failing that, to "formulate general orientations for exchange-rate policy" - which, however, "shall be without prejudice to the primary objective of the ESCB to maintain price stability".

Precisely how this division of responsibility for the external and internal value of the Euro will work out is not yet clear. Article 109 refers to consultations between the ECB and the Council "in an endeavour to reach a consensus consistent with the objective of price stability.." Such "coordination" between the monetary and the fiscal authorities within the Union is likely to prove crucial to the operation of EMU; but is not the subject of this study.

The existence of a single external value for the currency of all EMU participants also, however, has consequences for national fiscal polices; and in particular because there will also be common external trade and current account balances.

One market, one money observes that the Community's current account and the Euro exchange rate will "probably remain two among many policy objectives, as long as their level and evolution do not depart from normal limits". If, however, "the external deficit of the Community reaches certain limits, it will become the key policy target"; and - given that "monetary policy has an ambiguous action on the external account"[46] - correcting the deficit "will presumably need a fiscal policy move".

Which countries should then tighten their fiscal belts? At first sight, it should be those running trade deficits with third countries. And yet, as a result of intra-Community transactions (whether the statistics are kept or not) these countries may actually be running an overall trade surplus, and be candidates for fiscal *expansion*.

In any case, from the point of view of the overall current account, individual trade balances are irrelevant. More important is proportion of total trade. But "the benefits of a fiscal correction by a national government would accrue to the Community as a whole (through a reduction in the external deficit), whereas the home economy would bear all the costs".

"This", comments *One market, one money,* "is a textbook example of strong externality".

[46] Because the lowering of domestic demand and exchange-rate appreciation have opposing effects.

5.3 Public expenditure and taxation

Arguments for the coordination of fiscal policies within EMU such as the foregoing are based on macro-economic externalities. It is also possible, however, to develop a micro-economic case, based on the direct effects of public expenditure on the one hand, and the raising of taxation on the other.

Within the European Union there are certain possibilities for the citizens and businesses of one Member States to "free-load" on the public expenditure of another. One topical example is provided by the continuing disputes over payment for transport infrastructure: where investment in roads is largely funded out of general taxation, road-users from neighbouring states are able to use them free (which, of course, is not the case where tolls are levied). The example is that much more pointed where the bulk of traffic is in transit - as over the Brenner Pass.

It is also possible for the citizens of a country to be deprived of a desirable public good, which they themselves would be entirely willing to finance, because the expenditure would have to take place in a neighbouring state. Likewise, desirable public expenditure might *not* be undertaken because the main benefits would be felt in a neighbouring state. One clear example of such situations is pollution control.

The issue is not, however, clear-cut. It is true that a Member State which chooses to spend relatively less on collective goods and services can to some extent "off-load" the consequences onto neighbours (for example, through reciprocal agreements in the health field). On the other hand, a country which provides a relatively high level of collective goods and services can attract both individuals and businesses, exerting a competitive pressure on neighbours to raise spending.

The other side of this coin is the general level of taxation. One example is the controversial issue of "social dumping". Countries with relatively low levels of welfare spending will have lower social charges, and hence lower unit labour costs. Within a Single Market the consequent competitive advantage may then be considered "unfair" (though the argument is most often used in relation to competition from third-world and "Pacific Tiger" economies).

Company taxation provides a further example. A relatively low level of corporation tax, and a "business-friendly" overall tax *régime* is often cited as the main reason for the UK having attracted some 40% of all Japanese inward investment into the EU. The Ruding Report of 1992[47] addressed the question of whether some harmonisation of company taxation - and in particular the rates of tax - was necessary to provide a "level playing field" within the Single Market. A debate is still taking place on the matter.[48]

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[47] "Report of the Committee of Independent Experts on Company Taxation", *Official Publications of the EC, ISBN 92-826-4277-1, March 1992*; see also the Commission's reactions to the Ruding Report *(SEC(92)1118 of the 26th June 1992)*; and the Report of Patrick Cox MEP to the European Parliament *(A3-0207/94 of the 30 th March 1994).*

[48] The most recent move has been the Code of Conduct to prevent "unfair tax competition", adopted by the Council in December 1997.

Table 2: Tax revenues of government as a % of GDP (1995)

Country	Indirect Taxes	Direct Taxes	Social Security charges	TOTAL TAX
Belgium	12.8	17.8	17.5	48.1
Denmark	18.1	31.0	2.7	51.8
Germany	13.2	11.5	19.4	44.1
Greece	15.2	6.0	12.7	33.9
Spain	11.5	11.4	13.8	36.0
France	15.1	9.5	21.1	45.6
Ireland	15.8	14.7	5.2	35.7
Italy	12.0	15.1	15.2	42.3
Luxembourg	16.4	12.7	12.5	41.5
Netherlands	13.0	13.3	15.6	45.1
Austria	15.3	13.3	15.6	44.2
Portugal	14.2	9.1	11.1	34.5
Finland	14.1	16.4	15.0	45.4
Sweden	14.7	22.3	14.2	51.2
UK	16.2	13.0	6.2	35.5
EU	**13.9**	**12.8**	**16.0**	**42.7**

Source: Commission services

Though all tax systems are to some extent in competition with each other, however, different levels of detail can be distinguished.

- ♦ ***Taxes can be applied so as to favour particular firms of industries, so distorting competition.*** Competition policy already covers this point.

- ♦ ***Differences can exist in the balance between different forms of taxation (e.g. direct and indirect).*** Though it is not often recognised, this can also have competition effects. For example, some Member States finance a high proportion of social expenditure through VAT, which can be rebated on intra-Community transactions. Others rely on direct taxation, which can not.

- ♦ ***The overall level of taxation can vary.*** Countries with relatively high levels of taxation are likely to be at something of a competitive disadvantage as compared to others, though this could well be offset by the provision of extra collective services (see above).

The extent to which differences in the patterns of public expenditure and taxation warrant the coordination of fiscal policy is therefore a matter of judgement. Where the differences amount to "tax breaks", their legality is clearly in doubt. Differences in the *structure* of tax systems may in some circumstances warrant full harmonisation; and the same may be true of tax *rates* (though the Treaty currently provides a clear legal base only in the case of VAT and excise duties). Here *coordination* may provide an alternative to harmonisation, impinging less on national fiscal sovereignty.

Both in the case of particular taxes (notably company taxation) and in the case of the overall tax level, there is also a danger that competition between systems will lead to a steady erosion or "migration" of the tax base. The fear that this would happen in the case of VAT was one of the main reasons for the continuation after 1 January 1993 of the so-called "destination principle", as opposed to the "origin principle" originally proposed by the Commission. The same fear in the case of taxes on capital is the central theme of the Commission's recent communication on taxation.[49]

It can also be argued, however, that not only the overall level of taxation, but also the balance between taxes within it, is essentially a matter for individual Member States to choose for themselves. Any competitive advantage gained as a result should be considered entirely legitimate. *One market, one money*, envisages a situation in which all factors of production are mobile, and in which individual citizens and businesses are able "vote with their feet": i.e. move to find the expenditure/tax mix that suits them best. *Stable money - sound finances*[50] observes that competition between tax systems may well result in Member States setting tax rates

> *"at a lower level than they would if acting cooperatively, because they neglect the negative externality of their lower tax rates on the revenue of their neighbours";* but adds that *"adherents to the public choice school of thought would not consider this an undesirable phenomenon... They would argue that tax coordination amounts to setting up a disguised fiscal cartel".*

As against this, it is also clear that such a "non-cooperative equilibrium" will also apply on the expenditure side. There is likely to be "an insufficient provision of public goods, but an excessive provision of public 'bads' like pollution"[51]. Historical examples like the English "Poor Law" in the 17th. century illustrate the consequences. The poor wished to move where expenditure was highest; the well-off to live where taxation was lowest. Each parish therefore had an interest in providing as little relief as possible for the indigent, in the hope that they would move on somewhere else.[52]

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[49] The so-called "Monti paper" *(SEC(96)487 final of 20.03.96)*

[50] *op. cit.* (see footnote 1), p.42

[51] *One market, one money*, p.129

[52] Exactly the same phenomenon could be observed in the 20th. Century, in the case of London local authority housing. At the time when the efficiency of Borough Councils was often judged by how successful they were in reducing housing waiting lists, the paradox arose that the best way to achieve this was to build no housing! Families

Where the benefits and costs of public goods easily spill over from one jurisdiction to another, it is has therefore been generally found necessary.

- *either* to assign the provision of such goods to a higher level of government, according to the principles of "fiscal federalism";

- *or* to coordinate expenditure and taxation, if necessary by legislation (minimum standards of provision, grants from central revenues, etc.).

5.4 The "aggregate fiscal stance"

A third argument for coordination arises directly from the centralised monetary/devolved fiscal policy dilemma.

On the face of it, EMU will *not* be unique in the world in combining a single monetary policy with devolved fiscal policies. Within the United States, for example, states like California and New York have budgets exceeding those of most EU Member States; yet they are set without any attempts at "coordination"[53].

In this context, a number of studies have been made of fiscal policy in existing "federal" countries[54] - notably that by Lamfalussy annexed to the Delors Report. They have drawn attention, in particular, to two factors:

- the considerable degree of autonomy enjoyed by the constituent states: Lamfalussy notes, for example, that "federally-decided limits on the borrowing of regional governments exist only in Australia".

But, at the same time,

- the existence of substantial federal budgets which, as a general rule, equal the budgets of all constituent states together.

Consequently "in all mature federal countries, it is the central government that takes care of macroeconomic stabilization for the union as whole"[55]. Federal budgets are sufficiently large both

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seeking accommodation leant to move into those Boroughs where there was a significant building programme, and hence a better chance of getting re-housed.

[53] States, however, are constitutionally required to balance their budgets.

[54] Australia, Canada, Germany, Switzerland and the United States are generally considered to fall into this category.

[55] *Stable money - sound finances* p.44

for the "automatic stabilisers" to operate, and to permit more proactive Keynesian policies[56]. The autonomous fiscal stances of the constituent states are either of insufficient magnitude to disturb the federal stance, or cancel each other out (though *Stable money - sound finances* notes that "deviant budgetary behaviour" by the state of Ontario in Canada has provided an exception).

By contrast, the European Community Budget - at 1.2% of GDP, as compared to nearly 50% for EU national budgets, and about 22% for the US federal budget - is of relatively little importance. Both its prospective size and structure (in particular the concentration of spending in certain areas), observes Lamfalussy, make it "highly unsuitable" for the purpose of setting a macro-fiscal stance within EMU. Even if the Budget were doubled or tripled, "tremendous swings in revenue and spending would have to be allowed for if it were to perform a meaningful anti-cyclical function".[41]

This leads to the conclusion that fiscal stabilisation can only be achieved through the "aggregate fiscal stance" of the national budgets taken together. "If no attention were paid to the aggregate budgetary stance, the stabilisation burden on monetary policy might be excessive..."[41]

Does this automatically mean impinging on the autonomy of Member States to set their own budgetary positions? At least in the case of the automatic stabilisers, would it not be sufficient to allow normal cyclical forces to operate at national level?

Certain problems exist with this solution. Historically, as Lamfalussy observes, the budgetary positions of EU Member States have a "significantly greater degree of dispersion" than is the case with most federal states. And this, in turn, reflects economic realities: differences in the timing of economic cycles, and the impact of asymmetric shocks. There is no guarantee that the aggregate of the national fiscal stances will automatically produce the optimum fiscal stance for the Union as a whole.

The conclusion would seem to be that such an optimum stance can only be achieved by an element of coordination.

Unfortunately, the very factors which make an automatically optimum overall stance improbable also make coordination that much more difficult. Given that each Member State adopts the fiscal stance most appropriate to its own needs at any one time, any alteration in that stance as a result of coordination is bound to be sub-optimal for that State. How should the burden of changing stance in the interests of an overall optimum be shared?

Moreover, the definition of an overall optimum at any one time will itself be difficult, given the conflicting interests. Experience with the EMS has shown the tensions that can arise when the need to control inflation in one part of the Union is combined with a falling growth rate and rising unemployment in another. Finally, attempts to define an overall stance at Union level are vulnerable even more than national fiscal policies to "the well known Friedman (1953) critique

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[56] Research indicates that Keynesian policies are potentially effective only in economies over a certain size, and with correspondingly large budgets; see Inman and Rubinfeld: “The EMU and Fiscal Policy in the New European Community: An Issue for Economic Federalism *(International Review of Law and Economics, 1994 14, 147-161).*

that, owing to the slowness of implementation, discretionary fiscal policy impinges on the economy at the wrong moment, thereby amplifying, instead of attenuating, cyclical fluctuations".[41]

It is no wonder that *Stable money - sound finances* concludes its analysis of the problem with the remark that "achieving effective fiscal policy coordination will doubtless be one of the main challenges in the future management of EMU"![57]

[57] *op. cit.* p.45

6. SOME CRITICISMS AND ALTERNATIVES

In any case, the arguments for the coordination of nation fiscal policies within EMU do not themselves go unchallenged. Despite the theoretical case for matching EMU's centrally-determined monetary policy with a corresponding fiscal policy, and the presumption that coordinated policy changes can improve the welfare of all participants, it can also be maintained that coordination will actually produce a worse outcome than no action at all.

6.1 The fox without a tail

One of Aesop's fables, for example, concerns a fox which loses its tail. It then attempts to persuade the other foxes that they, too, should have the burden of their tails removed.

The moral of the story is that coordinating fiscal policy does not necessarily remove the "bias towards lack of fiscal constraint" observed by Lamfalussy. "Fox-without-a-tail" coordination would indeed result in the least responsible fiscal policy becoming the norm: one possible out-turn of the "free loader" dilemma.[58]

More plausibly, coordination might result in a general adoption of something near the *average* stance. Such an outcome is a frequent consequence of inter-governmental negotiations in other contexts, and also of the processes by which compromises are arrived at within the Council and other EU institutions. For example, a "coordinated fiscal expansion" might be agreed upon, quantified in relation to the average EU rate of unemployment.

Such a compromise, however, might be wrong for *all* the participants: not enough for countries with above-average unemployment, but creating labour-bottlenecks in those below. This could, for example, be the case if each Member State were in slightly different phases of the economic cycle, or if there were an external shock which affected Member States differently (for example, a sudden rise in oil prices).

"Fox-without-a-tail" coordination is that much more likely, given the already- mentioned problem of burden-sharing. Supposing, for example, that inflationary pressures (labour bottlenecks, localised price-rises) were to build up within one part of the EMU area, at the same time as high levels of unemployment and spare capacity continued to exist in other parts - entirely possible, given the rigidities of the European labour market, and the lack of labour mobility[59]. The danger of an aggregate rise in inflation would then lead the ECB to tighten monetary policy, so aggravating the recession in the high-unemployment areas. These, in turn, would find their budget deficits rising, either as a result of the automatic stabilisers, or of deliberate policy.

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[58] As illustrated by the tendency, observable in restaurants when it is known that the bill will be divided equally, to order the more expensive dishes.

[59] Even within as integrated an economy as the UK, the problem of recession in the North, combined with "overheating" in the South-East, plagued successive governments in the 1950s, '60's and '70s.

Attempts might then be made to activate the "excessive deficit" procedure, or a more stringent "stability pact", backed by financial penalties. The reaction of the Member States concerned would be to invoke "cohesion". Those Member States with the stronger economies would then face a difficult choice: *either* to make substantial transfers through the various Community financial instruments, *or* to agree to a less rigid overall stance (see Section 2.8).

6.2 "Government failure"

It is, moreover, always open to doubt whether the efforts of governments to remedy externalities will produce a better outcome than the "market failures" they seek to correct. "Government failure" can exist as well as "market failure".

This is not necessarily because governments fail to carry out what they agree to. The more likely reason is insufficient data about the situation at the time an agreement is made, and uncertainty about the consequences of any action taken. In a study of fiscal coordination at international level,[60] Ralph C.Bryant of the Brookings Institution draws attention to research[61] into policy coordination between the member nations of OECD. Governments were presumed to make policy adjustments on the basis of economic models - ten possible models were examined - which they believed would raise their own nation's welfare. Taking 1000 possible combinations of assumptions into account, Frankel and Rockett concluded that "coordination in the presence of model uncertainty can leave countries worse off *ex post* as easily as better off".

Bryant's own view is that "the authors overstate the pessimistic inferences drawn from their analysis". On the other hand, he concedes that, "incontrovertibly, policymakers can lower welfare by using an incorrect model. And since no one can know with any confidence what the true model is, policymakers will inevitably make mistakes".[62]

One important further issue in this context is: *cui bono*? Bryant draws attention to the view that "governments are organizations with interests of their own, which are different to, and potentially inimical to, those of general populations". Their "victims" can be their own citizens (for example, the authorities of a group of countries might agree on a joint monetisation of debt, where the danger of exchange-rate depreciation might otherwise have prevented them from doing so); or excluded parties like other countries and their citizens.

The conclusion of such analyses is that, instead of being encouraged to "coordinate", governments should be prevented from "colluding". The dichotomy bears a strong resemblance to that already well-aired within the European Union between the need for a cooperative industrial policy and the requirements of competition policy.

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[60] "International Coordination of National Stabilization Policies" *(Brookings Institution, Washington DC, 1995).*

[61] "International Macroeconomic Policy Coordination When Policy-makers Do Not Agree on the True Model" Jeffrey Frankel and Katherine Rockettt (*American Economic Review 1988*)

[62] *op. cit.* p. 82

6.3 The case for full autonomy

The first alternative to the coordination of fiscal policy is, of course, *not* to coordinate.

Problems of externalities, both macro and micro, will then continue to arise, and the aggregate fiscal stance will not necessarily be optimum from the point of view of the Union as a whole. On the other hand, it can be argued that where governments have access to, and are subject to the disciplines of, world financial markets, divergent fiscal policies cannot disturb monetary conditions. Consequently, Member States which have no difficulty in financing a particular fiscal policy should not be circumscribed by "coordination", any more than, given the "golden rules", they should be subject to limits on budget deficits and overall debt.

Various theoretical studies can be cited to support fiscal policy autonomy as against coordination. Using the IMF model MULTIMOD, for example, Paul Masson and Jacques Melitz[63] studied the effect of various shocks on a Franco-German monetary union, in which monetary policy was set, tightly, by a single monetary authority independent of the national fiscal authorities. They found that in the majority of cases "the country predominantly affected by the shock.... can respond by varying its fiscal policy and is able to improve its lot without notably injuring the other". (On the other hand, a scenario involving the doubling of the oil price raised "a possible instability in the absence of cooperation".)

The analysis in *One market, one money* of this and other studies concluded that "under normal circumstances, national budgetary autonomy in EMU should not lead governments to opt for suboptimal policy stances because of a failure to take spill-over effects properly into account.... Summing up, there is no compelling evidence that EMU would call for close coordination in day-to-day fiscal policy."

It also needs to be remembered that limitations on national budgetary autonomy do not come cost-free. "The paradox of EMU is that member states will have to use fiscal policy more actively to offset their loss of control over monetary policy.." observes Christopher Johnson in his recent book on EMU,[64] "yet that very same monetary policy requires some limits on fiscal policy". The danger will exist that without sufficient budgetary flexibility "national governments will be deprived of an important tool of economic management, and EMU will deliver lower inflation, but without higher growth".

6.4 A federal Budget?

The already-quoted evidence from existing economies which combine a single currency with substantially devolved fiscal policies - for example, federations like the US, Canada and Australia - is that a single monetary policy *is* indeed compatible with extensive autonomy and wide variation in fiscal policy. As Lamfalussy points out in his paper annexed to the Delors

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[63] "Fiscal Policy Independence in a European Monetary Union" *(De Pecunia, Vol.II, 2-3 Oct. 1990)*

[64] “In with the Euro, Out with the Pound” *(Penguin, 1996),* p.106

Report, the very fact of monetary union removes the most damaging temptation: that governments will try to escape the consequences of excessive budget deficits by monetizing them. In the past this has been precisely what "excessive deficit" countries[65] have done. By pointing to the true costs of deficits more clearly, EMU would automatically encourage discipline without further intervention.

Lamfalussy also observed that the evidence from existing federal systems "would not seem to suggest a bias towards lack of fiscal restraint". However, the key difference between these examples and EMU will be the absence of a substantial "federal" budget. How large would a European Union budget have to be to make intervention in national fiscal policies unnecessary?

6.4.1 Stabilisation

The first issue is the operation of "automatic stabilisers". Both common sense and evidence from the OECD suggest that the larger the tax-to-GDP ratio, the stronger the stabilizers will be. The figure for individual EU countries varies between 34% and 50%, giving, broadly, a 0.5% rise in the budget deficit for every 1 per cent fall in GDP. Where the tax-to-GDP ratio is in the 20-30% range (as in the case of the US and Japan), the figure is perhaps around 0.33%.

Such figures as these are of a different order from the 1.2% of GDP currently accounted for by the Community Budget. Even if the Budget were to rise to the McDougall figure of 5-7% of GDP, this is far below the 20-25% of existing "federal" budgets, and the stabilising effects would be correspondingly weak. Moreover, the Community Budget is funded through the complex system of "own resources", which effectively muffles any stabilising effect on the revenue side.

One solution, which would substantially change the situation at a stroke, would be to make Value Added Tax into a genuine "Community tax", paying all VAT revenues directly into the Community Budget.[66] The "federal" tax-to-GDP ratio would then be about 10%, providing still very modest but perhaps useful automatic stabilisation[67].

6.4.2 Fiscal transfers

The main possibility opened up by increases in the Community budget, however, would be greater fiscal transfers within the EMU area. This would help to reduce the wide disparities in

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[65] Italy, Spain, Greece and Portugal are cited here.

[66] So solving - as a bonus - the problems of moving to an “origin” system. See “Options for a Definitive VAT System” *(European Parliament Working Paper E-5, 1995).*

[67] From the point of view of stabilisation and the creation of a coherent "aggregate fiscal stance", however, it would not be necessary to pay the money into the Community Budget. The harmonisation of VAT rates would achieve the same effect. (see next section, 6.1.*v*).

real income between the different regions of the EU (see Table 3).

Table 3: Differences in GDP per head between regions of the EU(12), 1990

Average of the 25 weakest regions	52.3
Average of the 25 strongest regions	137.9
Weighted standard deviation	27.7

Source: Table 11, "Stable money - sound finances"

Whether the effect of EMU will be to widen regional disparities or to reduce them is a matter of dispute. The Commission's paper of August 1990 on EMU [68] cautiously remarked that "the effects of economic and monetary integration may be at least as beneficial for the less developed regions as for the more prosperous." It added, however, that "some historical experience suggests that regions within an economic and monetary union can be disadvantaged over long periods of time unless sufficient measures are taken." The Commission cited this very uncertainty as an argument for a precautionary enlargement of the Structural Funds.[69]

More controversial is whether there should be fiscal transfers from the Community Budget to national budgets. Having lost the ability to alter interest rates or to devalue, a Member State facing an asymmetric shock could well argue that the only choice remaining to it - unless such transfers were available - would be freedom to follow its own fiscal policies (see section 5.1). This, effectively, is the argument for "cohesion". During the Maastricht negotiations the Commission was careful to reassure those Member States anxious that EMU might mean more EU spending. Any increases would be gradual, and "would not imply a large-scale transfer of major expenditure responsibility from the national to the Community level.."

Effective inter-regional and inter-national fiscal transfers, however, would not require a Budget nearly as large as would be necessary for automatic stabilisers to operate. New Community finance would not be limited to the budgetary transfers themselves. Substantial issues of "Union bonds" would be possible, the interest on which would be paid from the budget. As was argued when the "Delors bond" proposal was made, the credit rating of the Union would enable funds to be raised on the best possible terms. Parliament's proposal during the Maastricht negotiations was that there could be a Community maximum debt up to the total of Community investment.

Given the current political climate, such developments are very unlikely in the near future. The most that *Stable money - sound finances* propose was a growth of overall EC expenditure to "between 1.75 and 2.1% of GDP over the next 15 years".[70] It remains to be seen whether opinions

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[68] *Economic and Monetary Union (Sec(90)1659 final of 21.08.1990)* pp22-23

[69] See, for example, the evidence of the then Regional Policy Commissioner, Bruce Millan, to the UK House of Lords Selected Committee on the European Union *(Report on EMU and Political Union, HMSO 30.10.1990)*

[70] *op. cit.* p. 55

will change once EMU has become reality.

7. MODELS OF COORDINATION

Conceding that some coordination of national fiscal policies is inescapable, how should it best be carried out? Will the mechanisms and institutional framework established by the treaty prove adequate?

One market, one money observed that, at the time of writing (1990), "genuine coordination issues" - as opposed to the need to reduce high levels of deficit and debt - had not received much attention. The word had "in reality two different meanings":

- "*all kinds of discussions among governments and central banks*", in which the coordination of actual policy might be "implicit" rather than formalised; and

- "*formal and negotiated coordination in policy-making whose need arises from the game-theoretic aspects of interdependence....*"

In the event. the Maastricht Treaty produced a framework based rather more on the former definition. Subsequent proposals - like that for a "stability pact" and for tightening up Article 103 - are in part attempts to shift in the direction of the latter.

7.1 The relationship spectrum

Theoretical studies of international affairs identify "coordination" as only one option in a spectrum of possible relationships between states. Positions in the spectrum include:

i. Full autonomy, or the complete application of subsidiarity

In this model each Member State makes decentralized decisions in the light of its own economic needs, without formal consultation or coordination of policies. This does *not* mean, however, that national governments are in practice be free to do what they like. In the context of fiscal policy, the mechanisms of coordination are in this case market forces, and in particular the judgement of the financial markets concerning each country's credit-worthiness (see section 3.2).

In EMU, market forces will be substantially strengthened by the "golden rules"; and could be further strengthened by greater transparency concerning the structure of Member States' debt (see section 2.4).

ii. Full autonomy, modified by an "optimising strategy"

Games theory suggests that "non-cooperative" attempts to optimise individual positions can in fact be sub-optimal not only for a group as a whole, but for each individual participant. Games theory also suggests various ways in which players can improve individual and overall outcomes without formally sacrificing autonomy. One is the so-called Stachelberg strategy: a dominant

"leader" continues to make choices in its own interests, and the rest modify their behaviour to fit these choices. The pre-1992 ERM in practice operated in much this way around the D-Mark, although in theory it should have operated by reference to the ECU basket.

iii) Full autonomy, modified by monitoring and non-binding recommendations

This is the model on which most existing international economic institutions are based. The participants agree on certain indicative rules or guidelines, and compliance with these is systematically monitored. Examples of such a system are the IMF's surveillance of exchange rates and related macro-economic policy; the reports of the OECD; the Group of Seven finance ministers' meetings; and the "broad guidelines" procedure of Treaty Article 103.

Despite the existence of central organisations, such bodies are essentially *intergovernmental*, and operate within the context of normal international law. Recent proposals by the French Government for a Group-of-Seven-type organisation would apply a similar model to EMU.

iv) Mutual recognition

Though each participant retains its autonomy to determine policy, certain decisions by others are also accepted as a basis for action. The principle is well-known in the field of standards and qualifications both at international level and within the Single Market. Its main relevance to fiscal policy might be in the field of regulating financial markets.

iv) Formal coordination

Though the boundary is not clear-cut, formal coordination goes further than most international relationships in presuming that the outcome will be changes to national policy, the result of bargaining and/or the application of previously-agreed rules. Examples at an international level include the World Health Organisation's procedures for dealing with communicable diseases, and perhaps the World Trade Organisation (the successor to GATT). Institutional structures are required within which the bargaining can take place; and so, in the last resort, are various disciplinary mechanisms to enforce rules and agreements.

Article 104c of the Treaty fits this model. ECOFIN is both the forum for negotiation and the vehicle of enforcement; and in this respect, the system combines elements of *intergovernmentalism* with the procedures and framework of *Community law*.

v) Harmonisation

Though the boundaries are again not entirely clear-cut, harmonisation differs from coordination in a number of important respects. For example, it largely excludes the element of bargaining. Once the rules have been established, they are applied automatically, and are justiciable.

Harmonisation, moreover, presumes uniformity of policy where coordination allows for heterogeneity. For this reason, coordination may produce a *better* out-turn than harmonisation: e.g. in cases of asymmetric shock.

The role of harmonisation in the field of fiscal policy has already been mentioned (see section 4.3). The full harmonisation - including the rates - of not only VAT and excise duties but also of company taxation and the taxation of interest, would substantially limit the autonomy of Member States to determine overall fiscal policy. As against this, the effect of setting common rates of national tax, together with the Community budget itself, would go a long way towards creating a coordinated "aggregate fiscal stance" for the Union as a whole. In effect, fiscal policy, like monetary policy, would be centrally-determined, ending the centralised/decentralised dilemma.

vi) Integration

Such centralisation of fiscal policy, produced as a by-product of tax harmonisation, might ultimately be formalised within a federal (or, for that matter, unitary) structure. In such circumstances the relationship between EU monetary policy (determined by the ECB) and fiscal policy (determined by the Commission, Council and Parliament) would be equivalent to the relationship today in Germany and the US.

The Preface to Bryant's study of international coordination interestingly forecasts that this final, "federalist mutual governance" model, "now relevant only as an analytical benchmark, is a possible outcome that can be imagined for the middle or late decades of the twenty-first century, possibly even sooner for regional groupings like the European Union".[71]

7.2 Rules or Discretion?

The coordination of policy can also take a number of forms. One basic division is between *rule-based coordination,* and *activist discretionary coordination*.

In principle, the "excessive deficit procedure" of Article 104c is a rule-based system. Action is triggered once a pre-determined statistical threshold has been reached: either the 3% deficit or the 60% debt ratio. The Article then lays down the successive steps which can lead, ultimately, to penalties (see section 2.1). By contrast, the "multi-lateral surveillance" procedure of Article 103 (see section 2.5) is basically discretionary. The "broad guidelines" are based on the best judgements of Commission, Council and European Council concerning the economic situation at the time. The decision-taking procedure is "political".

The rules/discretion line between the two Articles is, or course, somewhat blurred. In particular, there are strong discretionary elements in the operation of the excessive deficit procedure. The distinction is nevertheless real, as is evident from the debate as to whether the deficit/debt criteria

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[71] *op. cit.* p.xxv

are to be interpreted "strictly" or "flexibly".

7.2.1 The Arthuis proposals

The proposals made by the German Government in 1995 for a "stability pact" were a clear attempt to move the excessive deficit procedure in a rule-based direction. One key element of the proposals was to introduce *automaticity* into the application of sanctions.

The French Government responded by proposing another form of automaticity. At the informal ECOFIN meeting in Verona on 12/13 April 1996, the Minister for Economic Affairs and Finance, M. Arthuis, suggested that "a link be established between payments from the Structural Funds and macroeconomic policies pursued in the Member States". Payment of aid from the Cohesion Fund, for example, might be suspended "in the event of non-compliance with the individual recommendations addressed to each Member State with an excessive government deficit".

In its analysis of these proposals[72], the Commission observed that the "aim of the proposed conditionality is to encourage nominal convergence, and in particular budgetary discipline". The excessive deficit procedure would be strengthened to the extent that "national authorities would be anxious to avoid the suspension of payments..." It rejected the suggestion, however, for a number of legal and economic reasons. In the case of the Structural Funds, conditionality would breach the legal basis on which they were established. More important, however, the purpose of structural policies was "primarily to promote medium- and long-term development with a view to increasing the lasting growth potential of economies in difficulty". Cutting off Structural Fund money would make both nominal and real convergence even less attainable.

In any case, the main preoccupation of the French Government was not so much to introduce new penalties for breaches of budgetary discipline *within* the Euro area as to prevent "competitive devaluations" of currencies outside. Its proposals were therefore more part of the problem of "ins" and "outs" (see Section 8.3) than of fiscal policy coordination within EMU.

The debate on the Stability Pact provided a concrete example of the choice between rules-based and discretionary systems. Which is the better model? Bryant observes that "the debate about nonactivist rules versus activist discretion has a long history".[73]

7.2.2 Rules

The basic argument for a rule-based system is that it provides credibility and consistency over time. In the monetary field, for example, the knowledge that policy is being conducted in relation to one or more statistical indicators - for example, money-supply figures or inflation targets -

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[72] Working document of the Commission: enforcement of convergence in Stage 3 of EMU, *SEC(96) 489 final of 30.07.1996*

[73] *op. cit.* p.20

rather than in response to political pressure is a key factor in establishing the reputation of a currency. Indeed, this is the primary argument for Central Bank independence.

In this context, it can even be maintained that conducting policy in relation to variable indicators is itself too discretionary: the multiplicity of indicators for money-supply (M^0, M^1, M^3, etc.) and for inflation (inclusive and exclusive of interest rates, taxation, etc.) is evidence that the science, in real life, is inexact. Hence the early Friedman proposal that the money stock should grow smoothly and steadily at a rate fixed in relation to the growth of productive potential.

One current issue illustrating the advantages of rule-based systems is the need to define "exceptional and temporary" in the context of the Stability Pact. If fiscal disciplines are to be credible, political wrangling over whether a budget deficit is or is not "excessive" should be avoided - especially at what is likely to be a time of economic crisis. For this reason, ECOFIN attempted to define as far as possible in advance the circumstances in which derogations would be justified.[74]

The lack of knowledge about macro-economic behaviour, and hence about the effects of policies, constitutes the main argument against discretionary systems. Politicians and officials can get things wrong (see 5.2). For example, “fiscal fine-tuning” was discredited when it was found as likely to re-enforce as to counteract cyclical trends.

7.2.3 Discretion

There are also several arguments in favour of discretionary systems. The first is that policy-makers must be able to take account of experience.

At the beginning of the 1980's for example, monetary policy in the UK was closely tied to the M^3 monetary aggregate. As it became clear, however, that M^3 was giving false signals about economic conditions, attention shifted to the narrow-money definition, M^0. This, too, proved misleading, with the result that money-supply targets were effectively replaced by an exchange-rate target, culminating in Sterling's membership of the ERM. There followed the *débacle* of 1992, since when a system has been put in place which targets the rate of inflation directly.

Such a record might be taken to confirm the fickleness of politicians. More important, however, it illustrates the danger of adhering to rules and indicators which, in the light of experience, can turn out to be incorrect or misleading.

The second argument for active discretion is that it can sometimes be essential *not* to fulfil expectations. The ERM itself, and in particular the issue of intervention, here provides a good case history. The "rules" of the ERM provided for intervention "at the margin": that is, when any two currencies reached their respective upper and lower limits against each other, both Central Banks were obliged to purchase/sell the currencies concerned. This effectively gave the

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[74] Though the difficulties were put in a nutshell by Edward Kellett-Bowman MEP, who wondered whether a General Election could be considered a "natural disaster".

speculators a "one-way bet"; and it is not surprising that, following the 1992 crisis, the *Bundesbank* called for the abolition of intervention at the margin.

By contrast, support grew for *intra-marginal intervention*, designed to influence exchange rates before they reached their upper or lower limits. Such intervention was by definition discretionary - that is, speculators could not tell in advance when it would take place. Such a system has effectively been in general operation since the 2.25% bands of fluctuation were widened to 15%.

7.3 Synthesis: "learning by doing"

Technically, the boundary between rule-based and discretionary systems lies in the field of feed-back.

For example, one purpose of setting a ceiling on budget deficits is to prevent future inflation. The Maastricht figure is 3%; the Waigel proposal was 1%. Which might be correct? One way of finding out might be a simple system under which the deficit target would be automatically adjusted in the light of the rate of inflation after a suitable time-lag. If the formula for adjustment were fixed in advance, this would still be essentially a rule-based system.

However, the link between current budget deficits and future inflation - if it exists at all - is unlikely to be simple. The mechanism of transmission is monetary policy, which itself has many variables. Any system of feed-back would have to take account of these; and adjusting the parameters would be very much a matter of trial-and-error in the light of experience - i.e. of discretion.[75]

The coordination of fiscal policy within EMU will almost certainly have to follow this pattern, at least initially. With the possible exception of Germany and the Netherlands, all participating countries will need to adjust to an unfamiliar monetary framework. At the same time, the Union as a whole will be experiencing the unique "centralised monetary/devolved fiscal" environment. In a word, nobody knows what will happen.

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[75] This, of course, is how neural networks operate, and it might therefore be thought that such systems are rule-based. The logic used by neural networks, however, is “fuzzy” in the sense that no parameters are predetermined: the computer “chooses” in the light of data from the real world.

7.4 Reducing uncertainty

This fact, as we have seen (see section 6.2), can be used as an argument for eschewing cooperation altogether. However, the fact that cooperation *can* fail as a result of insufficient data, or the use of inaccurate economic models, does not mean that the situation cannot be improved as the result of "learning by doing".

The literature on international economics cited by Bryan[76], for example, highlights the gains to be made from "mere" consultation.

> *"Information exchanges about the 'initial conditions' in which economies are currently located and about the shocks they are thought to be currently experiencing can help to reduce uncertainty and thereby facilitate national decisions, even when there is no intention of explicitly coordinating policies".*

Some research shows, indeed, that the

> *"gains from information sharing and from agreement on instrument choice tend to be much larger then the incremental gains from going further to full-scale cooperation.."*

This leads to the conclusion that Article 103 of the Treaty has got it just about right. The preparation of national "convergence programmes" - even if these tend in an over-optimistic direction - and the forwarding by Member States to the Commission of information "about important measures taken by them in the field of their economic policy and such other information as they deem necessary"[77]: gives each Member State an idea of how policy is developing in all the others; enables a synthesis to be made, in which incompatibilities can be noted, and overall recommendations be made ("broad guidelines"); and permits the development of an "early-warning" system about impending fiscal problems, as suggested by ECOFIN: i.e. leads to improvements in the economic models being used.

This analysis leads to a number of broad conclusions.

7.5 Conclusions

First, the Union would be unwise to establish, initially, systems of fiscal coordination which relied too much on fixed statistical targets and rules, and on automatic penalties when thresholds are breached. As has been explained in section 3 of this study, the 3% and 60% ratios of the "excessive deficit" procedure are of dubious validity because they fail to take into account the *structure* of deficits and debt. Such rules should evolve in the light of experience.

Secondly, it would also be unwise to introduce a system whereby Member States failing to meet

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[76] *op. cit.* p. 41 (including footnotes)

[77] Article 103, para. 3.

budgetary targets were deprived of their entitlements from the Structural or other Funds. The legality of such a system is in question; and the loss of EU funding could well aggravate the budgetary problems of eh country involved.

On the other hand, the Union should also, initially, avoid coordination based on activist *ad hoc* programmes or prescriptive solutions to problems, either for individual Member States or for the Union as a whole. National ministers and officials are as likely to err when acting collectively as when acting alone, and reductions in margins for error will only come through experience.

The greatest gains from coordination will be obtained through *the reduction of uncertainty.* To some extent this can be the result of clear, consistent rules, in particular in the management of monetary policy. Equally important, however, is a regular flow of information about the *prospective actions of other players*. The system should therefore provide *strong feed-back mechanisms*, monitoring the effects of decisions taken with a view to adjusting policy.

In this context, the availability of *accurate, timely and compatible statistics* is likely to be of critical importance. The European Monetary Institute and Eurostat are already active in this field; but there are still large areas of imprecision, particularly in the fiscal field.

The fiscal impact of other common policies should be closely watched. For example, the *harmonisation of tax rates* in order to avoid distortions of competition within the Single Market could significantly reduce the ability of Member States to conduct an autonomous fiscal policy. To the extent that this reduced their ability to meet asymmetric shocks, or to take into account variations in cyclical factors, the result would be damaging. To the extent that it facilitated a coherent "aggregate fiscal stance" for the Union, it should be pursued only as part of a carefully-developed overall fiscal strategy.

Finally, given the uncertainties which are likely to limit the effectiveness of coordination for some time to come, everything should be done to strengthen the automatic disciplines provided by market forces. In addition to the "golden rules", the most significant gains are likely to come from *increased transparency* in the structure of deficits and debt, enabling markets to make accurate assessments of credit-ratings.

8. THE INSTITUTIONAL FRAMEWORK

Chapter 2 of this study, and Diagrams 1 to 4, have outlined the relationship between the various Community institutions in the field of fiscal policy.

- the **Commission** has the role of collecting information and of making recommendations to the Council; and

- the **Council** is both the forum for discussions on policy, for "peer pressure" and for taking decisions for action, generally by qualified majority.

8.1 The role of the European Parliament

The most that the Treaty provides the European Parliament, however, is the right to information - and in certain circumstances (e.g. confidential recommendations) not even that. Only in the case of a decision by Council to make public recommendations to a Member State under multi-lateral surveillance is anything more active foreseen: the President of the Council may then "be invited to appear before the competent committee" of the Parliament (i.e. the Committee on Economic and Monetary Affairs and Industrial Policy).

8.1.1 Evolution of the Treaty texts

This is very different from the structure envisaged by Parliament itself during the negotiations which led to the Maastricht Treaty. The text originally drafted for Parliament's Economic and Monetary Affairs and Industrial Policy Committee by the EMU *rapporteur*, Fernand Herman, envisaged the use of no less than the *assent* procedure to legitimise certain actions in the economic field - that is, the positive votes of at least half Parliament's Members would be required.[78]

There was then a steady retreat, through co-decision, then cooperation and finally consultation, to the mere (limited) right to be informed. For example, Parliament's suggested text covering the "guidelines" procedure stated that:

> *"the Council shall adopt these guidelines in co-decision with the European Parliament..."*[79]

The draft treaty[80] read:

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[78] See PE 140.147 of 10th May, 1990. In the field of budget deficits, for example, the Council could "act by a qualified majority if it has obtained Parliament's assent and unanimously if it has not" (draft Article 20)

[79] Herman Report A3-223/90

[80] (SEC(90) 2500 of 10.12.1990. At this stage, the Article was numbered 102c(2).

> *"the Council, acting by a qualified majority and taking into account the deliberations of the European Council and the opinion of the European Parliament…. ";*

while the final text (now Article 103.2) reads:

> *"..the Council shall, acting by a qualified majority, adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendations."*

The logic behind the final text of the Maastricht Treaty was the distinction drawn between those aspects of economic policy which would be dealt with at a *Community* level and those which would remain at *national* level. In the former case - notably that of monetary policy - the European Parliament would have a role in order to help close the "democratic deficit"; but the latter - notably fiscal policy - would remain the responsibility of the national parliaments.

As a result, the European Central Bank was made accountable in some measure to the European Parliament (see, for example, Article 109b, paragraph 3 of the Treaty), and Parliament was given a role in other aspects of monetary policy (for example, the appointment of the President and Executive Board of the ECB under Article 109a, or the conferring upon the ECB of special tasks relating to prudential supervision under Article 105[81]). In contrast, the European Parliament was given only a minimal role in the area of fiscal policy.

8.1.2 The problems of democratic control

Is it really possible, however, to divide the responsibilities for fiscal and monetary policies in this way? The Delors Committee Report proposed not just a Monetary Union, but an *Economic* and Monetary Union; and the Treaty's Title VI on EMU duly starts with Chapter 1 (Articles 102a to 104c) covering Economic - and in particular fiscal - Policy. The contents of the Chapter are no less a matter of Community competence than the succeeding one, on Monetary Policy.

Moreover, a neat distinction between the democratic control of monetary policy at Community level by the European Parliament, and of fiscal policy at national level by national parliaments, is not convincing. When the fifteen Finance Ministers take decisions together in ECOFIN (meeting *in camera*) they will be acting as a collective, supra-national executive body. It is impossible for them to be accountable, collectively, to fifteen separate national parliaments (see Section 8.4.2).

Does this matter? In the view of some economists, allowing fiscal policy to fall into the hands of politicians is as dangerous as in the case of monetary policy. "... There is no guarantee that majority rule - or *qualified* majority rule - legislatures will allocate public resources efficiently,"

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[81] Here, interestingly, the phrase "after receiving the assent of the European Parliament" is used.

argue Inman and Rubinfeld[81]. "The recent US experience is instructive on this point". In Congress, they point out, legislators tend to become members of those spending committees covering policies of interest to their constituents. Once there, they "seek policies that benefit the 'folks back home', typically, localized public goods or transfers...", which are paid for out of national taxation. Studies had suggested that "the economic inefficiency from such a legislative process may be as high as $.15 for each dollar spent..."

Inman and Rubin conclude that the European Parliament's behaviour in the fiscal field is likely to "closely mimic" that of Congress. Certainly, similarities in the committee appointment system powerfully support the thesis. However, in two important respects the US and EU models will be entirely different.

First, there is no question (as Imman and Rubin appear to believe) that fiscal policy will be fully centralised.

Secondly, there is no possibility, either, that the European Parliament will ever "alone assume responsibility for EC fiscal policy" (as they fear).

The issue at stake is the coordination of national policies. If this is not to escape democratic scrutiny in much the same way as a great deal of secondary Community legislation under "commitology", the European Parliament should be able to play a more normal role. In particular:

- Under Article 103(2), Council should not be able to formulate "the broad guidelines of the economic policies of the Member States and of the Community" until it has at least received the formal opinion of Parliament (in addition to the current informal procedures and cooperation with the Commission). Nor should it adopt the guidelines until Parliament has been re-consulted

- Under Article 103(4), at least those recommendations to member States which are to be made public should require the consent of the European Parliament.

- The consent of Parliament should also be required under Articles 104c(6), 104c(8), 104c(9) and Article 104(11) of the "excessive deficits" procedure.

The current Inter-Governmental Conference could recommend these changes following the proposed reduction of the basic legislative procedures to two.[82]

A new dimension to the issue has been created by the proposals for a Stability Pact. Not only would the provisions of Treaty Articles 103 and 104c be enlarged and tightened. There might also come into existence a new "Stability Council"[83], empowered to judge Member States' fiscal

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[81] *op.cit.* p. 156

[82] One of these would apply when the Council acted by unanimity, the other when it acted by weighted majority.

[83] This has indeed come into existence in the form of the "Euro-11" informal Council.

policies, and to levy fines (see Section 3).

The lack of any real role for the European Parliament in these circumstances would be even more regrettable. In addition, it might also bring into question the specific exclusion of an appeal to the Court of Justice under Article 104c(10).

8.2 The problem of regional and local authorities

The fiscal disciplines under EMU will apply not only to central government, but also to regional and local government. Article 3 of Protocol 5, which details the excessive deficit procedure, makes it clear that central governments of the Member States are responsible under this procedure, not only for their own deficits, but also for those of any regional and local authorities. Member States are required to "ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty".

Theoretically, this provision could cause constitutional problems for some countries. Where a region or state enjoys a high degree of autonomy within a federal-type system, agreements entered into at international level by the central government may not be legally enforceable upon them. The case of the Canadian State of Ontario, cited by Lamfallussy, provides an example - though the only one - of the difficulties that might arise in the fiscal area.

The Member States of the EU vary considerably in their degree of centralisation. For example, in the UK control over the spending of local authorities is extremely tight, with local revenue-raising also constrained in recent years through "capping".

Table 4: Expenditure of German federal and local government, 1987

Federal Expenditure		**Federal transfers**	**Sub-federal expenditure**
Gross	Net		
Percentage of total consolidated expenditure			
63.9	60.6	3.2	39.4

Source: Lamfalussy op. cit. Table 1

The federal structure of Germany, by contrast, allows greater freedom to regional and local government. The German government is itself responsible for only about 60% of total spending (excluding grants to the States), equal to some 30% of GDP. Figures for 1987 (pre-reunification) were appended to the Delors Report (see table 4).

However, in the context *revenue-raising*, as opposed to spending, Germany is as centralised as the UK. *Stable money - sound finances* points out that tax competences are typically more centralized than expenditure competences, and that "the most salient case is provided by

Germany, where... virtually all fiscal revenue of the *Länder* (arises) from shared taxes.[84] It would, in any case, take a very exceptional set of circumstances for a German *Land* (or group of *Länder*) to cause problems for fiscal coordination within EMU.

8.3 "Ins" and "Outs"

Considerable discussion has already taken place about the *monetary* relationships after 1999 between those EU Member States fully participating in EMU, and those not. The *fiscal* relationships have so far received less attention.

Many of the Treaty provisions on fiscal policy will apply to all Member States, "in" or "out" - indeed have applied since the coming into force of Maastricht or the start of EMU Stage II in 1994. The whole of Article 103, on **"broad guidelines"** and **"multilateral surveillance"**, for example, applies to all Member States. Those countries not in EMU Stage III after 1999 will therefore continue to participate in the **coordination** of economic policies within the Council.

Similarly, Article 109e, paragraph 2, makes it clear that the **"golden rules"** (Articles 104, 104a(1) and 104b(1) have applied to all countries since the beginning of 1994.

8.3.1 Excessive deficits

In the case of the **"excessive deficits" procedure** the position is more complicated.

♦ Under Article 109e, paragraph 4, a non-binding version of the excessive deficits provision has applied to all Members States since the beginning of EMU Stage II.

  "In the second stage, Member States shall endeavour to avoid excessive government deficits."

  From the start of Stage III this will be replaced for *participating* member States by the text of Article 104c(1):

  "Member States shall avoid excessive government deficits".

  The 109e(4) text will continue to apply, under the provisions of Article 109k, to "Member States with a derogation"; and under Protocol 11(6), to the UK.

♦ The procedures for **establishing an excessive deficit**, reporting on it, and **making recommendations** (Paragraphs 2 to 8 of Article 104c), which have been in effect since the beginning of 1994, will continue to apply to all Member States.

♦ However, the requirement that a Member State judged to have an excessive deficit should

[84] *op.cit.* p. 35

take **measures for deficit reduction** with a specific timetable, and to submit reports (Paragraph 9), will *not* apply to countries with a derogation, nor to the UK. The same will be true of the **sanctions** foreseen under Paragraph 11.

Given that almost all the appropriate Treaty provisions will apply to "ins" and "outs" alike, problems for EMU as a result of divergent fiscal policies therefore seem improbable. The "out" countries will by definition be unable to affect directly the monetary policies of the Euro area. As for indirect effects, the relative size of the Euro area economy will be so large as to be immune to most externalities.

8.3.2 Implications of the Stability Pact

The situation might change, however, if fiscal discipline were to go beyond what is currently in the Treaty. Some of the problems that might arise from a Stability Pact have already been examined (section 3.3.2.). They would be the consequences of applying different degrees of fiscal discipline to the "ins" and the "outs".

Which group of countries would benefit most economically is a matter for discussion. The "in" countries might be expected to have lower inflation and a strong currency. On the other hand, the "outs" might be able to enjoy lower unemployment and even faster growth - particularly if they were free to devalue in relation to the Euro.

This issue of "competitive devaluation" has been analysed in another European Parliament study,[84] and provides in itself an interesting example of the interaction between monetary and fiscal policy. On the one hand, it can be argued - as it has been by the French government - that the Single Market cannot be maintained if countries within are able to steal a competitive advantage by a depreciation of their currencies. On the other, it can be argued - as it has been by the British Government - that in conditions of a floating exchange rate can be no such thing as a "competitive devaluation". Exchange rates are determined by world currency markets.

Both arguments are flawed. There is no reason why a Single Market should no exist with exchange-rate changes, any less than with differences in tax or social security. To say that markets decide exchange-rate changes, however, is also disingenuous. Markets reduce the current relative value of a currency when they perceive that it is likely to lose purchasing-power as a result of internal inflation. And this, in turn, depends partly upon the fiscal policies pursued.

8.4 National fiscal sovereignty

It is worth examining closely the quotation from the European Monetary Institute include in section 4.1. Limits on budget deficits and on government debt, it first states, are *"not to be seen as constraints on the conduct of economic policy"*. Rather, they are intended to be only *"a*

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[84] *EMU and the Outsiders* (1996), Economic Series Working Paper W-23, DGIV, European Parliament, Luxembourg, May 1996.

mechanism for preventing the experience of several countries in the past..."

The only way to make sense of this sentence is to assume that the countries concerned were willing, but unable at the time, to prevent the fiscal development mentioned. Only if the exercise of fiscal sovereignty had effectively failed at national level would it accord with the principle of subsidiarily for the matter to be handle by the union.

However, there is not a great deal of evidence to support this theory. It is more likely that political choice was involved. One significant illustration is provided by the records of the United Kingdom - where the overall level of government was *reduced* from 80% of GDP in 1970 to about 35% in 1990 - with that of Italy over the same period. Italian debt *rose* from 38% of GDP to 98%. The UK is almost alone oil revenues played a part, so did the priority given to "good housekeeping" by Mrs. Thatcher. Shifting substantial fiscal sovereignty from the member States of the European level is therefore a politically controversial matter, even if it is "for their own good".

8.4.1 UK opinion

In this context, the state of political opinion in the united kingdom - and particularly in the UK Parliament - illustrates some of the issues at stake. The powers of the "English Parliament" have historically rested on the ability to "rant supply" to the Crown, the *quid pro quo* for which was the "redress of grievances". It was for this reason that the prominent Eurosceptic, Lord Tebbit, began his speech opposing EMU at the UK Institute of Directors 1996 Annual Convention by quoting Gladstone:

> *"The finance of this country is intimately associate with the liberties of the country. It is a powerful leverage by which English liberty has been gradually acquired. If these powers of the House of Commons cone to be encroached upon it will be by tacit and insidious measures; and therefore I say public attention should be called to it."*

The reality of House of Commons control over the Exchequer, and over national finance, is less than such rhetoric would suggest. Nevertheless, votes of the House of Commons do from time to time overturn the budget decisions of the crown. It was through just such a vote in 1993 that the UK acquired an 80% reduced rate of VAT on domestic heating and lighting, as opposed to the full standard rate announced in the Budget. Moreover the *threat* of a defeat on the Finance Bill acts as a check on the ability of any Chancellor of the Exchequer to do what he likes.

The belief that these historic powers will be "handed over to Brussels" not surprisingly arouses the passions of ardent Eurosceptics. To some extent this can be dismissed as the natural reluctance of politicians to lose some of their powers. Christopher Johnson refers to the American academic James Buchanan's theory of "public choice", which predicts that those in power will always choose a "second best" policy if the "first best" policy would involve accepting others' influence over their decisions.[86]

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[86] *op*.cit. p. 178

However, such feelings are not confined to politicians. It is worth recording that the Institute of Directors - which represents a large number of small and medium-sized companies in the UK - voted 60-40% *against* participation in the Single Currency.

8.4.2 The problem of intergovernmentalism

More moderate opponents of EMU in the UK recognise that the role of "Brussels" will in practice be very limited. Their main fear is different: that the Crown itself will be able to "escape" from parliamentary control by taking irreversible decisions on fiscal policy at intergovernmental level.

This is an issue of more than British relevance. Indeed, it goes to the very heart of the "intergovernmental" model of European union development. Of decisions are to be taken by ministers - that is, by national Executives, acting collectively - there will always be the possibility that the results will not be acceptable to the national legislatures or electorates. In such circumstances, *either*

- the decision will not be implemented in one or more Member States; *or*
- the national legislatures in question will be by-passed.

The failure of the Danish people to accept the Maastricht Treaty in the 1992 referendum is an example of what can happen in the first case. No only was a new negotiation, leading to the "Edinburgh compromise", necessary as a prelude to the second referendum; but the Danish "no" has widely been seen as one of the triggers of the September 1992 ERM crisis.

Belgium currently provides an example of the second case. The Government has calculated that, using normal constitutional procedures, it would not secure adoption in time of the measures needed to implement the Maastricht fiscal criteria. It has therefore decided to use extraordinary executive powers.

The dilemma is not, of course, new. The intergovernmental model is essentially one based on *international* (rather than Community) law, where there was always been a problem or reconciling the sovereignty of states with the doctrine that *pacta sunt servanda*. The solution has traditionally been to give the Executive - the Crown, or the US or French Presidencies - wide discretion in the conduct of external policy.

The day-to-day conduct of national fiscal policy, however, is somewhat different from the traditional subjects of international law: war and peace, recognition and statehood, treaties and diplomacy. Strange though it may at times seem, people seem happy to leave declarations of war to their King or president; but certainly not the rates of VAT or Income Tax. For this reason, intergovernmentalism is likely to work in some areas of policy, in particular the traditional subjects of international law covered by the "second pillar" of the EU; but not others.

8.4.3 Democracy

The final difficulty which must be faced in coordinating fiscal policies has already been touched upon in the Introduction. How are the broad objectives of price stability and fiscal rectitude, established in the text of the treaty, to be reconciled with the rights of electorates to choose between alternative parties and policies?

One possible answer would be to admit that the ability of national elections to effect policy changes has increasingly become circumscribed as national sovereignty has itself become circumscribed. Even if it were not written down in the treaty, the disciplines of global markets in any case limit te ability of countries to run up public debt; and those who promise to "spend the unemployed back to work" are merely attempting to deceive. As Henry Ford I might have put it, voters can have any fiscal policy they want, as long as it's black.

There is a lot in this. It is not, though, entirely true (see Section 4). Moreover, it does not answer the critical point: what if national electorates, despite all they are told by the experts, decide to try a different approach? The real answer to the problem must therefore lie in ensuring that all decisions taken, whether at national or European union level, enjoy democratic as well as legal legitimacy. The choice of procedures is limited.

The first model is that pioneered within the European Community by Denmark. No Finance Minister might be empowered to vote on a fiscal issue within Council without the specific, *prior* agreement of his or her national parliament. This could be a complete answer to the problem, but suffers from two drawbacks:

- it makes the timetable for decision-taking extremely lengthy - probably as long, indeed, as that for changing the treaty itself;
- it only works fully when Council acts by unanimity.

The second answer is to develop, as from time-to-time proposed by French politicians, a kind of European Senate consisting of member nominated from national taken by the Finance Ministers.

Again, there are two problems:

- There is no guarantee that the selected national parliamentarian in the Senate would be any more representative of national parliamentary opinion as a whole than the Finance Ministers themselves. Experience with such nominated assemblies, on the contrary, suggest that they are likely to be composed of assemblies, on the contrary, suggest that they are likely to be composed of atypical members with specialised enthusiast or expertise.

- The result would in effect be the re-creation of the old, nominated European Parliament, with all its dual mandate problems. It was in large measure to avoid these that the Parliament was directly elected in 1979.

The third answer, as recognised by Otmar Issing[87], would be a more robust *political* union alongside EMU. This would inevitably mean giving the directly-elected European Parliament a far more important role.

Why, indeed, should the electorate of the European Union as a whole not be given the chance to pronounce on fiscal policy? The Maastricht criteria, it is true, were ratified by all the member States in accordance with their constitutional requirements. But this is different from the practical out-turn of fiscal policy co-ordination.

Objectors will say that European Election are always fought by the parties on national issues. This is true; and will always be true as long as the key decisions are taken at intergovernmental level. Once the Parliament is seen to be playing a decisive role in its own right, however, the situation would change.

Fiscal policy coordination might be a good place to begin such a process.

[87] *op.cit.*

9. SUMMARY AND CONCLUSIONS

Economic and monetary union will give rise to a critical dilemma. Since monetary policy will by definition be decided centrally for the Union as a whole, the burden of adjusting for country-specific factors will fall on national fiscal policies. Yet, at the same time, complete autonomy for these policies could put at risk the conduct of monetary policy, in particular the objective of price stability.

The purpose of fiscal policy coordination within EMU will be to resolve this dilemma. Several indications of how it might be done will be found in this study.

- The statical *size* of budget deficits, and the overall level of public debt, are not as important as *how they are financed*. For this reason, the "golden rules" laid down in the Treaty might enable market forces to exert sufficient fiscal disciplines on Member States.

- Certain problems with market signals - and in particular doubts as to whether te "no bail-out" rule would ever be applied in practice - can nevertheless justify more direct measures to control "excessive deficits".

- Member States are making determined efforts to reduce 1997 budget deficits in order to qualify for EMU membership in 1999. Many of the measures taken, however, will only have "one-off" effects. The possibility that fiscal rigour will be relaxed once the pressure of qualifying for membership is off may justify the conclusion of a "Stability Pact". There is a danger, however, that a Pact will be too inflexible and divide the EU, while the fining provisions will nor prove credible.

- In any case, market forces should be strengthened by two further "golden rules":

  a) Member States' debt structures should be fully transparent.

  b) There should be rules on the maturity structure of debt.

  Increased transparency in the structure of deficits and debt will enable markets to make accurate assessments of credit-ratings.

- There is a little correlation between long-term interest rates and the level of debt as a percentage of GDP. The "sustainability" of debt depends on the extent to which the debt is funded by domestic savings; the maturity of the debt; the underlying primary balance; and the rate of economic growth. The 60% Maastricht reference level is therefore of little value.

- Likewise, the "correct" level of budget deficits/surpluses depends substantially on cyclical factors; and will not necessarily be the same for all Member States at any one time. There are also strong arguments for distinguishing between current and capital spending, and the relationship between the borrowing requirement and public investment. The 3% of GDP reference level for the borrowing requirement (or, indeed, any reference level at all) must be interpreted in this light.

- It is questionable whether monetary and fiscal policies aiming for zero inflation are wise, given that the marginal costs in terms of lost output and higher unemployment rise as inflation-rates approach zero. The "price stability" objective should be clarified so that monetary and fiscal policies aim for *a stable and low rate of inflation*, at a level which *maximises economic growth* and *minimises unemployment*.

- There are several reasons for coordinating national fiscal policies within EMU.

  i) "Fiscal expansion in one country" can have spill-over effects upon related economics, and create pressures for monetary accommodation.

  ii) National fiscal policies will have consequences for the common external balance of payments, and the external value of the Euro.

  iii) Varying levels of public expenditure and taxation also have spill-over effects upon neighbouring economies.

  iv) In the absence of a large EU federal budget, the "aggregate fiscal stance" is determined by the combined effects of national policies.

- However, the coordination of national fiscal policies will not automatically produce a better out-turn than allowing member States complete fiscal autonomy. "Fox-without-a-tail" coordination, for example, might result in the *least* responsible fiscal policy becoming the norm. There are arguments for preventing governments from "colluding" as well as for encouraging them to coordinate.

- In the long-term, a substantial increase in the size of the EU Budget would permit fiscal stabilisation policies, while allowing member States wide fiscal autonomy. It would also permit fiscal transfers to meet regional disequilibria within EMU.

- The union would be unwise to establish, initially of fiscal coordination which relied too much on fixed targets and rules; and also on automatic penalties for breaches for thresholds, which could aggravate the very problem they are designed to prevent. Such rules should evolve in the light of experience.

- It would also be unwise to introduce a system whereby member States failing to meet budgetary targets were deprived of their entitlements from the Structural or other Funds. The legality of such a system is in question; and the loss of EU funding would increase the budgetary problems of the countries involved.

- On the other hand, the Union should also, initially, avoid coordination based on activist *ad hoc* programmes or perspective solutions to problems, either for individual member States of for the union as a whole. National ministers and officials are as likely to err when acting collectively as when acting alone, and reductions in margins for error will only come through experience.

- The greatest gains from coordination come from *the reduction of uncertainty*. To some extent this can be the result of clear, consistent rules, in particular in the management of monetary

policy. Equally important, however, is a regular flow of information about the *prospective actions of others players*. The system should therefore provide *strong feed-back mechanisms*, monitoring the effects of decisions taken with a view to adjusting policy.

- The availability of *accurate, timely and compatible* is likely to be of critical importance. The European Monetary Union Institute and Eurostat are active in this field; but there are still areas of imprecision, particularly in the fiscal field.

- The fiscal impact of other common policies should be closely watched. For example, the *harmonisation of taxes rates* in order to avoid distortions of competition within the Single Market could significantly reduce the ability of reduced their ability to meet asymmetric shocks, or to take into account variations in cyclical factors, the result would be damaging.

- Though the European Parliament has been given a modest tole in *monetary policy* under EMU, it has been given hardly any role in the coordination of *fiscal policy*. This distinction is hard to justify.

- When the Finance Ministers of those countries participating in EMU meet to take decisions in the fiscal area, they will be acting as a collective, supra-national body. Their responsibility to fifteen separate national parliaments provides an unconvincing model of democratic control.

- Council should not be able to formulate "the broad guidelines of the economic policies of the member States and of the Community" under Article 103(2), until it has at least received the formal opinion of Parliament (in addition to the current informal procedures and cooperation with the Commission). Nor should it adopt the guidelines until Parliament has been re-consulted.

- At least those recommendations to Member States which are to be made public under Article 103(4), should require the consent of the European Parliament.

- The consent of Parliament should also be required under Articles 104c(6), 104c(8), 104c(9) and Article 104(11) of the "excessive deficits" procedure.

- An increased role for Parliament would help answer the question: how can monetary and fiscal stability be combined with democratic choice?

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