

Aspects of the fiscal policy in the European Union

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The saying 'two heads are better than one' reflects human behaviour at more than just the individual level. History shows that it can be applied to a country's behaviour as well. The European Union is one of the latest examples of countries 'teaming up' 'for better and for worse'. As expected, facing the worse is one of the most difficult aspects to deal with.

In what follows, I will explain why the need for a central budget and for a federal fiscal policy has been one of the most debated subjects related to the EU and I will discuss the most plausible solutions of this case.

Key words: central budget, federal fiscal policy, EU

The EU fiscal policy

"The hardest thing in the world to understand is the income tax." Albert Einstein

Perhaps the difficulty of the income tax approach has diminished, but the 'relativity' of the fiscal policy has remained and it is obvious even when we refer to a united Europe.

There is no general agreement among economists as to how far fiscal policy can be safely left to national governments. However, the idea of a centralised budget has been stressed by Kennen since 1969, or by the MacDougall Report since 1977 ('failure to do so would impose great social strains and endanger the Monetary Union').

Many have argued that in order to survive, the EU will need a system of interstate transfers, the so-called 'fiscal federalism'. This will be needed to help balance the

economies of the euro zone if they face asymmetric shocks. The problem, in such a case, is that fiscal policy is the only remaining major policy tool for reacting to nationally differentiated shocks. What would normally be solved by adjusting wages and prices has to be handled by using fiscal policy only.

In search of an answer, economists thought of applying the same solution adopted by other countries that have passed through similar situations. Thus, comparisons with the monetary unions that have been formed before are common in economic literature. However, examples like Germany, Italy or the US are not relevant. In these cases, things took place in the context of gold standard, which gave little autonomy to national governments anyway. Today's Europe gave up, by contrast, real powers of independent monetary policy.

As history does not seem to help, we have to turn to the present agreements. Thus, the

Treaty on European Union specifies three elements that should be taken into consideration when analysing the framework of fiscal policy (Hansen & Nielsen, 1997):

- discipline
- autonomy
- co-ordination

In fact, the idea of a common fiscal policy and flexibility is also analysed in Mundell's article on the optimum currency area, in 1961.

Fiscal discipline must ensure that the public-sector deficit is sustainable in the long run. In the Treaty, this is mentioned by Article 104c that limits the public-sector budget deficit to 3% of the GDP and the public sector debt to 60% of the GDP. Therefore, it is important that no state undermines the monetary union by creating a public-sector debt, which cannot be amortised.

As mentioned before, in a monetary union, the government no longer determines monetary and exchange rate policy, therefore it is important that it has a certain degree of autonomy over fiscal policy. This may be the result of a flexible way of using national fiscal policies.

The idea of co-ordination has to do mainly with the spill-over effects that fiscal policy has on output and interest rates. By co-operating, all states could achieve greater economic welfare that could enable them to pursue their economic goals independently. However, co-ordination implies centralisation, and even if it is a mild form of centralisation, it will meet political opposition unless its advantages are extremely clear.

Hansen and Nielsen have launched the idea of ad hoc policy co-ordination determined by the interdependence of the EU and the global economy. By this, it would be possible to achieve the optimal mix of monetary and fiscal policy in relation to the rest of the world. Fiscal policy co-ordination could also strengthen the union in international

negotiations and the global co-ordination of macroeconomic policy.

The importance of fiscal co-ordination is also emphasised in the Delors Report (1989). It states that, although this objective should be achieved as much as possible through voluntary co-operation, there is a need for 'binding rules' and for the transfer of decision-making power from member states to the Community.

Although there are substantial arguments in favour of policy co-ordination, some authors such as Gros and Thygesen (1992) or Eichengreen (1993), consider that there is no urgent need for rigorous day-to-day co-ordination of fiscal policy in order to deal with output spill-over, as such effects are difficult to measure.

Considering all the elements that form an economic and monetary union, it seems natural that all the solutions presented apply. However, there is a big variance among EU members and usually each country experiences a different stage of the economic cycle. Therefore, the sum of fiscal decisions by individual governments cannot guarantee a collective fiscal stance that is optimal from the point of view of the Union as a whole.

An alternative solution is to establish a special stabilisation mechanism at a certain level between that of the EU and the national budgets. Proposals for such a mechanism have been put forward by Italianer and Vanheukelen (1993). The idea is that the EU should subsidise the public-sector budgets of the member states that are hit by a negative asymmetric shock. The proposal emphasised that the transfers should be made not for the purpose of retribution, but only for stabilisation. The temporary nature of the assistance not only reduces costs to the Community budget, but also prevents serious delays in the necessary long-term adjustment of wages and prices.

It is surprising that about every action taken to make the process of unification easier generates a set of actions aimed at changing

the former. In the case of the Maastricht Treaty (1992) and of the Stability Pact (1997) which are subject to heavy criticism among specialists.

‘The paradox of the European Monetary Union (EMU) is that member states will have to use fiscal policy more actively to offset their loss of control over monetary policy, yet that very same monetary policy requires some limits of fiscal policy’ (Johnson, 1996). It is indeed the lack of flexibility in dealing with recessions that could create tensions between national governments and the European institutions. This tension could exist at two levels:

- ✓ countries will want to use automatic stabilisers in their countries during recession, which will put pressure on the European Central Bank (ECB) to relax monetary policies;
- ✓ countries that are hit by recession and exceed the budget deficit are subjected to fines.

The implications of this pact are far greater than expected. For most countries deviations from 3% deficit ceiling are expensive. For example, a country that runs a 5% deficit has to pay the equivalent of 0.4% of GDP for each following year. The fine paid by a country that exceeds this limit is substantially larger than the net contribution to the EU budget. Payments of this size have a large political impact, since they require a substantial increase in taxes and a decrease in expenditure. Therefore, the Stability Pact represents a strong motive for the member states to keep fiscal policy under control.

Actually, the Treaty has a ‘no bail-out clause’, which tries to avoid political pressure from a heavily indebted government that expects the ECB to come to its aid, or the market pressure. Although economists agree that limits on budget deficits are not the best way to deal with the political dimension of the solvency problem, excessive fiscal deficits can lead to monetisation or bail-out by partners, and

bring out the danger of inflation through excess money creation or stagnation through high long-term interest rates on public debt. Arguments for limiting budget deficits also warn about the possibility that countries might be tempted to compete in fiscal laxity in order to win the votes of their electors. Competition to cut tax rates can be healthy in reducing excessive tax burdens, but it can also result in undesirable cuts in essential public services and infrastructure (if governments try to reduce budget deficits while also cutting taxes).

Conclusions

The importance of the fiscal policy in the EMU has been the subject of several economic ‘prophesies’ (Economic Commission: *‘Indeed, EMU will place new demands on fiscal policy at the national level for short-term stabilisation and medium-term adjustment purposes in the case of country-specific disturbances’*) but not necessarily subjected to agreement. However, it is generally accepted that fiscal stabilisation depends on how national budgets adjust to shocks and that it should not be left entirely to the discretion of national governments. Arguments supporting this idea could be summarised as follows:

- A large budget deficit in one country puts pressure on the overall level of interest rates, crowds out the productive investment and diverts some Community saving to that country;
- Greater externalities: as countries become more integrated, the external effects of domestic policies take on greater importance;
- Policy co-ordination with third countries: without some fiscal power at the Community level, the EMU would lack an important tool in negotiating with third countries (Padoa-Schiopa, 1994).

Fiscal policy, apart from occasional attempts of co-ordination, will continue to be an important issue for the individual member states, and its major role will be to facilitate the adjustment processes that are necessary after asymmetric shocks.

National fiscal stances, while differing both in detail and in size, will be largely determined by the requirements of a policy mix in which the monetary component is already given. At the same time, national fiscal regimes, if properly co-ordinated, should be as capable of stabilising the EU economy as a federal system, provided that the automatic stabilisers are allowed to operate.

The current state of affairs is indeed unsatisfactory, meaning that, in many ways, it brings obstacles to economic unity rather than eliminate them. However, the Monetary Union will not collapse, since there has to be a strong 'system' of weaknesses in order to generate such a serious effect. Fiscal policy is indeed important but one should keep in mind that the EU is not only about money.

Whether it will adopt a federal system or not is related to the EU's chance of survival, to its ability of 'taming' economic differences and including them into uniformity, a type of federalism that aims at finding optimal combinations of unity and diversity. Therefore, the choice for Euroland is not between a federation or a non-federation but rather the appropriate degree of federalism.

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