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ABSTRACT

Normative Aspects of Fiscal Policy in an Economic Union: a Review*

This Paper provides a coherent, logical framework that connects the main issues concerning fiscal policy in an economic and monetary union. The focus is on normative issues within the European Union.

JEL Classification: E61, F42, H7
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NON-TECHNICAL SUMMARY

Europe has changed dramatically over the past 50 years. Over time, it has moved towards deeper economic integration and cooperation. However, contrary to other elements of the European Union (EU), cooperation in the area of fiscal policy has been considered controversial and not necessarily satisfactory. This Paper reviews recent theoretical developments to address the problems of coordination and cooperation in the conduct of fiscal policy in the EU.

The Paper does not attempt to present a thorough study of the various issues concerning fiscal policy in the EU. Instead, the aim is to provide a coherent, logical framework that connects the various issues raised in the literature. To do so, we make use of the main lessons from the theoretical literature on fiscal policy. The focus is on normative issues.

There is a rich literature on international transmission of fiscal policy. For instance, Frenkel, Razin and Sadka [1991] examine spillover via capital taxation. This analysis has been used to study the European case by Keen [1993]. For a survey of the literature on international transmission of fiscal policy, see Persson and Tabellini [1995]. However, Persson and Tabellini focus on political economy issues rather than on the arguments for international cooperation and the different forms it can take (coordination, rules, federalism, etc.). Therefore, our review Paper can be considered as complementary to theirs.

We first discuss the theory of fiscal policy in a closed economy. We then consider the issues of externalities and cooperation in fiscal policy in a multi-country setting. We consider, among others, the questions of whether national fiscal policies need to be restricted by supranational rules and whether national fiscal policies need to be jointly chosen and if yes, at what level.

The fiscal policy debate and in particular tax harmonization, means that national policy-makers will lose their competitive edge in the battle to lure inward investment and hence make a further surrender of sovereignty. The recent EU proposal to harmonize some tax rates (VAT, Energy, Excise Duty), although it is pushing the timetable forward, is in line with the already existing trend towards integration. As we said above, the official argument is that different tax rates distort decision-making. The unofficial argument is that tax competition can lead to a too small size of public sector.

We conclude that the ongoing fiscal policy debate is more socio-political than an economic issue. This has to do with the ‘optimal’ size of the public sector and the ‘optimal’ degree of integration of Europe.

I. INTRODUCTION

Europe has changed dramatically over the past 50 years. Over time, it has moved towards deeper economic integration and cooperation. However, contrary to other elements of the European Union (EU), cooperation in the area of fiscal policy has been considered controversial and not necessarily satisfactory. This paper reviews fiscal policy in the EU.

The paper does not attempt to present a thorough study of the various issues concerning fiscal policy in the EU. Instead, the aim is to provide a coherent, logical framework that connects these issues. To do so, we make use of the main lessons from the theoretical literature on fiscal policy. The focus will be on normative issues.

The paper is organized as follows. Section II discusses the theory of fiscal policy in a closed economy. Section III discusses cooperation in fiscal policy in a multi-country setting. Section IV closes the paper.

II. TAXES, FISCAL DEFICITS, AND PUBLIC DEBT IN A CLOSED ECONOMY

In the basic neoclassical model, the Ricardian equivalence theorem implies that real resources do not depend on the way of financing a given path of government spending (see e.g. Barro [1974, 1989]). Changes in public sector deficits arising from a switch from tax to bond financing (i.e. borrowing) of a given spending program have no real effects. Although the assumptions behind this debt neutrality result are very restrictive, this case serves well as a benchmark model. On the other hand, changes in government spending do have real effects, but while they stimulate some components of aggregate demand, they completely crowd out other components.

In the basic Keynesian model, deficits and debt-financed fiscal expansions can also crowd out private economic activity. For instance, in the textbook IS-LM model, a cut in income tax boosts private consumption but crowds out private investment via an increase in interest rates. Also, when we add dynamics, deficits can feed on themselves. If activity and hence the tax base go down, explosive debt growth is possible (see e.g. Buiter [1985]).

When tax policy is endogenous (i.e. it is chosen optimally), the neoclassical model suggests a simple function for deficits and debt (see Barro [1979]). Namely, it is desirable to smooth out distortions over time and thus to run surpluses (resp. deficits) when times are good (resp. bad). This model has been extended by, among others, Kydland and Prescott [1977, 1980], Lucas and Stokey [1983], Chamley [1986], Lucas [1990] and Chari, Kehoe and Christiano [1991 and 1996], who have studied the structure of optimal distorting taxation over time and its effects on private decisions under various commitment technologies. More recently, Bohn [1992] and Jones, Manuelli and Rossi [1993] have also endogenized government spending. Note that discretionary Keynesian theory of demand management also agrees with the optimality of deficit spending during recessions (see e.g. Buiter [1985]).

According to the above theoretical models, it seems that there is no reason to worry about fiscal imbalances. However, there is empirical evidence of persistent and excessive budget deficits, dynamic instability and insolvency. As a result, a growing theoretical and empirical literature has been devoted to the analysis of "policy distortions" or "policy failures" that can account for these inefficiencies.

The role of economic policy: lessons from theory

Before we discuss policy distortions or failures, let us recall some basic lessons from economic theory. Pareto efficiency means that it is impossible to make someone better-off without making someone else worse-off. This is separate from distributional or political goals. Then, the first welfare theorem tells us that competitive equilibria can achieve a Pareto optimal result. The second welfare theorem goes even further. It tells us that a central authority can achieve any particular Pareto optimal outcome (reflecting distributional or political goals) by lump-sum taxes/transfers and letting the market work. In other words, under the assumptions of these two theorems, the possibility of welfare-increasing intervention is limited to the carrying out of wealth transfers for the purposes of achieving distributional or political aims.

However, when there are "market failures", market equilibria cannot be relied on to yield Pareto optimal outcomes. Market failures include externalities[1], public goods[2],

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[1] That is, situations in which there are external effects from the actions of other agents (e.g., your neighbor's loud music at three in the morning disturbs you).

[2] That is, situations of special type of externalities in which if one agent provides one unit of a public good, all agents benefit (e.g., national defense, roadways, etc).

asymmetric information (adverse selection and moral hazard problems) and market power. In all these situations, decentralized market outcomes are Pareto inefficient. Hence, there is an efficiency role for economic policy. However, in a second-best world, policy intervention itself can be also associated with distortions or failures (due to e.g. distorting policy instruments and administrative costs). In what follows, we consider two popular cases of policy distortions.

Two examples of policy distortions

An important policy distortion is the lack of commitment technologies and the associated credibility problem. In a second-best situation, a plan that is optimal at some time t, it is not still optimal at time $t+s$, where $s>0$. Therefore, a policy-maker that has discretion to sequentially revise his policy and who operates in second-best environment, will face a set of additional incentive constraints at t, namely that actual and expected policy at all future dates $t+s$ be ex-post optimal. These additional constraints typically worsen the equilibrium outcome.

A famous application is the capital taxation problem (see Chamley [1986] and Chari et al [1991 and 1996]).[3] Once the capital stock is in place, its supply elasticity is zero, and a tax on it does not distort investment decisions. Hence the ex-post incentive to drive the tax rate on installed capital to its extreme value becomes very strong. A promise not to tax future capital is therefore non-credible. When binding commitments are not available, private investors realize the policy-makers' incentive for high taxes and invest little. In equilibrium, there is under-investment, and hence little tax revenues despite the high tax rate. As a result, there are "excessive" deficits, or other tax bases (e.g. labor) have to be taxed higher.

Another important policy distortion includes models of political (e.g. electoral and partisan) motives, short-term horizons of policy-makers, wars of attrition and reproduction of the status quo.[4] Now policy-makers are not benevolent. The general finding of the empirical literature is that political factors can help explain fiscal biases. For instance, in most OECD economies there is evidence that government expenditures go up, while taxes go down, in pre-election periods. This implies that incumbents try to "bribe" the electorate by creating a fiscal euphoria. Also, political instability and

[3] For a survey, see the Introduction in volume 1 edited by Persson and Tabellini [1994]).
[4] For a survey, see the Introduction in volume 2 edited by Persson and Tabellini [1994]).

government weakness are important in explaining inability to curtail fiscal deficits. Furthermore, partisan biases and political polarization are important roots of large fiscal deficits. See Roubini and Sachs [1989] and Alesina, Cohen and Roubini [1993].

Summing up, policy distortions can lead governments to run excessive deficits.

III. EXTERNALITIES AND COOPERATION IN OPEN ECONOMIES

In the presence of externalities (or spillover effects), there is fear that market and policy distortions in one European country may have adverse effects on other European countries. Hence, the arguments for international cooperation.

The presence of externalities is crucial. Various types of externalities have been stressed by the relevant literature (see e.g. Buiter et al [1993]). For instance, if a country's fiscal situation becomes unsustainable, other countries might be forced into a bail out of the insolvent national government. Or the European Central Bank may be forced to monetize unsustainable national debts, and so create additional inflation in the EU. Or national governments may be tempted to borrow too much once EMU starts, because the single currency will reduce the interest rate penalty that would otherwise have to face. These examples imply a moral hazard problem: member-countries have an incentive to follow unsustainable policies. However, even if there are no problems of insolvency and moral hazard, there are spillover effects via exchange rates and interest rates. For instance, in the presence of free capital mobility and trade linkages, there is the danger of spread of fiscal and financial crises to other countries.

If externalities across countries are empirically important,[5] there is a logic behind cooperation. Cooperation can take place in two ways: (i) through exogenous supra-national rules that restrict national fiscal policies; (ii) through explicit coordination of national fiscal policies (i.e. joint optimization). In what follows, we look at these two ways of cooperation.

Do national fiscal policies need to be restricted by supra-national rules?

The main idea behind exogenous policy rules is that institutional mechanisms can help resolve incentive constraints and reduce discretionary biases. For instance, rules can work as a substitute for endogenous reputational forces which require long time-horizons. Or rules can reduce fiscal deficits associated with political polarization and conflict. This is clearly a second-best argument, which provides a rationale for the Maastricht Treaty criteria and the "Stability and Growth Pact". Note that similar fiscal rules have been used in the USA.

The Stability and Growth Pact specifies that the medium-term fiscal objective is member-countries' government budgets to be in surplus or balanced. This will be annually monitored through the submission of a Stability Program. In case the deficit to GDP ratio exceeds 3%, the member-country will be subject to a fine.

The main idea behind such policy rules is about delegating economic policy in a second-best environment. For delegation of economic policy, see e.g. Rogoff [1985a] in a closed economy where monetary policy is delegated to a conservative central banker, and Giavazzi and Pagano [1988] in an open economy where monetary policy is delegated to an inflation-averse center country. The same logic applies to fiscal policy. For instance, Buiter et al [1993] argue that supra-national fiscal rules can offset political distortions that systematically induce excessive deficits. These supra-national fiscal rules can monitor agreements, interpret rules, and enforce agreed rules through sanctions against deviant members.[6] Along the same lines, Beetsma and Uhlig [1998] and Kempf [1997] show that an exogenously set fiscal pact can work as a commitment device in a monetary union. Also Chari and Kehoe [1998] show that when there are commitment problems, debt constraints can be desirable. All these applications are consistent with the general result that cooperation (and recall that fiscal rules constitute a form of cooperation) is a substitute for pre-commitment (see Tabellini [1986]).

Of course, binding supra-national fiscal rules are not the only way, or the best way, to achieve fiscal stabilization. Even if endogenous reputational forces are not possible, exogenous rules do not have to be supra-national. Domestic ones can also work. For instance, we know that there can be a common budgetary performance

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[5] However, some authors believe that spill-over effects among member-countries in the EU may not be quantitatively significant (see e.g. Buiter et al [1993]).
[6] There is a similar argument in the context of environmental policy where there are exogenous rules for emission limits.

irrespectively of the Maastricht Treaty. That is, a country can stabilize on its own. However, the interesting question is not whether a country can stabilize on its own or not, but whether supra-national rules can make the stabilization process easier, and in particular less costly in terms of recession. If membership in the EU works as an anchor for private expectations and reduces wage indexation, or as a mechanism that strengthens the position of groups favoring stabilization policies, then EU cannot make stabilization harder.

There are pluses and minuses. Consider first the pluses. First, the rationale for fiscal criteria as pre-conditions for admission is that they indicate – by actions and not by "cheap talk" – that commitment to the EU is serious and that participants share the same stability culture. That is, they are a test of strength of will. Second, the fiscal criteria have served as a prod to politicians to address fiscal problems and have improved the chances of achieving needed fiscal adjustments (see e.g. Masson [1996]). As Buiter et al [1993] say, "the Maastricht stick (fiscal discipline) and carrot (EMU participation) will figure prominently in the political debate over fiscal policy". Third, by narrowing the gap, fiscal rules encourage closer economic integration.

There are also minuses. First, whether exogenous (national or supra-national) mechanisms - which work as *deus ex machina* in the absence of endogenous forces - are welfare-improving is theoretically very difficult to be established (see the theory of second-best). Second, the emphasis of the fiscal criteria as pre-conditions for admission should be on the spending side rather than the taxation side so as to avoid further distortions (see Masson [1996]). Third, there is the usual trade-off between credibility and flexibility. There is fear that the system will be too inflexible to cope with local, or asymmetric, economic shocks (see also below). Finally, these rules may not be appropriately designed. For instance, in the euro-area today, the big economies have deficits of around 2% of GDP and still face a recession. If they let automatic fiscal stabilizers to do the job, deficits will exceed the limit of the Stability and Growth Pact which is 3%.

We summarize. Although there are problems, there are good arguments for fiscal rules. Supra-national fiscal rules work in the same way as national fiscal rules, and in addition they are more credible. This is a form of cooperation among member-countries. However, it is believed that explicit coordination - via joint maximization - is also required.

Do national fiscal policies need to be jointly chosen?

In the presence of spillover effects, uncoordinated national policies can be inefficient and hence capable of collective improvement. Hence, the arguments for explicit coordination of national fiscal policies. In terms of modeling, this means that national fiscal policies are jointly chosen by a central "planner".

When taxes/transfers are distortionary and there is capital mobility, each national government has an incentive to attract capital by reducing its own tax rate. Then, in a non-cooperative (Nash) equilibrium, tax rates are low. To be more precise, the main result of the literature is that, in the absence of Ricardian Equivalence, if the spillover effect of national tax policy is positive (i.e. an increases in the tax rate of the domestic economy increases the growth rate of the foreign economy), policy cooperation will increase tax rates, and hence reduce growth rates, relative to a noncooperative Nash equilibrium.[7] For comparison between cooperative and non-cooperative equilibria in the cotext of fiscal policy, see e.g. Chari and Kehoe [1990a], Buiter and Kletzer [1991], Devereux and Mansoorian [1992] and Levine and Brociner [1994].

Then, lack of coordination seems to stimulate private investment (as Chamley [1986] has shown, in the basic neoclassical model, distorting taxes should vanish in the long-run). However, this is an oversimplification. For instance, tax competition for mobile tax bases can lead to an unfair distribution of taxes between capital (which is mobile) and labor (which is relatively immobile). Also, the result that tax competition leads to efficient outcomes relies on very strong assumptions concerning preferences, and more importantly the role of public expenditures. Public expenditures can provide production and consumption services. For instance, in Barro [1990], public production services are the engine for long-run (endogenous) growth. Public consumption services also provide direct utility to households. In addition, public expenditures can redistribute income and reduce inequality; even leaving aside fairness issues, equality reduces social conflicts and can increase efficiency and growth (see Benhabib and Rustichini [1996] and Benabou [1996]). Therefore, tax competition can lead to sub-optimally low tax revenues.

The arguments for coordination become stronger in the presence of preexisting national distortions. For instance, there is the danger of transfers of distortions from

insolvent to solvent economies. This is particularly true when the size and significance of externalities among members-countries is high (see above).

However, some authors believe that the need for explicit coordination of national fiscal policies has been given too much attention. First, coordination can sometimes be counter-productive. For instance, Kehoe [1987] has shown that in a second-best environment without commitment technologies, moving from non-cooperation to cooperation does not necessarily improve efficiency.[8] Second, under high capital mobility, coordination may be redundant. For instance, the "market" can lead the local (national) authority to make the same decision as that of the central (federal) authority, even if each local authority solves its own uncoordinated optimization problem. In other words, the market itself internalizes spill-over effects. In such cases, it is indifferent if there is explicit coordination of national policies.[9]

Coordination at national and supra-national (federal) level

If we accept the above arguments for explicit coordination, a natural question to ask is: At what level? The rationale for a supra-national (federal) government is that coordination of fiscal policy can be attained better at a Community level than at an inter-governmental level. This is again a second-best argument. The idea is that although bargaining can take place at an inter-national level, imperfections in the bargaining process may prevent the emergence of an efficient bargaining outcome. For instance, day-to-day informal agreements between governments are less credible than a federal constitution.

This leads to the next question: What is the optimal degree of fiscal federalism? Or equivalently, how many hierarchical levels are optimal? In general, there is a tradeoff between local (national) decisions and central (federal or supra-national) decisions: Decentralized decisions benefit from better information, accountability and monitoring, while centralized decisions benefit from better credibility and internalization of externalities. In a world with imperfections, the optimal regime is intermediate between full centralization and full decentralization (see e.g. Piketty [1996], Gilbert and Picard

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[7] The results are reversed if the spillover effect is negative.

[8] Rogoff [1985b] has shown the same result in the context of monetary and exchange rate policy.

[9] However, this is not a general result. It depends on how symmetric the local jurisdictions are (see e.g. Kollintzas et al [1998] and Park and Philippopoulos [1998]) or how complete the information set is (see e.g. Gilbert and Picard [1996]).

[1996], Seabright [1996] and Caillaud et al [1996] for federal tax/transfers that internalize cross-jurisdiction externalities).

Therefore, there are good second-best arguments that suggest that fiscal policy should be conducted both at federal and national level. Each type of government does what it can do best. This is also the case in federal countries, like the USA and Canada. This leads us to a closer examination of the role of fiscal federalism. Before we discuss this, we study the need for policy instruments.

Need for flexibility and policy instruments

It is widely believed that the Euro zone is not an optimal currency area. That is, it is not an area where member-countries are affected in the same way by economic shocks. Then, in the presence of local or asymmetric shocks, there is need for policy instruments. Two obvious candidates for automatic-stabilization services against country-specific shocks are: (i) greater wage/price flexibility and (ii) enhanced labor mobility. Concerning (i), European governments acknowledge the need to improve the supply-side flexibility of their economies. In other words, it is widely believed that the cost of European over-regulation is a high unemployment rate. However, the political costs of deregulation make it very doubtful. Concerning (ii), the barriers of culture and language are likely to remain strong , or at least stronger than in say the United States.

This implies that we are left with macroeconomic policy (at least, in the short-run). Given the loss of monetary and exchange-rate policy autonomy, all that remains is fiscal policy. However, as we have seen above, there are also fiscal rules ("The Stability and Growth Pact") that are likely to restrict the use of fiscal policy as well. In this case, there are two solutions. First, those member-countries hit by shocks suffer a deeper recession. But this will make the EMU unpopular. Second, there is a federal government or a federal budget like in the USA. Fiscal federalism is the issue we examine next.

The role of fiscal federalism

We have already argued that, in second-best environments, federal policy can internalize externalities and improve efficiency. Let us now become more specific about the role of fiscal federalism.

First, consider stabilization policy as insurance against local shocks. As argued above, a remaining candidate for automatic-stabilization against country-specific shocks is federal transfer policy. That is, federal policy imposes taxes and ex post redistributes resources via transfer payments from regions facing positive shocks to regions facing negative shocks. Note that for this to correspond to insurance, the shocks should be as likely to affect one country as another, so that ex ante there is no presumption of being a loser or a gainer (see Masson [1996]). There is a rich literature on the role of federal policy in allocating risk and providing social insurance (see e.g. Persson and Tabellini [1996a, 1996b] and Alesina and Perotti [1998]).

A second justification for fiscal federalism has to do with help for growth. The EU budget transfers income from the richer to poorer countries and regions so as to help the latter to grow. Specifically, federal transfers are used to ensure the provision of minimum levels of key public goods and services (e.g. roads and education) which are believed to promote growth. The official argument in the EU, is that equality and reduction of social conflicts are necessary for the viability of European integration (see Dewatripont et al [1995]). See also Eichengreen [….] for the "equalization" effect of fiscal federalism.

However, federal activities require redistributive transfers, which can lead to problems. For instance, Park and Philippopoulos [1998] have studied the dynamics of growth in a model with federal redistributive transfers and taxes. They show that such transfers can lead to moral hazard behavior and dynamic indeterminacy. Thus, a federal redistributive system may increase political uncertainty and open the door for free-riding behavior in the administration of federal spending. Therefore, although it seems inevitable that there will be a pressure to move away from national independent policies toward a coordinated fiscal system, the way Europe deals with centralized fiscal powers remains to be seen.

Menu of fiscal policy instruments

At a less abstract level, it seems that income taxes will remain the cornerstone of national tax policies. That is, income taxes will become the core of member-countries' taxing autonomy, given that indirect taxes are likely to be harmonized (VAT or excises will be *de facto* harmonized). Given the damaging consequences of tax competition (see

above), there are therefore calls for cooperation in income taxes. There are also calls for cooperation in corporate taxes (see Spahn [1993]).

Concerning the EU budget, there is need for new tax instruments. On the revenue side of the EU budget, revenues from VAT are currently the most important resource. However, over the next years, the importance of interest income taxes is expected to increase, as well as the importance of eco-taxes, corporate cash-flow taxes and seigniorage taxes (see e.g. Spahn [1993] and Prudhomme [1993]). On the expenditure side of the EU budget, federal transfers to member-countries usually decrease with their relative per-capita income (see above). The EU budget is at the moment a balanced one on the grounds of budgetary discipline. However, there are arguments for a more flexible arrangement in the future.

III. CONCLUDING REMARKS AND SOME PROPHESIZING

The above issues are not new to economic theory. However, we have tried to present them within a coherent, logical framework.

The policy question is what we do next. These days, eleven European countries have launched the Euro, i.e. the single European currency. However, there are many who fear that handing over the conduct of national monetary policy to European central bankers in Frankfurt will mean surrender of sovereignty. At the same time, the fiscal policy debate, and in particular tax harmonization, means that national policy-makers will lose their competitive edge in the battle to lure inward investment, and hence a further surrender of sovereignty. The recent EU proposal to harmonize some tax rates (VAT, Energy, Excise Duty), although it is pushing the timetable forward, it is in line with the already existing trend towards integration. As we said above, the official argument is that different tax rates distort decision making. The unofficial argument is that tax competition can lead to a too small size of the public sector.

The above results imply that the big issues are more socio-political than economic. They have to do with the "optimal" size of the public sector and the "optimal" degree of integration in Europe. Concerning the former, fiscal rules and coordination are related not only to the costs of budget deficits and the need to restore efficiency, but also to the "optimal" size of the public sector. The real choice comes down to how much faith you put in government. Competent, benevolent governments

can be trusted with coordination and hence big sizes of the public sector. But governments lacking in these virtues will be tempted to use coordination (and harmonization) to shield themselves from the consequences of bad policies. In such a case, the argument is reversed, and it is competition among governments that brings benefits.

Concerning the optimal degree of integration in Europe, we feel that integration has more a political rather than economic rationale. Europe has changed dramatically in fifty years. There is now peace, mobility, coordination and an international environment which is good for business and people. More importantly, the ghost of war seems to have disappeared for good. These are great benefits whose importance is difficult to be measured.

Although the single-currency project could be better designed, few can argue against the benefits of closer coordination and integration. The problem over the coming years is whether the EU will be given enough time to prove its success. If it fails due to short-term economic problems (see recession), political choices will be severely restricted, and the medium-run and long-run merits of the new system will be unfairly and hastily be rejected.

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