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Fiscal Policy to Stabilise the Domestic Economy in the EMU: What Can We Learn from Monetary Policy?

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Abstract: *An important issue for the EMU countries is to what extent fiscal policy can be used to stabilise the domestic economy in the case of asymmetric macroeconomic shocks. The paper reviews possible reforms of national fiscal policy institutions in order to promote efficient fiscal stabilisation policy: (i) the introduction of a more transparent legal framework for the government's stabilisation decisions; (ii) the establishment of an independent advisory Fiscal Policy Council; and (iii) the delegation of actual stabilisation decisions to an independent Fiscal Policy Committee. The conclusion is that the Fiscal Policy Committee solution has much to speak for itself. It seems possible to delegate fiscal stabilisation policy decisions, in much the same way as monetary policy has been delegated to central banks, at the same time as fiscal policy decisions focusing on income distribution and social efficiency are kept in the political sphere. Such delegation can be made compatible with democratic accountability.*(*JEL* E61, E63, P16)

1 Introduction

For the member countries in the EMU monetary policy no longer exists as a national stabilisation tool. Neither the short-term interest rate nor the exchange rate can adjust to domestic macroeconomic conditions. This is likely to make it more difficult to stabilise the domestic economy in the case of asymmetric cyclical developments relative to the other countries in the euro area. It raises the question of to what extent fiscal policy can substitute for monetary policy as a tool of macroeconomic stabilisation at the national level.

Two important determinants of the possibilities to use fiscal policy for stabilisation purposes are (i) the technical effectiveness of fiscal policy as a countercyclical stabilisation tool; and (ii) the political-economy possibilities of using fiscal policy for this purpose. This article reviews these two issues and analyses the possibilities to increase the scope for fiscal stabilisation policy measures from these perspectives. A third aspect of fiscal stabilisation policy is whether time-varying tax rates and government expenditures might give rise

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The article builds on earlier work that I did for the Swedish Government Commission on Stabilisation Policy in the EMU (Swedish Government Commission on Stabilisation Policy 2002), the European Economic Advisory Group at CESifo (EEAG 2003), and the UK Treasury (Calmfors 2003a). I am grateful for comments from two anonymous referees.

to undesired allocation and income distribution effects. Although this issue as well must be considered in a full analysis, it is outside the scope of the present article.

The main contents of the article is as follows. Section 2 discusses why it may not be enough to rely on monetary policy as the only tool of macroeconomic stabilisation. Section 3 reviews different fiscal policy instruments and concludes that fiscal policy is indeed likely to be technically effective as a stabilisation tool. The main problem is instead the political-economy one of designing an institutional framework that fosters an effective use of fiscal policy to stabilise the economy, which is the topic of Section 4. Recent budgetary experiences of several EU member states seem to show that the fiscal rules at the European level are not sufficient for this purpose. Instead, I argue that a more appropriate institutional framework for fiscal policy should be established at the *national* level and that there are then important lessons to learn from monetary policy. Three different options are analysed.

- A minimalist reform agenda would be to adopt a more transparent institutional framework, setting clearer objectives and guidelines for the government's use of national fiscal policy as a stabilisation instrument, than is the case today.
- A slightly more radical approach would be to establish an independent national Fiscal Policy Council with the task of advising the government and the parliament on fiscal policy.
- A more far-reaching reform would be delegation of actual decision-making on national fiscal stabilisation measures to an independent Fiscal Policy Committee along similar lines as monetary policy has been delegated to independent central banks in most OECD countries.

The main contribution of the article is the analysis in Section 4 of the pros and cons of various institutional reforms in order to make national fiscal policy a more effective stabilisation tool. My main conclusion is that delegation of national fiscal stabilisation decisions to an independent Fiscal Policy Committee would have great advantages from an efficiency point of view, at the same time as a high degree of democratic accountability could be ensured. As discussed in Section 5, such delegation at the national level could be seen as a useful complement to the fiscal rules at the EU level. But as emphasised in the concluding Section 6, most people would today probably regard delegation of even limited powers to decide tax rates and government expenditures as highly controversial. Reforms of this type would therefore have to be preceded by a long time of discussion, just as was the case with delegation of monetary policy to independent central banks in many countries.

2 Why is not monetary policy enough?

Over the last decades, fiscal policy as a stabilisation instrument seems to have become regarded with increasing scepticism by both economists and policy makers. Indeed, there seems to have developed a conventional wisdom according to which monetary policy should be the primary stabilisation tool (see, for example, Taylor 2000; or Swedish Government Commission on Stabilisation Policy 2002). However, it has been argued recently that this downplaying of fiscal policy as a stabilisation instrument may have gone too far (see, for example, Ball 1997; Wren-Lewis 2000, 2002; Seidmann 2001; Blanchard and Perotti 2002; Wyplosz 2002a; and EEAG 2003).

There are several reasons why it may not be enough to rely on monetary policy as the only tool of macroeconomic stabilisation in many situations.

One argument is that monetary policy may be ineffective in a depression when the economy can be caught in a liquidity trap: because nominal interest rates cannot be negative, it is impossible also to achieve negative real interest rates if prices are falling. Japan is a recent example (see EEAG 2003). But also in more normal situations, there can be limitations to monetary policy, because central banks may be reluctant to change interest rates by much in the short run, as this would imply large variations in the prices of outstanding debt.

It has also been maintained that fiscal policy can more easily be targeted in a desirable way than monetary policy. Ball (1997) and Wren-Lewis (2000; 2002) argue that fiscal policy can be designed so as to have more even effects across the economy than monetary policy, which will have a greater impact on construction and investment goods sectors than on service sectors. These more even effects may sometimes be desirable. In other situations, one may want to target measures more specifically, for example to counteract variations in housing prices, which may be easier to do through selective fiscal policy (such as changes in tax relief for mortgage interest rates or changes in stamp duties) than through monetary policy (*UK Membership of the Single Currency* 2003; *Fiscal Stabilisation and the EMU* 2003).

But the strongest argument in favour of fiscal policy in the euro area is the risk of cyclical developments that affect individual countries in an asymmetric way. There is an obvious argument for such stabilisation policy in the case of a country-specific recession, as money wages, and thus also prices, tend to be rigid downwards (Calmfors 1998; Calmfors *et al.* 2001). The case for stabilisation policy in cyclical upswings is more complex. A relative price increase vis-à-vis other countries (a real exchange rate appreciation) may be a proper adjustment to asymmetric macroeconomic shocks that cause a boom in a country. Whether or not this is the case depends, as was discussed in EEAG (2002), on the character of the shocks. In the case of permanent structural changes, such as a permanent increase in the relative demand for a country's

output or a permanent increase in the relative productivity in the tradables sector of a country (the Balassa-Samuelson effect[1]), prices should be allowed "to do their job". But a price response may not be appropriate in the case of a temporary country-specific demand increase. The main reason is again downward money wage rigidity: inflation in a temporary boom tends to cause "permanent" wage increases that are hard later to reverse and therefore "lock in" real exchange rate appreciations. This makes it more difficult to stabilise the economy in the next downturn, as the real exchange rate appreciation then requires a more expansionary fiscal policy with larger budget deficits than would otherwise be the case (Swedish Government Commission on Stabilisation Policy 2002). The main rationale for fiscal stabilisation policy in a booming EMU country is thus intertemporal considerations relating to future stabilisation possibilities.[2]

A related intertemporal argument for fiscal stabilisation policy in booms in the EMU countries is the risk of strong asset price reversals, that is boom-bust cycles in asset prices, where first large price rises reinforce the upswing and then large price falls exacerbate the downturn. The macroeconomic consequences of such asset price volatility have been studied by Bordo and Jeanne (2002), who find boom-bust cycles to be much more common in real property prices than in stock prices and to be associated with larger cyclical swings in output. This finding is highly relevant for stabilisation policy in the EMU countries, because cycles are much more likely to be country-specific in real property prices than in stock prices.

3 The technical effectiveness of fiscal demand management policy

The impact of fiscal policy on aggregate demand depends, of course, on the particular instrument under consideration. Below I distinguish between measures that affect aggregate demand directly and those that work by changing relative prices.

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1 According to the Balassa-Samuelson argument, higher productivity growth in the tradables (manufacturing) sector in a country raises wage growth in the whole economy, and thus also the rate of price increase in the non-tradables (service) sector, where productivity growth differentials among countries are small. As a consequence, countries with higher productivity growth in the tradables sector tend to experience higher inflation than other countries. See, for example, EEAG (2002).

2 Some of the discussion on to what extent "prices should be left to do their job" in the EMU has focused on whether demand shocks are internal or external. It has been argued that price adjustments are appropriate only in the latter case (Blanchard 2001; European Commission 2002). In my view, these are not the relevant considerations, because a temporary increase in external demand is as problematic as a temporary increase in internal demand if it leads to a real exchange rate appreciation that is hard to reverse.

3.1 Fiscal policy and Ricardian equivalence

As to changes in income taxes and transfers to households, there exists a large literature questioning their impact based on the notion of Ricardian equivalence (see Elmendorf and Mankiw 1999). The well-known argument is that deficit-financed tax reductions, raising the disposable incomes of households, will fail to increase private consumption and thus to stimulate aggregate demand: households will realise that their life-cycle incomes have not increased, as they will have to pay for the deficits through higher taxes in the future. However, it is also well-known that the Ricardian equivalence results require very restrictive theoretical assumptions (lump-sum taxes, long time horizons and altruistic behaviour vis-à-vis future generations, rational expectations, and no credit constraints), which are not likely to apply in reality. Empirical analysis does also seem to indicate positive income tax multipliers, although they may be smaller than believed earlier. In a recent survey of empirical studies, Hemming et al. (2002) report an average estimated income tax multiplier of around 0.5. The results that automatic stabilisers, which work mainly on the tax side, reduce the volatility of output and consumption, are also strong evidence against Ricardian equivalence (Gali 1994; Fàtas and Mihov 2000; 2001).

Still, the Ricardian equivalence debate points to the importance of finding fiscal policy instruments that are as effective as possible. One would, of course, always expect tax and transfer changes targeted on low-income groups, which to a large extent are credit-constrained, to be more effective than measures targeted on high-income groups with better access to capital markets (Wren-Lewis 2000). Such targeting may also be motivated from a welfare point of view, as these groups are more exposed to cyclical income volatility than groups with higher incomes (Storesletten et al. 2001).

Also, temporary changes in government consumption should be more effective in affecting aggregate demand than general income tax changes. In fact, they have an aggregate demand impact also under the assumptions giving rise to Ricardian equivalence. This is obvious if, for example, an increase in current government consumption is financed through a reduction in future government consumption, as this does not involve any changes in the taxes paid by households and hence no changes in private consumption if that is based on life-time income. But a similar conclusion holds also if a temporary increase in government consumption is financed through future taxes. The explanation is that the short-run direct demand effects of the increase in government consumption are larger than the short-run reductions in private consumption due to perceived future tax increases: this is so because the changes in private consumption resulting from the changes in life-time incomes will be spread over the whole future, as households want to smooth consumption over time,

whereas the whole change in government consumption occurs in the short run (EEAG 2003).

The positive output effects of increases in government consumption have been confirmed in a number of recent empirical studies (for example, Rotemberg and Woodford 1992; Ramey and Shapiro 1997; Edelberg et al. 1998; Fàtas and Mihov 2000; and Blanchard and Perotti 2002). Some of the studies find that increases in government consumption are associated with increases in private consumption – and not decreases as implied by Ricardian equivalence (Blanchard and Perotti 2002; Fàtas and Mihov 2000). Hemming et al. (2002) in their survey of empirical studies report an average estimated multiplier for government consumption of one, which is about double the size of the average estimated income tax multiplier.

3.2 Fiscal policy to affect relative prices

One type of fiscal policy that has received fairly little attention is measures that work by changing *relative prices*. One such policy is temporary changes in the VAT, which affect private consumption in a similar way as temporary changes in the real interest rate: by changing the relative price between consumption in different time periods, households are induced to re-allocate spending intertemporally (Swedish Government Commission on Stabilisation Policy 2002).[3] It is a standard result in model simulations that a given change in the government budget balance has a larger multiplier effect if the VAT is changed than if the income tax is changed (see, for example, Wren-Lewis 2002; Wijkander and Roeger 2002; or European Commission 2002).

The possibility of cross-border trade is usually seen as a limitation on the possibilities to set VAT rates according to national priorities in the long term. But this does not apply in the same way to temporary VAT changes as a stabilisation tool in the case of country-specific cyclical developments. On the contrary, if a temporary rise in the national VAT rate in a boom shifts consumption purchases abroad, this, too tends to reduce demand domestically. (It will, however, introduce – temporary – allocation costs to the extent that consumer purchases are shifted from more to less efficient outlets).

An alternative way of changing the (after-tax) intertemporal terms of trade for households might be to vary the rate of capital income taxation (and interest

3 This presupposes, of course, that menu costs of price changes are not so large as to prevent a temporary adjustment of VAT rates from affecting final consumer prices. In practice this does not, however, seem to have been much of a complication in Sweden, where temporary VAT changes have at occasions been used as a stabilisation tool. Retailers seem simply to have made a general reduction from the total sum of purchases of each customer, amounting to the reduction in the VAT, without re-marking prices of individual goods.

deductions) over the business cycle.[4] One could also conceive of temporary investment taxes or subsidies to affect the timing of private investment.

Another possibility, which has also been overlooked in much of the international discussion, is to use temporary variations in the payroll taxes levied on employers as a stabilisation tool. By changing domestic wage costs, such a policy directly affects the real labour cost and the real exchange rate vis-à-vis other euro countries. It is not only temporary reductions in payroll taxes in downturns that may be of interest. In fact, temporary rises in employers' payroll taxes may be a very appropriate policy if an individual euro country experiences a boom. The reason is that higher payroll taxes for employers raise domestic wage costs and output prices, but not domestic wages. On the contrary, wage increases are likely to be held back to the extent that the demand for domestic output falls and the tax is shifted backward on to employees because "the room for wage increases" is reduced.[5] A temporary increase in payroll taxes may therefore be a desirable way of dampening a boom, because wage costs are raised temporarily at the same time as the risk that wages are bid up more permanently is reduced.

The idea of using cyclical variations in employers' payroll taxes as a countercyclical tool has large similarities with the system of so-called *buffer funds* that was set up in Finland in connection with the entry into the EMU in 1999. According to this system, funds are accumulated through temporary increases in employer contributions to the social security system in upswings. In downturns the funds are released, so that contributions can then be held down (Holm et al. 1999). Indeed, releases from the funds built up in 1999–2002 were used in 2003 for such reductions of employer contributions (Economic Survey 2003).

Fiscal policies working through changes in relative prices do not necessarily have to involve variations in the budget balance. One possibility in a recession is to combine a reduction of payroll taxes with increases in other taxes falling

4 Boije and Shahnazarian (2003) note that a given change in the after-tax interest rate can be achieved through either a change in the pre-tax interest rate or a change in the tax rate. A change in the rate of capital income taxation affects the whole spectrum of after-tax interest rates and returns, whereas a change in the central bank's repo rate only affects short-term interest rates. This difference tends to make changes in capital income taxation a more powerful stabilisation tool than central bank interest rate changes. At the same time, the values of a wider range of assets will be affected with larger wealth effects as a consequence. Another problematic side effect of variations in the capital income tax rate is that they will have distortionary allocation effects to the extent that they affect the incentives to reclassify labour income as capital income.

5 This latter tax-shifting effect has been shown empirically to be strong in the Nordic countries (Nymoen and Rødseth 1999; Calmfors and Uddén Sonnegård 2001). The wage-reducing effects mentioned in the text would be counteracted to the extent that compensating wage claims are triggered by the CPI rises associated with higher output prices when pay-roll taxes are raised, but this effect is, according to studies of the Nordic countries, likely to be small compared to the other effects.

on employees (income taxes, employee contributions to the social security system or the VAT) or reductions in government transfers to households. Such a policy has been labelled *an internal devaluation*, because it affects the real labour cost and the real exchange rate in the short run in a similar way as a nominal exchange rate devaluation and thus has similar output and employment effects, as discussed in Calmfors (1993; 1998). Internal devaluations of this type were made in Denmark in the late 1980s and in Sweden in the early 1990s.

One problem with internal exchange rate changes is, however, that real exchange rate changes are known to affect trade volumes with substantial lags (the J-curve effect). This is an argument for using an internal devaluation mainly as a measure of last resort in situations when there is no scope for increasing budget deficits and when a recession is likely to be drawn-out. A good example of such a situation could be the present German one, where a budget deficit in excess of the three-percent-of-GDP ceiling in the Stability and Growth Pact necessitates fiscal restraint, at the same time as there may be a persistent misalignment of the real exchange rate (because the D-mark was converted to the euro at an overvalued exchange rate) that needs to be corrected (see EEAG 2003; and Calmfors 2003b).

In view of my discussion, it appears difficult to claim that fiscal policy does not work as a stabilisation tool in a technical sense. The crucial issue is instead the political-economy one of to what extent policy makers will use the fiscal policy instruments in an appropriate way.

4. The political economy of fiscal stabilisation policy measures

It is easy to point to a number of political-economy reasons why discretionary fiscal policy is likely in practice to be used in a less effective way than monetary policy.

(i) Whereas monetary policy has been delegated to independent central banks, which are engaged in more or less continuous decision-making processes, *decision lags* for fiscal policy are long. The reason is that tax and government expenditure changes have to go through a lengthy parliamentary process, which is usually annual. This is perhaps most awkward with temporary VAT changes: it is a serious problem if, for example, a temporary VAT increase in a boom can be decided only after a time-consuming political process, as the anticipation of the measure will lead to effects that are the reverse of those desired in the period before the measure comes into force.

(ii) The problem of long fiscal policy lags is likely to be exacerbated by the fact that fiscal policy decisions are much more *complex* than monetary policy decisions, because there are a large number of tax rates and government expenditures that can be used as instruments. In contrast, monetary policy mainly involves only one interest rate decision.

(iii) Fiscal policy has also *other central objectives* than stabilisation, viz. income distribution and efficient resource allocation. Stabilisation objectives may therefore be confounded with income distribution and social efficiency objectives. As a consequence, measures undertaken for short-run stabilisation purposes may influence the long-run structure of taxes and government expenditures. Appropriate stabilisation action may therefore not be taken unless it is deemed to have desired long-run effects on income distribution and social efficiency.

(iv) An additional political-economy distortion of fiscal policy from a stabilisation point of view is that both the scope and timing of measures may be affected by *opportunistic motives* of incumbent governments to enhance their re-election chances. This can give rise to political business cycles.

(v) The political character of fiscal policy decisions, as well as the decision lags involved, make it much more difficult to reverse decisions than is the case for monetary policy. This problem of *irreversibility* is most clear-cut for increases in government consumption in a downturn, as it may be politically very difficult to fire the government employees hired when the next boom materialises (Wijkander and Roeger 2002).

(vi) Finally, a voluminous political-economy literature has highlighted the risk that a number of factors may result in a systematic *deficit bias* for fiscal policy (see, for example, Alesina and Perotti 1995; or von Hagen et al. 2002). These factors include: (a) fiscal illusion on part of the general public; (b) the use of debt by incumbent governments as a strategic variable to favour their own constituencies; (c) distributional conflicts; (d) lobbying by local constituencies for targeted benefits, the costs of which are shared nationally; and (e) problems of time consistency, according to which governments cannot resist *ex post* the temptation to abandon sound fiscal policy, even if it is clear *ex ante* that this is inappropriate. A more activist use of fiscal policy as a stabilisation tool could increase the deficit bias, as it seems more difficult to get political support for contractionary policy in booms than for expansionary action in downturns.

Considerations such as these above have led many economists to the conclusion that discretionary fiscal stabilisation measures are likely to be badly

timed, procyclical and conducive to fiscal laxity in general.[6] The prevailing conventional wisdom is that fiscal policy should mainly be confined to let the automatic stabilisers, that is the automatic cyclical variations in tax receipts and some government expenditures, dampen output and employment fluctuations (see, for example, Taylor 2000; or European Commission 2002). This is, however, a problematic conclusion as the automatic stabilisers can by their very nature only cushion macroeconomic shocks, but not fully offset them. Moreover, there is no reason to believe that the automatic stabilisers give the optimal degree of stabilisation, as their size is a by-product of decisions that have nothing to do with macroeconomic stabilisation (mainly the ratio of overall government expenditures to GDP and the generosity of income support for the unemployed). In addition, the automatic stabilisers tend to be destabilising in the case of permanent supply shocks, as they then tend to cause permanent budget imbalances.

The upshot is that there may at times be a need for discretionary fiscal policy action to counteract macroeconomic disturbances. This raises the issue of whether the potential for such policy could be enhanced through institutional reform mitigating the political-economy problems. As fiscal policy is decided at the national level also in the EMU, this is the appropriate level for such reform. I shall focus on the issue of to what extent lessons for the fiscal-policy decision-making process at the national level can be learnt from the institutional reforms in the field of monetary policy that have been undertaken in many places. As is well-known, there has been a general trend of delegating monetary policy to increasingly independent central banks that have been given well-defined objectives (price stability) and that seek to act within transparent policy frameworks. The ECB is a case in point, but *Sveriges Riksbank* (the Swedish central bank) and the Bank of England are even more obvious examples.

Below I shall discuss three options for institutional reform of fiscal policy at the national level that all seek to draw on the experiences from monetary policy.

(i) A more transparent framework with more clearly defined stabilisation objectives for fiscal policy and guidelines for how the instruments should be used.

(ii) The setting-up of an independent *Fiscal Policy Council*, with the task of advising the government and the parliament on appropriate fiscal policy action to stabilise the business cycle.

[6] This seems to be vindicated by past experiences according to, for example, Leibfritz et al. (1994), Buti et al. (1997), and European Commission (2001). But these empirical conclusions have to some extent been challenged by Mélitz (2000) and Wyplosz (2002a).

(iii) Delegation of actual fiscal policy decisions with the aim of countercyclical stabilisation to an independent *Fiscal Policy Committee* along the lines that monetary policy has been delegated to independent central banks.

4.1 A more transparent fiscal policy framework

The most conventional approach to reforming fiscal policy institutions would be to build on the recent reforms in many countries that have introduced more fiscal discipline through procedural changes in the budget process strengthening the position of the ministry of finance (see von Hagen et al. 2002) and greater transparency (like with the Code for Fiscal Stability in the UK and the Fiscal Responsibility Act in New Zealand). One aim would then be to increase the importance attached to stabilisation objectives and avoid that they are confounded with income distribution, social-efficiency and re-election objectives. Another aim would be to shorten decision lags. One way of doing this could be to adopt a *Fiscal Stabilisation Policy Act*, which would add well-defined stabilisation objectives to earlier existing long-run budget balance (or government debt) goals for fiscal policy.

For member states in the EMU, where the long-run national inflation rate is tied down by the common euro area inflation target of the ECB, the ultimate stabilisation objective for national fiscal policy should be to minimise fluctuations of output around its equilibrium (potential) level. Since the output level cannot be affected in the short term without excessive variability in the fiscal parameters, the goal should be *forward-looking* and apply to the medium term (Swedish Government Commission on Stabilisation Policy 2002). This is a similar argument as has been used for why monetary policy should try to stabilise inflation only over a medium-term horizon.

An important issue is whether fiscal policy measures to stabilise asymmetric cyclical developments in individual EMU member states should aim directly at output or use a national inflation target as an *intermediate objective*. The latter option has been proposed by The Swedish central bank (*Sveriges Riksbank* 2002), which has argued that Sweden should retain a national inflation target in the event of EMU membership. The justification would be that such an intermediate target is more transparent and thus more helpful in anchoring private-sector expectations than an objective of minimising output gaps, which are notoriously difficult to assess. In the case of asymmetric demand

disturbances, such a fiscal policy regime would help stabilise also the output level around its equilibrium value.[7]

The main problem with a national inflation target in the EMU is that it is in effect an objective for relative price developments (real exchange rate developments), because the ECB determines the overall euro area inflation. If there is no trend in the real exchange rate vis-à-vis other euro countries, the national target should be set equal to the ECB target. But if there is a trendwise change in the real exchange rate, then the national inflation target must deviate from the target for the whole euro area. Such a trendwise change could be due to relative demand or supply trends or to the Balassa-Samuelson effect (see Section 2). To the extent that such a trend is misjudged *ex ante*, there would have to be *ex post* revisions of the national target. This would mean that the simplicity and transparency of the target would be reduced in a way that does not happen under flexible exchange rates: even if inflation rates are the same for two countries, changes in the real exchange rate can then be achieved through changes in the nominal exchange rate.

Another problem would arise for a country with a national inflation target if the ECB were to miss its target for the whole euro area. For example, if the ECB overshoots its target, an individual euro country that wants to stick to its national target would have to compensate for higher price rises for imports from other euro countries by pursuing contractionary fiscal policy to reduce price rises for domestically produced goods. To avoid that, the national inflation target would again have to be revised *ex post* in response to euro area developments, which would again contradict the idea of having a simple and transparent intermediate objective.

The reasoning above provides strong arguments against having national inflation targets for fiscal policy inside the EMU. This does not mean, however, that relative rates of inflation and wage change vis-à-vis other euro countries should not be taken into account. On the contrary, these relative rates provide an important indicator of the possibilities of stabilising output in a medium-term perspective. A country-specific demand shock that increases output temporarily can lead to wage increases that are difficult to reverse in the next downturn and therefore jeopardise the possibility of stabilising future output (see Section 2).

Moreover, there may be a case for responding to wage shocks on the supply side with contractionary fiscal policy in order to create incentives for wage setters to exercise restraint. This conclusion builds on the recent literature regarding the interaction between monetary policy and large (co-ordinated)

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[7] The reason is that the output gap and inflation move in the same direction in this case, whereas they move in opposite directions in the case of supply shocks. In the latter case, an inflation target would thus lead to fiscal policy measures that would amplify output variations.

wage setters at the national level, who in an economy with an own currency and a flexible exchange rate can be expected to act strategically and internalise the monetary policy reactions of the central bank to their wage decisions. The argument is that an inflation-targeting national central bank in such a setting discourages high wage increases, and thus contributes to high equilibrium employment: wage setters realise that excessive wage increases, tending to cause inflation, trigger interest rate increases on the part of the central bank, which lead to larger employment losses than would otherwise be the case. Hence, the expected central bank response to high wage increases provides an incentive for wage restraint (Coricelli et al. 2000; Soskice and Iversen 2001; Calmfors et al. 2001).[8] In the EMU, where also large wage setters in an individual country are too small to trigger monetary policy reactions of the ECB, as they will only have a marginal effect on the overall euro area rate of inflation, this strategic wage-restraining effect of monetary policy no longer exists. Instead, there is a case for using national fiscal policy to create such a deterrent to excessive wage increases (Swedish Government Commission on Stabilisation Policy 2002).

A Fiscal Stabilisation Policy Act could also give guidelines for under which circumstances one should rely only on the automatic stabilisers and under which circumstances one should resort to discretionary action. Such an operating rule could, for example, specify that discretionary fiscal action should be taken when output gaps in the medium term are judged to exceed some critical level.[9] In addition, such a law should try to separate fiscal policies that aim at stabilisation as clearly as possible from policies designed mainly to meet income distribution or social efficiency objectives. For example, like in the Australian Charter of Budget Honesty, the government could be obliged to indicate which tax and expenditure changes are temporary (because they are undertaken for stabilisation purposes) and "the process for their reversal" (Business Council of Australia 1999). To shorten decision lags and reduce the risk that income distribution or re-election considerations come to dominate stabilisation considerations in concrete situations, a Fiscal Stabilisation Policy Act could also specify in advance a small number of fiscal

[8] In technical terms, the tightening of national monetary policy in response to inflationary wage rises increases the effective elasticity of labour demand with respect to the wage, which in standard trade union and wage bargaining models reduces the equilibrium wage (see, for example, Nickell and Layard 1999).

[9] The Swedish Government Commission on Stabilisation Policy in the EMU (Swedish Government Commission on Stabilisation Policy 2002) proposed that discretionary fiscal policy action should be taken only when output gaps are forecast to be larger than two per cent of GDP in either direction. The UK Treasury instead mentioned output gaps of 1-1.5 per cent of GDP as pre-announced trigger values for discretionary action in its evaluation of the consequences of EMU entry (*UK Membership of the Single Currency* 2003; *Fiscal Policy in the EMU* 2003).

policy instruments to choose from if the need for discretionary action would arise (Swedish Government Commission on Stabilisation Policy 2002).

One aim of a Fiscal Stabilisation Policy Act would be to increase the reputational costs for governments of deviating *ex post* from principles of stabilisation policy that are judged to be sound *ex ante*. A specific way of doing this has been proposed by the UK Treasury in its evaluation of the consequences of EMU entry (*UK Membership of the Single Currency* 2003; *Fiscal Policy in the EMU* 2003). The proposal is that the government should be obliged to write an *open letter* to the parliament as soon as the output gap over the medium-term horizon is forecast to exceed a pre-announced trigger value for discretionary fiscal policy action. This open letter should among other things explain why this situation is judged to occur, which policy is the most appropriate to deal with the situation, and over what time horizon the "excess" output gap will be eliminated. The proposal has been modelled along the lines of a similar, already existing, open letter procedure for monetary policy, according to which the Governor of the Bank of England must send an open letter to the Chancellor of the Exchequer as soon inflation deviates by more than one percentage point from the inflation target (currently 2.5 per cent).

A main advantage of trying to regulate the government's use of fiscal policy as a stabilisation tool through more transparent legislation is compatibility with current decision-making procedures. The main disadvantage is that the constraints imposed on the government's behaviour are weak and can easily be violated by a government with a parliamentary majority.

4.2 An advisory Fiscal Policy Council

A somewhat more radical approach would be to establish an independent advisory Fiscal Policy Council, which could be entrusted with the task of providing a regular input into the budget process, serving as a basis for fiscal policy decisions with the aim of stabilising the economy (Wren-Lewis 1996; Swedish Government Commission on Stabilisation Policy 2002). The Council could be required to publish regular stabilisation reports (corresponding to the present inflation reports of, for example, the Bank of England and *Sveriges Riksbank*) assessing the state of the economy. The Council could also have the task of giving recommendations to the government and the parliament on how much the budget target in a given year should deviate from the budget target over the cycle and/or on specific tax and expenditure changes to stabilise aggregate demand (Swedish Government Commission on Stabilisation Policy 2002).

The idea behind an advisory Fiscal Policy Council, as with a Fiscal Stabilisation Policy Act, is to influence the fiscal policy agenda by increasing the reputational cost for the government of attaching a low weight to considerations about stabilisation and long-run fiscal sustainability. One could conceive of several ways of giving such an advisory committee more teeth. One possibility could be to require the government to base its budget calculations on the council's estimates of the output gap and various tax and expenditure elasticities. This would reduce the risk that biased forecasts influence decision-making. There are also various ways of boosting the political weight of an advisory Fiscal Policy Council. One way of giving its recommendations a high status would be to have them formally addressed to the parliament and to require that they are discussed in a specific parliamentary session. One could also require the government to respond formally to the council's proposals. A more far-reaching possibility would be to stipulate that the normal procedure for the government would be to follow the stabilisation policy recommendations of the council and that deviations from them should only occur under exceptional circumstances: the government might be obliged to give a formal explanation to the parliament in such cases.

In some countries embryos of such independent advisory Fiscal Policy Councils exist. One example is the Economic Council in Denmark, which has three chairpersons ("wise men"), usually university professors. The "wise men" are appointed by the government and must according to the legal regulations be independent of "external interests". The "wise men" publish semi-annual reports, which contain a judgement of the cyclical situation, an evaluation of economic policy, and recommendations on possible changes. The reports are formally addressed to the government, which comments on them. The reports usually attract considerable media interest, and have been judged to exert substantial influence on policy (Andersen 1997; Swedish Government Commission on Stabilisation Policy 2002).

Another example is the German *Sachverständigenrat*, the members of which are nominated by the government and appointed by the president. The members are academic economists or "practitioners" with good knowledge of economic theory and experience of economic policy. Here, too, the independence of the council is guaranteed by law. The yearly reports of the Sachverständigenrat analyse main macroeconomic developments under varying assumptions, but do not give recommendations on specific policy measures. Although the government is required to respond formally to the report of the council, the general perception seems to be that it has not been so influential (Swedish Government Commission on Stabilisation Policy 2002; Simonian 2003).

A final example of an advisory fiscal council is the *Conseil Supérieur des Finances* in Belgium, which has been entrusted with the task of surveying

public finances and making recommendations on medium-term and long-term budgetary objectives for various levels of government. This council differs from the Danish and German ones to the extent that it has a mixed composition. It consists of civil servants from the federal government, representatives from the regions, external experts and directors from the central bank, and it is formally headed by the minister of finance. The recommendations have been judged to be quite influential, especially for promoting discipline among sub-national governments: for example, the regions have agreed to follow the recommendations of the council (Stienlet 1999; Hallerberg 2000; Swedish Government Commission on Stabilisation Policy 2002).

I have given three examples of existing advisory councils in the fiscal policy area. The examples serve to illustrate that the role of such councils will to a large extent depend on the reputation they can acquire over time through their judgements of the economic situation, policy analyses and ability to market their policy recommendations. It is possible that advisory Fiscal Policy Councils could play an important role, but it is also possible that they will not make a large difference.

4.3 Delegation of actual decisions

A very far-reaching institutional reform would be to *delegate* the *actual decisions* on fiscal policy measures to stabilise the economy to a *Fiscal Policy Committee*, composed of independent expert, in much the same way as monetary policy has been delegated to independent central banks. Could this work? Although the idea may at present seem politically far-fetched, it might be of interest to explore various possibilities.[10]

It must be recognised as a starting point that in any democratic society there exists a general problem of how to allocate decisions between the political and the technocratic spheres. This is done in different ways in different countries and the allocations also change over time. In addition, different trade-offs are made in different areas of policy-making.

The most important consideration for where to draw the line between political and technocratic decisions in a given area appears to be the relative importance of value judgements and technical expertise (Majone 1996). In the context

[10] My analysis here builds on a number of recent contributions. These include von Hagen and Harden (1994), Eichengreen, von Hagen and Harden (1995), Saint-Paul (1995), Calmfors (1995), Wren-Lewis (1996, 2000, 2002), Blinder (1997), Ball (1997), Business Council of Australia (1999), the Economist (1999), Eichengreen, Hausmann, and von Hagen (1999), Seidman (2001), Johansson (2002), Wyplosz (2002a,b), the Swedish Government Commission on Stabilisation Policy (2002), and EEAG (2003).

here, the argument is that macroeconomic stabilisation involves relatively little of value judgements and is to a large extent a question of technically finding the best ways of achieving what can be regarded as a commonly shared objective of minimising macroeconomic fluctuations. This is in contrast to those fiscal policy decisions that concern issues such as the overall size of government expenditures, the structure of taxes and government expenditures, and the path of government debt, which all involve value judgements on how to trade off income distribution against social efficiency aspects. The fundamental question here is therefore whether or not it is possible to separate fiscal policy decisions with the aim of stabilising the business cycle from those that mainly affect income distribution and social efficiency. Only stabilisation decisions should be a candidate for delegation, whereas other fiscal policy decisions clearly belong to the realm of ordinary political (parliamentary) decision-making.

Below, I outline two different models of delegation and analyse their relative merits.

Model 1: the Fiscal Policy Committee decides the annual budget balance

The first model is close to proposals by Wyplosz (2002a,b). It can be summarised in the following six steps.

(i) The parliament decides a target for the budget balance over the cycle.

(ii) The parliament delegates the right to decide the budget balance target in a given year (depending on the cyclical situation) to the Fiscal Policy Committee and precommits to following the recommendations of the committee.

(iii) The parliament decides the stabilisation policy objectives for the Fiscal Policy Committee and guidelines for how the actual budget balance should be allowed to vary over the cycle. Basically, this amounts to specifying to what extent one should rely on the automatic stabilisers and to what extent one should resort to discretionary action.

(iv) Following its instructions, the Fiscal Policy Committee decides which actual budget balance to aim for in a given year.

(v) The parliament decides which tax and expenditure policies are required to reach the target for a given year set by the Fiscal Policy Committee.

(vi) The Fiscal Policy Committee monitors budget and cyclical developments over the fiscal year and can request amendments to the budget to meet the target it has set.

According to this model, the parliament thus retains the right to decide through which tax and expenditure policies the annual budget target set by the committee should be met. This means that the parliament continues to decide on the main income distribution and social efficiency aspects of fiscal policy. As the Fiscal Policy Committee would determine only the variations around the path of government debt over the cycle, but not the path itself, its decisions would have a negligible effect also on intergenerational equity. The flip side of retained political decisions on all individual tax and expenditure decisions is that the Fiscal Policy Committee does not acquire full control over the stabilisation effects of fiscal policy. To the extent that different taxes and expenditures have different multipliers (see Section 3), political decisions on tax and expenditure changes consistent with the budget target of the Fiscal Policy Committee could still affect aggregate demand to a significant degree. This might seriously complicate the task of the Fiscal Policy Committee, as it may not be possible to offset such effects without violating the budget balance target over the cycle.

Model 2: the Fiscal Policy Committee varies individual tax rates or government expenditures

My second model of delegation is close to proposals by, for example, Ball (1997), Business Council of Australia (1999), and Seidman (2001). It involves the following five steps.

(i) The parliament decides a target for the budget balance over the cycle.

(ii) The parliament decides base values for all tax rates and government expenditures. These base values should be consistent with the budget target over the cycle.

(iii) The parliament delegates the right to vary certain tax rates or government expenditure levels within predetermined margins to the Fiscal Policy Committee.

(iv) The parliament decides the stabilisation policy objectives for the Fiscal Policy Committee and guidelines for how the instruments delegated should be used. The guidelines should require that the committee varies the fiscal policy instruments under its control in such a way that the budget objective over the cycle is met.

(v) Following its instructions, the Fiscal Policy Committee varies the tax rates and/or government expenditure levels under its control around the base levels set by the parliament.

An important issue with this model is how much freedom the Fiscal Policy Committee should have in its choice of instruments in a given situation.

A first possibility is that the parliament determines in advance which fiscal instruments should be varied if the need arises. The simplest alternative is to give the committee control over only one specific fiscal instrument. Alternatively, the parliament could prescribe *ex ante* that discretionary fiscal policy action should have a given composition (for example, 30 percent of a fiscal stimulus could be a VAT decrease, 20 percent a reduction in employers' payroll taxes, 10 percent a reduction in personal income taxes for low-income earners, and 40 percent an increase in government consumption), as proposed by Seidman (2001). This way the Fiscal Policy Committee decides only the overall size of fiscal stabilisation measures, but the political sphere retains significant control also over the short-run income distribution effects.

A disadvantage of predetermining the composition of fiscal stabilisation measures is that different policy responses may be called for depending on the type of macroeconomic disturbances. For example, an increase in government employment may not be an appropriate response to a reduction in export demand. So, deciding on the composition of stabilisation packages once and for all may unduly constrain policy choices in a given situation.

Predetermining the composition of discretionary stabilisation measures would also require the parliament to form an informed view of which instruments are "on average" the best. This choice would be most important if one only delegates the use of a single fiscal policy instrument to the Fiscal Policy Committee. Which one should then be chosen? There seems to be a presumption in the delegation literature in favour of taxes (Ball 1997; Blinder 1997; Business Council of Australia 1999). If so, one might argue that VAT changes could be a good candidate, as they affect private consumption in a similar way as interest rate changes, which are already subject to delegation. Delegation of the decisions on VAT changes would shorten decision lags. This is likely to be particularly important for this instrument, because long decision lags could actually reverse the effect of policies: for example, a temporary VAT increase to cool off a boom will have an expansionary demand effect in the period before it enters into force (see Section 3.2). However, variations in government consumption, for example through variations in general grants to regional and municipal authorities, might also be a suitable stabilisation policy parameter for a Fiscal Policy Committee.[11] As discussed in Section 3.1, empirical research suggests that expenditure multipliers are larger than tax multipliers. Delegation to a Fiscal Policy Committee could mitigate the

[11] A possible complication with this instrument is, however, that there may be substantial lags before these revenue increases result in expenditure increases at the level of sub-national governments.

problem of irreversibility, which is usually regarded as the strongest argument against increases in government expenditures in recessions (Wijkander and Roeger 2002; Swedish Government Commission on Stabilisation Policy 2002).[12]

Another possibility would be that the parliament decides on a set of fiscal policy instruments that the Fiscal Policy Committee can vary within certain limits, but leaves the committee complete freedom to choose which of these instruments to be used in a specific situation. This would allow the committee to use the instrument combination it finds most appropriate at each point of time. It would also allow the committee to adjust the use of instruments to changes over time in the way economists judge their effectiveness. With such discretionary power over which instruments to use in specific situations, the Fiscal Policy Committee would acquire some – but still limited – influence on income distribution and social efficiency, as there would no longer be a requirement that individual tax rates and government expenditures are changed symmetrically over the cycle.[13]

There is one important difference between letting the Fiscal Policy Committee vary the deficit target – as in Model 1 – and letting it vary specific tax rates or expenditures – as in Model 2. According to the former arrangement, the estimates of the committee of the cyclical situation of the economy would be automatically binding for the government. With the latter arrangement, one could fear that overoptimistic judgements of potential output on the part of the government might cause it to systematically overestimate the cyclically adjusted balance, which might contribute to a deficit bias. A possible way of addressing this problem is to require that the estimates of the cyclically adjusted balance are based on the judgements of the Fiscal Policy Committee in the latter arrangement, too (see the discussion in Section 5.2 of an advisory council).

Weaker forms of Fiscal Policy Committees

One could also conceive of weaker forms of delegation of fiscal policy decisions aiming at macroeconomic stabilisation. One possibility would be to

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[12] See also Section 4. Another proposal is that of Saint-Paul (1995), who proposed that the size and composition of active labour market programmes should be delegated to an independent Labour Market Board. This idea has been analysed theoretically by Calmfors (1995) and Johansson (2002).

[13] The short-run wealth effects could, however, be large if the Fiscal Policy Committee would be free to decide on variations in selective taxes, such as stamp duties or capital income taxes (and tax deductions for mortgage interest payments), directed largely at the housing market (see Section 2).

give a Fiscal Policy Committee control only over a well-defined "rainy-day" stabilisation fund, but leave the political sphere in full command of the rest of fiscal policy. Such a fund could, for example, be built up to a maximum level through specific tax receipts in booms and then run down through specific tax rebates in recessions. Many might regard this alternative as less controversial than the two models discussed above, because the powers of the Fiscal Policy Committee would then be more clearly delineated and would not interfere with the normal budget process. The idea has some resemblance with the Finnish buffer funds that were discussed in Section 3.2 (Holm et al. 1999; Swedish Government Commission on Stabilisation Policy 2002).[14] These funds differ, however, from the institutions discussed here, because they are of a corporatist nature: they are in effect controlled by the central labour market organisations and not by an independent committee of experts. A general drawback of the stabilisation fund solution is that it might introduce a "double command" to the extent that the government also uses the fiscal parameters under its control to influence the cyclical situation.

Another alternative has been suggested by Blinder (1997). According to this, the ultimate decision on a fiscal policy proposal of the Fiscal Policy Committee should be taken by the legislature, but be subject to a simple up-or-down vote. The proposal would thus have to be either accepted without any changes or rejected. In the latter case, one possibility could be to freeze tax rates and nominal government expenditures at last year's level. Such an arrangement would give the political sphere more influence than with delegation of the actual decision-making, but the Fiscal Policy Committee would still have a strong hand, as automatic "fiscal drag" would tend to strengthen the budget balance in case the committee's proposal is rejected by the Parliament.

Some contributions have proposed that monetary policy committees (or executive boards) in existing central banks could function also as fiscal policy committees (Ball 1997; Seidman 2001; and Wren-Lewis 2002). One motive is that there would be small set-up costs if one uses an existing institution, which already has an independent status and has acquired credibility for prudent stabilisation policies. Also, it might be regarded as politically less controversial to build on an already accepted institution rather than to establish a new one. Another argument has been that such an arrangement would facilitate co-ordination between fiscal and monetary policy. However, this

[14] Note also that the majority of US states have set up extrabudgetary "rainy-day funds", which can be drawn on in recessions without violating requirements that the budget should balance. These funds are not used for discretionary policy action but for letting the automatic stabilisers work, that is to avoid expenditure cuts when tax receipts fall. The rainy-day funds are, however, controlled by the state legislatures, although they are sometimes subject to specific rules on accumulation and use (see, for example, Knight and Levinson 1999; or Zahradnik and Johnson 2002).

argument does not apply to the EMU, where monetary policy is centralised and fiscal policy decentralised. Here, it would rather be a question of finding a new role for the boards of the national central banks. A counterargument is, however, that fiscal and monetary policy-making require different kinds of expertise. Another counterargument is that one might want to have a higher degree of accountability of the Fiscal Policy Committee (with dismissal possibilities) than is compatible with the present independence of the European System of Central Banks (see the next section). It might also be felt that delegating also fiscal stabilisation measures to the central bank sphere might result in too much concentration of power.

Democratic aspects of delegation

To ensure that fiscal stabilisation policy decisions are taken at arm's length from day-to-day politics, it has been suggested that the Fiscal Policy Committee should have a similar degree of independence as a central bank (see, for example, Blinder 1997; Ball 1997; or Wyplosz 2002a). This would imply that the committee is not permitted to take instructions regarding individual decisions from the government or the parliament, and that the latter institutions are not permitted to give such instructions. Appointments should be long-term and non-renewable. Committee members should have professional competence: either earlier practical experience of economic policy-making or analysis from ministries of finance, central banks, international organisations (like the IMF, the World Bank or the European Commission), private banks etc. or academic competence in the field of stabilisation policy and macroeconomic analysis. The Fiscal Policy Committee should be granted a long-term budget, which could not be changed from year to year.

The most common objection against delegation of fiscal stabilisation decisions is that it might interfere with generally accepted principles of democratic governance. How should one think about this?

To ensure the legitimacy of delegation of fiscal policy, the Fiscal Policy Committee would have to be subject to democratic oversight and be accountable for its decisions. Even if delegation is likely to improve fiscal policy "on average", democratic control would be needed to reduce the risk that the committee might at times pursue idiosyncratic objectives or just make bad technical judgements. Some lessons could be learnt from monetary policy, but one could also go further in some respects.

(i) Appointments of the members of the Fiscal Policy Committee should be made by the government and be subject to approval by the parliament. The candidates should be subject to questioning in the parliament before

they are confirmed, as is the case, for example, with members of the Federal Reserve Board in the United States (in the senate). There is a similar procedure for the members of the Executive Board of the ECB in the European Parliament, although the parliament's confirmation is not formally required.

(ii) A high degree of transparency should be required of the Fiscal Policy Committee. It would have to explain all its decisions to the general public and to publish background stabilisation reports at regular intervals. The minutes of the committee meetings and voting records should be published. The members of the committee should regularly take part in public hearings in the parliament.

(iii) The parliament should carry out *ex post* evaluations of the committee's performance with the help of outside expertise. If the Fiscal Policy Committee fails over a period of years to achieve its objectives by a large margin – which needs to be given a clear operational definition *ex ante* – the parliament should have the possibility of dismissing the whole committee or individual members of it. Preferably, such dismissal should require a qualified majority to protect the committee against misuse of this possibility.

(iv) One could also conceive of an escape clause, which would enable the parliament to override an individual decision by the Fiscal Policy Committee. Again, this could require a qualified majority.

(v) The ultimate check on a system of delegation is, of course, the possibility to abolish the system altogether if it does not work in the desired way.

In any discussion of democratic control, it is important to distinguish between the formal aspects of accountability and how the process works in practice. It has been argued that in practice there may be more accountability with the delegation of a specific "technical" task to an independent committee, with clearly defined objectives against which to measure performance, than to have it executed as one of many simultaneous tasks by the government (Majone 1996). The argument is that the assignment of well-defined tasks to independent bodies makes it easier to "nail down" mistakes than if a government is at the same time to be held accountable for its performance in a large number of fields through the ordinary political process.

My overall conclusion is that it appears possible to improve substantially the chances for well-designed fiscal policies to stabilise the economy through delegation of decision-making powers to an independent Fiscal Policy Committee without sacrificing either accountability or political control over income distribution and social efficiency.

5. National fiscal policy institutions and the EU fiscal policy framework

I have so far only discussed the implications at the national level of the various proposals for fiscal policy reform. An issue that needs to be addressed is how such national reforms would square with the fiscal policy framework at the EU level.

The EU fiscal rules are set out in the Maastricht Treaty and the Stability and Growth Pact. The formally most binding provision is the deficit ceiling for the government budget of three percent of GDP, violations of which can ultimately lead to fines. Another important provision is that government debt should be below 60 percent of GDP or, if it is higher, that it should "be decreasing at a satisfactory pace". The medium-term budget balance, which is interpreted as the cyclically adjusted budget balance, should be "close to balance or in surplus". Finally, there is a multilateral surveillance process for national budget positions, according to which the member states in the EMU are obliged to supply so-called stability programmes, which are evaluated by the European Commission and the Ecofin Council. The latter can issue "early warnings" to a state in the case of "a significant divergence" of budget outcomes from targets.[15]

There are two main motivations for why the fiscal rules at the EU level were introduced. The first rationale was a desire to strengthen fiscal discipline in general. The background was the increasing government indebtedness in most EU states in the 1980s and early 1990s (see, for example, EEAG 2003). As discussed in Section 4, the political-economy literature has also identified a number of factors that can lead to excessive government debt accumulation. Seen in this light, monetary unification offered a unique opportunity to impose constraints on government budget deficits: as the creation of the EMU required the set-up of new institutions anyway, it appeared much easier to establish such rules at the EU level than to initiate national reform processes, which could more easily be blocked by various vested interests.

The second motive for fiscal rules at the EU level is the moral-hazard problems that can arise in a monetary union because fiscal policies in one member state have spill-over effects on other member states. Most notably, both the ECB and the governments of the other member countries might in the end be forced to bail out an insolvent government of an individual member country, even though this is formally prohibited by the so-called no-bail-out clause in the Maastricht Treaty (see, for example, Buiter et al. 1993; Beetsma 2001; or Eichengreen 2003).

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[15] See, for example, EEAG (2003) or *An Agenda for a Growing Europe* (2003) for more detailed accounts of the EU fiscal rules.

In principle there are three possible ways of relating the national fiscal policy reforms I have discussed to the EU fiscal policy framework. The first alternative is to regard the reforms as a *complement* to the existing EU fiscal rules. The second alternative is to view the reforms as a *substitute*. The third alternative would be to allow member states to *opt out* of the current EU fiscal policy framework conditional on meeting commonly agreed minimum standards for national fiscal policy institutions.

5.1 National fiscal policy reform as a complement to existing EU fiscal rules

In my view the most natural approach would be to regard reforms of national fiscal policy institutions as a complement to the existing fiscal policy framework at the EU level. This is also the line taken by the Swedish Government Commission on Stabilisation Policy (2002) and the UK Treasury (UK Membership of the Single Currency 2003). In both cases reform proposals on national fiscal policy institutions were motivated by a desire to enhance the effectiveness of fiscal policy as a stabilisation tool in the event of EMU membership and to reduce the risks of violations of the EU fiscal rules by making fiscal policy responses more symmetric over the cycle (that is to ensure that there is enough fiscal restraint in upswings, so that countercyclical policies do not contribute to a deficit bias).

Adopting this view, there would be no need for a common EU approach to national fiscal policy reforms. Each member state would be free to choose the institutions it deems the most efficient to meet the common fiscal policy requirements and national stabilisation objectives. Indeed, the absence of common regulations of national fiscal policy institutions would even appear to be a great benefit, since it would allow *institutional competition*. To the extent that member states choose different fiscal policy institutions, there is the possibility of learning from each other about the advantages and disadvantages of different institutional set-ups. This would be of particular value in the case of more radical reforms, such as establishing independent Fiscal Policy Committees, where it is difficult in advance to foresee all possible consequences.

One issue that would have to be addressed with the Fiscal Policy Committee option is how to deal with violations of the EU rules on government deficits and debts. The instructions to a national Fiscal Policy Committee would have to specify explicitly how the committee should act if there were to be a conflict between the national stabilisation objectives and the EU rules. For example, there would have to be clear instructions on how the committee should respond

to early warnings and recommendations from the European Commission and the Ecofin Council as well as to the threat of EU sanctions.

5.2 National fiscal policy reform as a substitute for EU fiscal rules

A radically different alternative is to view instead national fiscal policy reform as a substitute for the existing EU fiscal rules. This has been suggested by, for example, Wyplosz (2002a,b).

The starting point for such a discussion is that it is not self-evident that the fiscal policy framework at the EU level should focus on numerical targets for government budget deficits and debts, as is now the case. Indeed, it can be claimed that the numerical targets chosen are arbitrary, and that this creates a legitimacy problem that may in the end make it very hard to enforce the rules (see, for example, Buiter et al. 1993; Wyplosz 2002a,b; or Eichengreen 2003). Another strategy that could have been followed in the Maastricht Treaty would have been to focus on common standards for the design of national fiscal institutions and decision procedures. The main reason why this approach was not adopted is probably that it was considered to imply too great interference with national sovereignty and to be associated with serious monitoring problems (Beetsma 2001; Buti and Giudice 2002).

However, the recent deficit experiences of in particular France and Germany have vividly illustrated the difficulties inherent in the present EU system of trying to enforce common numerical targets. There is a very evident risk that the existing fiscal rules will be violated in such a way that they lose their credibility. In such a situation it might appear natural to contemplate instead common EU minimum standards for national fiscal policy institutions as a more viable alternative. A parallel would be the common regulation of the legal status of the national central banks, which applies also to EU countries outside the euro area.

But, in my view, a common regulation of national fiscal policy institutions is not likely to be a good substitute for the present EU fiscal policy framework. Why should such an approach be more credible than the present one, if the latter is abandoned as soon as it is put under strain? Also, to allow for strong enough incentives for responsible fiscal policy in the absence of common EU numerical targets, reforms of national fiscal policy institutions would probably have to be quite radical, perhaps involving delegation of decision-making powers to independent Fiscal Policy Committees. It is likely to be very difficult to gain the necessary legitimacy for such wide-ranging changes if they are imposed on the member states from the EU level (see also Section 6).

5.3 National fiscal policy reform as a way of opting out from the existing EU fiscal policy framework

A final possibility would be to allow member states that adopt national fiscal policy reforms according to some minimum standards to *opt out* of the current EU fiscal policy framework. Member states could then choose between being subject to the currently existing fiscal rules and reforming national fiscal policy institutions and then be given larger room of manoeuvre, for example, a higher deficit ceiling (say four or five per cent of GDP instead of the current three). Such an approach has similarities to recent proposals by Pisani-Ferry (2002) and Eichengreen (2003).[16]

There could be many ways of formulating such an opt-out clause. One way of doing so would be to allow a government to breach the present three-per-cent-of-GDP deficit ceiling only if it is approved by an independent advisory Fiscal Policy Committee in the country (see Section 4.2). Another possibility would be for the EU fiscal rules to allow the member states to build up extrabudgetary rainy-day-funds under the control of an independent Fiscal Policy Committee that can be drawn on in downswings (without this being included under the three-percent-ceiling).[17]

5.4 National reform and EU co-ordination of fiscal demand management policies

My conclusion is that national fiscal policy reforms are best seen as a complement, and not as a substitute, to the existing EU fiscal policy framework. There are good reasons to let individual countries experiment with different fiscal policy institutions in order to learn from experience which arrangements work the best. For this reason, I am also sceptical about allowing opt-out possibilities from the present EU fiscal policy framework for countries adopting specific reforms, since they would require a common EU regulation of minimum standards.

The one complication with reforms of national fiscal policy institutions I see in the EU context is that discretionary co-ordination of fiscal demand-management policies among member states (in excess of the rules-based co-

[16] Pisani-Ferry (2002) proposed that member states opting for more transparency of fiscal policy should be allowed to opt out of the Stability and Growth Pact. Eichengreen (2003) proposed instead that member states reforming pension systems, unemployment and disability insurance, and revenue sharing arrangements between different layers of government according to certain principles could be exempted (by an independent Fiscal Policy Committee at the EU level!) from the requirements of the Stability and Growth Pact.

[17] See also Section 4.3. EU provisions for rainy-day-funds have been discussed in, for example, Buti and Giudice (2002), EEAG (2003) and *An Agenda for a Growing Europe* (2003).

ordination according to the Stability and Growth Pact) could be made more difficult. This could, for example, occur if fiscal stabilisation policies were to be delegated to independent Fiscal Policy Committees in some countries, whereas they would continue to be decided by governments in others. Then it would not be enough to co-ordinate fiscal policy in the Ecofin Council, as not all ministers of finance would have (full) control over domestic fiscal stabilisation efforts. If one believes that such co-ordination is important, there would be a need for institutional innovations at the EU level to handle the situation.

However, one could also take the view that far-reaching co-ordination of fiscal demand-management policies at the EU level is of limited value (see, for example, Calmfors 2001b). It is true in theory that there would be benefits from such fiscal policy co-ordination to the extent that this allows spill-over effects from national fiscal policy on other countries to be taken into account. But although we can point to various such externalities, we do in practice know very little about whether the "net externality" on other member states is positive or negative, and hence we cannot infer in a given situation whether co-ordination should lead to more expansionary or more restrictive fiscal policy.[18] Co-ordination attempts at the EU level are also likely to have high administrative costs, to prolong decision lags, and to make it more difficult to hold national policy-makers accountable for decisions. Considering all this suggests that it is much more important to design appropriate fiscal policy institutions at the national level than to try to create optimal conditions for co-ordination of policies at the EU level.

6 Discussion

I have reviewed different ways of reforming national fiscal policy institutions in the EMU countries in order to make fiscal policy a more effective tool of macroeconomic stabilisation. My finding is that there are large possibilities of doing this, and that there are then important lessons to learn from monetary policy. I have discussed a more transparent framework for the government´s use of fiscal policy as a stabilisation instrument, an independent advisory Fiscal Policy Council, and delegation of actual decision-making on fiscal stabilisation measures to an independent Fiscal Policy Committee. Such

[18] See, for example, Beetsma et al. (2001) or Andersen (2002) for discussions of various types of spill-over effects. In a recession, there will, for example, be positive externalities of expansionary fiscal policy in one country to the extent that this stimulates demand in other countries (both because of a direct demand spill-over and because higher prices in the home economy means a competitive advantage for other countries). But on the other hand there will be negative externalities to the extent that interest rates increase and there is an appreciation of the common currency.

reforms should be regarded as a complement, and not a substitute, to the existing fiscal policy framework at the EU level. To the extent that the incentives to exercise fiscal restraint in booms are strengthened and the temptations to use stabilisation considerations to justify fiscal laxity in general are lessened through national fiscal policy reforms, the probability increases that the EU fiscal rules are observed.

Somewhat to my surprise I have found that such a far-reaching reform as delegation of fiscal stabilisation policy to an independent Fiscal Policy Committee has a lot to speak for itself. But such an idea is, to say the least, politically very controversial. It touches what is often regarded as the very cornerstone of parliamentary democracy.[19] But thinking about it, it is difficult to find any fundamental difference between monetary policy and those fiscal policy decisions that aim at stabilising the business cycle. As noted by Blinder (1997), most of the arguments against delegation of fiscal stabilisation policy decisions could also be used against the already existing delegation of monetary policy. This would seem to suggest that the crucial issue is perhaps not whether fiscal policy decisions with the aim of stabilising the business cycle are less suitable for delegation than monetary policy decisions, but rather how much delegation of stabilisation policy decisions in total that is desirable.

It is too early to tell whether or not delegation of fiscal policy decisions with the purpose of stabilisation would be politically feasible. If it is to be done, it requires that a broad consensus on the desirability of such an institutional set-up develops. There is always a strong tendency to regard the existing division of decision-making powers between the political and technocratic spheres "as if they were the natural order of things" (Blinder 1997) and not subject to the possibility of reforms until the very moment such reforms take place. Earlier reforms of the institutional framework of monetary policy in many countries have shown, however, that reforms extending the sphere of technocratic decision-making in economic policy are sometimes politically feasible. So has the enhanced role in many countries of independent bodies in such fields as competition policy and financial supervision, where governments have increasingly focused on setting overall priorities rather than on making case-by-case decisions (EEAG, 2003).

[19] For this reason, the UK Treasury is negative to the idea of an independent Fiscal Policy Committee in its evaluation of the consequences of EMU membership (*UK Membership of the Single Currency* 2003). The argument is that "this would introduce some accountability problems and would not be consistent with parliamentary tradition in the UK, as it would challenge parliamentary sovereignty with respect to fiscal policy" (p. 132). A somewhat less balanced reaction is that of Mathieu and Sterdyniak (2003), who write that the proposal on an independent committee is based on the view that "democratically elected governments, thus the People, should be deprived of their authority" and that "this is a dangerous by-product of European construction".

My discussion shows that it would in principle be possible to delegate fiscal policy decisions with the aim of macroeconomic stabilisation to an independent expert body, while leaving the decisions on the size of government, the long-run tax and expenditure structure and the long-run debt path, which are crucial for income distribution and social efficiency, in the political sphere. Such a system could also be made compatible with a high degree of democratic accountability.

Delegation is likely to make fiscal policy a much more effective stabilisation tool. At the same time, delegation means that the electorate can influence fiscal policies to stabilise the economy much more slowly through the election process than is the case now. The crucial consideration is whether or not the efficiency gain in terms of macroeconomic stabilisation outweighs the reduction of the speed with which voters can influence stabilisation policy. If it is perceived to do so, delegation of fiscal policy decisions to an independent committee with the aim of stabilising the economy might ultimately come to be seen as equally legitimate as delegation of monetary policy to independent central banks. However, changes in this direction are likely to take a very long time and need to be preceded by many years of discussion.

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