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Fiscal Policy in Post-EMU Europe

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Introduction

European Monetary Union (EMU) affords an exceptional opportunity for social scientists to learn about the process of institutional change. Analysis of EMU is complicated, however, by the fact that the potential economic and political consequences of EMU are so diverse. For example, some see the adoption of the common currency as a symbolic act of great importance, signifying either the actuality or the potential of deeper political union among EMU member states. Some see monetary union as another brick in the edifice of the post-World War II international security structure, perhaps signifying some indissoluble linkage between Germany and France, or perhaps a departure from an international system dominated economically by the USA. At a much more mundane level, a single currency may simplify day-to-day economic life, reducing the amount of time and effort devoted to handling and exchanging currencies and solving messy arithmetic problems.

By contrast, a recent article by Freitag and Sciarini (2001) emphasizes the importance of EMU for the role of political institutions in budgetary policy. In a similar vein, the following comments will reinforce the message of the Freitag and Sciarini paper: some of the really crucial issues of a post-EMU Europe may show up in the making of *fiscal* policy, and not only in the context of macroeconomic management. Fiscal policy, meaning by this not only tax policy proper but also expenditure policy and debt management, is important not only because of its impact on aggregate demand, employment, and price stability. It is a principal means through which governments influence the distribution of income in society. The public sector in EU countries consumes or disposes of approximately half of GDP and, although a significant portion of government resources are devoted to the provision of traditional public goods (national defense and the like), redistributive transfers and social insurance programs account for the lion's share of the growth in the size of the public sector over the past century. By removing certain avenues of discretionary policy, EMU may significantly change the institutional context within which governments must operate in managing the conflicting demands of contending groups in the struggle for redistributive transfers. In this way, EMU may shift the focus of fiscal policy-making away from conventional macro-stabilization to structural issues; for example, the effects of fiscal policy on sectors, regions, income classes, and demographic groups. In this world, issues such as tax competition, the financing of social insurance systems, the reform of labor market institutions, interregional transfers, and other 'real-side' fiscal and regulatory policies may figure more prominently in fiscal policy debates.

These aspects of policy arise in several of the papers in the current issue. The paper by Clark et al. asks whether EMU, by constraining policy-makers, may reduce the range of choices presented to the electorate. They find that partisan differences have comparatively little impact on fiscal policy in EU countries in the pre-EMU period, and that EMU is unlikely, therefore, to give rise to policy convergence, which, in their view, is already prevalent. Although EMU may have only a limited impact on the policy 'distance' between parties, as Clark et al. suggest, it may nevertheless have a significant impact on their policy *positions*. Franzese and Mosher discuss policy-making in a competitive environment, stressing that principles of comparative advantage can be applied to policy choices as well as to market decision-making. Policy *diversity* among regions is a likely consequence. The paper by Rodden focuses on the mechanisms through which fiscal transfers among EU member states are determined. Although the redistributive role of the EU is quite limited so far, economic models of fiscal competition suggest that the competition for increasingly mobile resources among member states may impose limits on the redistributive functions of these governments, a development that may result in upward reassignment of redistributive tasks to the EU. If this should occur, the decision-making processes through which redistributive policies are implemented become even more important. Furthermore, existing and prospective EU-level redistributive policies interact with the consideration of EU enlargement, since new member states are likely net recipients of fiscal transfers. Their accession to the EU would increase their representation in EU policy councils, a consequence that existing member states surely must consider in their deliberations concerning enlargement.

The following remarks provide a brief elaboration of some of the foregoing themes. The next section highlights the role of EMU as an institution that affects the political economy of fiscal policy-making. Then I discuss some of the key sources of fiscal stress facing EU countries in the context of EMU. These stem partly from the interactions between demographic change, including the aging of the populations of EU member states and immigration, and extensive systems of social insurance and income redistribution.

Fiscal institutions, fiscal policies, and EMU

An interesting feature of the Maastricht Treaty was the establishment of 'fiscal criteria' for membership in EMU. According to these criteria, countries could gain membership in the EMU only by limiting their fiscal deficits to no more than 3% of GDP, and overall public sector debt to no more than 60% of GDP.

One possible reason for incorporating such criteria into an agreement on currency union is that they are needed to avoid fundamental financial or technical obstacles to the establishment or management of a common currency. European experience suggests that this is not the case, however. Take, for example, the monetary relations between Belgium and Luxembourg. The Belgian and Luxembourg francs long exchanged on a 1:1 basis prior to EMU. The currencies themselves, although distinct, were in practical terms unified. Yet the fiscal situations of these two countries could hardly be more different. Belgium, with a history of substantial deficits, has accumulated a government debt well in excess of 100% of GDP. Luxembourg, by comparison, has been a model of fiscal restraint and its debt / GDP ratio has been below 10%. Clearly, it is technically possible for two countries to maintain an effectively unified currency while following very divergent fiscal policies.

From a longer-term political economy perspective, on the other hand, the fiscal criteria of EMU may be very important – not because fiscal deficits are intrinsically incompatible with monetary union, but because they change the environment within which fiscal policy is made. The EU countries, as a group, generally have very high public expenditures and several of these countries – Italy is a prominent example – have financed substantial amounts of their expenditures through borrowing.[1] In the face of high expenditures, high taxes, and large government debt, monetary authorities may find it difficult to withstand pressures to absorb government debt, even at the risk of triggering price instability. In such a context, explicit fiscal targets, embedded in a major institutional and policy initiative such as EMU and accompanied by treaty obligations, may facilitate more restrictive fiscal policies and thus relieve some of the pressures on monetary authorities to absorb government debt. Indeed, the analysis of Freitag and Sciarini points in this direction: EMU seems to be exercising a significant influence on fiscal policy in member states, and, in doing so, may be reducing the role of other institutions – those that might normally be considered as more immediately connected with the making of fiscal policy.

Issues on the horizon: sources of fiscal stress for EU countries

Perhaps the EMU is becoming an institution that will have a significant impact on the environment within which fiscal policy is made. Since EMU, debt / GDP ratios have fallen modestly in participating countries. It is important to recognize, however, that debt and deficits, as conventionally measured, fail to reflect many aspects of the intertemporal stance of the public sector. In particular, governments own assets and are responsible for liabilities, implicit and explicit, contingent and realized, that do not appear in customary fiscal accounts. In particular, as is now increasingly widely recognized, public pension systems create implicit obligations to current and future retirees that are not, however, counted as government debt.[2] These implicit IOUs are extremely important in the OECD countries, including the member states of the EMU, both because these countries have large, generous, underfunded pension systems and because the populations in these countries are aging rapidly. Coping with the fiscal implications of an aging population promises to be a significant policy and political challenge in EU countries in coming years.

To the extent that EMU enhances the independence of monetary authorities, it increases the pressure on policy-makers to make 'real' (as opposed to nominal) fiscal and other policy adjustments in response to changing economic conditions. Potential responses to population aging and the fiscal stresses that it creates can be managed by (a) reductions in public pension benefits, (b) reductions in other public expenditures, (c) increases in taxes, (d) increases in borrowing, and (e) changes in immigration policy that increase the size of the working population (Straubhaar and Zimmermann, 1993; Johnson and Zimmermann, 1993). One can anticipate some policy movement on each of these margins, and perhaps more movement than would have been the case in the absence of EMU.

The EU countries – aging and prosperous – are surrounded by poor neighbors, some of them aging, some with very young populations. One way for EU countries to liberalize their (im)migration policies is to expand EU membership to include these countries, since citizens of EU member states are at least in principle free to seek employment in any other EU nation without legal impediments.[3] Expansion of EU membership thus brings with it the commitment to increased labor mobility – an option that is highly attractive to young workers in low-income countries, and that offers existing member states one path to management of the fiscal stresses of aging populations (Wildasin, 1999). On the other hand, accommodation of young workers from beyond the borders of existing EU countries is hampered by rigid labor market institutions. These institutions – including labor market regulations, collective-bargaining arrangements, minimum wages, and unemployment insurance – play a significant part in explaining high rates of unemployment in EU countries (Nickell, 1997, 1999; Saint-Paul, 1996), and are supported by powerful political constituencies. EMU may help to create a political environment within which labor market adjustment is promoted, not because policy-makers can no longer rely on monetary policy to cope with cyclical fluctuations *à la* Mundell (1961), but because policy-makers are constrained in their ability to manage fiscal stress through monetary expansion, giving rise to stronger incentives to restructure labor market institutions in ways that facilitate increased employment opportunities for increasingly scarce young workers.

Of course, labor market adjustment is a painful process. Existing workers in high-wage markets have powerful incentives to resist market liberalization, including not only deregulation of labor markets but also immigration. This is especially true for immigrants who pay relatively little in taxes and who are relatively high consumers of scarce public sector benefits – typically, immigrants with low skill levels whose earnings in destination countries are modest. As discussed in Wildasin (1994) and Razin and Sadka (1995), fiscal transfers from rich to poor regions can reduce the incentive for workers to migrate, thus protecting not only the earnings of existing high-wage workers and perhaps forestalling higher unemployment, but also limiting the extent to which immigrants 'dilute' the scarce redistributive resources of the public sector.

This does not necessarily mean that rich countries benefit, on balance, from transfers to poor countries, though they may. It certainly implies, however, that institutions that facilitate such transfers, such as the Common Agricultural Policy (CAP) and, more fundamentally, the EU itself, can serve some of the interests of donor states as well as recipient states. Thus, although EU enlargement is likely to be costly to existing member states, for example because of the extension of CAP and other fiscal transfers to new member states (Baldwin et al., 1997), there are nonetheless some offsetting benefits to the former, quite aside from the potential gains from increased trade (an issue that is at least partly separable from EU membership, since there are no fundamental obstacles to trade liberalization between EU and non-member states). As Rodden discusses in this issue, fiscal transfers within the EU tend to flow from high- to low-income countries, and representation in EU decision-making mechanisms appears to have a significant impact on the size and direction of transfers. And, whatever representation rules are ultimately utilized in EU decision-making, Eastern enlargement will certainly increase the influence of new and relatively poor member states relative to old and relatively rich ones. But, for the reasons indicated above, the current member states may still support EU enlargement owing to fiscal considerations.

Another way for EU countries to manage the fiscal stress associated with social insurance and redistributive policies is simply to reduce the magnitude of these programs. As suggested in classic treatments of the subject by authors such as Stigler (1959), Oates (1972), and others, competition for mobile resources limits the capacity of governments to engage in redistributive transfers. Integration of labor markets has already been discussed above with reference to migration. Competition for mobile capital is discussed by Franzese and Mosher in this issue. Current evidence on international tax competition (see, e.g., Devereux et al., 2001a, 2001b) suggests that source-based taxes on mobile capital, such as the corporation income tax, may indeed be falling over time in EU and other OECD countries. The role of EMU in this process, as suggested by Clark et al. in the current issue, may be rather modest. Increasing capital mobility among EU countries antedates EMU, after all, though EMU likely reduces exchange rate risk that may have impeded capital market integration to some extent.

Integration of markets for labor and capital is driven partly by policy choices – EU enlargement, for example. It also depends, perhaps more fundamentally, on changes in technology that lower the costs of communication and transportation. These developments shape the market environment within which policies must be made. In particular, integration of factor markets alters the benefits and costs of redistributive policies. Nothing prevents a ‘left’ party from imposing heavy taxes on mobile capital or high-income households but, whereas such a policy may have *benefited* low-income households in a world of limited factor mobility, it may *harm* them when it has the effect of driving productive resources out of the taxing jurisdiction.

To see the economic logic of this assertion, observe that both the ‘incidence’ and ‘efficiency’ effects of taxes (or subsidies) depend critically on the mobility of resources. To take polar cases for the sake of illustration, suppose that capital is initially completely immobile and that it then becomes freely and costlessly mobile on international markets. In a country with a ‘trapped’ stock of immobile capital, taxes on the return to capital depress the net rate of return received by capital owners. Since capital owners are, on average, relatively high-income individuals, such a tax falls relatively heavily on the rich, and may constitute an important part of a redistributive fiscal system that transfers resources from rich to poor. The ‘incidence’ of the tax – that is, the distribution of its real economic burden – is on the rich. Now suppose that a country’s domestic capital market becomes fully integrated with the rest of the world, so that owners of capital can freely invest wherever the net rate of return on capital is at its highest. A domestic tax on capital now drives some capital out of the taxing jurisdiction, making capital in domestic uses increasingly scarce and raising its *before-tax* rate of return. The reallocation of capital away from the taxing jurisdiction will continue until the before-tax rate of return has risen sufficiently to bring the after-tax rate of return up to the level attainable in the external market. When this adjustment process is complete, the owners of remaining capital in the domestic economy are still paying the local tax, but the burden of this tax no longer falls on them – they are compensated for it by the higher before-tax rate of return. The real burden of the tax falls on other resources owners in the domestic economy – workers, for example, whose productivity and wages will be lower because they have less productive capital with which to work. That is, the economic incidence of the capital tax is *shifted* from those upon whom the tax is assessed to others in the economy. The capital tax, in this world of free capital mobility, is no longer performing the economic function of taking resources away from capital owners for redistribution to others. In fact, the capital tax now merely creates fiscal incentives for capital reallocation, driving it away from domestic uses purely because of tax considerations and thus harming the efficiency of resource allocation. A tax on mobile capital that is used to finance transfers to immobile workers is not merely ineffective, it is actually, on balance, harmful to the owners of immobile domestic resources. In this world, the intended beneficiaries of redistributive policies are better off if the policy simply disappears.

The same logic explains why subsidies to mobile capital are also harmful. It is true that subsidies to domestic investment can raise worker productivity and wages, but, if the workers have to pay the taxes that are used to finance investment subsidies, the taxes that they pay will exceed the benefits that are obtained through improved earnings, because of the efficiency or ‘deadweight’ loss that results from investment decisions that are driven by fiscal incentives – subsidies, in this case – rather than by true economic benefits.

This simple argument is too simple, in that it sweeps aside complexities relating to the redistribution of income among owners of immobile resources, the varying degrees of mobility of different types of resources, or the possible efficiency gains from taxes on, or subsidies to, mobile resources when market failures prevent fully efficient market-driven resource allocation.[4] It makes clear, however, why highly competitive jurisdictions – state and local governments in the USA, for example – do not comply with the Franzese and Mosher prediction that competition for mobile resources (they focus on competition for capital) leads not merely to lower tax rates but to subsidies, possibly even at exorbitant rates. The key point is that redistribution *distorts* resource allocation when resources are mobile and thereby raises its cost, and this is true whether mobile resources are taxed or subsidized. Openness to external markets does not necessarily imply that political parties must share policy positions, but they can certainly create incentives for parties to adapt their policy positions, and the focal points of political disputes, in predictable ways. The findings of Clark et al. (this issue) can perhaps be interpreted partly in this light.

Finally, whereas competition for mobile resources may drive party platforms in particular directions *within* countries, it may simultaneously contribute to policy divergence *among* countries. As Franzese and Mosher emphasize, openness to external markets creates opportunities to gain from efficient specialization and exploitation of comparative advantage. Indeed, the costs of taxes and subsidies that favor inefficient economic activities and impede efficient ones become increasingly apparent only in economies with high degrees of factor mobility.

Notes

1 The Italian debt / GDP ratio, like that of Belgium, is well over 100%. See European Central Bank (2000) for recent figures.

2 On public sector accounting generally, see, e.g., Kotlikoff (1992) or Auerbach et al. (1994). Additional references are given in Boadway and Wildasin (1993).

3 The growing importance of immigration for developed countries in Europe is documented and discussed in OECD (1999) and Wildasin (2000).

4 See Wildasin (1998) and Wilson (1999) for relatively non-technical surveys of the literature that amplify the foregoing discussion.

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