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Unemployment and Fiscal Policy in the EU

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Introduction

The persistently high level of unemployment in many parts of the EU calls for a new approach to macro-economic policy. Current policy is still dominated by the neo-liberal approach reflected in the Delors Report[1] and Treaty of Maastricht, despite their evident failure to meet the needs of an era in which inflation is no longer the dominant problem. Monetary policy remains the primary, or only, instrument for demand management with a remit solely of achieving price stability. The use of fiscal policy remains out of fashion. Even if the remit of the European Central Bank were to include the objective of a high and stable level of employment, lower interest rates by themselves would be unlikely to produce any significant fall in unemployment - European interest rates have been relatively low for some time. What is needed is a more expansionary approach to fiscal policy.

The problem today, however, is that demand management is not on the current policy agenda. Public discussion is concentrated on a sterile debate about so called 'structural reform'. This is essentially about reforms to the labour market which would strengthen the power of employers relative to employees and their unions. The unstated rationale of this would be that it would make a recurrence of inflation less likely if the demand for labour were stronger. But this approach to reducing unemployment would still require measures to raise demand – something which never enters the discussion.

The UK Treasury's version of this approach is to call for greater 'flexibility' – this can cover a variety of things. Multi skilling and flexibility in the workplace can benefit both employers and workers. Flexible ('family friendly') working hours to help people with children, or caring for others, are also a positive development. But to provide more scope for changes in pay and working conditions without negotiation or consultation would be retrograde; and the idea that 'flexible' wages (i.e. wage cuts) are a remedy for unemployment is a pre-Keynesian fallacy - wages are not just a cost to employers, they are also a major source of demand. Further more, in so far as flexibility worked both ways, and wages went up more rapidly as unemployment came down, this would make it more difficult to achieve full employment without inflation. One of the advantages of national wage bargaining on the continental European model is that it helps to avoid wage inflation.

Fiscal policy

Fiscal policy is now the key to reducing unemployment in the EU. It can in principle operate at both a national and a European level. In the latter case co-ordination of national policies could ensure that policy in member countries was leaning in the same direction, either to stimulate demand in order to combat unemployment, or to restrain it when there is a threat of inflation. It has long been recognised that as the common market developed, growing inter-trade would increase the 'overspill' from changes in demand in one

EDITOR's NOTE

This is the seventeenth in a series of regular *European Policy Briefs* produced by the Federal Trust. The aim of the series is to describe and analyse major controversies in the current British debate about the European Union.

We would welcome comments on and reactions to this policy brief. Other Policy Briefs are available on the Federal Trust's website **www.fedtrust.co.uk/policybriefs.**

Brendan Donnelly (Director, Federal Trust) country onto its trading partners. This reduces the immediate impact of such changes on the country concerned, and makes each country increasingly dependent on demand conditions in neighbouring countries.

But while countries need to take a similar, expansionary or restrictive, fiscal stance in so far as demand conditions are similar, different policies may be required where demand conditions differ. For example, in present conditions, the expansionary stimulus needed in the euro area would not be appropriate to the same extent in the UK. Moreover, within the euro area itself, the fact that all countries are subject a common monetary policy means that any differences in demand conditions can only be tackled by differences in fiscal policy. A difficult balance needs to be struck. 'Co-ordination' calls for discussion and recognition of the need both for similarities and differences between countries. Such co-ordination should also be developed between monetary policy in the euro area and the monetary policies of other member countries. In an ideal situation, when agreement on appropriate national policies has been reached, an EU forecasting model, taking into account both fiscal and monetary policy, should show an appropriate demand balance in each country and hence the EU as a whole. This is, of course, a counsel of perfection: just as regional differences in economic activity will persist within countries, so demand management on its own will not eliminate all differences in unemployment rates between countries.

Although such co-ordination is provided for in existing Treaties it has made very little progress. This is not surprising when the use of fiscal policy for demand management is out of fashion and the Stability and Growth Pact inhibits any such action.

The Stability and Growth Pact

The Treaty of Maastricht signed in 1992 introduced 'the excessive debt procedure', which was subsequently elaborated in the Stability and Growth Pact which was finalised in Amsterdam in 1997.[2] Governments committed themselves to keeping 'the medium-term budgetary position close to balance or in surplus' and correcting 'excessive deficits as quickly as possible' – 'excessive deficits' are those exceeding 3 per cent of GDP. If the planned or actual deficit exceeds 3 per cent of GDP, the country is liable to incur a financial penalty. The only automatic exemption is when the deficit arises from 'an unusual event outside the control of the member state concerned' or from an economic downturn involving an annual fall of real GDP of at least 2 per cent a year. There is, however, a clause which allows a state to claim a possible exemption if the fall in output exceeds 0.75 per cent a year and there has been an accumulated loss of output relative to past trends. Where the circumstances are not regarded as 'exceptional', the Council can impose a penalty in the form of a non-interest bearing deposit which can be converted into a fine after two years.

The Pact itself did not recognise a failure of output to increase as a form of recession, nor the persistence of heavy unemployment as a sign that demand needs to be stimulated. But in response to current conditions, finance ministers earlier this year agreed to extend the exemptions to cover a protracted period of very slow growth. However, if the intention was to leave more room for the automatic stabilisers to operate, experience has shown that the 3 per cent deficit limit is too tight. Certainly the restrictions on deficits rule out any deliberately expansionary measures in the form of tax cuts or increases in public expenditure.

A weakness of the whole approach is that it makes no distinction between current and capital expenditure, thus creating a strong bias against borrowing for public investment. (In this respect it is more stringent than Gordon Brown's Golden Rule, that the current account budget should be balanced over the business cycle.) A related aspect of the Pact is the limit on public debt, 60 per cent of GDP. The basic problem with the Pact is that it is based on an exaggerated concern with the potential problem of excessive debt and the danger that loss of confidence in government bonds issued by one country might have repercussions throughout the whole euro area. It fails to recognise the fact that the greatest threat of excessive public borrowing comes from the danger of persistent low levels of demand and output driving budgets into deficit.

The Pact is overdue for amendment and the fact that Germany and France are now coming under the lash from the Commission makes such amendment more likely. I do not believe that the solution is to create a new set of rules. It has been suggested, for example, that something akin to Gordon Brown's Rules would be the answer. Rather the need is to legitimise a more proactive approach, which would allow France and Germany, for instance, to take measures to boost demand. There should be scope both for the automatic stabilisers to take full effect and for additional discretionary action where needed. The question of excessive debt should be considered on an ad hoc country by country basis as necessary. It is time to consider alternatives: see, for example Arestis et al. 2001.[3]

Tax harmonisation

One factor of growing importance in striking a balance between uniformity and diversity of approach to budgetary matters within the EU will be the growing pressure for tax harmonisation. We have now entered an era where there is a spectrum of taxes, ranging from those that can be set on a purely local basis, such as taxes on property or local services like restaurant meals, to those that sooner or later will only be effective if set on a worldwide basis, like taxes on financial transactions, such as stamp duty on shares - an area of growing importance. Within regional groupings like the EU, there is still some scope for variations in indirect tax rates, but this will be increasingly limited in the case of high value goods which are easily transportable.

Taxes on income from work can be levied on a national basis; but taxes on investment income (particularly on those at the top of the income scale) have for many years raised serious problems of evasion. Recent attempts the EU to tackle this have been hindered by resistance to taxing investment income at source, or even the exchange of information. The British government has been particularly reluctant to co-operate with other EU members in this field.

The area which has yet to be tackled, but is in many ways the most significant, is corporate taxation. There is first the question of standardising the rules for determining taxable corporate income – which would seem to be of positive benefit to trans-European companies. The second issue is that of standardising the rate of tax. British ministers have taken a strong line against this, extolling the merits of 'tax competition' as a means of attracting foreign investment. Not only is this a zero sum game within the EU, but it is a short-sighted view for any finance minister to take. If tax competition were to lead to a downward spiral in corporate tax rates and revenue from company taxation, governments would find it increasingly difficult to make up the loss through higher taxation of individuals - and find the money to satisfy public expectations of improvements in the quality of public services, such as education and health care.

Tax harmonisation has two effects on finance ministers' scope for manoeuvre on fiscal policy. It limits the choice of tax instruments for any one country on its own. On the other hand it opens up new possibilities for member countries operating in concert. The inability of one country to vary a harmonised tax rate on its own cuts down the options for altering its fiscal stance, but overall there should still be adequate room for a country to vary its tax take.

Public expenditure

Similar issues will arise eventually on the expenditure side; but in many fields, e.g. standards of education or health care, differences between countries seem likely to persist. In the field of social security, however, mobility of labour within the Community will lead to some pressure for harmonisation. This will initially be confined to the rules for becoming eligible for benefits rather than the level of benefits themselves. For example, credits for accruing state pensions and standard ages for drawing benefits need to be agreed in such a way as to safeguard pensions for people who spend their working lifetimes in more than one country; but as long as there remain substantial differences in real wage levels between countries, it would be reasonable for national state pension levels to reflect these. This suggests that any EU wide moves to boost (or restrain) public expenditure will tend to focus on expenditure on EU investment projects or Community wide expenditure programmes, such as regional assistance. As far as investment is concerned, in present circumstances renewed attention should be paid to infrastructure projects financed by EU borrowing either form the European Investment Bank or by issuing EU bonds. Such projects would not only be valuable in themselves but would be relatively easy to concentrate on areas of especially high unemployment. They would thus have the dual advantage of both stimulating demand in general, and benefiting employment and infrastructure in problem areas.

A European budget

Eventually, however, renewed attention will need to be paid to the enlargement of the EU budget itself, and how it will be financed. It is over 25 years since the MacDougall Report[4] first tackled these issues and sparked off debate on the role of a European budget. The report was primarily concerned with the budgetary implications of closer economic integration within the proposed monetary union, but it is also relevant to the longer term future of the Union even though all the countries involved may not adopt the common currency. The study was based on an examination of eight 'existing monetary unions' – five federations (the US, Canada, West Germany, Switzerland, Australia) and three unitary states (France, Italy and the UK), and examined the role of the federal or central government budget in reducing inequalities between regions and mitigating the effect on demand of 'shocks' hitting particular regions. The first concern depended on the resources devoted directly to infrastructure and other investment in the poorer regions. The short-term stabilisation effects depended on the operation of the automatic stabilisers i.e. reductions in tax revenue and increased expenditure in the affected regions.

In the federal countries studied, public expenditure at the federal level was of the order of 20 to 25 per cent of GDP, as compared with EU expenditure at that time of only 0.7 per cent. The report suggested that an increase of EU expenditure to 2 to 2.5 per cent over the next ten years would be needed to make inroads on the disparities between countries. But to achieve this effect the additional expenditure would have to concentrate on appropriate regional projects. This would constitute what might be called the 'pre-federal stage'. In the succeeding 'federal stage', expenditure of 5 to 7 per cent of GDP would be a starting point.

It was assumed that there would be no support for increasing the general level of public expenditure, so that increases in expenditure at the European level would reflect switches in expenditure from national level. The prime candidates in the pre-federal stage could be regional policy aids (employment or investment incentives), public infrastructure and urban development; a Community Unemployment Fund; cyclical grants to local or regional governments that would depend on regional economic conditions; and a budget equalisation scheme for extremely weak member states. Combating fluctuations in demand, particularly those that affected some countries more than others, was a major concern. The MacDougall Report left open the question of how the additional 'federal' expenditure would be financed but referred to VAT as a possible source. In the ensuing 20 years or so there has been very little progress in this direction. EU level expenditure is still only about 1 per cent of GDP, and the use of its budget to help stabilise demand is no longer on the agenda.

The discussion which followed the MacDougall Report concentrated on two main issues: the redistributive effects between nations and regions of such a European budget; and possible arrangements to strengthen the operation of automatic stabilisers at both the national and 'federal' (i.e. European) levels. It is a commentary on the times that despite the high level of unemployment in the Community at the time (over 11 per cent), the emphasis was entirely on stabilisation, not expansion. Indeed, one key paper put the NAIRU at over 10 per cent for five member countries.[5]

The main problems discussed were: what forms of 'federal' taxation and expenditure would be both politically acceptable and sensitive to cyclical fluctuations - and hence practical candidates for automatic stabilisers. In a series of papers on Fiscal Federalism[6] and its implications prepared for the Commission and published in 1994, those by Majocchi and Rey and by Goodhart and Smith focused on the stabilisation issue. The former emphasised the longer term need to enlarge the size of the European budget. and devise new sources with higher automatic flexibility: they suggested a carbon tax or a surcharge on income tax. But in the meantime they envisaged a Contingency Fund financed ad hoc and making conditional loans and grants on a discretionary basis. This is a far cry from automatic stabilisation, and the fact that the aid would be conditional conjures up unfortunate parallels with the IMF and its imposition of financial orthodoxy.

Goodhart and Smith emphasised the need for speed and were sceptical about the discretionary approach. They concluded that reliance would have to be placed on automatic stabilisers and co-ordination of national fiscal policies. But in any tightening of fiscal stance, for example, such co-ordination should not involve trying to force the countries with the largest deficits to do all the adjustments – a caution relevant today, in the reverse sense that any loosening of policy should include Germany, France and Italy who are already in trouble with Stability and Growth Pact.

It is clearly desirable that any expanded EU budget should have as great a stabilising effect as is consistent with other objectives, but this applies equally to national budgets. The particular advantage of a federal budget is that if one state is affected disproportionately by some asymmetrical shock, there will be a transfer of real resources to the affected state. It is not clear that transferring a particular tax from state to European level (e.g. VAT) would make any more (or less) effective as an automatic stabiliser on a European scale. The same applies to any discretionary changes. The real issue is the political and constitutional one of which is the least difficult way of reaching Europe-wide changes on taxation – taking decisions at EU level or reaching agreement between governments. Without any provision for majority voting on these issues, the former has the disadvantage that an EU decision requires unanimity, whereas with a national approach those who are in agreement may go ahead on their own – though not with making changes in harmonised taxes. Under the present Treaties is no provision for majority voting on tax harmonisation, so that both the initial decision to adopt a unified rate and a subsequent decision to change it would require unanimous agreement. This is hardly a promising outlook for such a form of co-ordinated action.

Constitutional issues

The practicalities of macroeconomic management are closely intertwined with those of political structure. The Maastricht concept of a monetary union with macroeconomic management solely in the hands of an independent European Central Bank appeared to obviate the need for any move towards a federal political structure capable of taking fiscal decisions - and ironically enough also failed to recognise the need for disparate fiscal action where demand conditions differed between countries. The use of fiscal policy on a European scale depends on the size of the European budget and the constitutional provisions for making decisions on changes in tax rates and public expenditure at the European level. (The recently rejected Constitution would have taken us no further forward on these issues.) Any progress in adopting expansionary fiscal measures on a European scale depends on our ability to co-ordinate action at national levels. But in the longer term, it is essential to strengthen the decision-making powers to take EU wide fiscal and other economic measures.

Any progress on this front, particularly in the UK, is vitiated by the emotional response to any suggestion of 'federalism' and the dreaded 'superstate'. But as Padoa-Schioppa has pointed out 'supranationality begins where the unanimity rule ends'.[7] The fundamental issue is in what areas the EU should have the dominant power, rather than whether decisions in these areas should be taken by majority voting on a national basis or by some form of elected European government. In a Union of 25 or more members unanimity will be hard to achieve. The need for majority decision taking will come increasingly to the fore and further consideration need to be given to the case for some form of elected European federal government with clearly defined and limited powers, leaving unspecified powers in the hands of national governments.

Conclusions

The high levels of unemployment in many parts of the EU, 9 per cent in the euro area (18 per cent for those under 25) are a serious threat to the political stability of the Union. If they are to be significantly reduced, there needs to be a gradual stimulus in demand to increase employment and investment in new capacity.

Given the present low level of interest rates, such a stimulus depends on the use of fiscal, rather than monetary, measures. This will only be possible if the Stability and Growth Pact is amended not only to allow the automatic stabilisers to operate fully, but also to provide for discretionary action which may temporarily increase budget deficits.

The extent of the fiscal stimulus needed will vary from country to country, but the overspill of demand between trading partners means that the mutual effects are important and should be taken into account when making decisions. Every effort needs to be made to co-ordinate action in this field.

Harmonising taxes, VAT for example, will limit individual countries' room to manoeuvre, in that no one country should any longer alter rates on its own. Changes should only be made on a uniform basis across the EU as a whole. Thus while harmonisation in certain fields (e.g. sales and corporate taxes) is both desirable, and eventually inevitable, it will both restrict individual countries' actions, and also create an 'all or nothing' situation across the Union as a whole.

Any attempt to conduct fiscal policy on a European scale raises the question of a European budget and the transfer of certain functions, and the funding of them, from nation states to the EU. This in turn raises the question of the best form of decision making in such circumstances, majority voting by member countries, or an elected federal government in some form. Such a government could have strictly limited specified powers, or 'competence', with all residual powers in the hands of the nation states.

The architects of Maastricht were able to avoid these fundamental constitutional issues because they saw no place for active fiscal policy on either a national or a European scale. But as economic union becomes ever closer, fiscal policy will increasingly have to be conducted at an EU level if we are to have the effective macroeconomic policies needed to restore and maintain full employment: and if we cannot do that, political stability and democracy in Europe will once again be in peril.

Notes

[1] *Report on Economic and Monetary Union in the Economic Community* (European Community,1989).

[2] Council Resolution 97/C 236/01.

[3] Arestis,P., McCauley,K. and Sawyer,M., *An Alternative Stability Pact For The European Union* (Cambridge Journal of Economics,2001)

[4] *The Role of Public Finance in European Integration* (European Union, 1977)

[5] Goodhart and Smith, see note 6.

[6] *Fiscal Federalism and its Implications for the EC* containing Goodhart, C.AE. and Smith, S., *Stabilisation* and Majocchi, A. and Rey, M., *Special Financial Support Scheme in EMU:Need and Nature* (Commission of the European Communities, 1994)

[7] Padoa-Schioppa,T. *Europe, a Civil Power: Lessons from EU Experience* (Federal Trust, 2004)