

## **REDUCING FISCAL PRESSURE UNDER THE STABILITY PACT**

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# Reducing fiscal pressure under the Stability Pact<sup>\*</sup>

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## **Abstract**

This paper evaluates the budget positions of European countries, in particular those planning tax cuts in the next years. The purpose is to show the room left to fiscal reforms after accounting for the constraints imposed by the Stability and Growth Pact. The main conclusion is that the presence of persistent differentials in terms of inflation and GDP growth among countries could make the transition towards full convergence (and budget balance) very costly for some countries, preventing them to reduce the fiscal burden. In so far, neither the Stability Pact nor ECB inflation target allow to fully mitigate cyclical downturns for those countries which are well below the potential output. Some policy prescriptions are thus derived.

**Codici JEL:**        **H30, H60, H62.**

**Parole chiave:**    **FISCAL POLICY, NATIONAL BUDGET, DEFICIT.**

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## INTRODUCTION

Most European countries have recently undertaken reforms designed to reduce tax burdens. Tax reductions occurred in the second half of the 1990s and they should accelerate over the next five years.

The objective is to reduce total taxation as a proportion of GDP, to reduce it on factors of production and on the employment tax wedge in particular. According to large part of the literature, these changes to the tax system must be substantial quantitatively if they are to have significant effects on economic growth.

This assumes the availability of considerable funds within national budgets and these are difficult to carve out of expenditure because cuts in spending are socially undesirable (retreat of the welfare state) or politically unfeasible. On the other hand, although big changes to the composition of total revenue are effective on the supply side, they could not generate any significant effects on the demand side.

In order to assess the consistency of the plans drawn up by many European countries to reduce tax burdens, one must first consider how much room is reasonably available for manoeuvre over the next few years. A crucial role is played in the identification of these resources by economic policies (Stability and Growth Pact, single European currency) and by the persistent differences between output growth and inflation in the euro area as these tend to generate inconsistencies with respect to the objectives of reducing taxation at least in the transition phase.

In this respect the 'close to balance' principle would allow only (a few) particularly virtuous countries to pursue expansionary fiscal policies (tax cuts). This produces on aggregate a mix of restrictive policies for euro area. A shift of public finance targets from deficits to debt would *de facto* free resources to reduce the tax burdens of precisely those countries that most need to stimulate GDP growth. Paradoxically, the current provisions of the Stability Pact ensure that only those countries close to potential growth are able to reduce taxation, while those with weaker economies are obliged to delay the launch of programs to reduce taxation.

The main result of this type of analysis is also the most critical for the prospects of economic growth in the euro area: the lack of flexibility in the Pact during the transition phase (or until all countries have balanced their budgets and inflation differentials have been

eliminated) precludes the use of fiscal policies to counter adverse economic situations for Germany and Italy in particular, which alone account for more than 50 per cent of the GDP of the entire area. For Italy, inflation and government debt are in any case higher than the average and expansionary fiscal policies may not be desirable. For Germany on the other hand, with the lowest inflation in the area and low national debt, the policy mix is heavily restrictive and unjustifiably penalizing. There are in fact clear risks that the German economy may worsen, assisted for the most part by the economic policy stance, and these risks could be reduced if exceptions were made to the Stability Pact.

The paper is organized as follows. The first paragraph focuses on the wide inflation differentials among the European countries experienced during last years. The second examines the consequences on the monetary policies and the coherence between the level of real interest rates and GDP growth rates of the European countries. Four alternative scenarios are shown in order to evaluate the effects on public budgets of the lack of co-ordination between the monetary and fiscal policy rules. The third paragraph examines the consistency between the tax reduction plans and the Stability Pact constraints. An assessment on the room for manoeuvre for tax reductions is proposed in the fourth and fifth paragraph. In the last paragraph some conclusions and policy prescriptions are drafted.

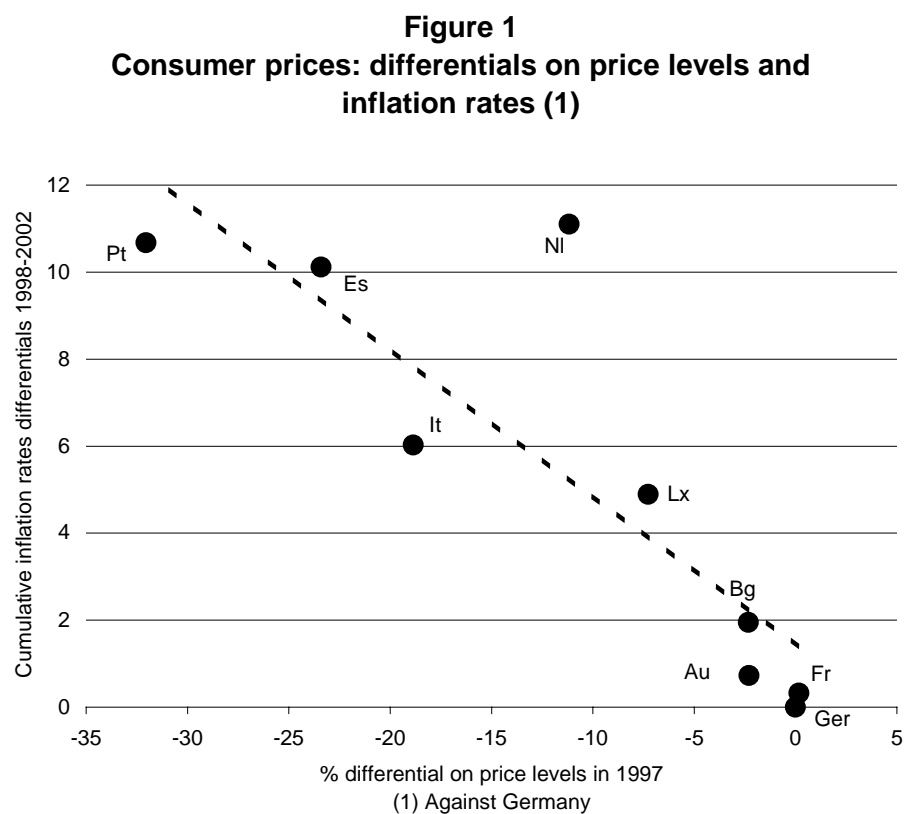
## **1. THE ORIGIN OF INFLATION DIFFERENCES AMONG EUROPEAN COUNTRIES**

The launch of the euro was characterized by large and persistent differences in inflation between single currency member countries. Diverging inflation rates do not necessarily constitute a problem within a single currency area. In fact in some cases they may have a positive effect to the extent that they demonstrate the capacity of relative prices to respond to shocks that have asymmetric effects on different areas. The growing number of inflation rate differences between countries in the euro area gives more grounds for concern when one considers that these differences have persisted since the EMS parity exchange rates were set in 1996. A limited group of countries has consistently recorded higher rates of inflation than others.

This trend may be interpreted in terms of the convergence of prices to a common level, which would have induced higher prices in countries where they were originally lower and lower rates of inflation where prices were higher. It is difficult to establish whether there has

been symmetry in this process. It is more probable that downward price rigidity has resulted in convergence occurring mainly through greater inflation in those economies where prices were lower. Nevertheless OECD statistics on relative price levels in different countries do show interesting trends, at least at a general level.

Price convergence can be illustrated by comparing cumulative inflation differentials over the last five years with differences between price levels in 1997. Germany was used as the benchmark country. The Figure 1 shows a close correlation between price differences at the start of the euro and cumulative inflation rates in recent years. The Netherlands are not in line with the other countries in the graph, probably because domestic inflation was stimulated by indirect taxation. Finland and Ireland constitute exceptions. Their price levels tend to converge towards those of the economies that are geographically closest, Sweden, Denmark, Norway and the United Kingdom respectively.



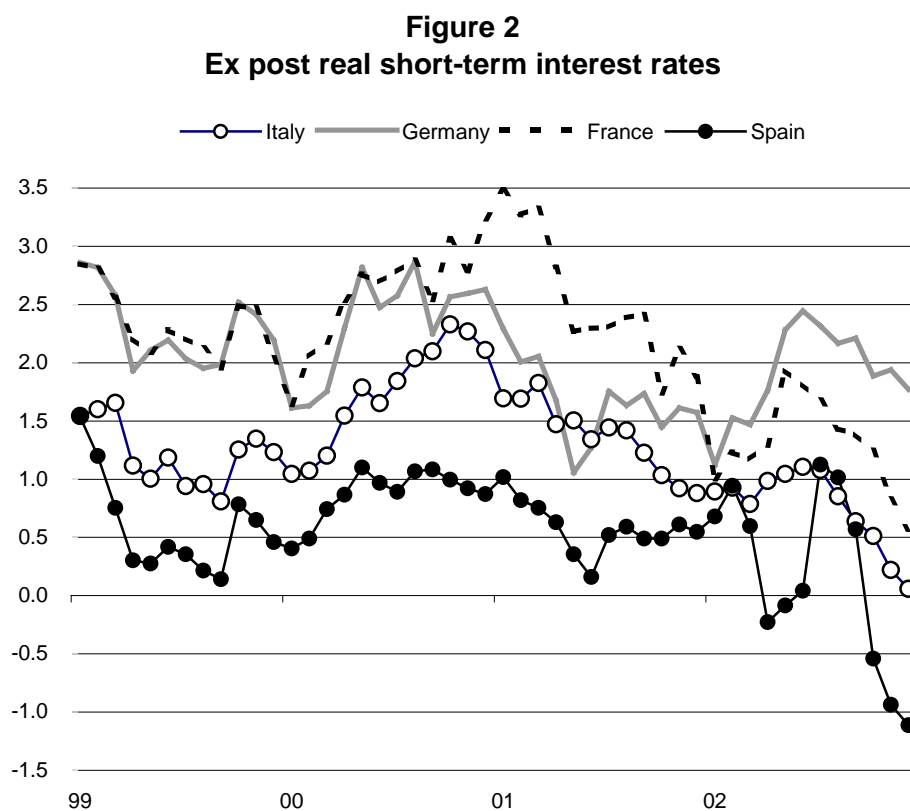
The persistence of inflation differences shown above does not necessarily imply changes in intra European price competitiveness. It may be a phenomenon described by the traditional 'Balassa effect': when productivity growth in 'tradable' sectors of the economy is high, as the result, for example, of a country catching up with more advanced economies, competitiveness measured by real 'aggregate' exchange rate indices, based for example on consumer prices, tends to deteriorate, while competitiveness in the tradable sector alone does not show an analogous deterioration.

Changes in price levels do not therefore necessarily condition the competitiveness of firms even if some effect in this direction is probable in the short term. What would then occur would be a process of price convergence by low income countries towards the price levels of high income countries. It must also be considered that price convergence processes may arise from the presence of imbalances at the time when EMS exchange rates were fixed. Some countries could have joined the system at too high (or too low) a rate, because the exchange rate compared to other currencies was set at a level that was too strong (or too weak). The Balassa effect mechanism could be overlaid by other phenomena such as simple arbitrage or even the effects of progress made with market integration.

Obviously the price levels of the different countries in the single currency do not have to converge completely. Differences between economies using the same currency are possible as a result of different economic characteristics. It is in any case plausible that differences that existed when the EMS exchange rates were fixed, were to a certain extent excessive. The persistence of inflation differences themselves confirms this hypothesis. The hypothesis of price convergence 'on levels' tends to exclude the possibility that inflation differences reflect analogous differences in real economic growth. It is also possible that in the medium term participation in the same currency area will strengthen mechanisms which attract prices to common levels that are too high for the less developed countries of the European Union. Should this phenomenon actually occur, it would have a negative effect on the more underdeveloped economic areas and would polarize development.

## 2. THE CONSEQUENCES ON THE BUDGETARY POLICIES OF COUNTRIES BELONGING TO EMU

The persistence of inflation differentials between European countries has an effect on their budgetary policies. Countries with low inflation rates have higher interest rates in real terms. Countries with high inflation enjoy exceptionally convenient monetary conditions. This phenomenon is illustrated in the figure 2.



If, as in the present case, inflation differentials and therefore real interest rates do not reflect the different growth rates of the various economies, this would have particular consequences for government finances. In fact for Germany in particular, real interest rates exceed growth in real GDP by a broad margin and this results in inconsistencies between development objectives and balancing the national budget, a situation similar to that experienced by other economies in the 1990's such as Italy and Spain.

Countries with higher inflation, on the other hand, experience particularly favorable conditions (table 1). For example growth in the Spanish economy between 1999 and 2002 was higher than real interest rates by a good three percentage points. For Ireland, this difference was as large as nine percent.

The first conclusion that can be drawn, as demonstrated below, is that Germany, whose economy is afflicted by various problems that limit economic growth, is subject to interest rates that are too high. These are having an adverse effect on the national budget due to the direct impact of higher interest payments and to the indirect effect of lower growth rates resulting from interest rates that are too high. Lower growth rates affect the government budget and the Stability Pact objective requires budgetary adjustments which further dampen German domestic demand.

**Table 1 - Coherence indicators between interest rates and GDP growth rates**

	<i><b>GDP</b></i>		<i><b>Nominal interest rate</b></i>		<i><b>GDP deflator</b></i>		<i><b>Real interest rate</b></i>		<i><b>Difference</b></i>	
	(annual average % change)		(short term)		(annual average % change)		(short term)		(real interest - GDP)	
	92-'98	99-'02	92-'98	99-'02	92-'98	99-'02	92-'98	99-'02	92-'98	99-'02
Germany	1.3	1.5	5.3	3.7	2.3	0.8	2.9	2.9	1.6	1.4
France	1.5	2.5	6.0	3.7	1.6	1.1	4.3	2.6	2.8	0.1
Italy	1.4	1.7	9.1	3.7	3.9	2.2	5.0	1.5	3.6	-0.2
Spain	2.2	3.2	8.5	3.7	4.0	3.5	4.3	0.2	2.0	-3.0
Holland	2.8	2.2	5.1	3.7	1.9	3.6	3.1	0.1	0.3	-2.1
Belgium	1.9	2.0	5.5	3.7	2.1	1.6	3.3	2.1	1.4	0.1
Austria	2.0	1.9	5.2	3.7	2.1	1.3	3.1	2.3	1.1	0.5
Finland	2.7	2.9	6.1	3.7	2.0	1.8	4.0	1.9	1.3	-0.9
Ireland	7.0	8.0	7.5	3.7	3.6	4.4	3.8	-0.6	-3.2	-8.7
Portugal	2.3	2.4	9.6	3.7	5.7	3.5	3.6	0.2	1.3	-2.2

## 2.1 Four theoretical scenarios

The launch of the euro determined conditions that were exceptionally unfavorable for some economies and particularly favorable for others. These conditions are exceptional because the process of converging price levels is a transitory phenomenon even if it may require many years to complete. That is why it is plausible to hold that the trends that occurred in the 1999-2002 period could continue for the next four or five years. This persistence constitutes an element of contradiction with respect to the convergence scenarios



of the Stability and Growth Pact. An idea of the quantitative dimension of this inconsistency can be gained from an examination of two benchmark cases that describe the public finance scenarios envisaged under the Stability and Growth Pact both in its current version and if the target is shifted to stability of the debt to GDP ratio. It will then be possible, on the basis of these scenarios, to assess the room available for tax cuts. Two theoretical scenarios are also proposed, in which inflation and growth gaps between member countries disappear, in order to ascertain the size of the effects that macroeconomic heterogeneity has on the choice of fiscal policies.

The *first scenario (benchmark 1)* reflects the current version of the Stability Pact according to which the countries in the monetary union must eliminate their budget deficits by the end of 2005. It must in any case be remembered that the interpretation of the Stability Pact has recently been subject to some revisions firstly with a preference for the objective of ‘close to balance’ budgets. To avoid excessive discretion in the interpretation of targets, ‘close to balance’ was quantified as a deficit of 0.5 per cent, even if this may obviously set a precedent for flexible interpretations. In the second place, the ‘close to balance’ target has recently been set back to 2006. Here too, a precedent has been set for further future postponements of the target deadline. There is also another element that could in future set a precedent for discretionary assessments of the results of the public finances of member states. The adoption of a target set in structural terms may result in disputes over the methods employed for measuring both output gaps and the output gap elasticity of budget items. Clearly the rigidity of objectives has been impaired by the greater flexibility in the criteria for interpreting the pact. The objective of balancing budgets by 2005 assumed in the simulation constitutes therefore a point of reference for assessing policies that result from observance of the Stability Pact rather than an assessment of the policies that will necessarily be adopted by member states.

Starting with current primary balances, adjusted for the effects of the business cycle, the change in the primary structural balance required to reach the budget balance in structural terms over the next few years is calculated. It should be pointed out that the fiscal adjustment required to achieve a balanced budget calculated in this way reflects the budget changes required starting from current levels of revenue and expenditure, but does not involve an assessment of trends in public finances over the next few years. For some countries spontaneous changes in revenues and spending over the next few years could in fact have

already been adjusted by corrective measures adopted in the past. In this sense the size of the adjustment estimated by us is that ‘which will be made’ to achieve objectives, rather than that which ‘should be further adopted’. The assumptions for the first hypothesis are as follows.

The hypotheses for growth and interest expenditure made in the OECD forecasts at the end of 2002 are assumed for each country.

The budgetary corrections that may be required are calculated algebraically, given the objective of balancing budgets, starting from the current level of deficit and also taking account of the reduction in interest expenditure generated by increasing the primary surplus. Obviously, it must be remembered that estimates of the structural deficits will differ depending on the method employed to calculate them.

**Table 2 - Change in structural primary balance required to meet the Pact targets**

	<b>Scenario 1</b>	<b>Scenario 2</b>	<b>Scenario 3</b>	<b>Scenario 4</b>
	<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>
Germany	2.7	0.5	0.1	-0.3
France	2.2	-0.1	-0.2	-0.3
Italy	1.4	0.7	1.0	0.2
Spain	-0.5	-4.1	-3.4	-3.1
Holland	-0.6	-3.6	-3.1	-3.0
Belgium	-1.8	-1.9	-2.3	-2.5
Austria	0.9	-0.7	-1.0	-1.2
Finland	-4.7	-4.8	-4.4	-5.0
Ireland	1.5	-1.3	-0.4	1.7
Portugal	2.1	-2.0	-1.3	-1.1

(1) Target: balanced budget in 2005.

(2) Target: stabilization of the debt to GDP ratio (reduction by 4 per cent of GDP per year for Italy and Belgium), assuming persistent inflation differentials, cf. the text for the underlying hypotheses.

(3) Target: theoretical stabilization of the debt to GDP ratio, assuming the same inflation rate for all the countries, cf. the text for underlying hypotheses.

(4) Target: theoretical stabilization of the debt to GDP ratio, assuming the GDP growth equals the average cost of debt servicing, cf. the text for underlying hypotheses.

The values presented in the attached table 2 must not therefore be interpreted as absolute and precise snapshots of the situation but as mere indicators of trends.

Starting from the current size of the primary balance, it is clear that practically none of the countries in the euro area except for Finland and Belgium have any room for expansionary type policy manoeuvres and a substantial corrective manoeuvre of almost three percent is required by Germany.

The situation presented in the benchmark 1 scenario clearly shows that as things stand at present the margins for reducing taxation in Europe are very slender, especially for the larger economies. This is particularly true if account is taken of the considerable efforts already required on the spending side if budgets are to be balanced without increasing fiscal pressure. A second alternative option can be developed from this first basic scenario.

In the *second scenario (benchmark 2)* the objective is changed to maintenance of a stable debt to GDP ratio for all European countries and a drop of four percent per year for Italy and Belgium, the countries with the highest levels of debt to GDP ratio in the area.

The objective of the second scenario is basically to identify room for manoeuvre in budget policies and to assess how consistent they are with conditions that would ensure a dynamic stabilization of debt to GDP ratio. It constitutes a departure from the logic of setting deficit reduction targets. The purpose is to take into consideration the different levels of government debt before defining deficit targets. The underlying macroeconomic situation for this scenario is based on the hypothesis that interest rates and average debt costs converge to the same levels over the next few years, but that the inflation and growth differentials between euro countries observed over the last three years are maintained. It is a useful scenario for projections over a three to four year period.

In this second scenario, almost all euro countries, including those mentioned above are able to reduce their primary surplus. Only Italy and Germany are required to take action to improve their general government primary balances, but the size of the intervention required is much less than in the first scenario. The most interesting aspect of this scenario is that some countries, such as Spain, The Netherlands, Ireland and Portugal gain room for manoeuvre to bring in policies that reduce their primary balances. This aspect is very important not just because it makes it possible to introduce policies for the structural reduction of taxation, but also because it quantifies the size of the possible intervention required to stabilize the business cycle. It seems clear that many countries today could pursue policies aimed at reversing the cyclical downturn without damage to the soundness of their public finances. Such room for manoeuvre was obviously not found in the previous scenario where the target was set in terms of budget deficit.

Clearly the assessment of the conditions required to stabilize debt proposed in scenario 2 is affected by the gaps between real interest rates and growth rates discussed previously. Although this phenomenon will reduce over the course of time, it will nevertheless persist for

a number of years. It is, however, also true that although the time horizon of the process is difficult to define, it would seem correct to hypothesize the elimination of inflation differentials within a few years. On the other hand differences in economic growth rates are destined to last longer.

The *third scenario* has therefore been constructed as a long term theoretical scenario. It assumes the same objectives as scenario 2, but the assumption of continued inflation differentials has been removed. It gives therefore the new equilibrium, once the process of convergence on common price levels is complete. It removes the anomaly of continued inflation differentials experienced in the start-up phase of the euro, but maintains the assumption of different rates of economic expansion. The average cost of servicing government debt is assumed to be equal to the current level of long term European interest rates, at a little over 4 per cent with marginal differences between countries. This hypothesis also assumes convergence to a common normal level in the medium term. The average cost of current debt servicing is in fact higher at around 6 per cent for European countries, a legacy of the higher rates at which debt was issued in the 1990s. An inflation rate of 1.7 per cent is assumed for all countries, consistent with the ECB's target for inflation. The average real cost of debt servicing is therefore around 2.5 per cent, marginally higher than the growth rate for the euro area over the last ten years (2.2 per cent between 1994 and 2002). The growth rates assumed for individual countries are the averages observed in the period 1994-2002. This third case basically replicates the results of scenario 2, but with smaller differences between countries, affording less room for manoeuvre to countries which had higher inflation rates in past years. Italy again requires a tightening of fiscal policy amounting to one percent of GDP. The room for relaxing Spanish and Dutch restrictive policies reduces, while the position of Germany improves further and would not require further fiscal corrective manoeuvres.

To summarize, a comparison of scenario 3 with scenario 2 shows that the conditions for the stabilization of government debt to GDP ratio for different countries in the euro area differ as a function of the different rates of inflation in individual countries. Furthermore it makes it possible to quantify the relative cost of large differences in inflation rates for countries with low inflation rates. Obviously one last point concerning the differences in growth rates between countries remains to be discussed. If Ireland is excluded, all the euro countries recorded average growth rates of between 1.5 per cent (Germany) and 2.9 per cent (Finland) in the 1999-2002 period, while average inflation rates for the same period measured by the

GDP deflator ranged from 0.8 per cent for Germany to 3.5 per cent for Spain, The Netherlands and Portugal.

The problem of growth differentials is, however, also important for Italy and Germany. In fact while the growth rates of other countries in the euro area have been more or less satisfactory, Italy and Germany have recorded average GDP growth rates of around 1.5 per cent. What is more, according to the OECD method (different methods of calculation produce very similar results) growth rates for potential output are at around the same level.

In this case too, it is clear, as with differences in inflation rates, that inconsistencies can emerge between the growth rates of individual economies and interest rates. For example the average GDP growth rate for the United States over the last four years (1999-2002) was 2.7 per cent, while it was 2.3 per cent for the euro area without Germany. In the same period real average short term interest rates were 1.8 per cent in the United States and 1.4 per cent in the euro area without Germany. Germany on the other hand has recorded average growth of 1.5 per cent and real short term interest rates of 2.1 per cent.

In this case too, we can try to quantify the consequences that the presence of GDP growth rate differences has for public finances by repeating the exercise performed for the previous scenario.

In the *fourth scenario* not only is the assumption of different inflation rates removed, but also that of different economic growth rates. The hypothesis is that the average cost of debt servicing is equal to economic growth for all countries. The results obtained are shown in the fourth column of table 2. The aspect to note is the increased room for fiscal policy manoeuvre acquired by Italy and Germany, the countries with the lowest GDP growth rates.<sup>1</sup> Conditions for the countries with the highest GDP growth rates in recent years, Spain and above all Ireland, worsen.

The theoretical scenario that we have proposed may therefore constitute a point of reference for quantifying how much of the recent economic downturn of some European economies reflects different growth and inflation rates within the area. The most striking case is Germany. There are no specific problems of imbalance in German government finances. Stabilization of the debt to GDP ratio would require a restrictive manoeuvre amounting to approximately 0.5 per cent of GDP (scenario 2), which is in any case due to European real

interest rates being too high with respect to the German GDP growth rate. Similar results are obtained for France and, although to a lesser extent, also for Italy (where the objective is not to stabilize but to reduce the debt to GDP ratio).

The results also show that the public finances of euro countries are on average sound. The conditions for stabilizing debt under the theoretical assumptions of scenario 4 are basically observed by all countries with the exception of Ireland, which should take corrective fiscal action amounting to 1.7 per cent of GDP, but thanks to the current level of interest rates can achieve the same result with a worsening of the primary rate by 1.3 per cent of GDP (scenario 2).

### **3. TAX REDUCTION, GROWTH AND STABILITY PACT CONSTRAINTS**

There are many reasons why a reduction in fiscal pressure is desirable both from the viewpoint of equity and efficiency. One of the recurring justifications for policies designed to reduce fiscal pressure is that of growth. It is in fact held that high taxation in an economic system causes inefficiency by generating distortions and adverse incentives which prevent a country from growing at its potential rate of development (or from raising this). This assumption is not fully shared in the economic literature, but represents one of the cornerstones of supply side economics. It is true, however, that fiscal policy plays an important role in governing business cycles and that is why countries that have recorded modest GDP growth rates for a period of time should seek to reduce fiscal pressure.

Let us therefore leave aside requirements to reduce tax burdens as dictated by structural factors, high fiscal pressure, low growth potential, and concentrate on identifying economies within the European Union which would need to take action to stimulate demand in the next three years. The focus of our analysis here is on room for manoeuvre within the European Union for reducing taxation without paying for it with spending cuts, which otherwise would have a negative effect on demand, at least in the short term.

<sup>1</sup> The figure for Finland should be read with caution since it is determined by its negative net financial liabilities.

One measure of the need to cut taxation for countries in the European Union might be the output gap.<sup>2</sup> A classification of countries most in need of reducing their tax burden can be drawn up from OECD estimates for European countries over the three year period 2002-2004 by simply comparing individual output gaps with the average for all the countries considered.

Table 3 shows first of all that, in the period considered, GDP is lower than potential output for all the countries in the euro area and that the average output gap for the European Union is -1.2 per cent for each year. In absolute terms, therefore, a reduction in taxation that would stimulate growth with effects on demand would be desirable for all countries. In relative terms those countries furthest behind with respect to the European average are The Netherlands, Portugal, Finland, Germany, Italy, Austria and to a lesser extent Belgium, all with a greater need to reduce taxation.

It should also be noted that of these countries, Finland, Austria, Italy and Belgium (together with France) have the highest fiscal pressure in the euro area, leading one to suspect that for these countries a high tax burden constitutes at least one of the most important factors (on the supply side) that is holding back potential economic growth. On the other hand, countries like Spain, the United Kingdom and Ireland do not seem to require urgent and substantial tax cuts both because of their estimated position in the business cycle in the 2002-04 three year period, with GDP growth at rates higher than the potential rate (relative to the European average), and because of their current tax levels (they are the countries with the lowest fiscal pressure in the European Union). The position of France and Portugal is not so clear, the former characterized by high fiscal pressure but also with GDP growth rates higher than the potential rate, while the latter is characterized by the opposite.

Once the countries which require substantial tax cuts have been identified on the basis of the output gap criterion we can see which of them has sufficient resources to reduce taxation without corresponding cuts in spending, starting from the current budget position and the Stability Pact constraints.

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<sup>2</sup> This approach leaves aside arguments on the cyclical convergence of countries belonging to the European Union to concentrate on the cyclical positions of individual countries with respect to potential output. What results is that although from a 'European viewpoint' countries like The Netherlands, Ireland and Portugal should pursue restrictive economic policies to achieve convergence of GDP growth rates and price levels, from a 'national' standpoint their policies should be expansionary, since these countries are producing below their potential growth rates. This type of analysis therefore makes a far from negligible contribution to criticism of the soundness of the Stability Pact.

### Table 3 - Room for manoeuvre

[illegible]



As can be seen from table 3, there are very few matches of countries with should reduce fiscal pressure and which have the funds to do so under the conditions of scenario 1 (benchmark case 1). Basically under the terms of the Stability Pact, which requires a structural reduction of budget deficits, only The Netherlands, Belgium and Finland are in a good position to guarantee the necessary stimulus to their economies with the latter in a particularly good 'room for manoeuvre-output gap' position compared to the other two economies.

It should also be noted that the terms of the Stability Pact are so strict that, quite apart from whether there is a need or not, only four countries have any room for manoeuvre to make a significant reduction in taxation. The limits imposed by the Stability Pact are extremely penalizing for the two main economies, Italy and Germany, in need of action to put growth back on a path closer to that of potential output.

As mentioned previously, changing the targets of the Pact from deficit to debt would loosen its iron grip on the economic policies of European Union countries. With the same action that is planned to structurally balance budgets (current version of the Pact), room for manoeuvre would be created to cut taxes by an average of 2 per cent of the GDP of the economies in question. This would amount to around 0.7 per cent of GDP growth per year, a by no means small amount for the purpose of stimulating growth.

According to Leibfritz *et al.* (1997), the impact on European GDP of reducing taxes by 1 per cent of GDP would range, depending on the taxes in question, from around 1.5 per cent (if the reduction was exclusively on consumption taxes) to 3 per cent (if taxation on corporate income only was cut), if it was funded from an equal reduction in expenditure or had a neutral effect on the net budget balance. Since under the hypothesis of the benchmark 2 case, additional resources would be created with respect to achieving the objectives, the reduction in the tax burden would not have to be paid for to have the same effects estimated by Leibfritz *et al.* (1997)<sup>3</sup>. It follows that the adoption of a Stability Pact based on debt would allow cuts in taxation sufficient to close the output gap, if an elasticity of 2 is assumed, halfway between the values given above, together with a reduction in the tax burden by 0.7 percentage points per year.

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<sup>3</sup> Basically it is hypothesized that the estimates of Leibfritz *et al.* (1997) continue to be valid in the short term as an impact on demand, if the reduction in taxation is funded with a budget surplus. In this manner the effects on the supply side generated by spending cuts are not considered. Anyway, since they are medium to long term phenomena, they are unimportant for the purposes of our analysis.

Nevertheless, because the change of target from deficit to debt does not give all countries the same uniform advantage, the divergence among countries would be aggravated, since compared to the deficit target, use of the debt target reduces the heterogeneity of the corrective action required. In fact if it is assumed that the gain resulting from revising the pact is used to reduce taxation and that this has the effect of raising GDP with an elasticity of 2, what emerges is an increase in the variation of output gaps with respect to the current situation.

To assess the desirability of such a change of policy, account must therefore be taken of the trade-off between raising GDP growth rates in the European Union (and in the euro area in particular) and the importance of convergence between countries. It is in fact found that the achievement of the former objective is tied inevitably to pursuing policies that favor Germany and which, not necessarily, involve a reduction in existing differentials in the euro area in the short term. The fragility of a fiscal policy with a common set of rules for all countries in the area is therefore evident, both because of its rigidity and of the arbitrary manner in which the constraints that comprise it are set.

#### **4. REFORMS IN THE MAKING AND ROOM FOR MANOEUVRE**

The arguments set forth in the preceding pages make a considerable contribution to reducing the credibility of some plans to reduce taxation announced in major European countries. Given the structural constraints of the Stability Pact, what emerges is a substantial lack of resources to fund significant cuts in taxation unless this is done with sharp reductions in spending.

Without going into an analysis of what would constitute the best combination of revenue and expenditure, what we wish to point out here is the large gap that exists between the size of plans to cut taxes and the most optimistic forecasts of growth that might provide the resources required to fund those plans.

Reasoning in terms of structural balances reduces the possibility of revising estimates of GDP growth rates upwards and of increasing the room for manoeuvre to reduce tax burdens, because a cyclical rise in GDP growth (and therefore in revenues) would have no effect on structural deficits as calculated by the European Commission. In fact no strong

heterogeneity emerges from the estimates provided by the European Commission (2002) itself with regard to the sensitivity of deficits to cyclical variations, since the range varies from an elasticity of 0.7-0.8 for northern countries to 0.3-0.4 for the smaller countries with strong convergence on the value of 0.5. Consequently, unless the business cycle performs much better than forecast for some countries, no great changes are to be expected in the estimates made by the OECD concerning structural balances.

On the other hand, the potential growth rate of some European countries could be pushed upwards to automatically reduce the need for corrective budgetary action and create room to free resources that could be used to reduce fiscal pressure. In this case too, the size of the revisions would be minimal compared to the plans announced to reduce taxation and to close the gap between current budget situations and the structural deficit. It is implausible to think that changes in potential GDP growth rates would be sufficient, in the cases of Germany and Italy, to fund reductions in budget deficits and cuts in taxation which for these two countries amount to approximately 4.2 per cent and 3.4 per cent of GDP.

Even under the extremely optimistic hypothesis put forward by some national governments that tax cuts will fund themselves as a result of rises in potential GDP, Germany and Italy would in any case lack the funds to reach the target of a structurally balanced budget which, as already seen, are considerable, amounting to 2.7 per cent and 1.4 per cent of GDP respectively. Similar reasoning is also applicable to other European Union countries which need to reduce fiscal pressure but which, as previously shown, lack the resources to fund cuts of this size and at the same time observe the constraints of the Stability Pact. In conclusion, it is difficult to imagine significant reductions on fiscal pressure in Europe, at least over the next three years, unless this is balanced by substantial cuts in spending.

## **5. FISCAL REFORMS: THE STABILITY PACT AND A SINGLE MONETARY POLICY**

One of the elements highlighted by the analysis conducted above is the persistence of inflation and GDP growth differentials among countries in the euro area, which would not seem to be offset by the adoption of a common monetary policy.

Furthermore, the scenarios 3 and 4 presented above show that even if these inflation and GDP growth differentials are eliminated, there would not be sufficient room for

manoeuvre to allow implementation of the plans to cut taxes put forward by individual national governments.

Recognizing that there is a lack of resources to fund a reduction in fiscal pressure in Europe that is not accompanied by cuts in spending consistent with observance of the Stability Pact, raises the question of what room there is for manoeuvre, with revenues remaining constant, to generate changes in national fiscal systems. Account must also be taken here of the effects that a single monetary policy could have on deciding which taxes to cut in the presence of significant inflation differences.

According to the estimates of Leibfritz *et al.* (1997), for example, although it is difficult to quantify because of the possible inflationary effects and the uncertainty connected with shifts in taxation, changing the composition of taxes by one percent of GDP from tax on labor to tax on consumption could increase GDP by around 0.7 per cent on average in Europe with a greater effect estimated for The Netherlands (0.9 per cent), Germany and France (0.8 per cent in both cases).

Without going into problems connected with the feasibility of policies that reallocate taxation, one may first deduce that among countries in need of expansionary policies to boost growth in their economies, those subjected to particularly restrictive monetary policies would have more incentive to pursue expansionary fiscal policies or even inflationary policies designed to counter them. Observation of table 3 shows that The Netherlands, Portugal, Finland, Germany, Italy and Austria are countries that might require expansionary fiscal policies. Of these, Germany and Austria experienced restrictive monetary policy in the three year period 1999-2002, while the other four benefited from particularly favorable monetary conditions, The Netherlands and Portugal especially so.

In a similar context, since Germany and Austria did not have the resources to fight fiscal pressure, they could on the other hand be motivated to change the composition of their taxes that, although it would fuel inflation, would stimulate growth and compensate for the restrictive monetary policy. On the other hand a policy that increased consumption taxes would not be advisable at all for Italy and Portugal and would in any case be a difficult course to follow since they already suffer from high inflation<sup>4</sup>.

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<sup>4</sup> Given the high inflation rates observed in these countries, this prescription holds even if the assumption that higher consumption taxes generate more inflation is not true in general.

What therefore emerges, given the architecture of economic policies in Europe (euro area), is the possibility for some countries to change the rates of individual taxes and, as encouraged by the European Commission, to reduce the tax burden on labor in particular, since they are unable to reduce total fiscal pressure in the short term.

The other side of the coin, however, is that if such a phenomenon occurred, it would mean that the institutions and the rules that govern economic policy would show a propensity to encourage greater inflation. Free riding phenomena might occur together with conflicting tariff policies that could hinder the central bank in its activity of maintaining price stability.

## **6. SOME POLICY SUGGESTIONS**

The analysis proposed in this chapter has dwelt on various inconsistencies between the macroeconomic situation and the fiscal and monetary policies of member states in the euro area. The emphasis has been placed on the divergence between GDP growth rates and real interest rates in different countries. It has been argued that if this type of divergence is to be considered normal and taken for granted in the euro area, it is also true that the size of the differences has been particularly high as a result of an anomalous divergence of inflation rates. One would suppose that a process of catching up to reach common price levels was in progress. The lack of consistency between fiscal policies and interest rate levels should in any case constitute a transitory phenomenon. However it is worth noting that these phenomena could not only last a long time but also occur again when other countries join the euro area. We have listed below some possible policy prescriptions for the next years.

The large differences in inflation rates started with the exchange rate grid, which induced large gaps in price levels when countries first joined the euro. From this viewpoint, one policy prescription is that in future, new countries joining the single currency should preferably decide to fix their exchange rate in line with the euro for a very long period (of at least five or six years) before adopting it. Obviously this indication may result in other types of inconvenience which we will not dwell on here.

It has been found that inflation differences have generated government budget problems for countries with low inflation. One policy prescription is that these countries must not be doubly penalized because the Stability Pact obliges them to take substantial measures to reduce their current deficits, especially for those countries that do not have a high level of

debt. In fact given that the overall situation of European public finances is quite sound from the viewpoint of stabilizing public debt, it would be wise to recommend a revision of the Stability Pact along those lines. This recommendation is particularly valid in the case of Germany that not only has a low rate of inflation but also the lowest economic growth rate.

The difficulty in reducing total fiscal pressure under the Stability Pact, together with the presence of inflation and economic growth differentials that are not attenuated by a common monetary policy indicates the existence of incentives (or requirements) to change the composition of taxes that would lead to greater output growth, but also to increased prices.

The aspects mentioned above apply essentially to Germany, which is at the moment the economy most heavily penalized by the gap between its GDP growth rate and its interest rates. One possible alternative for the architecture of economic policies could consist of a special exception being made for Germany with regard to the balanced budget objective.

As a further comment to the results summarized above, it should be noted that none of the policy caveats that we have proposed question the final objectives of European policies as described by the current ECB objectives and the Stability Pact. We have simply shown that the start of the euro represents a transitory phase (which may, however, be quite long) during which various one-off adjustments are occurring. These adjustments are modifying behavior patterns and making it more difficult to establish the outcomes of policies. The unusual uncertainty that characterizes the current phase would suggest cautious policies without over ambitious objectives. Big changes can have unpredictable outcomes. However, setting targets for both public finances (balanced budgets) and for inflation (price stability) was very ambitious. While it is true that redesigning the objectives could have negative consequences in terms of loss of credibility, it must also be considered that wider margins for deviating from those objectives would allow the difficult phase we are going through to be managed with greater flexibility. These proposals have been partly adopted in the most recent policies which opted for maintaining rigid targets but allowing flexible interpretation (the ‘close to balance’ clause; reference to the concept of a ‘structural deficit’, postponement of the deadline for balancing budgets). It is a useful compromise between the need to prevent fiscal squeezes in the current phase and to avoid the loss of credibility that would result from explicitly revising the objectives.

To conclude, however, one practically general result of the analysis conducted above is that policies to reduce tax burdens are incompatible with trying to achieve parity for general

government structural balances over the next three years. Achievement of this dual objective can only be guaranteed by substantial (even if not advisable, from our point of view) cuts in spending, higher than those already planned by many countries in order to observe the constraints of the Stability Pact.

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