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Fiscal Policy and Macroeconomic Performance in the Euro area - Lessons for the Future

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Working Paper

7/2006

Eckhard Hein and Achim Truger,
Macroeconomic Policy Institute (IMK) in the
Hans Böckler Foundation

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Lessons for the Future

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Fiscal Policy and Macroeconomic Performance in the Euro area

– Lessons for the Future[#]

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Abstract

Since the start of the European Monetary Union fiscal policy in the Euro area has been dominated by the Stability and Growth Pact (SGP). Quite obviously the SGP has been unsuccessful in fulfilling its goals, fiscal sustainability and supporting economic growth. More and more countries have exceeded the 3 percent of GDP limit for the budget deficit, while at the same time macroeconomic performance has been unsatisfactory. We analyse fiscal policy and its macroeconomic impact for the Euro area as a whole and for selected countries and compare it with US fiscal policy, with a special emphasis on the period 2001-2005. Whereas US fiscal policy has been strongly counter-cyclical, thus stabilising the economy, in the Euro area fiscal policy has been much more restrictive and has had procyclical and therefore destabilising effects for many countries. However, one cannot put all the blame on fiscal policy. The ECB's restrictive monetary policy and divergent and destabilising wage developments across the Euro area are at least as important as fiscal policy in the explanation of the Euro area's weak economic performance. As a possible solution for the future, we suggest to replace the SGP by expenditure paths as coordination tool, and we discuss an important modification of the concept. Such expenditure paths could co-ordinate fiscal policies across the Euro area in a counter-cyclical way and at the same time ensure fiscal sustainability. Unfortunately, as long as monetary and wage policies remain uncoordinated and destabilising, any improvements in fiscal policy will not be very effective in enhancing economic performance.

JEL-Code: E 62, E 63, E 65, E 61.

Key words: Fiscal policy, consolidation strategies, macroeconomic policy mix, Euro area

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1. Introduction

Since the start of the European Monetary Union (EMU) fiscal policy in the Euro area has been dominated by the Stability and Growth Pact (SGP). However, the SGP has been unsuccessful in fulfilling both of its goals, fiscal sustainability and supporting economic growth: In recent years, more and more countries have exceeded the 3 percent of GDP limit for the budget deficit. At the same time, macroeconomic performance has been unsatisfactory, with the Euro area economy only slowly recovering from the post-2000 stagnation. The prolonged stagnation as well as the ongoing fiscal problems have revived the macroeconomic debate on a reform of the SGP. A reform was finally introduced after a legal conflict between the European Commission and the European Council about the Council's right to simply ignore the Commission's recommendation to further pursue the excessive deficit procedures against France and Germany. However, the reform did not fundamentally change the SGP. Therefore, the economic and political debates on SGP reforms continue. In the current paper we would like to contribute to this debate. After a rather detailed account of fiscal policy developments and their impact on the Euro area economy, we present a modified expenditure path concept as an alternative to the current SGP.

The paper is an extension of our earlier work, in which we tried to explain the long-run growth and employment differentials between the Euro area and the USA by a macroeconomic policy view, stressing the more restrictive stance of monetary, fiscal and wage policies under the 'Maastricht Regime'.¹ We proceed as follows: Section 2 compares the macroeconomic performance in the Euro area and its individual member countries with the performance of the US economy. Section 3 provides a more detailed description of fiscal policies and consolidation efforts in the Euro area since 1991. In Section 4 we analyse the macroeconomic impact of fiscal policy and in Section 5 we will put this in a broader perspective discussing also monetary and wage policies. In Section 6 we comment on the recent modifications of the SGP and present our reform proposal based on expenditure paths. Section 7 points to a potential drawback by asking whether fiscal policy can really improve

¹ See Hein/Truger (2005a, 2005b) and Hein/Niechoj (2006) on the Maastricht regime, Hein/Truger (2005c, 2005d) on the special situation of the German economy and Hein/Truger (2006a), Hein/Schulten/Truger (2006) on the risks of deflation in Germany and Europe associated with this constellation. Also Fritzsche et al. (2005), Palley (1998) and Solow (2000) have argued that a favourable coordination between monetary and fiscal policies rather than deregulated labour markets can be held responsible for the superior development of the US-economy during the 1990s compared to Germany or the EU.

growth and employment under the current regime of monetary and wage policies in Europe. Section 8 concludes.

2. Unsatisfactory macroeconomic performance in the Euro area

Since the growth slowdown in 2000/1 the Euro area has had a difficult time to recover and macroeconomic performance has been worse than in the USA. There the economy returned rather quickly to its impressive growth path of the late 1990s. On average over the period 2001-2005, annual real GDP-growth in the Euro area has remained more than 1 percentage point below US-growth (Table 1). The growth differential, already to be found since the start of the convergence process towards the EMU in the mid-1990s (Hein/Niechoj 2006), seems to have become persistent. The unemployment rate in the Euro area is still considerably above the US level. Between 2001 and 2005 inflation in the Euro area has on average slightly exceeded the European Central Bank's (ECB) inflation target of 'below, but close to, 2 percent in the medium term' (ECB 2003: 79). But the deviation from the US inflation rate is rather small. Taken together, in recent years the US-economy has once more managed to combine reasonable growth, low unemployment and low inflation in a far better manner than the Euro area.

Slow growth and high unemployment are by no means equally distributed across the Euro area (Table 1). Whereas during the period 2001-2005 in particular the large economies Germany and Italy, together with the Netherlands and Portugal, have been suffering from real GDP growth rates well below the Euro area average, Spain, Finland, Greece and Ireland have experienced growth considerably above this average. The unemployment rates display a wide dispersion across Euro area countries, too. Finally, also inflation rates show major differences between Euro area countries, with rates well below the ECB's target in Germany and Finland, and well above the target in Spain, Greece, Ireland, the Netherlands and Portugal.

Table 1: Real GDP growth, growth contributions of demand aggregates, unemployment rate and inflation rate in the Euro area countries, average values for 2001-2005*

	USA ¹	Euro area ²	Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	Portugal
Real GDP, annual growth rate, percent	2.6	1.4	0.7	1.6	0.6	3.1	1.5	1.5	2.3	4.4	4.6	0.9	0.6
Growth contribution of domestic demand including stocks, percentage points	3.1	1.3	-0.2	2.0	1.0	4.2	0.7	1.4	2.3	4.5	3.0	0.5	0.5
Growth contribution of private consumption, percentage points	2.2	0.8	0.2	1.1	0.3	2.0	0.6	0.6	1.6	2.7	1.9	0.2	0.9
Growth contribution of public consumption, percentage points	0.4	0.4	0.0	0.5	0.4	0.8	0.1	0.5	0.4	0.3	0.5	0.5	0.4
Growth contribution of gross fixed capital formation, percentage points	0.5	0.2	-0.4	0.3	0.3	1.4	0.0	0.4	0.4	1.4	1.4	-0.1	-0.7
Growth contribution of balance of goods and services, percentage points	-0.5	0.1	0.9	-0.4	-0.4	-1.1	0.8	0.1	0.0	-0.1	1.6	0.4	0.1
Employment, annual growth, percent	0.7	0.9	-0.2	0.5	1.2	2.9	0.2	0.5	0.9	1.3	2.9	0.0	0.4
Unemployment rate, percent	5.4	8.5	8.7	9.2	8.4	10.5	4.4	7.8	8.9	10.2	4.4	3.6	5.9
Inflation rate (HCPI), percent	2.6	2.2	1.6	2.0	2.4	3.2	1.9	2.0	1.4	3.5	3.4	2.8	3.2

¹ USA: national CPI, ² Euro area: HCPI.

Source: Eurostat; authors' calculations; U.S. inflation rate: Reuters Eco Win.

3. Maastricht, the SGP, and fiscal consolidation in the Euro area-countries since 1991

Since the early 1990s fiscal policy in the Euro area has been dominated by the Treaty of Maastricht and since the start of the Euro in 1999 by the Amsterdam SGP (European Commission 2002). As conditions of entry to the monetary union, the Maastricht Treaty set a maximum deficit ratio (proportion of current budget deficit in relation to GDP) of 3 percent and a maximum debt ratio (proportion of public debt in relation to GDP) of 60 percent. In 1997, the SGP made this regulation even tougher by prescribing for the medium term, i.e. a time span which stretches across economic cycles, balanced budgets or budget surpluses in order to reduce the level of debt.² Achieving these conditions was intended, on the one hand, to enable the automatic stabilisers to work during economic downturns without violating the 3 percent deficit criterion. On the other hand, it should ensure the long run sustainability of public finances. Especially, it was intended to create leeway for possible future funding objectives which may arise from demographic developments such as social security provision for the elderly.

The SGP requires member states to present annual stability programmes to the European Commission, which describe how they intend to achieve balanced budgets, and which can be employed as an advance notice when a country is approaching the 3 percent limit for its current budget deficit. If this mark is exceeded, the ‘excessive deficit procedure’ (EDP) is applied (EC Treaty, Art. 104). If the country is not in a deep recession, defined as an annual real GDP shrinkage of more than 2 percent, and if the country in question refuses to introduce consolidation measures, penalties of up to 0.5 percent of GDP per year may ultimately be incurred. In spring 2005 the SGP has been modified so as to mitigate the strictness of the excessive deficit procedure somewhat. In Section 6 we turn to a more detailed description and evaluation of these modifications which have not questioned the substance of the original SGP.

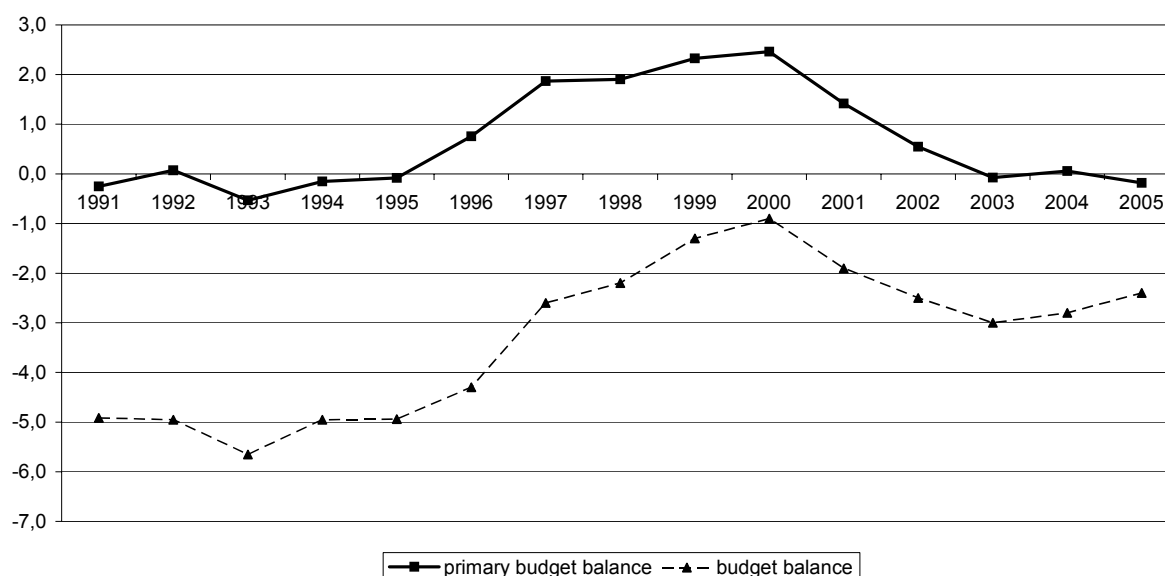
With respect to deficit reduction, fiscal policy has been rather successful (Figure 1, Table 2). For the Euro area as a whole the budget balance was reduced from an average -5.1 percent of GDP in the first half of the 1990s to -2.3 percent in the second half. After the economic slowdown in 2000/2001 the budget balance has decreased again, but on average for the period 2001 to 2005 to only -2.6 percent of GDP. There seems to have been a permanent improvement in the budget balance of about 2.5 percentage points. The cost of this deficit reduction in terms of a loss in public goods provision or in higher taxes is considerably smaller. The primary budget balance, i.e. net lending excluding net government interest payments, had to be improved by only 2 percentage points for the second half of the 1990s and by 0.5 percentage points for the period from 2001 to 2005. The substantially lower average interest burden of public debt is at least partly due to the remarkable reduction in the average long term nominal interest rates which was caused by the rapid interest rate convergence towards the lower German level. In that respect fiscal policy obviously gained from the common currency. Similar tendencies with respect to public deficit reduction can be found for most of the single member countries, albeit to quite different extents (Table 2). Belgium, Finland, Greece, Italy and Spain stand out with particularly large deficit reductions above 5 percentage points. Together with Portugal – and with the exception of Finland – these are also the countries that gained the most from falling interest rates.

² See Allsopp/Vines (1998), Arestis et al. (2001), Eichengreen (1998) and Semmler (2000) for a more detailed analysis of the original SGP.

Fiscal policy has been rather unsuccessful in stabilising the gross debt-GDP-ratio (Table 3). For the Euro area as a whole this ratio went up from an average 65.5 percent of GDP in the first half of the 1990s to 73.5 percent in the second half. From 2001 to 2005 the average level was somewhat lower (69.5 percent), but still above the 60 percent upper limit of the Maastricht Treaty and the SGP. The most important reason for this development is certainly that France and Germany as the two largest Euro area economies both increased their gross public debt-GDP-ratio by almost 15 percentage points. After all, six countries managed to reduce their gross indebtedness noticeably.

**Figure 1: Government budget balance and primary budget balance:
Euro area 1991-2005 in % of GDP**

Source: Eurostat; primary lending: OECD (2005). Budget balances 2000-2002 corrected for proceeds from UMTS auctions.



Many countries did not succeed in complying with the deficit rules of the SGP (see Table 4). Over the last four years, for the Euro area as a whole the deficit ratio has been close to the 3 percent limit within a narrow band between 2.4 and 3.0 percent of GDP. Since the start of the EMU, six out of twelve member countries have exceeded the 3 percent limit of the SGP, with the exception of the Netherlands all of them three times or more.

Table 2: Average government budget balance and primary budget balance for the Euro area countries and the USA from 1991 to 2005 in percent of GDP

	Deficit / GDP ratio			primary Deficit / GDP ratio		
	1991-1995	1996-2000	2001-2005	1991-1995	1996-2000	2001-2005
Austria	-4.0	-2.5	-1.0	-1.0	0.5	1.4
Belgium	-6.3	-1.3	0.1	3.5	5.9	5.3
Finland	-4.6	1.3	3.2	-5.2	2.8	3.4
France	-4.6	-2.6	-3.2	-1.9	0.2	-0.7
Germany	-2.8	-2.2	-3.6	-0.1	0.8	-1.0
Greece	-11.2	-5.2	-5.7	0.5	3.6	0.0
Ireland	-2.5	2.1	0.2	2.3	4.2	0.4
Italy	-9.9	-3.3	-3.4	1.7	4.6	1.6
Netherlands	-3.3	-0.3	-1.8	1.0	3.6	0.3
Portugal	-6.5	-3.4	-3.8	0.8	0.3	-0.9
Spain	-5.6	-2.5	-0.1	-1.4	1.3	2.0
Euro area	-5.1	-2.3	-2.6	-0.2	1.9	0.4
USA	-4.5	0.0	-3.5	-1.0	3.0	-1.5

Note: Balances 2000-2002 are corrected for proceeds from UMTS auctions.

Source: OECD (2005); authors' calculations.

Table 3: Gross government debt for the Euro area countries and the USA from 1991 to 2005 in percent of GDP

	1991-1995	1996-2000	2001-2005
Austria	60.7	65.8	64.8
Belgium	134.1	119.7	99.5
Finland	46.8	50.3	42.9
France	44.7	58.2	61.7
Germany	47.3	60.6	63.4
Greece	99.3	108.9	109.8
Ireland	90.9	55.7	31.2
Italy	115.3	117.4	106.2
Netherlands	77.5	66.2	51.9
Portugal	60.1	56.9	57.7
Spain	54.9	64.7	49.5
Euro area	65.5	73.5	69.5
USA	74.5	67.3	62.5

Source: Eurostat; values for USA: European Commission (2005) and authors' calculations.

Table 4: Excessive deficits in Euro area countries from 2000 to 2005 in percent of GDP

	2000	2001	2002	2003	2004	2005
France			3.2	4.2	3.7	
Germany			3.7	4.0	3.7	3.3
Greece	4.1	6.0	4.9	5.8	6.9	4.5
Italy		3.2		3.4	3.4	4.1
Netherlands				3.1		
Portugal		4.2			3.2	6.0

Source: Eurostat.

4. The macroeconomic impact of fiscal policy

In order to take account of the macroeconomic impact of fiscal policy it is not sufficient to look at the development of actual deficits, as in the previous section. Actual deficits may simply reflect the underlying economic situation and not active fiscal policy. Therefore, we assess the extent to which fiscal policy exerts a stabilising or destabilising influence on the business cycle by comparing changes in the output gap and the cyclically adjusted budget balance-potential GDP ratio (CBR), using the relevant values from the OECD Economic Outlook (OECD 2005).³ The output gap serves as an indicator of the current state of economic activity. If it is positive, capacity is outstripped, if it is negative, capacity is not fully utilised. Consequently, a positive change in the output gap indicates a cyclical upturn, whereas a negative change points to a cyclical downturn. If there is a positive (negative) change in the CBR, then structural deficits fall (rise) or structural surpluses rise (fall), and fiscal policy provides a restrictive (expansive) stimulus to demand. If the CBR remains constant in the face of a changing output gap, fiscal policy is neither expansive nor restrictive and the automatic stabilisers are simply left to take effect.

Such cyclically adjusted measures can be criticised for a number of theoretical and empirical reasons and should therefore be interpreted with great care. Theoretically, they are very close to the idea embedded in the standard NAIRU models: There is a long-run equilibrium, determined by structural characteristics of the labour market, which is independent of the short-run fluctuations generated by demand shocks or macroeconomic policy. We do not share this view (Hein 2004, 2006a, 2006b). Empirically, these measures are very sensitive to the exact method used and to the choice of observation period. The separation of a cyclical from a potential or trend component can be biased because the potential component may be endogenous. After some years of high (low) growth caused by ‘short-term’ demand side measures or shocks, the potential or trend growth will go up (down) thereby underestimating the cyclical component compared to a situation without such demand side measures or shocks. Therefore, the cyclically adjusted budget deficits (surpluses) for low (high) growth countries may be considerably overestimated. Despite these serious problems we consider the measures as useful. First, the OECD numbers we have used have proven to be less susceptible to the endogeneity bias than, for example, the values published by the European Commission

³ For a detailed exposition of the methods used by the OECD see Giorno et al. (1995).

(2005). Second, if certain empirical findings about the stabilising or destabilising effects of fiscal policy can be derived within such a mainstream framework, then this rather strengthens the point from a heterodox perspective.⁴

Measured in the way described, fiscal policy in the Euro area as a whole from 1991 to 2005 developed as follows (Figure 2): In a first rather long phase from 1991 to 1999 fiscal policy was strongly restrictive with average annual improvements in the CBR of more than 0.5 percentage points. Especially at the beginning of the 1990s, fiscal policy went through a seriously pro-cyclical episode because it decreased structural deficits despite a sharp fall in the output gap. From 1999 to 2000 fiscal policy switched to pro-cyclical expansion in the peak of the 2000 boom. From 2000 to 2002 it counter-cyclically stabilised the Euro area economy after the slowdown in 2000/2001. Finally, from 2002 until today, fiscal policy has had a destabilising effect because the CBR has been slightly increased despite the continuing slowdown. This general picture – strong restriction over the 1990s, loosening at the end of the 1990s, short counter-cyclical reaction after the 2000/2001 slowdown, and a pro-cyclical stance in the present economic downturn – applies to almost all of the individual Euro area countries. With respect to the extent and the exact timing, there are some substantial differences across the countries, though.

The course of fiscal policy in the Euro area is in remarkable contrast to that in the USA (Figure 3). There, after a strong counter-cyclical stabilisation effort in the recession 1990/91, fiscal policy changed to a clearly counter-cyclical path of strong restriction during the upswing until the peak of the boom in 2000. After the sharp downturn in 2000/2001, fiscal policy once again reacted in a strongly counter-cyclical way, decreasing the CBR by more than 5 percentage points from 2000 to 2004. From the empirical evidence over the whole period, therefore, it must be concluded that fiscal policy in the USA has played its macroeconomic stabilisation role properly, whereas in the Euro area fiscal policy has acted in an often pro-cyclical and therefore destabilising way

⁴ Of course, the results for a given set of countries and a given time period should be more or less robust to the method used and to additional observations due to new data over time. At least with regard to the latter and for Germany, the Euro area and the US most of the qualitative results we obtain have proven to be rather robust to new data, as we conducted this kind of analysis with almost every new edition of the OECD Economic Outlook data since 2001 (see Hein/Muelhaupt/Truger 2001, Hein/Truger 2005a, 2005b, 2005c, 2005d, Truger/Hein 2002).

Figure 2: Government budget balance, cyclically adjusted budget balance and output gap: Euro area 1991-2005 in % of (pot.) GDP

Source: OECD (2005) Budget balance 2000-2002 corrected for proceeds from UMTS auctions.

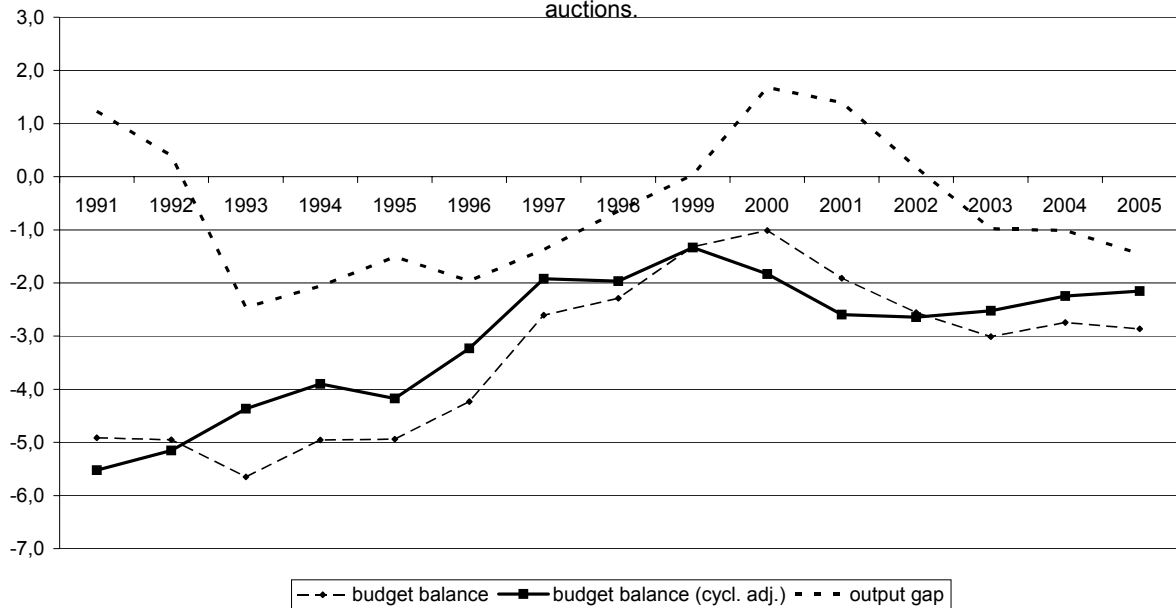
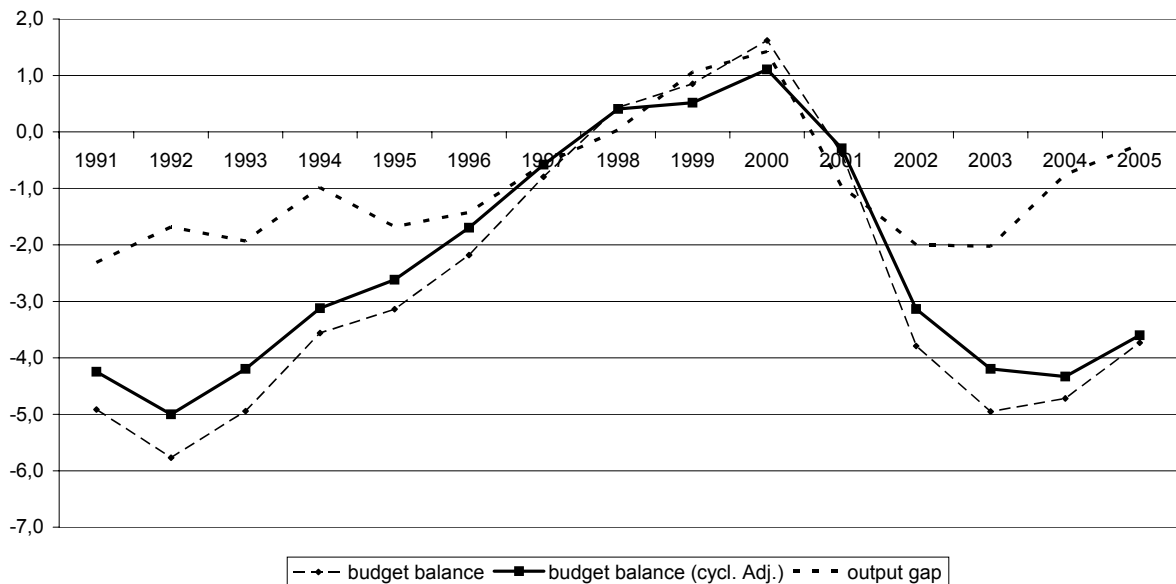


Figure 3: Government budget balance, cyclically adjusted budget balance and output gap: USA 1991-2005 in % of (pot.) GDP

Source: OECD (2005)



This result is reinforced by the developments in the recent economic slowdown from 2001 to 2005 (Table 5). In the face of an average annual fall in the output gap of 0.6 percent of GDP, Euro area fiscal policy was only slightly expansive with an average annual decrease in the CBR of 0.1 percentage points. However, almost the total expansive, counter-cyclical reaction occurred in 2001, when the fall in the output gap was small (Figure 2). In 2002 fiscal expansion was hardly measurable and since 2003, fiscal policy has even been slightly pro-cyclically restrictive. The cumulated negative fiscal stimulus over the last three years has amounted to 0.5 percent of GDP.

For the individual Euro area countries the picture is rather diverse (Table 5). However, there has not been a single country that did not see a pro-cyclically restrictive fiscal policy in at least one year during the recent slowdown. Over the whole period from 2001 to 2005, fiscal policy was strongly expansive in only two countries: The high growth countries Finland and Ireland both decreased their average annual CBRs by 0.8 percentage points. Four countries, namely Italy, Greece, France and Germany saw a slightly expansive fiscal policy over the whole period with their CBRs decreasing by 0.3, 0.2, 0.1 and 0.1 percentage points respectively. In Greece the fiscal expansion turned out to be pro-cyclical, as the output gap improved at the same time. The precise pattern in that country, however, was of a stop and go nature. In France fiscal policy reacted in a really counter-cyclical way against the fall in the output gap from 2000 to 2003. After 2004 it switched to restriction and became noticeably pro-cyclical in 2005. In Italy, almost all of the expansion occurred from 2000 to 2001, when the output gap was still slightly improving. From 2002 to 2004, however, when the output gap worsened considerably, fiscal policy was pro-cyclical, before once more turning to expansion in 2005. In Germany, virtually all of the expansion occurred in 2001 with only a minor worsening of the output gap. In 2002 German fiscal policy was neutral in the face of a strong fall in the output gap. Since 2003 it has pro-cyclically tightened despite further substantial drops in the output gap. In the five remaining countries, Spain, Austria, Belgium, the Netherlands and Portugal, fiscal policy was pro-cyclically restrictive over the whole period from 2001 to 2005. Whereas in Spain both the drop in the output gap as well as the negative pro-cyclical fiscal stimulus has been comparatively small, both values have been substantial in the other countries. In Portugal and Austria the cumulated negative pro-cyclical fiscal stimulus from 2001 to 2005 amounted to 3.8 and 3.0 percent of GDP, respectively. In striking contrast to the European experience, US fiscal policy from 2001 to 2005 was very expansive

with an average annual decrease in the CBR of 0.9 percent (Table 5). There has not been a single year with pro-cyclical fiscal restriction during the economic downturn. Since 2005, the second year with an improving output gap, US fiscal policy has returned smoothly to careful restriction, again.

Table 5: Indicators for fiscal policy in the Euro area countries and the USA, average values, 2001-2005*

	USA	Euro area	Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	Portugal
Budget balance (percent of GDP)	-3.5	-2.6	-3.6	-3.2	-3.4	-0.1	-1.0	0.1	38751	-5.7	0.2	-1.8	-3.8
Budget balance (percent of GDP), annual change, percentage points	-1.1	-0.4	-0.5	-0.3	-0.5	0.3	0.0	0.0	-1.0	-0.1	-1.1	-0.6	-0.5
Cyclically adjusted budget balance (percent of cyclical adjusted GDP), annual change, percentage points	-0.9	-0.1	-0.1	-0.1	-0.3	0.3	0.4	0.3	-0.8	-0.2	-0.8	0.1	0.1
Output gap, (percent of cyclical adjusted GDP), annual change, percentage points	-0.3	-0.6	-0.8	-0.5	-0.5	-0.1	-1.0	-0.5	-0.5	0.4	-0.8	-1.4	-1.4
Number of years with pro-cyclical fiscal policy during an economic slowdown	0	3 (2003-2005)	3 (2003-2005)	1 (2005)	3 (2002-2004)	2 (2002-2003)	3 (2001-2002, 2004)	4 (2001-2003; 2005)	1 (2005)	1 (2005)	2 (2003-2004)	2 (2003, 2005)	3 (2002-2004)
Negative fiscal stimulus in economic slowdown, cumulated (percent of potential GDP)	--	0.5	1.1	0.5	0.8	0.9	3.0	1.9	0.5	2.2	2.8	1.2	3.8

Notes: *Forecast values for 2005.

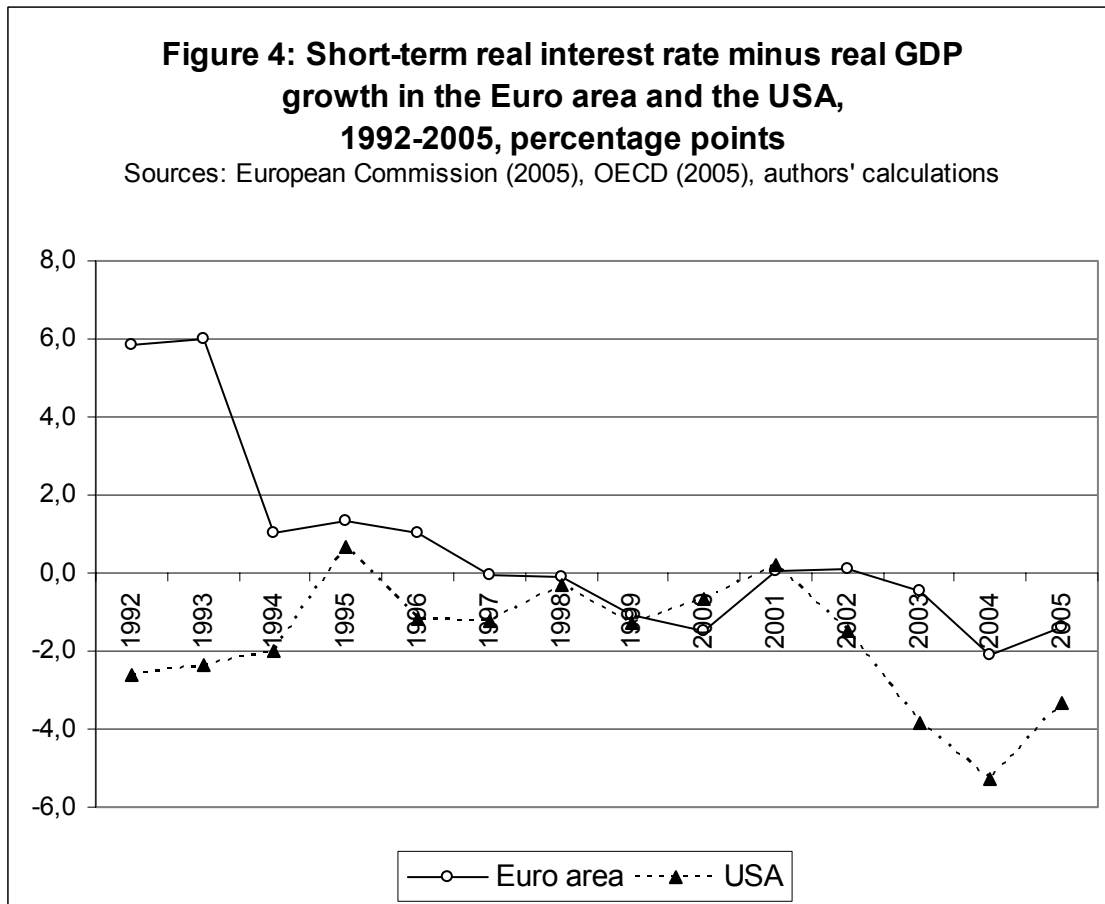
Sources: OECD (2005), authors' calculations.

Therefore, it is hard to escape the conclusion, that the SGP did lead to destabilising, pro-cyclical fiscal policy reactions to the post-2000 crisis in several countries. With the exception of Greece and to some extent also France, all the countries with excessive deficit problems stopped their initially expansive fiscal policy and were driven into pro-cyclical, restrictive measures as soon as their deficit had reached the 3 percent of GDP limit. Without doubt, the resulting negative fiscal stance has contributed to the ongoing stagnation tendencies after 2000 within these countries and in the Euro area as a whole. Of course, fiscal policy is only one factor in the explanation of macroeconomic performance. However, with respect to GDP growth it is striking that all of the four countries with below Euro area average growth rates (Germany, Italy, the Netherlands and Portugal) suffered from inadequately restrictive fiscal policies. And from the four countries with above average growth rates, after all three countries (Ireland, Finland and Greece) had expansive fiscal policies.

It is sometimes argued that the countries with excessive deficits might have avoided their problems and the ensuing pro-cyclical fiscal policy if they had pursued a tighter fiscal policy during ‘good times’. At the first sight this argument has some appeal as most of the countries in question had at least one short episode of pro-cyclical expansion at the end of the 1990s or in 2000. However, stronger fiscal restriction could have meant some damage. As a rough estimate suggests, in order to avoid excessive deficits and pro-cyclically restrictive policies in the period from 2001 to 2005, the countries concerned would have had to decrease their budget deficits by an additional 2 to 4 percent of GDP within only 2 or 3 years. Moreover, the restriction would have hit the economies in a situation in which they were just recovering from the early and mid-1990s stagnation with a prolonged period of tight and often pro-cyclical fiscal policies. Without doubt, the ‘good times’ would have been turned into ‘bad times’ by such a policy. As the ultimate retreat proponents of tighter fiscal policy might question that restrictive fiscal policy causes any demand side problems, at all, due to ‘non-Keynesian effects’ of fiscal consolidation (see e.g. Alesina Perotti 1996). However, it has convincingly been argued that such a position cannot be defended in any sensible way (see e.g. Arestis/Sawyer 2003).

5. The macroeconomic impact of monetary policy and wage developments

Macroeconomic performance cannot be explained solely by fiscal policy but has also to take into account monetary and wage policies. Monetary policy can be assessed by the development of the short-term real interest rate. It is now widely accepted that modern central banks use the short-term nominal interest rate as an economic policy instrument. If central banks target inflation they have to set nominal interest rates with an eye to the ensuing real rate, as proposed in the famous Taylor-rule, for example (Taylor 1993). In order to take into account the underlying economic situation, we consult the differences between both the short- and long-term real interest rate and real GDP-growth. We expect a negative influence of real interest rates on economic growth working through different transmission channels (money, credit, asset prices, exchange rates) (Bernanke/Gertler 1995, Cecchetti 1995).



Whereas the Euro area short-term real interest rate was positive on average over the period after the 2000/1 growth slowdown, the Federal Reserve (Fed) managed to establish a negative short-term real interest rate of -0.2 percent in the USA (Table 6). These expansionary monetary policies contributed to the quick recovery of the US economy. The USA returned to a negative short-term real interest rate-real GDP growth rate-difference already in 2002, whereas in the Euro area this difference became negative only in 2003 (Figure 4). On average over the recent years, the Fed has established a favourable short-term real interest rate-real GDP growth-difference (-2.7 percentage points), and also a growth-friendly long-term real interest rate-real GDP growth constellation (-0.7 percentage points). By contrast, in the Euro area the short-term real interest rate-real GDP growth-difference has been only slightly negative (-0.8 percentage point) on average over the period 2001-2005. The long-term real interest rate-real GDP growth-difference has even been positive (0.7 percentage points). The ECB has been reluctant to stimulate the economy by cutting interest rates in the face of the slowdown.

Table 6: Indicators for monetary and wage policies in the Euro area countries and in the USA, average values, 2001-2005*

	Euro											Nether-	
	USA	area	Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	lands	Portugal
Monetary Policy													
Short-term real interest rate, percent	-0.2	0.6	1.2	0.8	0.4	-0.4	0.9	0.8	1.4	-0.7	-0.6	0.0	-0.4
Long-term real interest rate, percent	1.9	2.1	2.6	2.3	2.0	1.1	2.5	2.3	2.9	1.0	0.9	1.4	1.2
Short-term real interest rate minus real GDP growth, percentage points	-2.7	-0.8	0.5	-0.8	-0.4	-3.5	-0.5	-0.7	-0.8	-4.9	-5.7	-0.8	-1.0
Long-term real interest rate minus real GDP growth, percentage points	-0.7	0.7	1.9	0.7	1.3	-2.0	1.0	0.8	0.7	-3.3	-4.3	0.7	0.6
Wage Policy													
Nominal compensation per employee, annual growth, percent	4.0	2.5	1.7	2.7	3.1	3.3	2.0	2.8	3.2	6.5	5.7	3.9	2.3
Nominal unit labour costs, annual growth, percent	1.7	1.7	0.3	1.7	3.2	2.9	0.8	1.8	1.8	3.3	3.3	2.7	2.1
Labour income share [#] , percent	62.6	58.0	58.1	57.4	55.6	57.1	62.5	61.7	55.6	58.0	47.8	59.2	63.0
Change in labour income share to previous year, percentage points	-0.4	-0.2	-0.5	0.0	0.2	-0.5	-0.6	-0.2	0.5	-0.2	-0.2	0.0	-0.6

Notes: *Forecast values for 2005, [#]compensation per employee divided by GDP at current market prices per person employed.

Sources: *European Commission (2005), OECD (2005), authors' calculations.*

ECB policy has been particularly harmful for the largest Euro area member country, Germany (Table 6). As the German inflation rate has been lower than the EMU average and the nominal interest rates have almost completely converged since 1999, Germany's real interest rates have even been higher than the Euro area average since then. This has contributed to an unfavourable short-term real interest rate-real GDP growth-difference. Germany was the only member country in which that difference was positive on average over the period 2001-2005. On the other hand, the high inflation countries Spain, Greece and Ireland have had negative short-term real interest rates and a very growth favourable constellation with negative differences between both the short- and long-term real interest rate and real GDP growth.

Therefore, the ECB's 'anti-growth-bias', i.e. a too restrictive definition of price stability for the heterogeneous currency area - as an annual increase of the harmonised consumer price index of below but close to 2 percent (ECB 2003: 79) - and an asymmetric response to the

expected deviation of actual from target inflation,⁵ has contributed to the weak growth and employment performance of the Euro area as a whole and to the economic problems of the largest Euro area member, Germany, in particular. However, it has to be conceded that the ECB cannot react directly towards the inflation differences between Euro area member countries. This is where wage policies become relevant.

Wage policies can be assessed by nominal wage growth (compensation per employee), unit labour cost growth and the labour income share. Nominal wage setting affects unit labour cost growth and inflation. If nominal wages increase at a faster pace than productivity plus the price level do, unit labour cost growth and inflation will speed up.⁶ This will cause real interest rates to fall. If nominal wages increase at a rate below the sum of productivity growth and inflation, unit labour cost growth will slow down and cause disinflation. Finally, deflation may be the consequence. Deflation causes increasing real interest rates and rising real debts with potentially negative effects on investment and growth.⁷ Once deflationary processes have started, monetary policies lowering nominal interest rates will be ineffective.

Wage policies, however, may not only affect prices, but may also change distribution if firms do not completely pass unit labour cost variations to prices or if prices of other inputs do not change in step with unit labour costs. Under these conditions nominal wage moderation causes the labour income share to fall (Hein/Schulten/Truger 2006). Theoretically, the effects of income shares on GDP growth are ambiguous (Bhaduri/Marglin 1990). With the propensity to save out of wages falling short of the savings propensity out of profits, a falling labour income share means a cut-back in consumption demand and capacity utilisation with directly contractive effects on investment and GDP growth. A fall in labour income shares that is associated with nominal wage restraint would, on the other hand, improve international competitiveness and, therefore, stimulate export demand, investment and growth. With a slowdown in inflation, the central bank may also cut interest rates and stimulate investment and growth. Finally, a falling labour income share is associated with rising unit profits which may also improve investment and growth.

⁵ The ECB has tended to tighten whenever inflation increased above the target without relaxing when inflation expectations came down. For a general critique of the ECB's 'anti-growth bias' see Bibow (2002, 2005a, 2005b) Hein (2002) and Hein/Truger (2006b).

⁶ See Arestis/Sawyer (2005) and Hein (2006a) for recent post-Keynesian models of distribution conflict and inflation.

⁷ See Hein (2006a, 2006b) for the integration of real debt effects into Kaleckian models of distribution and growth with conflict inflation.

Since the stimulating effects of wage moderation and declining labour income shares for investment and growth are rather indirect and uncertain, in particular in large and rather closed economies as the Euro area and the USA, the direct and contractive effects will presumably dominate here. And since nominal wage increases, which will shift distribution in favour of labour income, will also trigger inflation and concomitant restrictive central bank interventions, nominal wage growth according to the sum of long-run productivity growth and the central bank's inflation target and hence roughly stable labour income shares should be generally favourable for growth and employment in large and rather closed currency areas.

On average over the period 2001-2005, nominal wage growth in the Euro area has been lagging behind the USA (Table 6). But taking into account productivity growth, nominal wage increases in both currency areas have been stability oriented: nominal unit labour costs have grown by 1.7 percent and have hence not caused any inflationary pressures. Moderate wage increases were accompanied by a decline in the labour income share, both in the Euro area and in the USA. Whereas in the USA this decline compensated for the increase in the previous years generating a stationary trend since the early 1990s, in the Euro area the recent decline has continued the decreasing trend since the early 1990s. Although labour income shares in the two economies had similar levels in the early 1990s, the Euro area value is by now 4 percentage points below the US-value contributing to domestic demand problems in Europe.

Below the surface of Euro area aggregate values there is a wide dispersion of wages and nominal unit labour cost growth rates (Table 6). In Italy, Spain, Greece, Ireland and the Netherlands nominal unit labour costs have grown at rates around 3 percent on average between 2001 and 2005 which interfered with the ECB's overly ambitious inflation target. Nominal unit labour costs in Germany, however, and to a lesser extent in Austria, have grown at especially low rates causing deflationary risks, which have been accompanied by a rapid decline in labour income shares contributing to domestic demand problems. Especially wage developments in Germany have been completely inappropriate for the largest economy in a currency union:⁸ Overly moderate wage policies have improved price competitiveness and profitability of German firms and have made German export surpluses almost quadruple between 2001 and 2005. Since around 44 percent of German exports go to the Euro area,

increasing German export surpluses cause major problems for the other Euro area countries. Whereas Germany has continuously increased its current account surplus, amounting to 4.1 percent of GDP in 2005, the other larger Euro area countries (France, Italy, Spain) are increasingly driven into current account deficits (Table 7). Some of the smaller countries either see their surpluses decline (Belgium, Finland) or cannot decrease their huge deficits (Greece, Portugal). If this constellation persists it will inevitably induce the other Euro area countries to use deflationary wage policies as well. The risk of deflation will then spread across the Euro area.

Table7: Current account balances as a percentage of GDP in Euro area countries and the USA, 2001-2005

	2001	2002	2003	2004	2005
Germany	0.2	2.3	2.2	3.8	4.1
France	1.6	0.9	0.4	-0.4	-1.6
Italy	-0.1	-0.8	-1.3	-0.9	-1.5
Spain	-3.9	-3.3	-3.6	-5.3	-7.7
Austria	-1.9	0.3	-0.5	0.3	-0.4
Belgium	3.4	4.6	4.1	3.3	1.4
Finland	7.2	7.6	3.8	5.3	3.5
Greece	-8.1	-7.5	-7.2	-6.3	-7.0
Ireland	-0.6	-1.0	0.0	-0.8	-1.5
Netherlands	2.4	2.9	2.8	3.3	5.8
Portugal	-8.4	-8.0	-0.9	-3.6	-6.7
Euro area	0.1	0.7	0.3	0.5	-0.2
UK	-2.2	-1.6	-1.5	-2.0	-1.8
Sweden	4.4	5.3	7.5	8.2	7.1
Japan	2.1	2.8	3.2	3.7	3.4
USA	-3.8	-4.5	-4.7	-5.7	-6.5

Source: OECD (2005).

It would be highly desirable to have a closer look at the interaction between monetary and wage policies, on the one hand, and fiscal policy, on the other. However, such an analysis would be beyond the scope of this paper. Only a few, qualitative and preliminary remarks can be made at this stage. From the empirical indicators presented in Sections 4 and 5 it seems that fiscal policy did not play a decisive role in the explanation of macro-performance relative to the Euro area average for every country. For example, in the fast growing countries Ireland and Greece macro-economic conditions generated by wage and monetary policies were quite

⁸ See Hein/Truger (2006a) for a more extensive discussion.

favourable for above average growth rates. Likewise, in the slowly growing countries Germany, and to a lesser extent also Italy, the conditions generated by monetary and wage policies in themselves seem to have been adverse to growth. In the four countries just mentioned, therefore fiscal policy seems to have played the role of an additional factor amplifying the tendencies generated by the other policy areas. In Spain, the slightly restrictive effect of fiscal policy was too weak to compensate for the favourable growth conditions generated by monetary and wage policies. However, it seems that in the Netherlands and Portugal, where monetary and wage policies reactions were rather close to the Euro area average, fiscal policy turned the balance towards the below average growth performance. The same seems to hold for Finland's above average growth.

6. Improving fiscal policy within the EMU: Towards an expenditure path concept

6.1 The 2005 reform

In the light of these results, a reform of the SGP was inevitable. The recent reform in spring 2005 means some important changes (European Council 2005). Alongside substantial modifications with respect to the medium term objectives, which permit some deviation from the 'close to balance or in surplus rule' depending on national circumstances, the application of the EDP has been reformed and softened to some extent: The Council has specified the 'relevant factors' to determine whether a country exceeding the 3 percent limit 'really' has an excessive deficit. The previous exception of a severe economic downturn has been softened and it is now included an accumulated loss of output due to protracted very slow growth. The following types of spending may justify a temporary and small transgression of the deficit limit: spending on the Lisbon agenda, especially R&D and innovation policies, public investment, financial contributions to international solidarity and European unification as well as pension reforms. Debt sustainability is to be given greater relevance, too. Also the deadlines before identifying excessive deficits, taking action following a policy recommendation, and for the deficit to actually be corrected have all been extended.

The reform has addressed one of the most obvious failings of the original SGP: Countries with difficulties in meeting the 3 percent ceiling or the close to balance medium-term target now have a range of possible factors that they can call upon to justify their inability to meet the targets. Some of the factors – debt sustainability or spending on the Lisbon agenda certainly make more sense from a macroeconomic point of view than others (pension reform).

Nevertheless, the reform has increased fiscal leeway for some countries to a certain extent. For example, Germany and France can avoid the immediate threat of penalties. However, the practical usefulness of the reform is limited. This has been demonstrated by the recent recommendations by the Commission and the decisions by the Council concerning the EDPs against Germany, Italy and Portugal.⁹ In these cases both the Commission and the Council have taken a rather narrow view and do not even seem to concede the full leeway given by the reformed SGP. Despite the fact that the economic recovery is only weak and uncertain, a rather ambitious and risky consolidation path has been called for.

Therefore, a more fundamental reform of the SGP is required. In what follows, we present an alternative coordination and consolidation concept based on expenditure paths that allows for coordinated fiscal policies across the Euro area in a counter-cyclical way, while at the same time ensuring fiscal sustainability. We first present the original concept and then some modifications.¹⁰

6.2 Expenditure paths for non-cyclical government spending

We take as given that fiscal policy remains essentially a matter of national responsibility. The goal for national fiscal policy is having automatic stabilisers work – always under the constraint that for the individual countries a given medium term debt-GDP-ratio is not exceeded. Without such a limit, there may arise the ultimate danger of an ever accelerating government debt limiting the room of manoeuvre for public investment and other desirable government expenditure. Increasing public interest payments may also have serious regressive distributional effects with a negative impact on aggregate demand.

To this end, the individual countries should establish expenditure paths for non-cyclical spending, which would be financed in the long term by tax revenue.¹¹ Cyclical spending should then be allowed to float freely around this target without being constrained by budget deficit limits. In this concept, governments can and should refrain from discretionary tax

⁹ For an up to date overview of the EDPs see the relevant internet pages of the European Commission under http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm.

¹⁰ Buti et al. (2003) give an overview of a series of reform approaches which for reasons of space cannot be discussed here. For an overview of the more recent debate on the SGP see Coeuré/Pisani-Ferry (2005) and Calmfors (2005).

¹¹ For the original proposal for the Euro area see Hein/Truger (2005d). On similar proposals for Germany see Bartsch et al. (2002), Eicker-Wolf/Truger (2003) and Horn/Truger (2005). These proposals are based on the work of Horn/Scheremet (1999) who refer to the successful process of budget consolidation in the US during the 1990s.

cuts/increases other than for purposes of changing the level of government spending. In a downturn, increases in expenditure and falls in revenue cause budget deficits which are financed by borrowing, thus increasing the level of debt. In an upturn, on the other hand, budget surpluses arise, which are used for consolidation purposes. If non-cyclical spending grows at a higher rate than long-term nominal GDP, the result is rising super-cyclical budget deficits. If it grows at a slower rate, structural deficits are reduced. Alignment of the expenditure path with a growth rate below the long-term nominal GDP path can therefore contribute to a revenue-side budget consolidation, if a structural deficit requiring consolidation existed at the outset. Therefore, countries exceeding their public debt target value should choose an expenditure growth rate slightly below nominal GDP trend growth, whereas others could let expenditure grow at the same rate as nominal trend GDP.¹² Of course, such values for the expenditure paths should be a matter for co-ordination between member countries. In addition, with a modernised stability pact there should be checks to ensure that individual countries comply with the prescribed expenditure paths for non-cyclical public spending. Moreover, the appropriateness of these expenditure paths themselves should also be subject to regular review, since the reference variable, i.e. the nominal potential GDP path, is liable to change as a result of public and private investment activity.

In our view, the expenditure path concept has several advantages.¹³ First, with respect to consolidation, the ultimate target value is the debt-GDP-ratio, which is much more directly relevant for fiscal sustainability than budget deficits. Second, the chosen variable, non-cyclical government spending, is in fact under the government's control, whereas the budget deficit is an endogenous variable of the whole macroeconomic process. Third, the expenditure path allows for automatic stabilisers to take effect. The adoption of pro-cyclical fiscal policies

¹² Taking nominal GDP trend growth as a reference for non-cyclical spending may be problematic if there are large variations in the inflation rate. The trend may then be subject to frequent changes that do not reflect changes in the underlying real growth trend. Additionally, there might be an incentive for governments to inflate, in order to get more fiscal leeway. We are grateful to Joerg Bibow and Andrea Terzi for pointing out this latter possibility to us. Therefore, one might also use the real GDP trend plus the ECB's target rate as a reference for the expenditure path. In order to simplify the exposition we refrain from doing so in the text. Nevertheless, we have included the real GDP trend plus the inflation target in Table 8.

¹³ It has been argued that expenditure paths imply a very specific concept of the desirable public spending ratio and that they therefore restrict national governments' room for manoeuvre (Buti et al. 2003a: 104). However, it should be pointed out that in the context of the concept presented here, first, the paths established are country-specific. Second, the path approach does actually allow for changes in the public spending-GDP-ratio. In this case, however, an increase in this ratio would have to be financed by additional taxation. A reduction in the public spending-GDP-ratio would be possible by lowering the expenditure path and taxation. Although this could have the effect of increasing the average restrictiveness of fiscal policy, the adjustment would nevertheless be smoothed out and the automatic stabilisers would be able to continue operating in a somewhat weakened fashion around the lower path.

is prevented. Fourth, there is real coordination of fiscal policies within the Euro area, preventing free rider behaviour. Pressure from the European level might also help to enforce counter-cyclical fiscal policy on the level of the individual countries. Fifth, under the current macroeconomic regime dominated by monetary policy, macro-economically sensible and hence ‘credible’ rules for fiscal policy might also induce the ECB to cooperate.

6.3 An adjusted expenditure path concept with a bit more discretion

How would the Euro area and its member countries have fared in the period 2001 to 2005 under the described expenditure path regime? As the concept relies completely on automatic stabilisers, one can use the results of the analysis of cyclical deficits from Table 5 as well as Figures 2 as a first approximation. If fiscal policy had been completely neutral, that would have meant a zero percentage point change in the cyclically adjusted budget deficits. Obviously, fiscal policy in Belgium, Spain, Austria, the Netherlands and Portugal could have been more expansive and hence less destabilising. As seen before, the latter three countries have been hurt particularly by the restrictive stance of their fiscal policies, and the latter two are also among the countries that were or still are subject to the excessive deficit procedure. On average all the other countries would have seen more restrictive fiscal policies under the expenditure path. For Greece this would have been desirable, because its fiscal policy was pro-cyclically expansive. For Italy, the same may be true, as the fiscal expansion occurred in 2001 when the output gap was still improving, so that fiscal policy would have been slightly less restrictive during the slowdown from 2002 to 2005. Ireland and Finland would have been forced to refrain from their more or less successful discretionary counter-cyclical fiscal policies, which would certainly have reduced their above average growth substantially. From these countries’ point of view, this would have been regrettable, but from the point of view of decreasing economic divergence within the Euro area, it would have been welcomed – under the condition, of course, that the average level of growth attained by the macroeconomic policy mix in the Euro area is appropriate. The more problematic cases seem to be France and Germany. In both countries the substantial discretionary counter-cyclical fiscal expansions in the first years after the slowdown, would not have been possible under the conditions of an expenditure path. On the other hand, these countries would not have been forced into restriction in later years. At first sight the expenditure path would have been an improvement for many countries, but not for all, particularly not for France and Germany, two of the countries most in trouble with their excessive deficits.

Table 8: Nominal growth rates of GDP, trend GDP, selected categories of government expenditures and total revenue for the Euro area countries and the USA, average 2001-2005 in percent

	USA	Euro area	Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	Portugal
Gross domestic product, value, market prices	4.9	3.5	1.7	3.3	3.5	7.4	3.1	3.6	3.2	8.1	9.0	3.4	3.6
GDP trend*	5.2	4.0	2.2	3.8	4.5	7.4	3.5	3.8	5.6	8.5	13.3	5.6	6.4
real GDP trend* plus target inflation rate	5.3	4.4	3.7	4.6	3.7	5.9	4.4	4.3	4.7	5.8	10.4	4.8	5.0
Government final consumption expenditure	7.0	4.2	1.2	4.3	4.9	8.4	2.5	5.0	5.6	6.6	12.1	5.6	5.4
Government fixed capital formation	5.0	3.5	-4.2	4.3	8.2	9.5	-2.9	2.5	6.1	3.1	11.2	4.0	-1.6
Subsidies	6.1	1.7	-4.0	7.9	1.9	5.1	3.5	2.6	-0.1	1.4	4.7	1.8	10.4
Gross government interest payments	-1.2	-1.4	-0.3	0.6	-1.7	-3.5	-1.0	-4.2	-6.7	-1.2	-2.1	-4.3	2.0
Social security benefits paid by government	7.3	4.0	2.5	3.8	4.4	7.0	4.0	4.7	4.2	9.4	14.8	3.7	8.7
Government total disbursements	6.3	3.7	1.4	4.1	4.0	7.1	2.2	3.6	4.4	6.1	11.5	5.3	5.4
Total receipts Government	2.9	2.9	0.2	3.4	2.9	7.9	2.2	3.5	2.3	6.2	8.3	3.8	4.3
Investment (percent GDP)	2.7	2.5	1.5	3.2	2.5	3.5	1.1	1.7	2.9	3.7	3.9	3.3	3.3

Notes: *GDP trend: 6 year moving average of annual growth rates.

Source: EU-Commission (2005).

However, this rather mixed evaluation changes considerably, if one takes a look not only at the development of structural deficits but also at the average growth rates of public expenditures and revenues (Table 8). If we take the growth rate of final government consumption as a proxy for non-cyclical expenditure, according to the expenditure path, final government consumption should grow in line with the nominal GDP trend (moving average of the growth rates of the past six years). The same applies for government investment and also subsidies. Government social benefits and interest payments may vary with cyclical fluctuations; the former can be expected to grow at a higher rate than nominal GDP trend during economic slowdowns and rising unemployment. In the absence of discretionary tax increases/tax cuts, public revenue should grow in line with actual nominal GDP.

For the Euro area as a whole and for most of the countries, especially for Germany, public revenues grew at a rate significantly lower than actual nominal GDP. This is a strong indication, that there have been substantial discretionary tax cuts in many countries (for Germany: Truger/Jacoby 2004, Truger 2004). At the same time, for some of these countries, especially again for Germany, non-cyclical government expenditure, and in fact also total expenditure grew at a significantly lower rate than nominal trend GDP. Also quite strikingly, for some countries the growth rate of social benefits has been lower than could be expected from the extent of the economic slump. Therefore, in some countries a more expansive fiscal policy would have been achieved through a shift in the expenditure-/revenue mix. Most

importantly, less tax cuts in favour of higher expenditure growth would have been more in accordance with the expenditure path concept and could have had a positive macroeconomic effect, because expenditure multipliers are substantially higher than tax multipliers. In addition, a shift between different revenue categories might also have been conducive to growth.

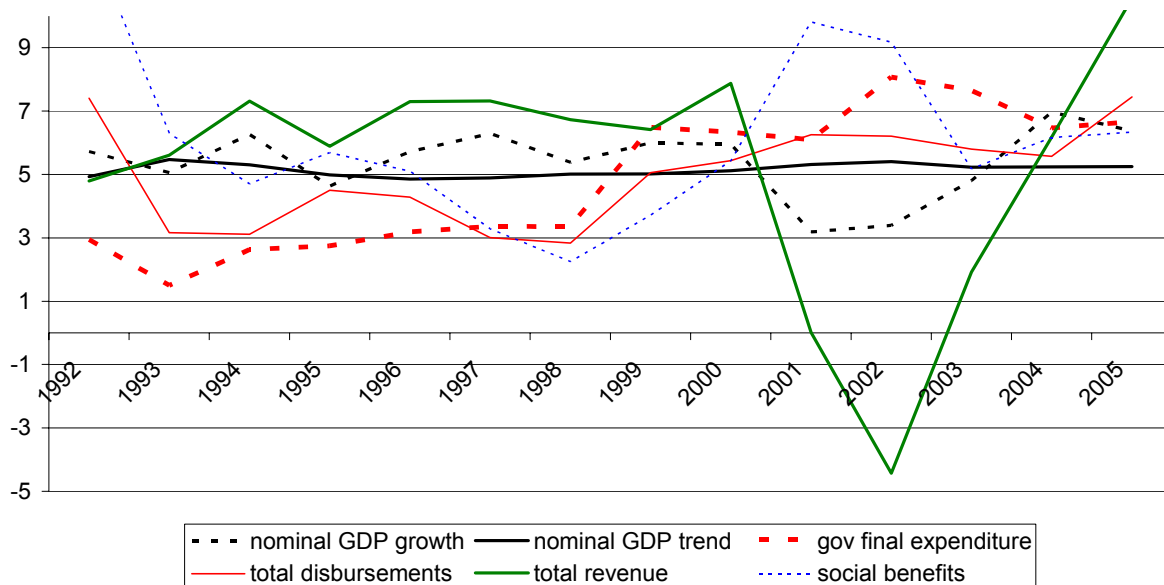
Nevertheless, under the conditions of an expenditure path the gain in terms of fiscal expansion relative to the status quo would certainly not have been very strong and it is doubtful, whether it would have been strong enough for a sustained economic recovery in the Euro area countries which were hit the hardest by the post-2000 slowdown. Even in the absence of reliable quantitative econometric results considerable doubts can be obtained by qualitative considerations. Taking the US economy as a benchmark, letting automatic stabilisers work would hardly have been sufficient for the Euro area to recover in a comparable way. As already demonstrated (Figure 3), US fiscal policy reacted in an aggressively discretionary counter-cyclical way against the slowdown, decreasing the CBR by more than 5 percentage points from 2000 to 2004.

Two objections may be raised. First, automatic stabilisers in the USA are usually estimated to be considerably lower than in most European welfare states, so that relying on automatic stabilisers might nevertheless be sufficient in Europe. Second, it is well known that the US government reacted to a large part with aggressive tax cuts to the post-2000 slowdown, which may be rather ineffective due to low multipliers. However, both objections cannot change the basic conclusion. First, with respect to automatic stabilisers, the overall fiscal policy reaction in the USA was much more aggressive than anything that could have been achieved by automatic stabilisers in any Euro area country: The actual deficit in the USA was increased by 6.6 percent of GDP from 2000 to 2003 in the face of a worsening of the output gap of 3.4 percent of GDP, i.e. an increase of almost two percentage points per percentage point of decrease in the output gap. However, the usual estimates for automatic stabilisers in many European countries are somewhat higher than 0.5 percent (see e.g. van den Noord 2000). Additionally, one must take into account that many of the labour market reform strategies advocated by the European commission would actually lead to a considerable weakening of automatic stabilisers in Europe (Mabbett/Schelkle 2005). Second, with respect to tax cuts, although the Bush tax cuts played a very substantial role in the fiscal expansion in the USA the expenditure side was also much more expansive than its Euro area counterpart, with a

growth rate of government final consumption substantially above nominal GDP trend growth (Table 8). Moreover, fiscal policy has been much more expansive in the USA even though the Fed's monetary policy was much more aggressive than the ECB's reluctant and restrictive monetary policy (Section 5). Moreover, the ECB's interest rate policy can only be oriented towards the economic situation in the Euro area as a whole. It cannot take into account the specific national economic circumstances of those countries which were hit especially by the post-2000-slowdown. Therefore, in the case of asymmetric shocks in a monetary union the case for discretionary national fiscal policy is on the agenda.

Therefore, the expenditure path concept has to be modified in order to allow for stronger fiscal expansion during economic slowdowns and recessions. As one measure, for example, public investment above the level implied by the expenditure path could be allowed for. Additionally, discretionary increases in social benefits, other expenditure categories or perhaps also certain tax cuts might be applicable. All such transgressions of the path should, of course, be coordinated on a European level. In order to reconcile such periods of more aggressively expansionary discretionary fiscal policies with the goal of fiscal sustainability, the expenditure path for non-cyclical spending would have to be slightly below nominal trend GDP growth during 'good times' in order to allow for sufficient consolidation.

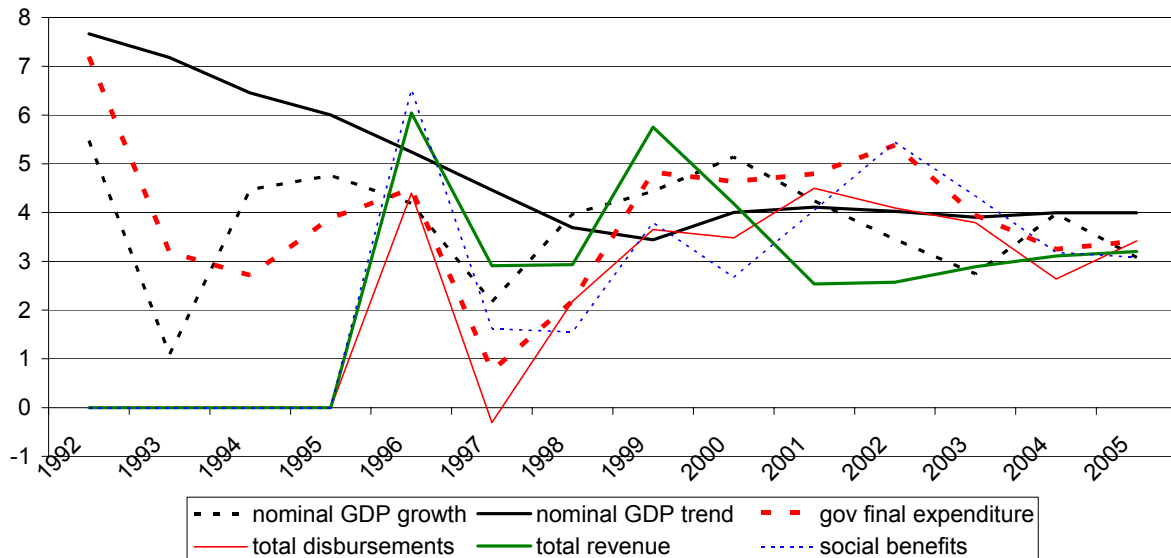
Figure 5: Nominal GDP, nominal trend GDP, government expenditure and revenue:
USA, 1992-2005, growth rates in %
 Source: EU-Commission (2005)



Actually, this seems to have been exactly the strategy US fiscal policy has chosen (Figure 5). In the USA, non-cyclical government expenditure grew at a rate of about 3 percent from 1992 until 1998, whereas the nominal GDP trend grew between 5 and 6 percent. During the persistent upswing with decreasing unemployment, the growth rate of social benefits declined. At the same time, tax revenues grew more than proportionately, as is to be expected in the absence of major tax cuts. The result was fiscal consolidation: By 1998 the government budget was in balance. After consolidation had been achieved, non-cyclical expenditure grew in line with nominal GDP trend until the slowdown in 2000/2001. Since then non-cyclical expenditure growth has been significantly accelerated. In addition, social benefits have been raised in a discretionary way and huge tax cuts have been implemented, thus exerting an enormous fiscal stimulus to the economy. Since 2004, well after the recovery had been achieved, tax revenues have been accelerating strongly again. At the same time the expansion of government expenditure has been decreased to a certain amount. It remains to be seen, whether fiscal policy in the USA will repeat its successful consolidation strategy of the 1990s. In striking contrast to the US experience, fiscal policy in the Euro area was much less systematic. (Figure 6) There is no systematic pattern in the development of government final consumption. Years with strong counter-cyclical restriction (1997) are followed by pro-cyclical expansion (1999 and 2000), which in turn is followed by pro-cyclical restriction since 2004. Revenue growth rates are subject to substantial variation which hints at intermittent hectic attempts of consolidation and stimulation. Therefore, Euro area fiscal policy could learn a lot from its US counterpart.

**Figure 6: Nominal GDP, trend GDP, government expenditure and revenue:
Euro area, 1992-2005, growth rates in %**

Source: EU-Commission (2005). Total disbursements 2000-2002 corrected for proceeds from UMTS auctions.



7. Can fiscal policy do the job under the current regime of monetary and wage policy?

Switching from the current SGP to a suitable concept based on expenditure paths would substantially improve fiscal policy's macroeconomic stabilisation role while at the same time not endangering the medium-term objective of fiscal sustainability. This result has been implicitly derived under the *ceteris paribus* assumption with respect to the other policy areas, monetary and wage policies. Unfortunately, however, it is highly probable that the advocated change in the fiscal policy regime would lead to reactions in the other areas. Under the current 'Maastricht regime' dominating the Euro area, these reactions might worsen macroeconomic performance. In the end, isolated changes in fiscal policy institutions might not be sufficient.

The switch to an adjusted expenditure path concept during the period from 2001 to 2005 would have meant a more expansive fiscal policy both for the Euro area as a whole and for most of the individual countries. It is questionable, whether the ECB would have tolerated such a policy. As it is a strong defender of the SGP in the strictest possible form, it might even be that fiscal policy has already entered the ECB's reaction function, so that it would have directly compensated a more expansive fiscal policy with a more restrictive monetary policy. Even in the absence of fiscal policy as an explicit argument in the ECB's reaction function under the current un-coordinated state of wage policy within the Euro area countries,

a stronger fiscal expansion would have certainly led to an increase in wage growth. Given the ECB's too ambitiously low inflation target, the ensuing inflationary tendencies or just the improvement in the output gap, would certainly have induced the ECB to raise interest rates, thereby worsening macroeconomic conditions all over the Euro area.¹⁴ As a side effect, government debt and interest payments would have further risen, limiting fiscal leeway in the future. Therefore, a thorough change in the framework of fiscal policies in the Euro area might require a similarly thorough change in the framework of monetary and wage policies to be effective in enhancing economic performance.

8. Conclusion

Since the start of the European Monetary Union fiscal policy in the Euro area has been dominated by the SGP. Quite obviously the SGP has been unsuccessful in fulfilling its goals, fiscal sustainability and supporting economic growth. More and more countries have exceeded the 3 percent of GDP limit for the budget deficit and the public debt-GDP ratios have been growing, while at the same time macroeconomic performance has been unsatisfactory. It has been shown that, whereas US fiscal policy has acted in a strongly counter-cyclical way, stabilising the economy, in the Euro area fiscal policy has been much more restrictive and has had pro-cyclical and therefore destabilising effects for many countries. It has also been shown, that one cannot put all the blame on fiscal policy: The ECB's restrictive monetary policy and divergent wage developments across the Euro area are at least as important as fiscal policy in the explanation of the Euro area's weak economic performance. As a possible solution for the future we have suggested to replace the SGP by expenditure paths for non-cyclical spending as coordination tool, and we have discussed an important modification of the concept. Expenditure paths could co-ordinate fiscal policies within the Euro area in a counter-cyclical way and at the same time ensure fiscal sustainability. As the comparison with US fiscal policy suggested, the expenditure path should be set at a rate below nominal trend GDP with variations above trend allowed during economic downturns. Replacing the SGP with such an expenditure path concept would substantially contribute to a better macroeconomic performance within the Euro area. Unfortunately, as long as monetary and wage policies remain un-coordinated and destabilising any isolated improvements in fiscal policy might not be very effective in

¹⁴ For a recent empirical estimation of the ECB's reaction function see Hein/Truger (2006b). Empirically there is no indication that the budget deficit has entered the ECB's reaction function, however both the output gap, and

enhancing economic performance. Therefore, the key to improving the Euro area economy is to establish a regime of coordinated macroeconomic policy including fiscal as well as monetary and wage policies.

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