24th October 1988

To: Dr. Baer

From: Dott. Borio
M. Van den Bergh

Co-ordination of fiscal policies in an European Monetary Union

Please find attached, as requested, a note on the need for, and possible forms of, fiscal policy co-ordination in an European Monetary Union.

Attachment

27th October 1988

Macro-co-ordination of fiscal policies within a European Monetary Union

Introduction

The following pages address the question of the need for and form of fiscal co-operation required in a monetary union. Section I lays out the general problem. Section II considers what clues can be gained from the experience of federal states, with particular reference to Germany and Canada. Section III assesses possible lessons for the European Community. Finally, some conclusions are drawn.

I. A priori arguments favouring greater fiscal co-ordination

A co-ordination problem exists whenever, taken in isolation, a country would tend to carry out policies without due regard to the costs/benefits that these may imply for others. Arguments in favour of heightened co-ordination of fiscal positions at national level in a monetary union must therefore be based on the following premises:

(a) that the incentives for misalignment of national policies are greater in a union than under present arrangements;

(b) that mechanisms for offsetting the effects of these policies at a supra-national (i.e. Community) level would be inadequate.

The note for discussion CSEMU/3/88 addresses these questions. There is little doubt that the likely size of the Community budget,[1] or indeed the functions that it might need to perform, would make it highly unsuitable either as a counter-cyclical tool or as a means of offsetting

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1. At present the EEC budget is only about 1% of EEC GDP.

any tendency towards financial indiscipline of national budgets ((b) above).[2] But this only indicates that if greater co-ordination is needed then it must somehow imply some form of constraint on national budget positions.

Whether such restrictions are needed at all depends on whether monetary union increases governments' incentives for policy misalignment ((a) above). The traditional arguments found in the literature emphasise the sizable spill-over effects associated with a common market (large income-expenditure leakages at regional level compared with those at national level). They are applicable to the extent that the union is viewed as encouraging greater economic integration. They suggest a contractionary, rather than expansionary, bias[3] and originate largely from a belief in fine-tuning. Greater co-ordination could clearly be rationalised along these lines. But except for those sentences referring to demand management the note for discussion CSEMU/3/88 does not appear to rely on this possible justification.

The main concern of that note (page 5) is that the balance of incentives/constraints of a monetary union favours financial indiscipline of national governments. This could endanger the overall fiscal/monetary policy mix of the Community. It is difficult to answer this question on a

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2. Indeed, size is only a necessary not a sufficient condition for either role. Without specific institutional safeguards there might be little guarantee that the Community budget would be financially prudent when national governments are not. Nor need it be capable of taking effective counter-cyclical policies.

3. Because each individual country (region) suffers from larger spill-over effects than the area as a whole, it has less of an incentive to expand. The argument assumes that perceived constraints on expansion are not relaxed, an issue discussed below. See e.g. P.R. Krugman, Economic Integration in Europe, Annex A to Efficiency, Stability and Equity (Padoa-Schioppa Report), EC, 1987, especially page A-19. But regardless of whether there is a contractionary or expansionary bias, the size of spill-over effects calls for greater co-ordination to calibrate policy.

priori grounds alone, nor have we been able to find any relevant theoretical economic literature.[4] Consequently, what follows considers the experience of the two federal states, Canada and Germany, which appear to provide some, albeit crude, parallels with possible conditions within a European Monetary Union.

II. The experience of the Federal States: Canada and Germany

In neither Canada nor Germany are there any statutory constraints on the expenditure levels of regional and local authorities (henceforth referred to simply as "regional") - provinces and municipalities in Canada and Länder (states) and Gemeinde (local governments) in Germany. In both countries there exist arrangements for revenue sharing and intra-government transfers - essentially from higher to lower levels of government. But regional authorities retain great autonomy in the sphere of taxation (both in the choice of tax base and rates) beyond the minimum requirements considered indispensable for the prevention of serious competitive distortions. This degree of autonomy in the expenditure and taxation spheres are considered inalienable principles of a federal state. Fiscal autonomy, of course, goes hand in hand with fiscal responsibility in the sense that the budgets of the individual regional authorities have to support the burden of interest payments of the regions' own debt (see below).[5]

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4. The traditional macro-economic analysis focuses on the use of fiscal and monetary policies as tools for attaining internal and external equilibrium in individual countries (states). The more recent game-theoretic literature considers similar issues but still on the assumption of potentially flexible and effective fiscal policies. The literature on fiscal federalism, on the other hand, focuses on the need for a minimum of fiscal policy harmonisation to avoid competitive distortions (standardisation of tax and social security contributions) and on mechanisms for horizontal and vertical income redistribution. See e.g. Report of the study group on the role of public finance in European integration, (McDougall Report), EC, 1977.

5. In Germany the Länder can all borrow at roughly the same conditions as the Federal Government. In Canada individual regional authorities' credit ratings differ significantly (from medium to the highest grade), at least judging from their international borrowing.

Beyond that, in Germany, in contrast to Canada, some efforts have been made to co-ordinate the budgetary policies of the various levels of government through the "Finanzplanungsrat". The body is composed of the Federal Minister of Finance (Chairman), the finance ministers of the various Länder and representatives of the Gemeinde. The Bundesbank regularly participates in the meetings. The body's recommendations, however, are not binding, given the major degree of autonomy of the government units.[6]

Given their large degree of autonomy, in neither Canada nor Germany are there any limits on regional entities' borrowing capacity. In Canada they are denied access to central bank credit. In Germany, these credit facilities are of minor significance. Similar restrictions apply to the federal government in both countries. Beyond these constraints, the Bank of Canada has no influence on the financing choices of the various levels of government, whereas in Germany the Bundesbank plays a consultative role through a variety of mechanisms. In neither country are there any restrictions on foreign currency borrowing, but only in Canada have the governments felt any need to resort to it. At the end of the 1983-84 fiscal year, for instance, some Can. $ 10 billion of the outstanding bonds and debentures of the provinces, or almost a quarter of the total, had been raised in foreign markets. About 60% of total foreign borrowing had been done in the United States.

Tables 1 and 2 provide key indicators of the relative size of the fiscal units in the two countries. In both countries expenditure by regional authorities exceeds federal expenditure. Its distribution among regions, however, is more concentrated in Canada than in Germany, with Ontario and Quebec accounting for about one-third of total (consolidated) government spending, or some 15% of GDP. Net lending positions tend to be more evenly distributed across regions, especially in Germany.

The experience in neither country would seem to suggest serious problems of long-run control over regional spending and deficits. Table 3 indicates no discernible tendency for either aggregate net lending or

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6. For the period 1985-87 the Finanzplanungsrat recommended to the various government units to keep the growth of spending at around 3%, i.e. below the growth of nominal income.

expenditure of regional authorities to grow over time. If anything, in both Canada and Germany aggregate net lending of the regions has shown a somewhat more restrained performance than its federal counterpart.[7] Expenditures exhibit a broadly similar pattern at the two government levels.

Consistently with this broad picture, in neither country have our preliminary enquiries revealed great concern about the co-ordination issue. This is not to say that episodes or periods of tension cannot be found. Recently, for instance, the federal authorities in Canada have not appreciated Ontario's spending spree associated with its booming regional economy, while western provinces, damaged by the oil price fall and agricultural difficulties, have been unable to cut expenditures in the face of the recession-induced decline in revenue. This pattern of events has partly thwarted efforts at fiscal consolidation.[8] Nor can it be denied that if counter-cyclical fiscal policy is attempted at all, then it is at the federal rather than regional level. There are sound theoretical arguments why that should be so. But the evidence does suggest that fears of serious fiscal co-ordination problems resulting from the financial indiscipline of regional units within a monetary union are not easily supported by the experience of federal states.

III. Possible co-ordination requirements in a EMU

While the above evidence is suggestive it is not immediately clear to what extent it can be used to make inferences about possible co-ordination problems in Europe. A possible objection could be that the size-distribution of national government units in the Community is unlikely to resemble that of either Canada or Germany. It would then be particularly difficult to compare the area-wide impact of financial indiscipline by individual government units. Table 4, however, indicates that the EEC and Canada are not that dissimilar in this respect.

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7. In Canada this does not seem to have been true in the 1960s, however.

8. See OECD Economic Surveys, Canada, 1988.

The size distribution of the national governments in the EEC also suggests that any co-ordination problem is likely to be largely circumscribed to the big four. Together they account for some 80% of EEC government spending and GDP. Taken individually, the relative size of the countries - which largely determines the area-wide impact of given changes in their fiscal positions - varies from some one-quarter (Germany) to one-sixth (the United Kingdom) of EEC GDP. The size of individual governments' expenditure - which largely determines the likely order of magnitude of any given change - varies from about 12% (Germany) to some 7% (the United Kingdom). The other countries follow at a considerable distance. At one extreme, the conceivable behaviour of Greece, Portugal and Ireland - either taken individually or as a group - can have little discernible impact on the macro-position of the Community as a whole. The present Community budget is indeed about the same size as Greece's GDP and some 40% larger than Ireland's.

Fears of independent fiscal behaviour by individual countries might prima facie suggest the need for certain uniform limits on maximum permissible budgetary positions. But from the co-ordination point of view it might be more meaningful to define a rule or constraint on one country's behaviour in relation to the costs (benefits) that its own action would imply for the <u>other</u> area members, not for itself. This could be the general criterion for determining whether rules are "equal" between countries. On this basis it is unclear whether significant restrictions need be imposed on countries like Greece, Ireland and Portugal. At the other extreme, the area effects of changes in large countries' policies, notably Italy, require greater attention.

Additional considerations suggest that fears of fiscal laxity may be exaggerated. The move to a monetary union may in fact increase constraints on fiscal expansion precisely in those countries with a track record in fiscal indiscipline. For it is exactly these countries which have had recourse to direct controls on financial domestic and international transactions to keep financing costs artificially low and who therefore

stand to lose most (e.g. Italy, Spain, Greece and Portugal).[9] To the extent that they are binding, the abolition of restrictions on residents' purchases of foreign assets would reduce the demand for domestic securities. More importantly, with the liberalisation of financial services in the Community the battery of controls which directly or indirectly increases the demand for government liabilities and/or reduces the return paid on them will need to be largely dismantled. Otherwise, quite apart from any legal obligations, the domestic financial industry, notably banks, would face serious cost disadvantages given increased competitive pressures.[10]

The above arguments and the preliminary evidence from federal states suggests that, from the viewpoint of longer-run constraints on financial laxity, there exists considerable room for flexibility in fiscal arrangements. Safeguards in the form of a strong commitment to an anti-inflation monetary stance may indeed be sufficient if buttressed by strict restrictions on access to central bank, and if so wished, on non-union currency borrowing.

If, however, further safeguards are deemed desirable, it is easier to say what form they should not take than to specify their precise characteristics. Firstly, they should not be defined in the form of common (identical) ceilings for all countries. Quite apart from the feasibility of finding a mutually acceptable ceiling that represented a binding constraint for the Community as a whole, it would not seem meaningful to do so on theoretical grounds. Secondly, to the extent that the present and prospective (i.e. on present declared policies) aggregate fiscal position of the Community does not appear to be markedly out of line with a proper long-run fiscal policy stance it might not be unwise to choose limits/rules ultimately consistent with medium-term objectives defined by the relevant national authorities. Thirdly, this implies that there need be no agreement on a common form of constraint (e.g. ceilings on expenditure-, net lending-

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9. The implicit tax levied through controls just on domestic financial holdings may be quite large. See, e.g. OECD Economic Survey, Spain, 1986.

10. Ibidem.

or debt-to-income ratios (Table 5), rules limiting debt financing to capital expenditures). What matters is only consistency with the long-run objective.

Conclusions

The argument that, contrary to the experience in federal states, a European Monetary Union would not have a centralised budget to correct the aggregate fiscal policy stance (for disciplinary or counter-cyclical reasons) is valid. Any correction could not be achieved without impinging on the freedom to determine national budgetary positions. From this, however, it does not follow that greater co-operation would be needed in the first place.

The need for stricter constraints on national budgets can be thought to derive from weakened constraints on financial indiscipline. However, a preliminary look at the experience of federal states does not suggest that fiscal indiscipline by regional authorities has posed serious long-run obstacles to a proper medium-term policy stance. This appears to have been so in the two countries considered, Canada and Germany, despite different size configurations of government units and commitments to long-run price stability. Furthermore, there are good reasons to believe that because of the elimination of direct controls on financial transactions implied by the move to an EMU, constraints on discipline are likely to become more stringent precisely for financially lax countries.

The need for closer co-operation could more readily be rationalised in terms of counter-cyclical/shorter-term demand management (see page 2). The larger size of intra-union cross-border spill-over effects in goods markets would be the main reason. However, it is unlikely that current perceptions of the proper role of monetary and fiscal policy would warrant agreement on this justification (at least among Committee members). It would be a step back towards the mechanistic view of the Werner Report. It would also imply rather different rules for national budgetary positions from those discussed by the Committee.

A third possibility could be to argue that the larger size of spill-overs in <u>financial</u> markets is <u>itself</u> a justification for some form of mutually-agreed constraint. The spill-over is seen as an unwelcome infringement of a country's autonomy: with the wedge afforded by changing

exchange rate expectations gone, any increase in interest rates and displacement of borrowing ("crowding out") resulting from an expansionary fiscal policy in any one country would be more forcefully transmitted to other Community members. This is clearly so whether the increase is deliberate or simply the result of inadequate control mechanisms. Countries may therefore wish to set some sort of limit on other members' fiscal position.[11] The quantitative significance of these spill-over effects in practice remains an open question.

The size distribution of countries within an EMU suggests that co-ordination problems would be largely circumscribed to the big four. Smaller countries, taken individually, should not give rise to concern in terms of their macro-impact on the union. Not even taking them as a group is it reasonable to expect major disturbances. This is especially so in the light of retrenchment programmes embarked upon because of purely domestic considerations. On the basis of their size alone, from the viewpoint of macro-co-ordination there would be no justification for insisting on major restrictions on their budgetary position.

Any proposed constraint on budgetary positions should preferably accommodate as far as possible differing national fiscal preferences thereby acting merely as a defence of last resort. It would also need to pay particular attention to large countries.

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11. Any larger spill-over effects in goods, as opposed to financial, markets need not be regarded as detrimental by other member countries. Unless they exacerbate excess demand conditions they would in fact be beneficial. They cannot thus justify asymmetric constraints, i.e. upper limits to fiscal positions.

Table 1

Fiscal indicators of regional authorities[1] in Canada, 1982

Province or territory	Expenditure[2]	Net lending[2]	Expenditure[2]	Net lending[2]
	in percentages of national GNP		in percentages of total	in percentages of own revenue[3]
Ontario	7.8	- 0.3	16.7	- 3.6
Quebec	7.4	- 0.1	15.8	- 0.8
Alberta	3.4	+ 0.5	7.2	+ 13.4
British Columbia	2.8	- 0.1	6.0	- 1.7
Saskatchewan	1.0	+ 0.0	2.2	+ 2.6
Manitoba	1.0	- 0.0	2.1	- 2.9
Nova Scotia	0.9	- 0.1	1.9	- 14.8
New Brunswick	0.6	- 0.1	1.3	- 11.1
Newfoundland	0.5	0.0	1.1	-
Prince Edward Island	0.1	0.0	0.3	-
Northwest Territories	0.1	0.0	0.3	-
Yukon	0.0	+ 0.0	0.0	-
Total[4]	25.6	- 0.2	54.9	
Federal Government[4]	21.0		45.1	

1 Provinces and Territories, including local authorities.

2 Estimates based on consolidation of expenditures and revenues of provincial and local authorities measured on an administrative basis. Calendar year for the provinces and fiscal year for the local authorities.

3 Including Federal Government transfers.

4 These figures are not comparable with those in Table 3 because they are estimates based on an administrative, rather than national accounts, basis. This problem distorts especially the revenue side, reducing the net borrowing requirements. The main item responsible is the inclusion of net revenue from pension schemes. On a National Account basis, aggregate regional net lending (including hospitals) was - 5.7 billion.

Source: Statistics Canada, Canada Yearbook 1988 and own estimates.

Table 2

Fiscal indicators of regional authorities[1] in Germany, 1987

Länder	Expenditure	Net lending	Expenditure	Net lending
	in percentages of national GNP		in percentages of total	in percentages of own revenue[2]
Nordrhein-Westfalen ...	4.5	- 0.3	14.3	- 7.6
Bayern	2.9	- 0.1	9.1	- 2.7
Baden-Würtemberg	2.6	- 0.1	8.3	- 4.0
Niedersachsen	1.9	- 0.2	6.0	- 9.4
Hessen	1.7	- 0.1	5.3	- 5.2
Berlin	1.1	- 0.05	3.4	- 2.3
Rheinland Pfalz	0.9	- 0.1	3.0	- 9.3
Schleswig-Holstein	0.7	- 0.1	2.2	- 0.9
Hamburg	0.6	- 0.1	2.0	-10.1
Saarland	0.3	- 0.05	1.0	-12.9
Bremen	0.3	- 0.05	0.9	-12.7
Total	17.2	- 1.1	55.0	- 6.5
Federal Government ...	13.1	- 1.4	43.0	-11.5

1 Länder and Gemeinde combined, excluding social security.

2 Including government transfers.

Source: Statistisches Bundesamt Wiesbaden, Finanz und Steuern, Fachserie 14, Reihe 2.

Table 3

Fiscal indicators of federal and regional[1] authorities in Germany and Canada, 1970-87

Country/Government level	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987
	in percentages of GNP									
Germany	Expenditure									
Federal, net[2]	11.2	13.0	12.5	13.1	13.4	12.9	12.6	12.2	11.8	11.7
Federal Transfers[3]	1.8	2.2	2.0	2.0	1.9	1.8	1.7	1.7	1.6	1.6
Regional	17.6	21.3	20.8	20.8	20.6	19.8	19.3	19.3	19.1	19.0
	Net lending									
Federal	+0.04	-3.2	-1.9	-2.5	-2.4	-1.9	-1.6	-1.2	-1.2	-1.4
Regional	- 1.3	-2.9	-1.9	-2.3	-2.0	-1.4	-1.0	-0.8	-1.0	-1.1
Canada	Expenditure									
Federal, net[2]	13.4	16.3	15.7	16.3	18.9	19.0	19.5	19.6	18.7	18.1
Federal Transfers[3]	3.8	4.5	4.1	4.0	4.2	4.3	4.5	4.5	4.1	4.1
Regional	21.4	23.1	23.8	24.0	26.4	26.7	25.8	25.9	25.8	25.4
	Net lending									
Federal	+0.2	-1.1	-3.5	-2.0	-5.4	-6.1	-6.8	-6.6	-4.9	-4.2
Regional	- 0.8	-1.4	-0.3	-0.3	-1.5	-1.5	-0.5	-1.0	-1.2	-0.7

1 For Germany, Länder and Gemeinde combined; for Canada, provincial and local government combined including hospital sector (i.e. the PLH sector).

2 Excluding transfers to Regional Authorities.

3 Transfers to Regional Authorities.

Source: Bundesministerium der Finanzen, Finanzberichte; IMF Staff Report for the 1988 Article IV Consultation for Canada.

Table 4

Government expenditure and net lending in the EEC, 1988[1]

Countries	Expenditure	Net lending	Expenditure	Net lending	Expenditure	National GDP
	in percentages of own GDP		in percentages of EEC GDP		in percentages of total EEC expenditure	in percentages of EEC GDP
Germany	47.1	- 2.0	12.4	- 0.5	25.3	26.3
France	51.3	- 2.3	10.2	- 0.5	21.4	19.9
Italy	50.3	-10.4	9.1	- 1.9	18.9	18.0
United Kingdom	41.7	- 2.0[2]	6.7	- 0.3	13.9	15.8
Spain	42.1	- 4.9	2.9	- 0.3	6.0	6.8
Netherlands ...	58.2	- 6.0	2.9	- 0.3	6.0	4.9
Belgium	52.4	- 6.1	1.6	- 0.2	3.3	3.3
Denmark	57.3	1.7	1.4	0.0	2.3	2.4
Greece	47.3	- 9.8	0.5	- 0.1	1.0	1.1
Portugal	41.7	- 7.8	0.3	- 0.1	0.8	0.8
Ireland	52.1	- 7.8	0.4	- 0.1	1.0	0.7
Luxembourg ...	51.2	3.1	0.1	0.0	0.0	0.1
EEC[3]	47.8	- 4.4	-	-	100.0	100.0

1 Based on estimates and forecasts made by the Economic Secretariat of the European Community.

2 The more recent figures for the United Kingdom (World Economic Outlook, June 1988) indicate a surplus of 0.4% of GDP. They are not significantly different from the above projections for the other three large countries.

3 The Community budget for 1988 was some ECU 40 billion. This is equivalent to 1.0% of EEC GDP.

Source: Economie Européenne, No. 34.

Table 5

Gross government debt in EEC countries

	1983 Debt	1988 Debt		
	% own GDP	% own GDP	% EEC GDP	% total EEC debt
Germany	40.9	45.2	11.9	19.3
France	30.7	40.3	8.0	13.0
Italy	72.1	97.9	17.6	28.6
United Kingdom	57.5	54.1	8.5	13.8
Spain	34.5	51.6	3.6	5.8
Netherlands	61.9	85.2	4.2	6.8
Belgium	105.1	128.4	4.2	6.8
Denmark	62.6	53.3	1.3	2.1
Greece	44.3	67.2	0.7	1.1
Portugal	56.2	78.5	0.6	1.0
Ireland	107.4	138.0	1.0	1.6
Luxembourg	14.6	14.8	0.0	0.0
EEC		61.6		100.0

Source: Economie Européene, No. 34