Coordination of Fiscal Policies: A Necessary Step toward a Fiscal Union

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The post-2007 economic crisis has illustrated the advantages and limitations of an active fiscal policy. The current difficulties in the euro area point to the failures of European governance, including the fiscal framework of the Stability and Growth Pact (SGP). The necessity of a fiscal rule is a consensus among economists. The first aim of the rule is to ensure credible and sustainable control of public finances. The second aim is to facilitate the relationship between governments and the Central Bank. The SGP is based on the existence of a public spending bias; deficits are not reduced in good times because governments tend to use fiscal policy in an exaggerated manner, making it difficult to achieve a balanced budget. The aim of the SGP is also to reduce negative externalities. A country in a monetary union may be tempted to use large deficits because the crowding-out effect is diluted in the euro area. The current context clearly indicates a failure of the Pact in these main objectives. Some European countries have taken advantage of good economic periods to finance fresh expenditure, rather than to consolidate their fiscal positions (Hauptmeier *et al.* 2011). The case of Greece demonstrates the existence of free-riding behaviour. Moreover, the political will to implement the excessive deficit procedure has failed, leading to the repeal of several procedures (France and Germany in 2003, Greece in 2007). The new reforms of the Pact tend to increase fiscal discipline and improve enforcement mechanisms. Balanced budgets and debt objectives are given more importance by requiring larger adjustments when ceilings are exceeded. The sanction process has been accelerated because the European Council can only prevent sanctions proposed by the Commission if a qualified majority votes against these sanctions. However, the principle of automatic sanctions has not been successful, which limits the effectiveness of the new pact.

The occurrence of a global crisis demonstrated the need for fiscal action at the European level, rather than only at the national level. Several studies support the case for a fiscal union in the euro area. There are various proposals for the design of this fiscal union: (i) an interregional fiscal transfer mechanism as insurance against asymmetric shocks (Dullien and Schwarzer 2005), (ii) an increase in the European budget to establish a horizontal fiscal equalization mechanism (Italianer and Vanheukelen 1993; Hammond and von Hagen 1998), and (iii) the introduction of Eurobonds backed by all member countries (De Grauwe and Moesen 2010; Favero and Missale 2011).

Although the propositions presented above are relevant, they face a major political deadlock. Therefore, European fiscal integration must be conducted following another path. Using the typology of Fuest (2011), we propose a further 'supervision and coordination' approach, focusing on the aspect of coordination. According to this approach, European governance is based on strong fiscal rules and the effective coordination of decentralized fiscal policies. This approach allows a trade-off between commitments based on a system of rules and the need for flexibility to respond to various economic shocks. The use of effective fiscal coordination is institutionally justified because it is compatible with the EU operational framework, it is theoretically justified because it implies higher welfare, and it is economically justified because it takes into account macroeconomic heterogeneities. The coordination of fiscal policies in a monetary union is multifaceted: it encompasses several situations and reactions. The implementation of effective coordination may lead to institutional change through the establishment of a permanent fiscal council.

The paper is organized as follows: the first section presents justifications for the use of fiscal coordination. The second section proposes a new analytical framework for coordination, and the third section discusses the role of a fiscal council. The final section offers some conclusions.

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Why should fiscal policies be effectively coordinated?

Coordination and welfare gains

The literature on this subject has shown the importance of coordinating fiscal policies. Some authors suggest that coordination is not useful because the SGP should be sufficient. Effective coordination implies discretionary behaviours that may be costly; these behaviours may be time consuming, cause time lags in decision making and implementation, and dilute national responsibility (Issing 2000). From this perspective, coordination does not necessarily enhance welfare in a monetary union (Beetsma and Bovenberg 1998; Beetsma *et al.* 2001; Dixit and Lambertini 2003).

In contrast, several studies have confirmed the advantage of effective coordination when governments consider externalities of other countries' actions (Engwerda *et al.* 2002; Uhlig 2003). Coordination is more advantageous when the scope is ambitious and coordination is not limited to surveillance of national policies (Ferré 2008). Fiscal coordination appears to be compatible with the SGP and may even enhance stabilization gains (Schalck 2006). Finally, it should be noted that gains from coordination are more important when governments internalize the objective of monetary policy and in the case of a conservative central banker (Cavallari and Di Gioacchino 2005; Acoccella *et al.* 2007).

Macroeconomic heterogeneities

Although the academic debate is not clear cut, a crucial, yet under used, advantage of fiscal coordination is the existence of macroeconomic heterogeneities, which reflect differences in economic structures and differences in macroeconomic key variables (GDP, prices, costs, international trade). In a heterogeneous monetary union, fiscal convergence through a fiscal rule can lead to a suboptimal situation involving measures that are partially or completely unsuited to the national situation, which may increase negative externalities, rather than reduce them. Conversely, effective coordination considers these differences and allows adjusted responses.

We can distinguish several macroeconomic heterogeneities; we will focus on three to support our argument. The first heterogeneity is the structure and the effect of national fiscal policies. Due to the subsidiarity principle, countries use fiscal policy for internal purposes that correspond to preferences for social protection and the provision of public goods. Hence, there are differences in fiscal variable reactions to economic cycles (Bouthevillain *et al.* 2001) and in fiscal multiplier values (Favero *et al*. 2011).

The second heterogeneity concerns the monetary policy. The ECB established monetary policy for the euro area as a whole based on an analysis of the average situation. However, the effects of monetary policy are asymmetric across countries (Angeloni *et al.* 2003; Affinito and Farabullini 2009), which can lead to unsuitable policies that are too restrictive for some countries and too lenient for others. The asymmetric effects can be explained by the characteristics of borrowers (including risk aversion, disposable income, and alternative funding sources) and the characteristics of banking systems (including concentration and balance sheet structure).

The third heterogeneity includes all national differences because it consists of the divergence of economic growth. We can easily see the persistence of non-synchronized business cycles, or 'rotating slumps', which weaken European economies through wage-price and real interest rate dynamics (Landmann 2011). Without a fiscal stabilization mechanism to limit the size of the national cyclical fluctuations, the euro area would be characterized by macroeconomic instability.

A new framework for fiscal coordination

Coordination of fiscal policies is often presented as a stabilization tool for supply or demand shocks through the minimization of a joint loss function by all governments. This view is restrictive because coordination can take many forms appropriate for different situations. Therefore, we propose a new framework based on two criteria: the origin of the shock relative to the monetary union (internal or external) and the shock's propagation (individual or common). The breakdown by the origin of the shock reflects differences in the action capability (room for the manoeuvre's amplitude, efficiency measures, role of institutions). The breakdown by propagation corresponds to a requirement of the viability of a monetary union because we must consider several economies. The combination of these two criteria leads to four possible situations in terms of coordination (Table 1).

Table 1

Types of coordination

	Individual shock	Common shock
External shock	Support	Effective coordination
Internal shock	Supervision	Cooperation

The support case corresponds to the reaction to an individual external shock. The aim is to limit the propagation of a negative shock within the monetary union or, conversely, to share a positive shock with other countries. For example, the support could manage speculative attacks on government bonds that lead to non-justified financial difficulties. This coordination could consist of temporary discretionary measures (guarantees, loans, and incentives to trade).

The supervision case corresponds to the reaction to an individual internal shock. It reflects the monitoring of fiscal policies to avoid pro-cyclical policies. The objective is to limit negative externalities and free riding. Greece's statistical revisions on the public deficit and the increase in public expenditure in good times are examples of supervision implementation. Supervision can be conducted through fiscal rules. From this perspective, the rule is seen as a passive approach to coordination.

Effective coordination is a reaction to an external common shock. The aim is to provide a comprehensive and coherent response to achieve greater stabilization, thereby preventing national differences that induce significant tensions within the monetary union and undermine its viability. The establishment of the European recovery plan in 2008 is a good example of overall effective coordination. Conversely, the lack of cooperative behaviour may lead to the development of sub-groups of countries that are in similar situations, but have different needs (e.g. GIPS versus core countries). The European leaders' difficulties in coming to an agreement on the case of Greece demonstrate the dangers of a monetary union without a coordination mechanism.

The last case is cooperation, which is the reaction to an internal common shock. In such cases, aggressive competition among states to promote their economies is less profitable because the situation is a zero-sum game: gains made by the competition may be reduced by externalities from the economic degradation of other economies. Cooperation is a way to limit the adverse effects associated with fiscal competition.

The role of a European fiscal council

The coordination of fiscal policies as presented above does not require an institutional change; coordination can be accomplished within the European Council with the assistance of the Commission. However, coordination is more effective if it is conducted by a permanent fiscal council. The fiscal council is often presented in literature on this topic as an enforcement tool for fiscal rules or an independent fiscal watchdog (Calmfors 2010). This role can be extended. The appropriate response to a shock may evolve over time, implying a transition from one type of coordination to another. This transition may be costly in terms of delays in decision making and action. The fiscal council may significantly reduce these costs through forecasting exercises, as well as *via* the evaluation of *ex ante* and *ex post* fiscal measures. The question that remains is the selection of its members.

Conclusion

The recent economic and financial crisis has demonstrated the weakness of current European governance and revived the debate on the fiscal union. Given the operational framework and preferences of policy makers, this union should initially be made through fiscal policy coordination. This mechanism would take into account national differences and increase welfare in the euro area. This paper shows that there are several forms of coordination that contribute to a flexible stabilization mechanism, which is more effective if it is connected to a European fiscal council. National governments must delegate more responsibility at the European level, an idea which they have found difficult to accept to date. This nevertheless constitutes a logical and desirable approach to economic and political integration in a monetary union.

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