DOI: 10.1007/s10272-006-0175-6

W. J. M. Heijman*

The Need for a European Fiscal Policy

In the debate about the Stability and Growth Pact the focus is mainly on the stability part of the Pact. However, in many European economies, economic growth is a far more important issue. How can economic growth be stimulated by a coordinated European fiscal policy?

Much has been said about the Stability and Growth Pact (SGP) and its proposed changes since it was installed. The comments focus mainly on flexibility of the rules, how to tackle misbehaviour and how to secure a non-partisan implementation of the rules.[1] Further, there is fear that making the SGP rules less strict would mean higher inflation rates, higher interest rates, and a weaker euro.[2] What is missing in these comments are the possible effects on the European economies of a coordinated fiscal policy. Such a policy might result in much smaller national public deficits than might be expected from the non-coordinated expansion of public expenditure.

The reason for an increase of public expenditure is clear. The European economy has been stagnant for some time now. In some EU countries there has even been talk of a shrinking economy, with all its consequences for job opportunities and government finances. For many experts, the recipe for recovery is to be found in the United States, where the government boosts the economy by reducing taxes and increasing military spending. Further, the world economy is stimulated by China's runaway economic growth. Europe has too little to set against these examples. If it is to speed up recovery, Europe too needs an active fiscal policy. In this article we sketch the possible effects of such a policy, with the help of an input-output model.

For a long time, the Dutch government has chosen to keep its projected budget deficit to a minimum by means of cuts. There are not too many alternatives for a small European country like the Netherlands. An anti-cyclical fiscal policy, in which the reduction in private investment is balanced by an increase in public spending or a reduction in taxes, is not an option because the open character of the economy allows a large proportion of the benefits to flow abroad, leading ultimately to an increase in the budget deficit.[3] Only a concerted effort by all the euro countries together can provide relief.

Since the introduction of the euro, the euro countries have opted for a number of stabilising measures with the aim of limiting inflation and maintaining the value of the euro in relation to other important currencies like the American dollar. The most significant of these is undoubtedly the rule that the government budget of all EU countries should be kept in balance. We have seen that these stabilisation measures have worked so well that the euro has become a strong currency. However, one of the effects of this is that while import costs of goods from outside Europe have gone down, export costs have gone up. A strong euro has not, therefore, contributed to economic recovery. Furthermore, the stabilisation treaty has made national fiscal policy measures (like increased spending budgets and tax reductions) dysfunctional, without replacing them with a coordinated European fiscal policy. We

* Professor of Regional Economics, Department of Social Sciences, Wageningen University, The Netherlands.

[1] See for example S. C. W. Eijffinger: Reform of the Stability and Growth Pact: Evaluating the European Commission's Communication of September 2004, in: INTERECONOMICS, Vol. 40, No. 1, 2005, pp. 10-13; D. Gros: Reforming the Stability Pact, in: INTERECONOMICS, Vol. 40, No. 1, 2005, pp. 14-17.

[2] C. Hefeker: Will a Revised Stability Pact Improve Fiscal Policy in Europe?, in: INTERECONOMICS, Vol. 40, No. 1, 2005, pp. 17-21.

[3] D. Shaviro: Do Deficits Matter?, University of Chicago Press 1997.

Table 1
Effects of a 5% Increase in Government Spending in The Netherlands

	Calculated public financial result 2001[1] (% of GNP)[2]	Public financial result 2001 (% of GNP)	Change in GNP 2001 (%)	Change in trade balance 2001 after increase in public spending (% of GNP)
France	-1.08	-1.10	0.04	0.017
Netherlands	-0.94	0.08	2.21	-1.016
Germany	-2.09	-2.11	0.07	0.024
Italy	-1.69	-1.70	0.03	0.011
UK	0.78	0.76	0.06	0.022
Ireland	3.38	3.36	0.10	0.024
Denmark	2.24	2.22	0.05	0.022
Greece	0.00	0.00	0.01	0.004
Portugal	-3.45	-3.47	0.04	0.017
Spain	2.45	2.43	0.04	0.013
Belgium	0.30	0.23	0.19	0.072
Luxembourg	6.75	6.71	0.08	0.038
Sweden	3.76	3.74	0.05	0.024
Finland	3.93	3.91	0.05	0.019
Austria	0.01	0.00	0.04	0.015

[1] By public financial result is meant government income minus government expenditure. A minus sign in the first two columns of Tables 1, 2 and 3 therefore indicates a public deficit.

[2] The GNP amounts are taken from the Eurostat yearbook 2003, The statistical guide to Europe, data 1991-2001.

Table 2
Effects of a 5% Increase in Government Spending in Germany

	Calculated public financial result 2001 (% of GNP)	Public financial result 2001 (% of GNP)	Change in GNP 2001 (%)	Change trade balance 2001 after increase in public spending (% of GNP)
France	-1.02	-1.10	0.19	0.077
Netherlands	0.28	0.08	0.54	0.201
Germany	-2.78	-2.11	3.11	-0.668
Italy	-1.64	-1.70	0.17	0.065
UK	0.81	0.76	0.17	0.056
Ireland	3.44	3.36	0.37	0.088
Denmark	2.34	2.22	0.27	0.116
Greece	0.02	0.00	0.06	0.024
Portugal	-3.38	-3.47	0.24	0.091
Spain	2.49	2.43	0.17	0.057
Belgium	0.40	0.23	0.45	0.172
Luxembourg	6.94	6.71	0.52	0.228
Sweden	3.81	3.74	0.17	0.074
Finland	3.99	3.91	0.20	0.078
Austria	0.18	0.00	0.45	0.178

can safely assert that the only remaining form of European macro-economic policy is monetary policy.

The monetary policy in European countries is decided by the European Central Bank in Frankfurt. This institution has within its brief two important and interconnected tasks: (1) limiting inflation, and (2) stabilising the euro. We can confirm that the European Central Bank is successful in these tasks: inflation is low and the euro is a stable currency. In contrast to the Federal Reserve Bank the European Central Bank is not responsible for economic growth and the related development of employment opportunities.[4] In Europe this is still entirely a matter for national governments, whose hands are tied by the stabilisation treaty. It would therefore be a good idea to reformulate the role of the European Central Bank in line with the American model.

Projected Effects of a Dutch Government Budget Increase

The model describes the internal and external trade relations of the fifteen EU countries.[5] The economies of these countries are interdependent, on account of internal trade between them.[6] A rise in government spending in one country affects not only its own national economy but also that of other member countries, due to the "trickle down effect".[7] In a small, open economy, such as that of the Netherlands, this is considerable, which means that a stimulating fiscal policy launched by the Dutch government alone has little impact on the size of the national economy but a big impact on the budget deficit. This is illustrated in Table 1. A change in government spending of 5% leads to a rise in GNP of 2.2%.[8] This is in line with a multiplier effect of only 1.19 (the change in GNP divided by the total amount of the increase of public spending).

This would have turned the small financial surplus of 2001 into a financial deficit of almost 1% of the national income, which is in fact well within the maximum permitted deficit of 3%.

When drawing comparisons with the countries around us, it is striking that Belgium and Ireland, with

[4] F. S. Mishkin: The Economics of Money, Banking and Financial Markets, Pearson Education 2001.

[5] The countries that joined on 1 May 2004 are not included. Furthermore, not all EU members at the time, most noteworthy the UK, had the euro as their currency.

[6] Internal trade figures are from the Eurostat Datashop in Voorburg (the Netherlands).

[7] A. R. Hoen: An Input-Output Analysis of European Integration, Capelle aan den Ijssel 1999, Labyrint Publication.

[8] By economic growth, in this article, we mean the increase in GNP relative to the GNP of 2001.

Table 3
Effects of a 5% Increase in Government Spending by all EU Member States at once

	Calculated public financial result 2001 (% of GNP)	Public financial result 2001 (% of GNP)	Change in GNP 2001 (%)	Change in trade balance 2001 after increase in public spending (% of GNP)
France	-1.42	-1.10	4.19	-0.321
Netherlands	-0.29	0.08	3.96	-0.373
Germany	-2.49	-2.11	3.93	-0.377
Italy	-2.02	-1.70	4.12	-0.317
UK	0.47	0.76	4.12	-0.287
Ireland	2.95	3.36	3.24	-0.410
Denmark	1.86	2.22	4.12	-0.365
Greece	-0.19	0.00	4.48	-0.191
Portugal	-3.67	-3.47	4.44	-0.205
Spain	2.21	2.43	4.31	-0.225
Belgium	-0.21	0.23	3.78	-0.446
Luxembourg	6.35	6.71	4.14	-0.366
Sweden	3.28	3.74	3.92	-0.456
Finland	3.47	3.91	3.81	-0.441
Austria	-0.41	0.00	3.95	-0.405

their respective economic growth levels of 0.19% and 0.10%, would stand to gain the most from this.

Effects of a German Government Budget Increase

In this scenario, the country with the highest national income increases its budget by 5%. It can be seen in Table 2 that Germany, with a rise in GNP of 3%, would benefit more from its own increase than the Netherlands would. Germany's economy is more closed than that of the Netherlands, where increasing government spending by 5% would only boost economic growth by 2.2%. The multiplier for Germany is 1.71, compared to 1.19 for the Netherlands.

The striking difference between these scenarios is that while the German budget deficit would grow by 0.7% as a result of a budget increase, the Dutch deficit would grow by 1%. This is undoubtedly linked to the greater openness of the Dutch economy, and the consequent, relatively small, scale of the multiplier.

In comparison with other countries, where the income would increase by a few tenths of one percent, the Netherlands, with a growth of 0.54%, would benefit the most from the German initiative. Equally, of all these countries, the Netherlands suffers more negative consequences from the current stagnation of the German economy.

Effects of an Increase in Government Spending by All EU Member Countries

What would happen if all the EU member states increased their government spending by 5%? The prediction is that the budget deficit would not increase dramatically.

In Table 3 we can see the calculated effects of a joint spending increase on national income, the budget deficit and the trade balance of the EU member states. GNP would go up by between 3.24% (Ireland) and 4.48% (Greece). In no single country would a joint initiative boost the economy by more than 5%. The reason for this is that demand within the EU would go up, while the demand for EU products in the rest of the world is assumed to remain constant. Therefore, incomes from exports to countries outside the EU would not change, which puts a break on economic growth in member countries.

As far as budget deficits are concerned, the following points are noteworthy. In comparison with 2001, deficits would go up and surpluses would go down, although by smaller amounts than those that would result from unilateral spending increases by individual governments. For the Netherlands for example, a unilateral increase would create a deficit of 0.94%, while a joint one would create a deficit of only 0.29%. In Germany, the figures are 2.78% for a unilateral increase and 2.49% for a joint one.

A joint increase in spending would worsen the trade balance in all the member states. The degree to which this would happen would depend on the level of the marginal import quota. The projected increase in the trade balance deficit after a joint spending increase ranges from 0.23% (Spain) to 0.46% (Sweden) of the GNP. This is because exports to countries outside the EU are assumed to be constant, while imports from these countries depend on the incomes of the member states. In this case, economic growth throughout the EU would automatically worsen the trade balance of member countries.

In Table 4, the multipliers and the economic growth of EU countries are compared.

The multiplier shows the rate of increase in income per extra euro spent. This clearly differs per country. A country with a fairly open economy has a low multiplier if it implements a policy of stimulation. A country with a relatively closed economy, on the other hand, has a high multiplier. The size of a country's multiplier in a joint policy of stimulation depends on trade relations

Table 4
Multiplier Effect and Income Growth

	Multiplier for countries separately	Multiplier for a joint policy	Growth of GNP for a unilateral policy (%)	Growth of GNP for a joint policy (%)
France	1.67	2.03	3.45	4.19
Netherlands	1.19	2.13	2.22	3.96
Germany	1.71	2.15	3.11	3.93
Italy	1.83	2.20	3.44	4.12
UK	2.03	2.42	3.45	4.12
Ireland	1.21	2.70	1.46	3.24
Denmark	1.47	1.92	3.15	4.12
Greece	2.21	2.34	4.22	4.48
Portugal	1.77	2.32	3.39	4.44
Spain	1.97	2.53	3.37	4.31
Belgium	0.99	2.00	1.88	3.78
Luxembourg	1.00	1.86	2.23	4.14
Sweden	1.42	1.79	3.11	3.92
Finland	1.52	1.98	2.92	3.81
Austria	1.47	1.97	2.93	3.95

with other EU member states. Ireland, for instance, has a fairly low multiplier (1.21) in a unilateral increase in government spending, whereas its intensive trade relations with other EU states lead to a very high multiplier (2.70) in the scenario of a joint increase. The Netherlands has quite an open economy (an individual multiplier of 1.19), but because a high proportion of its exports go outside the EU, the multiplier in the scenario of a joint EU stimulation policy is lower than that of Ireland (2.13).

In terms of economic growth, Ireland would benefit least from either the unilateral increase or the joint EU-wide increase. This shows that a high multiplier does not always mean a high economic growth rate. Since the increase is represented by a percentage of overall government spending, a relatively small government sector would entail a small increase, which in turn would limit the impact of the increase on the economy.

Discussion and Conclusion

The input-output model has, of course, its limitations and these include a lack of attention to dynamic or supply-driven factors. Further, it is well known that a Keynesian spending policy has a short-term effect only. To restore the European economy in the long run a number of painful measures will have to be taken in other areas of the economy. For example, the labour market is in great need of reform in order to make it more flexible. However, to make that work an impulse on the demand side of the economy will certainly contribute to the success of the proposed restructuring of the labour market. With a view to the reservations made, the results of the model calculations should be treated with a certain amount of caution.

However, what is more important is the philosophy behind the model. Because there is no question of a common fiscal policy in the EU, each EU country faces a “prisoner’s dilemma”, whereby it seems to be in each country’s interests not to stimulate the economy, with the net result of a less than optimal European economic situation characterised by low economic growth and rising unemployment. The results of the model calculations show that a joint fiscal policy could really provide part of the solution to the current economic malaise.

The current economic situation in Europe is not very hopeful. The objectives of the European Central Bank are being reached, but this does not seem to be the key issue at the moment. It is much more important to stimulate job creation in Europe. Unfortunately, the dominance of monetary aims, the attendant (reformed) stabilisation pact and the absence of a coordinated fiscal policy mean that the euro countries do not have the option of the kind of anti-cyclical budget policy that is implemented in the USA by means of planned tax reductions and increased government spending.

Not even the largest member states, France and Germany, would be able to revive the European economy single-handedly. Both the European and the global economy have thus become dependent on economic growth in the USA and in emerging economies such as China and India. If this is insufficient, the feeble growth of the European economy will turn into a recession, bringing rising unemployment in its wake.

It is therefore imperative that, together with supply-side measures, the euro countries develop a coordinated fiscal policy. If the European and global economy is to be stimulated, European governments must jointly implement a shrewd package of stimulation measures, geared not only to spending effects – important as these may be – but also to the long-term effects on, for example, the European knowledge economy. Like this, it cuts both ways. A joint initiative can limit the consequences for the national budget, even to the extent that the current stability requirements can be met.