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Fiscal Consolidation and Macroeconomic Stability
in Europe

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1. Introduction - The Decision for a Common Currency

At the beginning of May 1998, the Council of the European Union decided upon the constituent memberships in the European Monetary Union (EMU). Based on Article 121 of the Amsterdam Treaty and taking into account the convergence report by the European Monetary Institute (EMI) and the European Commission, it was stated

that eleven Member States of the European Union - Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Spain and Portugal - fulfilled the preconditions for the adoption of a single currency according to the EC Treaty andthat consequently, the EURO was to be introduced in these countries on January 1, 1999. While the report stated for Greece and Sweden that the requirements for the introduction of the EURO were not yet met, the Council renounced at evaluating economic convergence for Denmark and the United Kingdom, as these two countries had previously notified that they did not intend to participate in stage Three of Economic and Monetary Union.

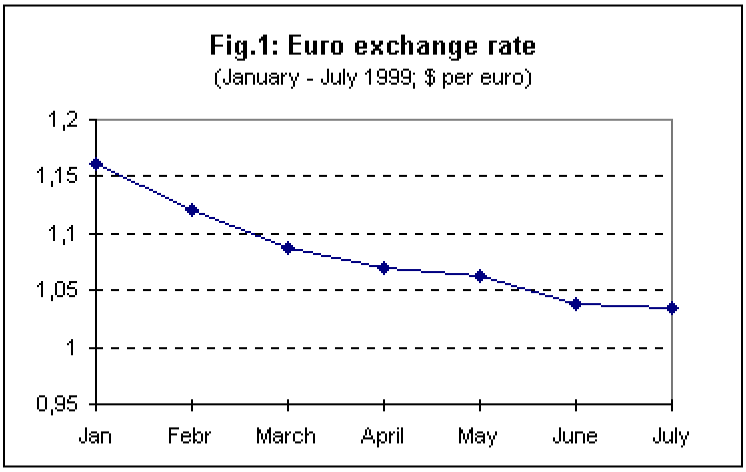
2. External Stability

The once heated debate among scientists and politicians about the introduction of the EURO has considerably cooled down *in the meantime*. This does not only stem from the fact that the new currency has become an irrevocable reality but also from its first *practical tests* in an international economic environment that has increasingly been shaken by financial crises.

There are some concrete indications for the latter. Last year's global economic activity had markedly diminished in the course of last year. The Asian crisis had grown and spilled-over into Russia and Brazil. The recent turmoil of international financial markets entailed significant exchange-rate volatilities. Many stock exchanges witnessed severe drops in share values. All this sparked insecurity and gave way to the concern of a global economic recession. As one of the largest economic areas in the world the EURO-currency area has proven to be a stabilizing element for the global economy in these unsecure times.

It may not, of course, be neglected that the EURO has lost over 10 percent of its value against the US Dollar since its launching at the beginning of this year (cf. Fig.

1). Nevertheless this development should not be assigned to the weakness of the EURO but is rather the result of the of the US Dollar's strength, due to a long lasting and ongoing economic upturn in the United States, which takes place at moderate price increases and at low unemployment figures, even if, on the other hand, the current-account deficit of the United States is continually rising.

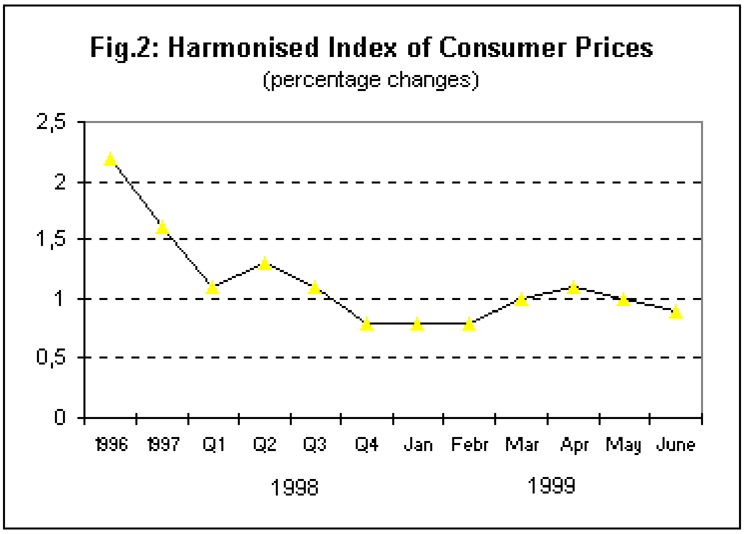


Source: European Central Bank, Monthly Bulletins

Anyway, in the newly created currency area, the concern for the exchange rate vis-a-vis the Dollar has lost some of its meaning as compared to concerns about former exchange rate volatilities among single member currencies. With the introduction of the EURO most of the foremost external trade was turned into internal trade. Far more than half of EMU-Member States's exports remain within the EURO-currency area, only a tiny share is exported outside this area.

3. Internal Stability

Turning to the other side of currency stability, i.e. internal stability, a very favorable picture emerges at the moment - at least at a superficial level of investigation. An almost complete price stability prevails. Based upon the Harmonised Index of Consumer Prices (HICP), the yearly inflation rate within the EURO-currency area remains below one percent (cf. Fig. 2).

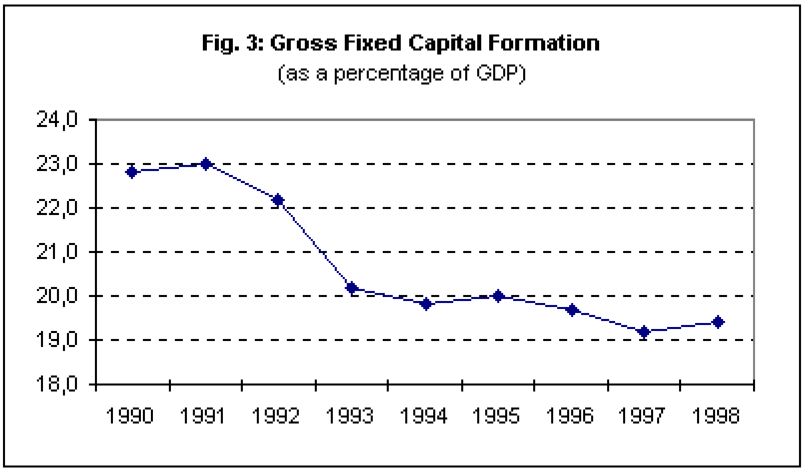


Source: European Central Bank, Monthly Bulletins

The decrease in inflation rates during the last years has inspired some commentators of economic policy to issue warnings against the dangers of deflation. This debate might give rise to a misconception as it obviously has a negative connotation. There are certainly few objections to price stability and it is always to the consumer’s advantage if there is not only a decrease in the rate of inflation but also in the price level itself. But apparently, the fear for a reduction of the price level results from the broader assumption that it would harm economic development or that the resulting demand gaps would prevent a self-supporting and forceful growth of production and employment. Accordingly, it is concluded that the task of economic policy should rest in stabilizing the economy either by means of a reduction of official interest rates or by filling demand gaps through fiscal policy measures.

First, it should be noted that there is no reason to speak of a decline in total demand. "Growing 3.0 percent, real GDP in the EURO-currency area increased markedly in comparison to the previous year, despite a deterioration of the international economic environment. ... The growth rate realized in 1998 was the highest since 1990. It was accompanied by a growth in employment and - for the first time since 1995 - a decline of unemployment". The dilemma lies in the fact

that investment quotas in Europe are declining in the long term, despite the slowly beginning economic upswing since 1995 andthat growth rates are not sufficient to solve one the most pressing economic problems, i.e. a reduction of the high rate of unemployment.
The GDP share of investments in the euro area has in fact declined significantly since the beginning of the nineties from its peak value of 23 percent down to about 19 percent in 1998 (cf. Fig. 3). Moreover, a renewed slowdown of growth rates towards 2 to 2.5 percent is shaping up for 1999. But this figure is exactly the growth limit at which hardly any positive employment effects are to be expected.



Source: European Central Bank, Monthly Bulletins

Empirical data show a clear correlation between the lack of investment as the decisive factor for the growth of production potential and the lack of jobs. From 1990 to 1998, when the rate of investment declined by about 4 percentag points, as indicated in fig. 3, the number of unemployed persons in the euro area has been rising by about 40 percent. In 1990 about 10 million people were unemployed. In December 1998 this number had grown up to 14 million persons, which comes up to more than 10 percent of the working force living in this area. This comparison highlights the fact that overall trends in European unemployment primarily reflect structural problems which cannot be overcome by countercyclical fiscal policy measures alone. Long-term problems may only be solved by means of long-term concepts. This brings up the question for the right way to enforce stability and full employment, i.e. the question of what there is to do and who is supposed to do it.

4. The Role of Monetary Policy

In recent debates on economic policy it has been stressed - especially from the German point of view - that the central bank and the government could improve the condititions for growth and employment by means of setting low interest rates and by fostering private consumption. In its annual economic report the German government has accordingly expressed its explicit wish that monetary policy should provide a stronger impulse to economic growth. At the same time, the government has reinforced its intention to assign a higher priority to demand management as a part of its fiscal-policy goals in the future.

The idea that monetary policy could provide a stimulus for economic growth, rests on a seemingly plausible reasoning:

on the one hand it is hoped that a reduction of official interest rates would unleash private investment activity, either because the costs of loan-financed investment decrease or because of the fact that with lower interest rates, financial investments seem to be less attractive than investments in real capital goods;on the other hand trust is laid in the fact that interest rate reductions lead to a depreciation of the domestic currency thereby causing a downward movement in export prices which could enhances the competitive stance of the economy.

The exchange rate argument is too short-sighted. A central bank using monetary policy in order to devalue the currency will endanger domestic price stability. In a devaluation strategy the central bank would have to buy foreign currency in exhange for local money. This leads to a rise in domestic money supply, thus increasing inflationary dangers in two respects. Fueled by the enlargement of the monetary base, import prices would rise due to the now more expensive foreign currencies. Moreover, it cannot be ruled out that the devaluation strategy of a big currency area might incite competing countries to react in the same way, thus triggering a depreciation spiral. Although some short-term benefits might exist for single countries, such a behavior would lead to considerable disadvantages for all countries in the long run.

A policy of cheap money designed to foster private investment is built on sandy grounds. If at all, this instrument is merely suited to complement a balanced wage policy and fiscal policy. It cannot, however, deliver a growth impulse strong enough to overcome either the long-lasting weakness of investment or high unemployment. It is of course self-evident that a central bank has to tailor money supply to the market in a way that development opportunities of an economy are not limited from the financing side.

For this reason, the European Central Bank grounds its annual target corridor for money growth on certain assumptions for the medium-term development of real GDP, not on the actual development of current GDP. This approach adds some countercyclical characteristics to monetary policy right from the beginning, since money supply in principle follows the trend of GDP growth, even if actual growth rates temporarily deviate from this trend or in case of cyclical growth volatilities due to an underutilization of production capacities.

Not much more may be expected from monetary policy, especially not that short-term official interest rates set by the central bank have any significant influence on long-term investment behavior. As formulated very adequately by Karl Schiller (the finance minister of the "Grand Coalition", 1966), monetary policy is only capable of leading the horses to the waterhole, but they will have to guzzle all by themselves. But even in setting short-term rates, the central bank has to proceed carefully, as the effects of this policy will materialize completely only with long lags of about one or two years.

Using Schiller’s analogy, if monetary policy fills too much water in the trough today in order to accomodate demands for a support of private investment it may not simply drain it once inflationary tensions arise in a consecutive economic upswing. Any attempt to smooth growth rates by means of a countercyclical monetary policy, includes the danger of a reinforcement of business cycle fluctuations. These would then force the central bank to tighten the reigns even more than would have been necessary under a balanced, medium-term oriented monetary "policy of a calm hand".

In any way only a minor influence of monetary policy on investment decisions via the interest rate channel may be supposed. More important factors for investment are market development, labor costs, tax levels and other cost- and revenue considerations. This argument is supported by empirical data of the last years. At the beginning of this decade, real interest rates in the EURO-currency area stood at a level between 6 and 7 percent. With some very short interruptions, they have then declined steadily and have today reached a historically low level of hardly above 3 percent. Investment has by no means increased simultanously during that time. As was already mentioned before, the investment quota has instead declined significantly.

If we therefore draw the conclusion that monetary policy can neither serve as a "deus exmachina" of a countercyclical fiscal policy nor a solution to structural economic problems it still maintains an important function. Whenever it is successful in safeguarding price stability, it will strengthen accountability, credibility and reliability of economic policy, thereby contributing to smooth economic growth and full employment.

5. **The Role of Fiscal Policy**

At any time, monetary policy has to be aware of additional inflationary pressures resulting from factors other than monetary supply. This is especially important if monetary policy strives to be succesful in assessing opportunities for real economic development correctly and to adapt monetary supply accordingly. For this reason, monetary policy often has the ungrateful task to either refute exgagerated expectations into the capabilities of its policy or to be obliged to discipline other economic policy actors.

Conflicting Goals of Monetary and Fiscal Policies

Monetary policy has repeatedly been at odds with fiscal policy. The first is not capable of realizing an interior and exterior currency stability if the latter is not equally oriented towards stability and solidity. Both policy areas are highly interdependent: in the long run, a currency can only be stable if fiscal policy is solid. Longer-lasting fiscal deficits that will lead to an unsustainable position of government budgets will either lead to inflation financing or to bankruptcy.

Some 60 years ago, at the beginning of January 1939, the former Reichsbank's Board of Directors wrote a dramatic letter to the "Fuehrer and Reichkanzler", Adolf Hitler, out of which I would like to quote the following distinct exerpt:

"To a decisive degree the the currency is threatened by the unscrupulous expenditure policy of the government. The unlimited ballooning of public expenditures hampers any attempt to introduce an orderly budget, brings government finance close to breakdown despite an enormous tax load, and thus shatters from there central bank policy and the currency. There is neither any congenious and subtle recipe nor any fiscal and monetary technique, no organization and no control measures, that would be effective enough to restrain the devastating effects of an unbounded expenditure behavior on the currency. No central bank is capable of maintaining the currency value against an inflationary expenditure by the government."

This letter which depicts the conflict between monetary policy and budgetary policy with brilliant lucidity, led to the dismissal of the complete Board of Directors. The Reichsbank was forced to serve the purpose of expansionary war financing with price controls. This produced a hidden inflation which after World War II led to the currency reform of 1948.

The dilemma of an appropriate assignment between monetary and fiscal policy has sufficiently become apparent in times of war financing. But it also reaches dangerous dimensions in fairly "normal times". The history of the European Monetary System has continuously given evidence of this fact. Only 6 years ago, the exchange rate system once more ran into a crisis as the so-called "policy-mix" had been turned upside down, as monetary and fiscal policies of some countries combatted each other instead of looking for ways of mutual coordination.

In some countries, expansive fiscal policy had triggered an economic overheating with subsequent inflation. The decay of internal stability then affected the external stability. National central banks attempted to avert devaluations of their domestic currencies and the subsequent loss of currency reserves by ever increasing official interest rates. This kind of monetary policy strangled domestic economic activity. At the same time, fiscal policy kept on trying to fight the decrease in econonomic activity and the consecutive rise in unemployment with the help of policy measures designed to stimulate private demand. This finally led to a vicious circle of rising interest rates, rising government expenditures, and rising public debt.

Not even a policy of high interest rates was capable of stabilizing the external value of currencies affected by domestic inflation. Thus the vicious circle of mutually reinforcing monetary and fiscal policy measures was finally broken through the power of foreign exchange markets where speculative attacks on weak currencies led to a cut of ties between stable and inflation-prone currencies. The European Monetary System was only to be saved through a common decision by EC-finance ministers at the beginning of August 1993 to widen the ERM fluctuation bands around the central rate to ± 15 percent.

The fiscal convergence criteria of the Treaty of Maastricht

It has in sum been a very wise decision by the fathers and mothers of the Treaty of Maastricht, to establish fiscal discipline as one of the fundamental preconditions for the introduction of a common currency, because in the long run monetary policy is not capable of safeguarding the value of money against a permanently expansive fiscal policy. Fiscal policy is thus vital for the credibility of any stable currency.

The requirements for fiscal discipline were substantiated numerically in a protocol to the Treaty of Maastricht through two so-called fiscal convergence criteria:

first, yearly budget deficits may not exceed 3 percent of GDP andsecond, total government debt may not exceed 60 percent of GDP.

As a consequence of the insistence of the German government, these rules were ammended by the European pact on stability and growth at the beginning of 1999, that will set a guideline for fiscal policy of the member countries in the coming years. According to the pact, public budgets are supposed to be balanced or even to be in surplus in the medium term.

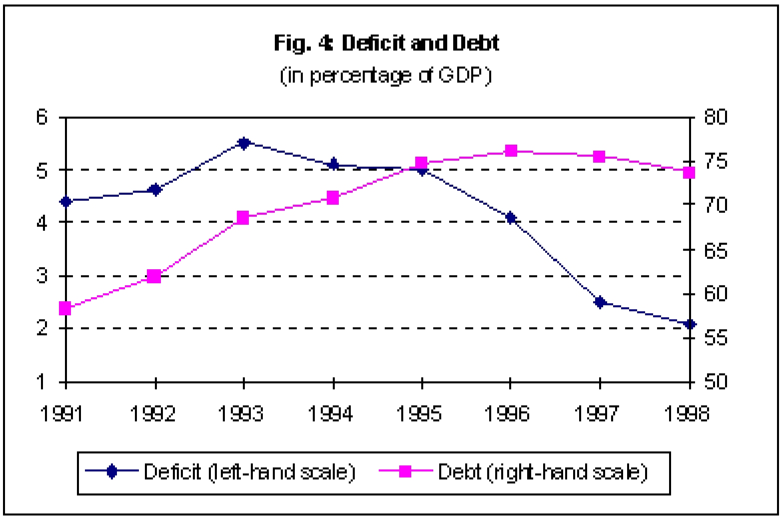
This is at least required for "normal cyclical situations" and any "normal cyclical fluctuations" should easily be handled within the 3-percent deficit limit. Stricter rules have been established with regard to deviations from this basis. A deficit ratio of 3 percent may only be exceeded in case of an exceptional state of emergency, e.g. a natural disaster, or if the economy tumbles into a severe recession, during which real GDP falls by more than 2 percent per year.

There lies, however, a long way between wish and reality. The distance between political declarations of intent and the actual facts surfacing after a closer second look, is at times considerable. This has already become apparent in the decision upon participants in Stage Three of EMU. On several occasions - the last time on its Dublin meeting in December 1996 - the European Council had stressed its intention to apply strict standards with regard to the criteria for fiscal discipline. The European Monetary Institute (EMI) as the predecessor of the European Central Bank, had been ordered to verify the preconditions for the introduction of a single currency. In its so-called convergence report the EMI came to the conclusion that only four Member States - Denmark, Finland, Ireland and Luxembourg - fulfilled the fiscal convergence criteria without any reservation. In eight of the eleven constituent members - Belgium, Germany, Spain, France, Italy, Netherlands, Austria and Portugal - "further substantial consolidation ... is necessary" as the European Monetary Insitute put it with discretion.

This reminder by the European Monetary Institute, that was supported by the Deutsche Bundesbank who made use of an even more distinctive language in its own convergence report, was meant to serve two purposes with regard to consolidation. On the one hand, the convergence criteria were actually fulfilled in only very few cases. Although deficits lay below the 3-percent mark in the reference year of 1997 in most EMU countries many countries still violated the second fiscal criterion very clearly. In some cases, debt ratios exceeded the 60-percent limit substantially. This was true for Ireland, the Netherlands, Spain and Portugal. Especially outstanding in this regard were Belgium and Italy, whose debt ratios to GDP exceeded 120 percent, being twice as high as the ceiling for entry into EMU as permitted by the Maastricht Treaty.

The warnings issued by the guardians of the European currencies not to interrupt the process of budgetary consolidation were intended to stress the point that a solid fiscal policy - a sustainable fiscal policy in the real sense of the word - cannot be characterized by the snapshot of a single year. Rather, debt reduction has to be embedded in a long-term and serious process of fiscal rectitude.

Those who believe that governments admonished in such a way will have an easy road ahead, are to be reminded of the so-called consolidation process in the Federal Republic of Germany in the eighties. It is a widespread misbelief that a reduction of public deficits will automatically lead to a shrinking of public debt - i.e. the public debt quota as specified by the Maastricht Treaty, to be more precise. Many governments - and this includes the German government - had to encounter the painful experience that tearing down a quickly built up "tower of debt" can be a very exhausting, i.e. time-consuming task, and that this process will impose a burden on budgetary and fiscal policies for years, or even decades.



Source: European Central Bank, Monthly Bulletins

As one can see from fig. 4, though there was a net decline in the overall budget deficit in the euro area since 1993, the debt quota continued its distinct rise during the years 1994 to 1996 and is only reverting in very slow rates up till now.

Even in the case of the Federal Republic of Germany in the eighties, a real reduction of the debt quota was not achieved. Despite a tedious reduction of deficits, the only result was a slowdown of the debt's rate of increase, finally leading to a stabilization of the debt quota on a level of around 43 percent by the end of the eighties. But this could only be realized as the whole process was supported by favorable conditions for economic growth at that time.

Creative Public Accounting

Considering the enormous degree of inertia of the political process with regard to budgetary consolidation, it is surprising, and even somewhat suspicious, at what speed the member countries of the European Union succeeded in reducing their deficits within two or three years prior to entry into EMU. This leads me to the second argument put forth by central bankers in favor of a sustainable consolidation and against a too myopic thinking.

Many budgetary measures of European countries were not only short-winded but absolutely nonserious in fiscal policy terms. There is not a small number of examples that were documented in the press under the somewhat ironic heading "creative public accounting" or "budget cosmetics", at times in a very detailed manner.

In *France*, the government has received a payout from France Télécom in 1997 of about DEM 11 billion and has in turn taken over long-term pension liabilities in its budget.In *Italy*, a "Euro Tax", of which 60 percent are supposed to be redeemed in consecutive years was introduced in order to consolidate the budget. Transitional pension fees for retiring government employees were paid with a six-month delay, the payout of corporate tax credits was postponed and mandatory advance disbursements on behalf of publicly appointed tax collectors to the tax office were raised. In addition, a six-month waiting period for retirees between the filing of the claim and the first pension payment was introduced. Moreover, a decision was made to cut back advance payments on public contracts from 10 to 5 percent of the contract's value. Finally, the debt of the Italian state railroad system was reclassified.In *Spain*, tax revenues were anticipated by means of an increase of advance payments. Moreover deficit finance of the railroad system and of the public broadcasting company was substituted by loan guarantees.Belgium sold official gold reserves to the amount of nearly DEM 11 billion and disposed of public real estate.Austria outsourced a public finance company for road construction from its official budget and sold part of its government stocks in the Bank of Austria.In 1997, *Germany* has shifted expenses into consecutive budget periods and received advanced cash payments through changing the payment date for the mineral oil tax. In addition stocks of Lufthansa and Deutsche Telekom were sold. Finally, a - however unsuccessful - attempt was made to ease the budgetary burden by means of an revaluation of currency reserves held by the Bundesbank.

Besides these examples many governments have privatized public corporations and thus disburdened their budgets from expenditure liabilities in the short term. Privatization should not be critized as such. On the contrary, privatization is indeed desirable whenever it enables enterprises to profit from the higher efficiency of the private sector in the production of their goods and services. However, privatization cannot assure a solid base for sustainable fiscal policy. Public assets, once sold, cannot generate a continuous flow of receipts.

A positive effect on the structure of public budgets is only to be achieved by privatization, if the government not only acts in a formal way by tranforming public enterprises into private companies but is really getting rid of permanent subsidies to unprofitable public corporations. This requires, however, that no government liabilities for either outstanding debt or for pension expenditures are taken over from public enterprises, as has been the case with France Télécom or in connection with the privatization of the German Bundesbahn.

Medium-term Perspectives

Creative public accounting and short-sighted budgetary measures are not capable of solving the pressing problems of fiscal policy. A sustainable strategy in line with a medium-term perspective is indispensable. In this regard, one could await with courious anticipation if the countries of the Euro-currency area would direct their budget policy to a more solid path in 1998 in contrast to the reference year 1997, that was marked by certain sham measures.

The result is disappointing. In both its Monthly Report of March 1999 and in its first Annual Report, the European Central Bank noted with grief that no progress was made in consolidating public budgets. The (weighted average of the) fiscal deficit was 2.1 percent of GDP in 1998. Thereby the deficit value fell below the value of 1997 by merely 0.2 percentage points, which means that it has still been much closer to the upper limit set by the Maastricht Treaty than to the values allowed by the Stability and Growth Pact.

This very meager reduction of the deficit was "exlusively attributable to vigorous economic growth and not to serious budgetary consolidation efforts. Moreover, countries of the Euro-currency area profited from low interest rates, that contributed to a reduction of interest expenditures of about 0,4 percentage points on average."

Apart from this comparison to the previous year, the medium-term perspective is unfortunately not much brighter either. "For the purpose of monitoring the development of the budgets and for recognizing indicators of possible faulty developments in the budget, but also for alleviating economic policy coordination (Ki: in the European Union), an early warning system was established in connection with the Pact on Stability and Growth. For this purpose the participating countries present annual stability programs to the Council and to the Commission, that contain a depiction of the medium-term budgetary goals."

In the medium-term financial plans presented so far, it has become apparent, that most countries "(are) still far away from the medium-term goal of reaching a 'budget near balance or in surplus' as laid out in the Stability and Growth Pact. At the same time, most governments assume that they will make little progress in achieving this aim in the course of the following years. Rather, governments seem to rely more on the assumption of continued economic growth paired with low interest rates and on the favorable effects these developments produce on public budgets.

In case of a serious or longer-lasting weakening of economic growth, public deficits could easily reach the debt limit, as current financial plans do not provide for sufficient safety margins. ... Moreover, debt levels are still way too high, and debt quotas have started falling only very recently, without showing clear signs of a more rapid decline. Thereby, debt quotas continue to exert strong pressure on public budgets, as interest expenditures claim a significant share of public revenues."

Due to their enourmously high debt levels, the Member States of the Euro-currency area have come to spend more than 5 percent of their GDP on interest expenditures on their debt. The times in which governments could still win room for manoeuvre in their budgets by means of deficit finance are long gone anyway. Deficits are not sufficient any more to pay for the high interest burden.

The Federal Republic is a clear example for this fact. The forcasts of economic research institutes assume that the German finance deficit will lie scarcely below DEM 70 billion this year (1999). At the same time interest expenditures are twice as high, i.e. almost DEM 145 billion. Even if new public loans borrowed each year are spent completely on interest expenditures, DEM 80 billion additional taxes have to be raised in order to finance the complete interest burden.

The meaning of public investment

A common objection to this argument holds that there are no general caveats against debt finance of public expenditures and that it would even be desirable as long as it serves to finance public investments. Indeed, in past decades, governments have neglected to care enough about the productive use of their expenditures. With rising shares of public spending and of public debt to GDP, the share of investment spending has continually been declining.

By favoring consumption expenditures governments have caused considerable economic damage to capital accumulation, economic growth and employment. It is an astonishing phenomenon, that individuals are keen on saving a significant share of their income whereas the government obviously deems it appropriate to cut their income (i.e. their ability to save) through high taxes, and to direct these funds into consumption for a longer timespan; as if government had to correct the people's distinct will to save. Insofar the reminder for governments to care for an investment-oriented structure of public expenditures can be supported without a doubt. However, the positive assessment of public investment and of the instruments suitable to finance them, must seriously be put into question.

Even if one starts from the somewhat heroic assumption that all public expenditures are - in themselves - productive in one way or another, one may not forget that they need to be financed and that this aspect of government interference (i.e. the imposition of taxes and the recourse to capital markets) is - in itself - linked to economic burden in any case. Thus one always has to ponder the disadvantages stemming from the finance side against the advantages of the expenditure side.

Considering the real economy however, one has even to think one step further. The intrinsic burden of financing government activity lies in the fact that private economic activity is pushed back and substituted by public usage of the economy's production potential. This is a serious reason why any expansion of government activity has meaningful economic limits. It is not only a question of how to judge the productivity of public investment but also of how to evaluate economic alternatives. In other words: even if public investment expenditures are productive will their expansion only make sense when their productivity is higher than of the private investment that is crowded out.

Following this reasoning, there will certainly be no caveats when the call for more public investment incites politicians to straighten the structure of public expenditures according to a more future-oriented design. However, this should by no means happen through an expansion of government activity. We need more room for private investment - for private economic activity as such - because growth and full employment will not be attainable without it.

The public sector share in GNP is too high

In many EU countries, public revenue shares have reached a level that is harmful to economic growth. In a number of member countries we find revenue shares that exceed 50 percent of GDP by far (Denmark, Finland, Sweden) or come close to 50 percent (Belgium, France, Italy, Luxembourg, Netherlands, Austria).

In Germany, the overall tax ratio has declined markedly since the beginning of the nineties. On the other hand, social security contributions were liftet, so that the total public revenue share to GDP has risen even further. Consolidating fiscal deficits by way of raising taxes and social security contributions - a way many European countries chose in the last years - is however the wrong method. It is not suited to solve the problems of growth and employment in Europe.

In this regard it is also not very helpful when politicians proudly hint to the fact that Germany’s revenue share is lowest of all Europe. In a global economic context, the EU countries do not only compete among themselves to attract mobile capital, that is supposed to create jobs. They also compete with Asia and America. The latter have much lower public expenditure ratios, e.g. of 36 percent in Japan and of 32 percent in the USA.

The European partners have so far avoided to tackle the debate about how much government is necessary in order to regain flexibility and to keep its competitive stance on world markets. This debate is urgently needed and could help to promote the EURO’s development towards a strong and stable currency. Instead, EU countries have recently begun to look for ways to limit unfair tax competition. Their concern to loose tax revenue is obviously stronger than the fear to put a strain on employees and investors through a too high tax burden or to push them into the shadow economy.

The conception of a lasting and sustainable fiscal policy finally entails that it does not stop with the static analysis of current conditions. It has to obviate such developments in time that possibly lead to crises in the medium- and longer-term. In their most recent reports both OECD experts and the European Central Bank have pointed out that it is necessary to take precautions for future budget burdens by means of reducing the tax burden today.

It has long been known that "government budgets in general and pay-as-you-go pension- and health-care systems in particular will face serious financial consequences resulting from the ageing of populations in the medium-term in nearly all countries of the EURO-currency area. For these reasons, public budgetary planning should not only be designed to forearm public finances against financial effects of possible future recessions, but also to build up reserves by help of which those implicit future financial liabilities can be reduced, that have bottled up within the public sector."

Supply-side economics versus demand management

Although the shares of public expenditures and of public debt to GDP have - not only in Germany but also in many other European countries - reached a level at which a return is indispensable -

because high interest expenditures pose a heavy burden on public budgets andbecause the extent of public activity is such that it narrows the scope of private sector’s decisions in a way that the basis for a growing economy, i.e. investment and employment, is threatened -

and although these problems have been well known for over twenty years, some deep disagreements still linger on as to the question of what scope consolidation measures should take and in how far supply and demand effects of consolidation are compatible with each other. This is because a concept that recommends public expenditure cuts on the one hand promising expansionary effects on the other seems contradictory at first sight.

The controversy between supply-side economics and demand management is not new; in recent times, however, it has been exaggerated through some economic policy debates. Demand management is by no means impossible. However, for two reasons one has to be well aware of its limitations:

- On the one hand, experience with expansive fiscal policy during the last decades has been disappointing in all respects. Expansive periods of German fiscal policy, for example, were in no way self-financing, as they should have been according to an academic primer. Instead, remote damages always arose in the form of rising public expenditure and debt quotas.
- On the other hand, the problem of high unemployment in Europe does not only stem from an insufficient utilization of production capacities. It is rather the lack of private investment without which jobs cannot be created in adequate numbers. Structural problems of this kind can therefore not be solved by demand management unless one risks a conflict with monetary policy.

OECD calculations have shown for instance that the unemployment ratio in Germany could have been reduced by a maximum of 1.8 percentage points, down from 11.4 percent in 1997, without running the risk of a conflict with monetary policy. Any attempt to go beyond this point would have led to an increase of the ratio of inflation. Such a strategy would be a dangerous mistake. Already at the beginning of the seventies, a German finance minister (who later became chancellor), held the view that the German people could rather stand a five percent increase in prices than a five percent increase in unemployment, only to discover later that economic policy does not have a choice between higher unemployment and higher inflation. Rather, any attempt on behalf of fiscal authorities to stimulate demand at the expense of currency stability will end in inflation, thus bringing about an increase in both unemployment and inflation ratios in the economy.

Finally, one has to address the inverse question if consolidation of public budgets really has contractive effects on the expediture side of the budget, i.e. the question if cutbacks in public budgets inhibit job creation and are thus harmful to the economy. There is a number of both theoretical considerations and practical experience, that contradict this thesis, especially if one looks beyond the short-term horizon.

There is no doubt that public expenditure- and revenue ratios have reached critical values. If the government is capable of conveying hope for a lasting future tax relief in a credible way, and if it takes resolute measures to deminish expenditures, so that there is a guarantee for a reduced future burden from the government’s use of capital markets, then private households and private business will vigorously expand their consumption in anticipation of future tax cuts, doing so despite or, respectively, because of, falling public demand.

There is empirical evidence that these considerations are not only academic in nature. Some impressive examples for successful consolidation policies can be found in the cases of Denmark, Ireland, Sweden and England. Thourough analysis of consolidation policies in many OECD countries reveals that a too prudent consolidation policy indeed puts a burden on the economic climate. But that on the other hand strong and continued cuts of government demand can influence private demand positively.

At the same time, it became clear that not only the scope but also the structure of consolidation measures are decisive factors for the success of fiscal policy interventions. Cases of successful consolidation were primarily the result of a reduction of expenditures not of an increase in taxes. In these successful cases the burden of adjustment rested much more on a reduction of transfer spending and government wages than on a cut in public investment.

All in all, experience in many countries indicates that a resolute and courageous policy of consolidation that does not shy away from sensitive cutbacks of welfare benefits and of public services offers the best basis for fiscal policy to regain leeway, thus opening new perspectives for growth and employment.

Conclusion

There is a growing consciousness in the governments of Europe that the structural problems of public households and of the job market may not be merely solved through short-term expansionary measures any more. Instead a sustainable and forward-looking policy is necessary.

If economic policy actors are aware of this responsibility and if they act accordingly, then there is substantiated hope that the continued integration of the European internal market in combination with a stable European currency will offer many chances for more growth and employment. From this perspective it is not crucial who pays most for Europe but who makes best use of the chances that free markets in large economic areas offer.