Fiscal policies and economic growth

This article discusses the role of fiscal policies in enhancing growth in the long term and their effects on economic activity in the short term. It stresses that the framework of rules and institutions that governs markets and policies must set the appropriate incentives for private agents and policy-makers to adopt growth and stability-oriented decisions. It also reviews the theoretical arguments and the available empirical evidence on the efficiency of fiscal policies in affecting the main determinants of long-term growth and in stabilising cyclical fluctuations of aggregate demand in the short term.

The article argues that stable, sustainable and efficient fiscal policies exert a favourable effect on long-term growth performance. They stimulate savings, capital formation, employment and innovation and also create a macroeconomic environment in which the task of a stability-oriented central bank is facilitated.

In the euro area, common rules on budgetary discipline coupled with the clear allocation of responsibilities for fiscal policies to national governments provide an appropriate framework for the implementation of stable and sustainable fiscal polices. The improvement of budgetary positions and the decline in public debt ratios in recent years are encouraging signs in this regard. As for the efficiency of fiscal policies, the article presents the key elements of the EU strategy to increase the contribution of public finances to economic growth. However, the responsibility for its implementation lies with national governments. Given the ambitious objectives of the common strategy, governments should not delay the necessary reforms of their national rules and institutions to strengthen the positive impact of fiscal policies on growth.

1 Introduction

When looking at the growth performance in the euro area countries in recent decades, two observations are noteworthy. First, growth has declined significantly since the 1960s. In the 1980s and 1990s, growth was below that in the United States. Second, rigidities in labour markets leading to relatively low employment and high unemployment rates coupled with a lack of structural reforms have often been cited as part of the explanation. The employment rate in the euro area is more than 15 percentage points lower than in the United States (see Charts 1 and 2). Examining some euro area fiscal indicators, it is apparent that the government sector plays a far larger role than in the United States. Government spending absorbs nearly half of GDP on average in the euro area as compared with less than one-third in the United States (see Chart 3). This requires a far higher level of taxes than in the United States (see Chart 4). Fiscal deficits are now relatively low on average, but this was not the case until a few years ago, so that average government debt in the euro area is still high, at 70% of GDP (see Charts 5 and 6).

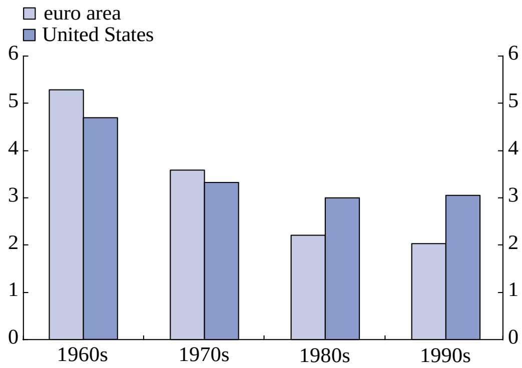
There is a broad consensus that these developments in fiscal policies contribute to the relatively weak growth performance in the euro area. Past deficits have been too high, resulting in the accumulation of significant debt that could undermine macroeconomic stability. The interest payments on debt also keep the tax burden much higher than is necessary to finance only primary expenditure. Fiscal policies have often been pro-cyclical, thereby not contributing appropriately to smoothing fluctuations in demand. Finally, overly high public spending holds back a sustainable reduction in distortionary taxation and inhibits the full exploitation of the growth potential of European economies.

The article argues that the institutional framework in which private and public agents perform their economic activities is crucial for growth. This framework of institutions comprises the legal rules and norms that constrain the behaviour of policy-makers and thereby define their incentives to act (such as the budget deficit ceiling of the Maastricht

Chart 1

Growth in the euro area and the United States, 1960s-1990s

(average changes of real GDP, in percentage points)

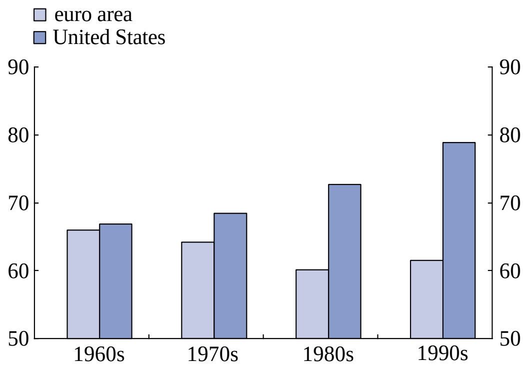


Sources: European Commission and ECB calculations.

Chart 2

Employment in the euro area and the United States, 1960s-1990s

(as percentage of population aged 15-64)

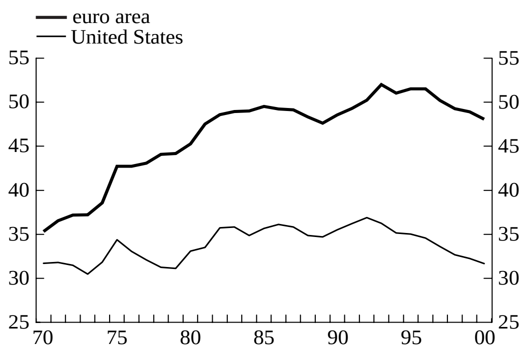


Sources: European Commission and ECB calculations.

Chart 3

General government expenditure in the euro area and the United States, 1970-2000

(as a percentage of GDP)

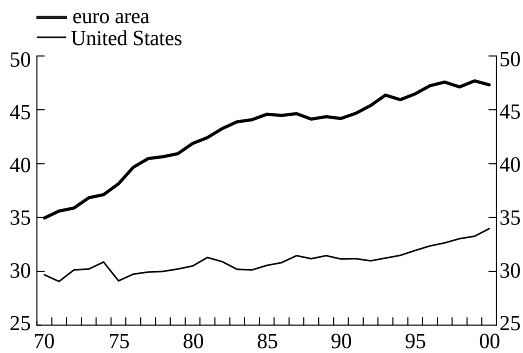


Sources: European Commission and ECB calculations.
Note: Euro area data exclude Luxembourg from 1988 to 1994.

Chart 4

General government revenue in the euro area and the United States, 1970-2000

(as a percentage of GDP)

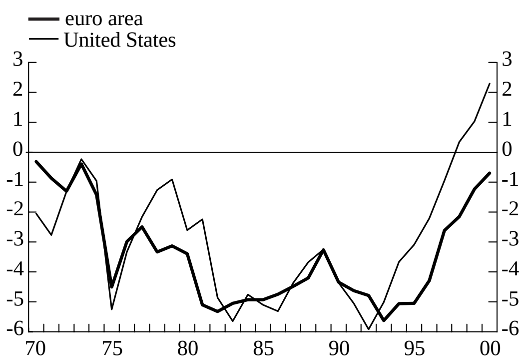


Sources: European Commission and ECB calculations.
Note: Euro area data exclude Luxembourg from 1988 to 1994.

Chart 5

General government balance in the euro area and the United States, 1970-2000

(as a percentage of GDP)

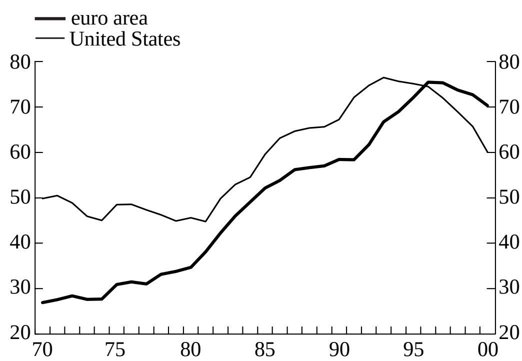


Sources: European Commission and ECB calculations.
Note: Euro area data exclude Luxembourg for 1988 and 1989.

Chart 6

General government debt in the euro area and the United States, 1970-2000

(as a percentage of GDP)



Sources: European Commission, OECD and ECB calculations.

Treaty). However, such institutions must not be confused with institutions which are organisations (such as the ECB or the European Commission). Growth-enhancing policies in the fiscal area can be achieved via changes in rules and institutions. Box 1 presents a conceptual approach to this issue.

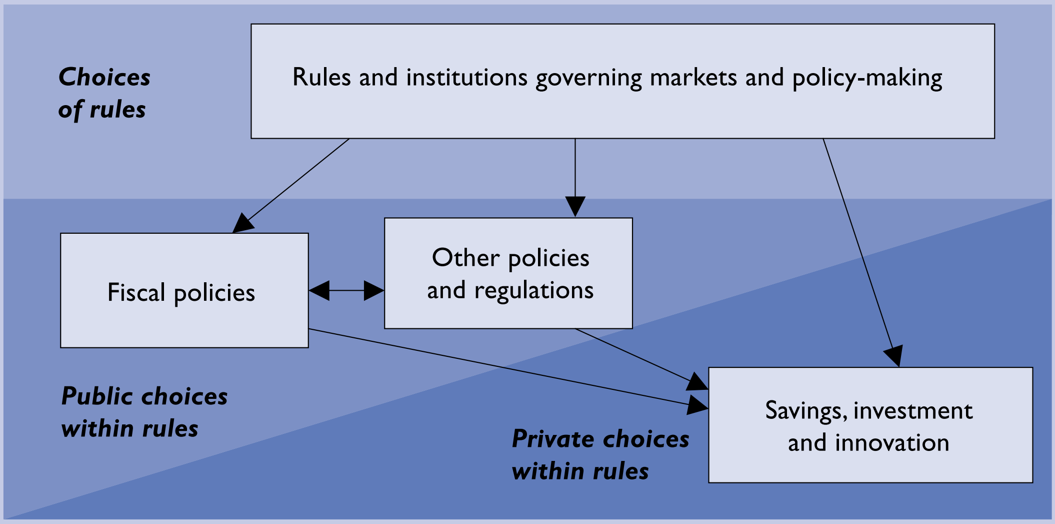
The following section examines how fiscal policies can influence the main determinants of long-term growth. Section 3 deals with the impact of fiscal policies on short-run economic activity and its stability. Section 4 reviews the rules and institutions framing fiscal policies in euro area countries in the light of the EU growth strategy recently proposed by the Commission and the ECOFIN Council. The article concludes that the current EU-wide rules support stability-oriented and sustainable fiscal policies and thereby foster growth. However, the efficiency of fiscal policies, which substantially affects the growth performance of different economies, remains a national responsibility. Euro area countries should pursue comprehensive reform of their rules and institutions in order to achieve more efficient fiscal policies and thus meet the EU strategy's ambitious targets.

Box 1

Rules and institutions, fiscal policies and growth

Rules and institutions are key to growth. They consist of the legal (and sometimes informal or cultural) constraints that determine the incentives for public and private agents to consume, save, invest, work and innovate. They shape growth directly through their effects on markets and indirectly in the way they constrain policies. Rules can affect the stability, sustainability and efficiency of fiscal policies and their interdependence with other policy areas. Diagram 1 illustrates the links between, on the one hand, rules and institutions and, on the other, growth-enhancing savings, investment and innovation.

Diagram 1: The links between rules and growth



Private initiative requires the secure functioning of markets, allowing appropriate returns from capital accumulation, work and innovation.

- Agents need to be sufficiently sure that they can benefit from the returns on their investment or innovation. In essence, two sets of rules guarantee this:
  - well-established property rights enhance the control over and security of returns on investment;

– rules promoting market exchange (e.g. via contract law, freedom to set prices) are a prerequisite for a market economy. Functioning markets generate information via the price mechanism which, in turn, induces agents to work, invest, specialise and innovate so as to make a profit.

- Rules must promote competition, secure adequate information and allow efficient risk management.

Rules should also guarantee that government actions do not undermine but rather support the functioning of markets.

- Government actions should be limited and well constrained by appropriate rules and institutions.
- Rules can enhance the efficiency of fiscal policies and reduce the scope for rent seeking. Examples include audit rules, public procurement rules and cost-benefit analysis in the context of deciding on public activities and regulation.
- Rules can also secure the stability of fiscal policies by preventing erratic changes in deficits, tax laws and expenditure programmes.
- Budgetary institutions and fiscal rules can prevent an expenditure and deficit bias in the political process that could create too large a public sector and undermine the stability and sustainability of public finances.

Interaction effects across policy domains and regulations are important and call for comprehensive reform of rules and institutions.

- The costs and benefits of public policies need to be assessed carefully and may differ depending on the institutional framework in which the policies are undertaken.
- Fiscal rules could improve fiscal discipline and thereby the credibility of monetary policies. Similar interdepencies exist, for example, between fiscal and labour market policies and fiscal and competition policies.
- Market rules can constrain fiscal policies and vice versa: the protection of property rights should prevent expropriatory taxation. Subsidised public services can inhibit if not eliminate private markets.

2 Fiscal policies and long-term growth

Growth is determined by capital formation, technological change, employment and savings

In the early literature on economic growth, population increases and technological progress alone determine exogenously the long-term growth rate of output. Policy changes could affect the equilibrium level of output (for example via raising capital investment and labour supply) but not the long-run growth rate.

By contrast, in the more recent endogenous growth literature long-term growth is explained by introducing additional elements. The latter include, for example, a knowledge-producing sector, defining capital in a broad way to include human capital and knowledge spillovers, or assuming that capital accumulation has large positive externalities. Investment in one sector can have positive spillover effects on the productivity of human and physical capital in other sectors. Investment in computers in one firm will allow the dissemination of computer literacy and may promote the use of computers in other firms and sectors.

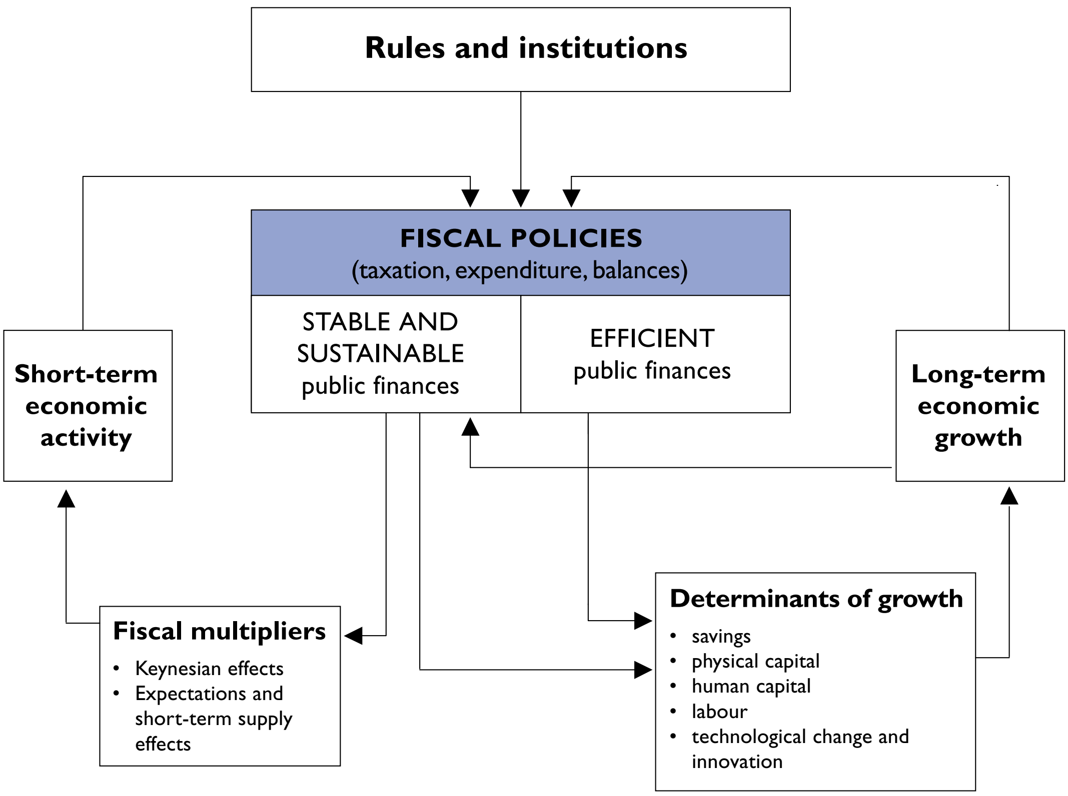
This more recent literature considers the determinants of growth (physical and human capital investment, technological change, employment and savings) and predicts that policy changes can affect the long-run growth rate by influencing economic agents' decisions concerning these variables. Changes in public expenditure and taxes that increase investment externalities, boost human capital or generate knowledge can then have effects on the level and the growth rate of output.

It is worth stressing that the influence of fiscal policies on growth can only be generated within an appropriate broader policy framework. Sound public budgets support a macroeconomic environment in which the task of a stability-oriented central bank is greatly facilitated, thereby securing an environment conducive to growth-enhancing savings and investment. Fiscal policies that foster employment or innovation create their strongest effect when they are not undermined by less favourable policies and regulations of labour markets, trade or competition. These channels of transmission and basic interdependencies between fiscal policies and long-term growth are depicted in Figure 1.

Fiscal policies, capital formation and technological change

Governments have traditionally focused their efforts to promote growth on capital formation, and more specifically on providing public infrastructures, including highways, certain transportation facilities, or water and sewers lines. Two arguments for government involvement in this domain have been used. First, infrastructure was often perceived as a natural monopoly where private providers would charge monopoly prices and give rise to potentially large inefficiencies. Second, there are instances where the consumption of infrastructure is difficult to control so that private provision could not take place. In recent years the role of the government as the single provider of infrastructure has been questioned, and much experience has been gained with the private provision and operation of infrastructure under public regulation and supervision.

Figure 1
The links between fiscal policies and economic growth and activity



There is reasonable evidence in industrialised countries on the positive effects of public investment on growth. Nevertheless, public investment can crowd out private sector investment in physical capital, either by directly replacing private investments or by drawing funds from an inelastic supply of savings such that the rising costs of capital make certain private projects unprofitable. Public support of private investment via tax incentives could also stimulate capital formation beyond what the market would provide on its own. However, there are adverse effects on growth stemming from the need to finance public activities with taxes. As regards physical capital formation by private firms, corporate income taxation increases the cost of capital, reducing the net return from capital. Hence it may discourage physical capital accumulation. Many studies find that investment is, in fact, negatively related to the cost of capital to a significant but not extremely large extent, especially in the short run.

Human capital accumulation is typically seen as being at the core of growth. Highly qualified workers are necessary, in particular, for countries to benefit from new technologies. Governments have traditionally favoured human capital formation via spending on education, including schools, universities, on-the-job training or adult education. Education is either provided by government directly, or privately provided education is financed (or supplemented) by public funds. In any case, public support for education seems to be essential for people who are "credit constrained", such as children or their parents who do not have the income and collateral that would grant access to credit to finance their "optimal" private education.

Most of the reliable empirical evidence suggests a significant impact of human capital accumulation on growth. Empirical studies also find that government spending on education and training has significant effects on future economic growth. However, if additional public spending on education is financed by higher taxes on labour, the net outcome might have a negative effect on human capital investment, depending on how progressive such taxes are. The more progressive a tax system, the more likely it is that it would discourage investment in education, because taxes may reduce the return on education more than they reduce the cost of investing in it.

Fiscal policies can also foster technological change and innovation, thereby boosting the economic growth rate. Investment in research and development is a key factor in determining technological change and innovation. There are two main reasons for insufficient private investment in research and development that could justify government involvement in such activities. First, private investors would not consider the positive spillovers to other sectors of the economy, which could suggest that higher investment is socially desirable. Second, private agents may not be able to exclude others from using the results of investment in research and development and would thus fail to invest sufficiently. Public intervention by direct means, such as provision and funding, and also indirectly through tax incentives, could bring the research and development undertaken closer to the social optimum. However, there are also pitfalls in the public support of research and development. Governments have an information disadvantage and will not necessarily support the research initiatives with the highest return. Moreover, public investment in research and development may not only be unproductive; it may even divert energy and resources from more productive ventures, thereby reducing innovation and growth.

The empirical evidence in industrial market economies points to a significant role of research and development in enhancing growth. It seems to indicate that current private investment in research and development in most countries is lower than the optimum.

Box 2

The contribution of public finances to growth: the EU growth strategy[1]

The European Council in Lisbon has set a new strategic goal for the European Union "... to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." Public budgets can contribute to achieving this goal by fostering growth and employment through three channels – supporting a stable macroeconomic framework via sound public finances, making tax and benefit systems more employment friendly and redirecting public expenditures towards physical and human capital accumulation. Broadening the focus from achieving budgetary stability towards putting the emphasis on the overall contribution which public finances can make to growth and employment marks a new step in the fiscal policy agenda in EMU.

Sustaining sound public finances: after many years of striving to achieve sound public finance positions, the challenge now is to complete this goal and sustain these positions while at the same time lowering the tax burden (especially on low-paid labour), strengthening public investment in physical, human and knowledge capital and preparing for the budgetary consequences of ageing populations. Therefore:

- to meet the short-run challenges, and consistently with the Stability and Growth Pact, the Council and the Commission affirm the need to avoid pro-cyclical fiscal policies, especially by strict expenditure control. The Council and the Commission agree that in this respect cyclically-adjusted balances should be used as an additional tool when assessing budget positions. Further refinement of the method for determining the cyclical component of the budget balance will be pursued by the Commission in co-operation with the Economic and Financial Committee and the Economic Policy Committee.
- to meet the medium-term challenges, tax and expenditure reforms must be designed to achieve a sustainable reduction in the tax burden and maximise their contribution to growth and employment. To this end, tax cuts need to be accompanied with a firm control on and, where appropriate, reduction of public expenditure. They should also target the removal of rigidities, especially in the labour market. An appropriate balance and sequencing has to be drawn between running down public debt, cutting taxes, and financing public investment in key areas. This balance can vary according to the particular circumstances and priorities of Member States.
- to meet the long-term challenges, the Council and Commission agree that a three-pronged strategy is needed to tackle the economic and budgetary challenges of ageing populations. This should include a suitable combination of running down public debt at a faster pace, measures to raise employment rates (especially amongst women and older workers), and reform of pension systems to place them on a sound financial footing including greater recourse to the funding of public pensions. The ECOFIN Council intends to deepen its examination of the long-term sustainability of public finances, in particular in the framework of the multilateral surveillance and the stability and convergence programmes.

Making tax and benefit systems more employment friendly: some progress has been made towards making tax systems more employment-friendly, by lowering the fiscal burden on labour as well as reducing marginal tax rates. However, overall labour taxation (taxes and social security contributions) in many Member States still remains high by international standards, and reforms in some countries have been piecemeal. Much less progress was made in making benefit systems more employment friendly, and changes in net replacement rates have been relatively small. Only few Member States have developed in-work benefits to boost earnings of low-paid workers. The Council urges Member States to accelerate where appropriate the reforms of tax and benefits systems with the objective of making work pay and curbing unemployment traps.

Redirect public expenditures towards physical and human capital accumulation: recent trends show that levels of public investment have stopped declining and are starting to increase in some countries, a welcome development as it has been combined with efforts to increase efficiency via the introduction of market mechanisms. In restructuring public finances, priority should be given to education, training and R&D. Efforts to enhance physical and human capital accumulation must to a large extent come through expenditure restructuring. The Council urges Member States to pursue a balanced combination of spending restructuring, tax reforms, and other structural measures. Only through such a comprehensive strategy can the EU meet the Lisbon challenge.

1 *Highlights excerpted from the Joint Report of the Commission and the ECOFIN Council to the European Council, Stockholm 23-24 March 2001.*

From the policy point of view, redirecting public expenditures towards physical and human capital accumulation, giving priority to education, training and research and development, is one of the main aspects of the EU growth strategy (see Box 2, which provides an account of this strategy).

Fiscal policies and employment

The way in which fiscal policies affect employment is a complex issue, and the incentive and disincentive effects of public intervention need to be weighed carefully. For example, well-designed unemployment benefits not only provide important safety nets for people, they also allow workers to search longer for the most productive employment. However, this might lengthen the period of unemployment, which would have second-round effects on the productive potential of the economy, because long-term unemployed workers experience a depreciation of their human capital.

The possible drawbacks of social benefits are illustrated most clearly by their effects on labour supply. Unconditional and/or unlimited payment of unemployment benefits has frequently been cited as an important disincentive to work. Unemployment benefits can also reduce the pressure to reform an inefficient labour market with high unemployment because the jobless are provided with such benefits. Moreover, public pension systems have significant effects on labour supply (see Box 3 for the potential effects of pension reforms on the determinants of growth). Little penalisation or even active encouragement of early retirement have reduced labour supply. Early retirement prospects also constitute a disincentive for workers to maintain professional skills and engage in lifelong learning. Furthermore, early retirement incentives can facilitate labour shedding even when dismissal is very difficult. As a result, firms needing to reduce employment would cut their older workforce. This may be the more experienced rather than the least productive staff.

Labour market policies can, when properly designed and implemented, enhance labour supply and demand and consequently the rate of employment. Training programmes can facilitate skill maintenance and upgrading, thereby reducing skill-mismatch and human capital degradation among the long-term unemployed. Another challenge is the re-integration of groups which are difficult to employ, such as low-skilled people, long-term unemployed and older workers.

All these potentially beneficial effects of public policies cannot be assessed independently of the impact of the taxes required to finance them. Labour taxes, including social contributions, which are the main source of financing for these policies, raise labour costs and drive a wedge between gross wages (paid by the employer) and net wages (received by the employee). Where, owing to labour market rigidities, employers are forced to bear the costs of higher taxes, they would tend to reduce labour demand. The extent to which producers cut employment is measured by the elasticity of labour demand with respect to real labour costs. This elasticity does not seem to be very high on average but it is estimated to be higher for less skilled workers, who are often more easily replaced by physical capital and rationalisation than highly skilled workers. Decisions on labour supply could also be affected adversely by taxes if the tax burden results in a lower net wage received by the employee. Empirical evidence shows that effects of taxes on labour demand are greater than those on labour supply.

From the available empirical evidence it can be safely concluded that, on balance, it is often the combination of high labour taxes and generous benefit systems that results in employment disincentives. The disincentives are typically strongest for low-skilled/low-income workers. In the case of the latter, marginal effective tax rates, i.e. the loss via taxes and forgone benefits

Box 3

Pension reform and the determinants of growth

Reform of pay-as-you-go systems can support growth

With increasing awareness of the economic and fiscal implications of ageing populations, the reform of publicly financed pension systems has become a widely discussed issue in many industrialised countries. The effects of ageing are of particular concern for those euro area countries in which the old age dependency ratio is projected to double over the coming decades (for a more detailed discussion see the article entitled "Population ageing and fiscal policy in the euro area" in the July 2000 issue of the Monthly Bulletin). According to the Economic Policy Committee (EPC) report on ageing, this would push up public pension expenditure in the euro area from 11.2% of GDP on average by more than 4 percentage points of GDP over the same period. It would therefore impose large fiscal burdens on current and future generations, unless reforms were to be implemented swiftly. Reforms of pay-as-you-go systems can broadly follow two approaches: parametric reforms designed to adapt the existing system to the changing environment, and systemic reforms diversifying the financing of the system. Both approaches can support growth by improving fiscal sustainability and the efficiency of public finances.

Parametric reforms

Parametric reforms affect the financial viability of pay-as-you-go systems through changes in the regulatory parameters determining contributions and benefits.

- Such reforms improve the sustainability of the pension system and overall public finances; fiscal sustainability, in turn, positively affects macroeconomic stability and the environment for investment.
- By raising the effective retirement age and the participation of older people in the labour market, parametric reforms can increase the supply of labour.
- Longer working lives also increase the incentive for workers and enterprises to build up human capital. Higher human capital should boost productivity.
- Further reforms can strengthen the actual or perceived link between contributions and benefits, thus reducing the perceived tax on labour, with positive effects on its supply and demand. Such measures include increasing the importance of labour income in the pension formula or the introduction of notional accounts, i.e. an accounting framework that links individual contributions directly to future individual benefits.

Systemic reforms

Systemic reforms support pension financing through the introduction of an additional, fully funded pillar.

- Similar to parametric reforms, the diversification of pension finance improves fiscal sustainability and the overall economic environment.
- The introduction of funded schemes is expected to result in higher savings, providing a larger pool of resources to finance investment projects.
- Additional funds lead to a deepening of financial markets with favourable growth effects deriving from higher efficiency of capital allocation and lower costs of financial intermediation.
- As participants perceive their contributions to the funded pillar as savings rather than taxes, negative tax distortions of labour income are reduced and labour supply and demand rise.

Recent experience

The problem is well-identified and there is consensus on many of the specific reforms needed. Overall, however, progress on pension reform in the euro area has been disappointing and the postponement of decisive changes is evident in a number of countries. Moreover, the lack of an appropriate legal and fiscal framework for funded pensions in several Member States makes it difficult to increase private saving for retirement.

for each additional euro earned, are near or even above 100% for certain segments of the wage band in many euro area countries (the so-called unemployment trap).

The reform of the tax and benefit systems to make them more employment-friendly is also one of the key elements of the EU strategy to increase the contribution of public finances to growth.

Fiscal policies and savings

All investment needs to be financed by savings. Most savings come from the domestic economy while foreign savings normally only supplement domestic savings. Within the domestic economy, the private sector is by far the predominant source of saving.

Transfers to households, including social payments, are the main channel through which public spending affects private savings accumulation. In this context it has to be borne in mind that transfers could have a negative effect on savings.

Pensions are by now the most important item of public benefit systems and considerable increases in expenditure are expected for the future if current policies are maintained. Delaying effective retirement and introducing more funded pension schemes would imply more old-age-related savings. This is likely to have a positive impact on aggregate savings.

All in all, it seems reasonably safe to conclude from the empirical evidence that high taxes financing large public sectors tend to have a negative effect on savings, and thereby on investment and growth. Just as labour taxes discourage work, taxes on savings tend to discourage the latter and encourage consumption. Most prominently, corporate income taxes, but also other capital income taxes, are likely to cause a reduction in private savings by lowering their net return.

Low and stable deficits and sustainable fiscal accounts support long-term growth

Sound fiscal accounts are likely to have positive effects on aggregate savings and investment. If public investment spending remains unchanged, lower deficits will imply higher public savings. If the latter are not fully offset by lower private savings, total aggregate saving will increase. This, in turn, will boost private investment via a larger savings pool and lower real interest rates. However, the impact of improved public accounts on aggregate savings crucially depends on the degree of substitutability between public and private savings. Although the existing empirical evidence is somewhat inconclusive, it tends to reject the hypothesis of a full offsetting of government deficits by private savings. Thus, lower fiscal deficits tend to raise aggregate savings and improve long-run growth prospects.

Severe adverse growth repercussions can be expected when fiscal deficits result in significant public debt and undermine confidence in the long-term solvency of government. If public finances are not perceived as sustainable, governments in such a position have to pay a growing risk premium on the interest bill for their public debt, which, in turn, raises the fiscal deficit. A growing share of savings is then invested in government debt rather than in private investment (crowding out).

High deficits are unsustainable and undermine savings and investor confidence via another channel. If high public debt raises the spectre of government default – even if only in the distant future – people will perceive a growing risk of financial instability. The risk of instability will, in turn, deter savers and investors. In such an environment, the price mechanism as a guiding device for investment decisions will become less meaningful, as investors will not know whether price developments reflect instability or profit opportunities.

With fiscal sustainability in doubt, governments may be forced to raise taxes or cut spending at short notice, reducing the stability and predictability of public policies. In extreme cases, governments may even face a liquidity problem which could undermine the proper operation of core government functions (e.g. if government wages are not paid or maintenance work is not conducted). In other words, unsustainable fiscal positions are likely to undermine the efficiency of public policies.

From the above, it can be concluded that sustainable and efficient fiscal policies are conducive to economic growth, as recognised in the EU growth strategy. They stimulate investment and innovation while minimising potential adverse repercussions through disincentives to save, invest, work and innovate. Lean public sectors with little unproductive spending and efficient tax systems, low public debt and the prospect of future liabilities being covered are consistent with high growth.

3 Short-run effects of fiscal policies on economic activity

To enhance growth, fiscal policies must not only be sustainable and efficient, they should also be conducive to economic stability in the short run. However, while there is broad agreement on the role of fiscal policies in establishing the appropriate incentives and framework for fostering sustainable growth, there is much less consensus on the possibility of fiscal policies affecting economic activity in a predictable way in the short term.

Automatic stabilisation is preferable to discretionary fine-tuning

There are several demand and supply channels through which fiscal policies can affect economic activity in the short term. Keynesian theories stress the demand-side effects on economic activity. A tightening of fiscal policy can have temporary contractionary effects on output, and a fiscal expansion can temporarily raise output via the aggregate demand channel. The change in demand owing to a change in government expenditures or taxes affects output via private agents' reactions to the change in disposable income derived from the government's measures. These are the so-called fiscal multiplier effects. Empirical studies bear out that these multiplier effects take place in normal circumstances. On the basis of this reasoning and evidence, and assuming that governments always know what fiscal response is needed and when, supporters of this approach prescribe activist fiscal policies to stabilise output.

Nevertheless, this argumentation has been contested and does not provide a sound justification for discretionary fiscal fine-tuning (or activist fiscal demand management). The government would need to know when to act and by how much to expand or tighten demand. Moreover, there are important implementation problems related to activist fiscal demand management.

Assuming that there is a macroeconomic shock resulting in an economic slowdown and that an expansionary reaction seems appropriate, it takes time to channel related measures through the administrative or legislative process and it takes even more time until such policies become effective. By that time, the macroeconomic shock giving rise to the decision may have already vanished. The measures could become pro-cyclical if they fall in the subsequent upswing. Instead, automatic stabilisation works through the immediate changes in some revenue and expenditure items (such as income taxes and unemployment benefits) induced by fluctuations in economic activity. More importantly, people can form expectations about these effects, thus facilitating their timely reaction. They also do not have to be changed and repealed over the business cycle.

If activist fiscal policies result in pro-cyclical policies rather than in the dampening of demand fluctuations, this could also make monetary policy oriented towards price stability more difficult. If inflationary or deflationary tendencies are reinforced, monetary policies might have to react more strongly than they would have had to without fiscal interventions.

In the case of activist fiscal policies, it may also be difficult to repeal the original decision at a later stage since this could generate resistance on the part of those who benefit from the measures. This could induce a systematically expansionary bias in fiscal policies and lead to unsustainable budget deficits over subsequent business cycles. In addition, an activist fiscal policy stance is more likely to create uncertainty about the future fiscal policy course and undermine the appropriate formation of expectations conducive to short-term output stabilisation. These factors could also have adverse effects on fiscal sustainability and reduce the long-term growth prospects of the economy.

Fiscal policies based on automatic stabilisation, therefore, seem more reliable than discretionary demand management in dampening normal cyclical fluctuations. Moreover, discretionary fiscal policies are only likely to prove effective in influencing economic activity in a predictable way if the sustainability of public finances is preserved. When there are doubts about the latter, other effects, rather than those of Keynesian multipliers, can become important.

Expectations and short-term supply effects can shape the short-term consequences of fiscal reform

A new strand of arguments which has further increased doubts about the effectiveness of activist fiscal demand management is of particular interest when considering the potential adverse effects of fiscal structural reform on short-run economic activity. Structural reforms that would also imply short-term fiscal consolidation are especially likely to have smaller or even opposite (non-Keynesian) effects on economic activity than those suggested by the Keynesian approach.

Expectations and short-term supply effects can result in non-Keynesian effects in such a way that fiscal consolidation could have expansionary effects. The negative effects of the fiscal multiplier following fiscal consolidations, for example, might be fully compensated for and even reversed by increases in private consumption owing to changes in households' expected permanent income and in the market value of household wealth. First, fiscal consolidation raises households' expected after-tax permanent income, as the related tax increases and expenditure decreases allow a reduction in the future tax burden. Second, real interest rates are likely to fall following credible fiscal consolidation. The market value of private wealth increases if market interest rates fall, thereby stimulating consumption.

The effect of fiscal measures on economic activity also depends on expectations associated with fiscal measures, their composition and their credibility. Non-Keynesian effects are larger when the measures enhance sustainability, as the risk of policy reversal is then minimal and their perceived credibility rises. Cuts in welfare spending, excessive social security and government employment and wages are often mentioned in this context. These measures indicate that the government is serious about reform, since they are often politically unpopular. They also typically enhance sustainability.

Empirical findings of this strand of literature support the argument that successful budget adjustments, in the sense of lasting consolidation, seem to stem from expenditure cuts, in particular reductions in excessive social benefits and public employment. Non-Keynesian effects from tax increases have been deemed important in the context of large consolidations and high debt levels. This supports the relevance of such effects when fiscal measures strengthen sustainability.

In summary, sound public finances should rely on automatic stabilisation rather than on discretionary fine-tuning to dampen the cyclical fluctuations of aggregate demand. They should also contribute to macroeconomic stability and facilitate the monetary policy-makers' task of maintaining price stability. Moreover, non-Keynesian effects could improve the short-term output effects of fiscal structural reform aimed at consolidating public finances and making them more efficient. There is the potential for a virtuous circle: sound fiscal policies can enhance economic stability in an environment of stable prices and sustainable public finances. This, coupled with fiscal structural reform, can foster economic growth that, in turn, facilitates further reform.

4 Rules and institutions for growth-enhancing fiscal policies

According to the arguments presented in the previous sections, rules and institutions in the fiscal area conducive to growth and economic stability should aim to achieve two objectives. First, they should guarantee budgetary discipline and preserve the sustainability of public finances, thus contributing to macroeconomic stability and indirectly to maintaining price stability. Second, rules and institutions should promote the efficiency of the public sector and the predictability of fiscal policies and provide the appropriate incentives for private agents to enhance long-term growth.

With regard to the first objective, the framework of fiscal rules and institutions in the EU has enabled Member States to come a long way towards stability-oriented and sustainable public finances. However, progress towards the second objective of more efficient fiscal policy, which is an exclusive responsibility of Member States, and which is sometimes referred to as "the quality of public finances", has been more limited. EU Member States agreed in the ECOFIN Council on the main lines of a policy strategy to maximise the contribution of public finances to growth and employment in order to attain the ambitious objectives set by the Lisbon European Council. However, the incentives to implement this strategy are insufficient and the absence of reforms in the framework of national rules and institutions is an important reason for this.

The current fiscal rules in the EU provide the appropriate framework for preserving sound and stability-oriented public finances. One of the main concerns in the process of moving towards Monetary Union in the EU was how to prevent unsound and unsustainable fiscal policies in the euro area, as had emerged in the 1970s and 1980s. A continuation of such policies would have jeopardised Monetary Union and prosperity. Hence governments agreed, first in the Maastricht Treaty, later complemented by the Stability and Growth Pact, on certain rules of budgetary discipline in the EU, keeping, however, full autonomy of fiscal policies under the responsibility of national governments.

These fiscal rules arguably promote the first objective mentioned above. The 3% ceiling for the deficit to GDP ratio, and more forcefully the medium-term target of fiscal positions "close to balance or in surplus", should secure sound fiscal policies where automatic stabilisation can operate freely to smooth output fluctuations. Discretionary policy changes should not jeopardise the long-term sustainability of public finances. A sound budgetary position should also secure a widening margin for a policy of alleviating the tax burden – at least over time by allowing steady debt reduction. A well-defined procedure of prevention, monitoring and sanction mechanisms strengthens the credibility of this constraint. Moreover, the 60% ceiling for the debt to GDP ratio established in the Treaty, coupled with the prohibition on government bailouts when debt becomes unsustainable and the prohibition on monetary financing, aim at strengthening the soundness of public accounts.

The Stability and Growth Pact framework, however, does not render national fiscal rules and institutions redundant. On the contrary, the latter can and must continue to contribute to sustainable public finances, thereby complementing EU-wide rules. National budget processes underpinning a prudent fiscal position are particularly important to secure appropriate budget preparation and execution. If national budget institutions are effective in achieving fiscal commitments, this will reduce the likelihood of slippages, thereby strengthening the credibility of the Stability and Growth Pact. "Internal stability pacts" at the country level – especially in Member States where sub-national layers of government are granted substantial autonomy – formalise the joint responsibility for the final budget outcome across all levels of government. This should prevent local or regional governments from undoing the fiscal consolidation efforts made by the central government.

On the whole, the success of the new institutional framework embodied in the Treaty and the Stability and Growth Pact in promoting budgetary discipline seems to confirm the importance of rules and institutions. Fiscal deficits have come down and sound budgetary positions have been achieved in the majority of euro area countries. The volatility of fiscal balances is much reduced and public debt is declining. This is no reason for complacency, and countries with imbalances remain, but major progress has been achieved compared with the situation only a few years ago.

Fiscal structural reforms

As regards progress with the fiscal structural reform agenda, however, much less has been achieved. Taxes have come down, but tax cuts are often not part of a comprehensive reform strategy. Moreover, they have not been accompanied by sufficient expenditure restraint, thereby delaying the achievement of the Stability and Growth Pact targets in some countries. Hence, tax cuts in some countries have turned out to be pro-cyclical and have contributed to short-term upward pressures on prices. Benefit reforms, including urgently needed pension reforms, have been largely piecemeal and half-hearted. Consequently, in the euro area the public sector and the tax burden remain much larger than in most competitor countries and employment rates remain low.

An important reason for this slow progress lies with inappropriate national rules and institutions. Expenditure reform is perhaps the most important area in which changes in the fiscal policy framework could make a difference and, as a second round effect, permit further tax reductions. It is also crucial to connect taxation and the social benefit system in a compatible way to prevent employment and investment disincentives. Developing a framework that includes privately managed, funded pensions and the privatisation of public sector goods and services provision on a larger scale could result in more efficient fiscal policies and significant expenditure savings. Moreover, a further strengthening of fiscal transparency, better control mechanisms to enhance the efficiency of public policies and regulation, and better dissemination of modern technology and management practices in public administration are also frequently suggested as ways of reinforcing countries' institutional frameworks, and thereby the efficiency of fiscal policies.

Finally, it is worth stressing that rules on fiscal policies alone are not enough to increase long-term potential growth in the euro area, and expectations as to what can be achieved from fiscal reform alone should not be unrealistic. There are important shortcomings in other policy domains and there can be strong interaction.

5 Concluding remarks

This article has looked at the role fiscal policies can play in enhancing long-term growth and short-term economic stability. As regards long-term growth, sustainable and efficient fiscal policies are warranted. They stimulate investment and innovation while minimising potential adverse repercussions through disincentives to save, invest, work and innovate. And they facilitate the task of monetary policy-makers to maintain price stability. In fact, there is likely to be a virtuous circle of reforms boosting fiscal efficiency and sustainability, with the resulting environment of strong growth and rising employment facilitating further reform. To set such a virtuous circle in motion should be the objective of any fiscal reform strategy.

As regards short-term economic activity, sound public finances relying on automatic stabilisation are conducive to economic stabilisation in normal circumstances. They enhance the sustainability of public finances (and thereby growth) and facilitate price stability-oriented monetary policy. Moreover, non-Keynesian effects could improve the short-term output effects of fiscal structural reforms.

The framework of rules and institutions that governs markets and policy-making must set the appropriate incentives to adopt growth and stability-oriented decisions and policies. The existing EU rules on budgetary discipline provide such incentives and promote sound and sustainable public finances. It is no coincidence that significant progress has been made in this direction in all euro area countries. By contrast, progress in achieving more efficient fiscal policies via structural reforms has been far more limited. Responsibility lies with national governments. Changes to the rules and institutions in euro area countries are important so that governments conduct their activities in the most efficient manner. This will permit a lasting reduction of high public spending ratios and distortionary taxes. In conjunction with other reforms, it will enable countries to achieve the ambitious targets in terms of economic growth and employment set at the Lisbon summit.