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**Nominal Wage Flexibility and Fiscal Policy:
How Much Can They Reduce Macroeconomic Variability in the EMU?**

by

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Summary

If EMU membership causes a tendency to larger macroeconomic variability, the incentives for nominal wage flexibility are enhanced. It is improbable, however, that an increased degree of nominal wage flexibility can offset this tendency more than to a small extent. The most serious outcome would be if upward wage flexibility increased significantly, but there is only a limited (or no) increase in downward flexibility, as this would lead to a larger risk that a country-specific boom triggers a rise in real labour costs and a real exchange rate appreciation that take a long time to unwind. As a consequence, EMU membership is likely to increase the demands on fiscal policy as a stabilisation tool. For political-economy reasons, one cannot, however, expect an increased use of fiscal policy to compensate fully for the loss of national monetary policy in the EMU. But the effectiveness of fiscal policy for macroeconomic stabilisation can probably be increased substantially through various institutional reforms establishing a more well-defined and transparent policy framework similar to what has been done in the field of monetary policy.

1. Introduction

EMU membership means giving up monetary policy as a national stabilisation policy tool. Neither the short-term interest rate nor the exchange rate can then adjust to domestic macroeconomic conditions. This is likely to make it more difficult to stabilise the economy when domestic cyclical developments deviate from those in other euro countries. To judge the consequences of this for macroeconomic variability requires an analysis of alternative ways of stabilising the economy. This note focuses on two issues:

- (1) To what extent may the need for stabilisation policy be reduced by an endogenous response of wage-setting practices, involving more flexibility of nominal wages?
- (2) To what extent may national fiscal policy make up for the loss of national monetary policy?

The two questions are interrelated, as adjustments in the wage-setting process reduces the demands on fiscal policy, and a larger role of fiscal policy in macroeconomic stabilisation reduces the demands for nominal wage flexibility.

Although most macro economists seem to subscribe to the view that EMU membership tends to increase cyclical variability, this view is not uncontested. One could therefore read my analysis as a conditional one: *if* EMU membership tends to give more macroeconomic variability, to what extent can this tendency be counteracted through adjustments in the wage-setting process and through more activist fiscal policy?

2. EMU membership and nominal wage flexibility

According to a common view, nominal wage rigidity is a key cause of why temporary macroeconomic shocks may give rise to large fluctuations in output and employment. With demand shocks, variations in nominal wage growth (or in the nominal wage level) can help stabilise the real wage and thus also output and employment. With supply shocks, such as variations in the rate of productivity growth, nominal wage rigidity may imply less flexibility in the real wage level than is desirable for employment stabilisation.

A central issue when analysing the effects of EMU membership is to what extent the degree of nominal wage flexibility might increase and counteract the tendencies to increased macroeconomic variability. A problem for such an analysis is the lack of a generally accepted theory of wage stickiness. Instead, one has to make judgements on the basis of various types of reasoning, as in Calmfors (1998).

A first approach views the degree of nominal wage flexibility as the consequence of the *length of wage contracts* (Gray, 1978; Ball, 1987). The optimal contract length for wage setters depends on a trade-off between on the one hand trying to keep down the number of bargaining occasions, and thus bargaining costs, and on the other hand maintaining the capacity to adjust wages quickly to unanticipated macroeconomic developments in new contracts. To the extent that EMU membership tends to increase variability in employment, real wages and profits, the incentives for short contract periods in order to achieve nominal wage flexibility are enhanced. Unfortunately, there is not much empirical basis for assessing how strong these effects could be. Calmfors and Johansson (2002) have made an attempt at quantification by solving numerically a simple model for the choice of optimal contract length, assuming that wage setters try to avoid variability in both employment and the path of real wages. Under the assumptions made, EMU membership creates an incentive for large reductions of contract length (to about one half or one third of the length without membership), but still leads to a large increase in employment variability (it approximately doubles). According to the model computations, the combination of EMU membership and an endogenous shortening of contract length causes a huge increase in the variability of the rate of price change (it increases fivefold or more).¹

Another approach focuses instead on the prevalence of *contingency clauses* in existing wage contracts, which make it possible to adjust already agreed wage changes in

¹ The model calculations do not take into account that the increased variability in the rate of price change may reinforce destabilising movements in the real interest rate (the so-called Walters effect): for example, if the reduction in inflation in a demand-driven recession is reinforced by nominal wage flexibility, the real interest rate increases more than would otherwise be the case. Taking this effect into account might further reduce the stabilising effects of increased nominal wage flexibility on output and employment. The overall outcome for output and employment stability is not clear, however, as increased nominal wage flexibility would also reinforce stabilising variations in the real interest rate in the case of temporary supply shocks: the real interest rate would, for example, fall more in the case of a negative supply shock, which reduces output and raises inflation.

response to prespecified events (Gray, 1976; Blanchard, 1979; Walsh, 1995; and Heinemann, 1999). One example is indexation clauses, linking wage changes to consumer price increases, as used to be common in many European countries, and still exist in Belgium, Finland, Luxemburg and Spain. Calmfors and Johansson (2002) found that the incentives for such contingency clauses are likely to be enhanced by EMU membership in a similar way as the incentives for shorter contract length.² But another finding was that the increase in macroeconomic variability associated with EMU entry might very well be too small to trigger the introduction of such clauses if they did not exist before. Profit-related pay is another type of contingent wage contract. One could hypothesise that the incentives for such pay arrangements would also be enhanced by EMU membership, although I am not aware of any formal modelling of this.³

A third approach stresses *co-ordination failures* as the main cause of nominal wage stickiness (Ball and Romer, 1991). Unless macroeconomic disturbances are very large, the incentives to adjust wages in individual bargaining areas may be small in the absence of co-ordination with other bargaining areas. This aspect may be particularly relevant to the UK economy in view of the decentralised and overlapping character of wage setting, which rules out co-ordinated wage responses to macroeconomic disturbances of the social-pact type that has occurred in several EMU countries (the most outstanding examples are Ireland, the Netherlands and Finland; see Calmfors *et al.*, 2001). The analysis of Holden (1994, 2001), which builds on the idea that the *fall-back option* for wage bargainers if they cannot agree on a new wage contract is to continue with the earlier wage contract, also suggests that larger macroeconomic shocks in the EMU may not lead to more nominal wage flexibility unless shocks are very large. If shocks are limited in size, it will pay no party to wage bargaining to initiate a labour market conflict to change the *status quo*.

² Leichter (1998) arrives at a similar conclusion.

³ Note, however, that simple profit sharing à la Weitzmann (1985), according to which the employee is paid the sum of a fixed nominal base wage and a fixed share of the firm's profit per employee, instead of just a fixed ordinary nominal wage, would not help stabilise output and employment. The profit-maximising condition is then that the value of the marginal product of labour should equal the base wage. If the base wage is set lower than the ordinary wage, equilibrium output and employment increase, but the variations around the equilibrium in the case of unanticipated price and productivity shocks are not affected (Calmfors, 2002).

A last approach, finally, focuses on how strong *social norms* about fairness may cause *downward* nominal wage rigidity. This may not only imply that nominal wage levels are difficult to cut, but also that wage setters feel entitled to at least some nominal wage increases, which form a reference point when individuals evaluate their utility along the lines of the Nobel laureates Kahneman and Tversky (1979). There exists ample evidence from various survey studies of the importance of social norms against nominal wage reductions except in very extreme situations, such as when the survival of a firm is at stake (see, for example, Bewley, 1999). This again raises the possibility that increased macroeconomic variability associated with EMU membership may not be enough to change the degree of nominal wage rigidity significantly. This hypothesis receives some support from two recent Swedish studies. Agell and Lundborg (1995) examined how a number of personnel managers in 1991 judged the possibility of nominal wage cuts. Agell and Lundborg (1999) reports on a similar survey made in 1998. The authors could not find more positive attitudes towards nominal wage cuts in the latter survey even though there had been a dramatic increase in unemployment and an equally dramatic reduction in inflation between the two surveys. This suggests that it may be very difficult to change social norms on nominal wage reductions.

My overall conclusion is the same as in Calmfors (1998), namely that tendencies to increased macroeconomic variability in association with EMU membership would create incentives for more wage flexibility, but that this is likely to counteract these tendencies only to a limited degree. One should be especially concerned about the risk of downward money wage rigidity, the macroeconomic consequences of which are more serious the lower the inflation target of the ECB, as low inflation reduces the room for achieving real wage cuts and real exchange rate depreciations (reductions of wage costs relative to other euro countries) without cutting nominal wages.⁴

⁴ Indeed, there might be a harmful interaction between downward nominal wage rigidity in general in the euro countries and the price stability target of the ECB. Downward nominal wage rigidity might create an incentive for the ECB to choose a low target, which could reinforce nominal rigidities. The argument is that the ECB may want primarily to maintain a stable rate of inflation. At a low rate of inflation, the restriction that nominal wage levels cannot be cut binds more often. Hence, the rate of wage change will vary less, which makes it easier for the ECB to stabilise the rate of inflation. Downward nominal wage rigidity in the euro area could also increase the risk of differential cyclical developments among the member countries. If booms in some countries drive up the average rate of inflation in the euro area, the ECB will tighten monetary policy. The more downward wage rigidity there is in the countries not experiencing booms, the

In addition, I want to point to a risk that has not been much discussed before. The risk derives from a possible interaction between increased *upward* nominal wage flexibility and unchanged (or only slightly increased) *downward* flexibility in the case of EMU membership. The explanation for such an outcome would be that the forces reducing downward wage flexibility (social norms) are much stronger than the forces working against more upward wage flexibility, which might imply that EMU membership could change the degree of wage flexibility in an asymmetric way. (A case in point would be that trade union fears that real wages will be eroded by inflation have recently motivated indexation clauses, according to which higher than expected inflation triggers additional wage increases, whereas lower inflation does not trigger lower increases, in Spain and Finland.⁵)

The consequence of such an asymmetric change in the degree of nominal wage flexibility would be an increased risk that temporary demand increases in an individual country cause wage increases, which because of downward money wage rigidity are hard later to reverse and therefore "lock in" a higher real wage level and an appreciation of the real exchange rate. This way increased upward nominal wage flexibility in the case of EMU membership could indeed make it more difficult to stabilise the domestic economy in the next downswing, which would be entered with too high real labour costs and an overvalued real exchange rate (see EEAG, 2002 and 2003, for an analysis of these issues).

3. The role of fiscal policy

If increased nominal wage flexibility cannot work as a good substitute for national monetary policy in the EMU, the remaining option to handle asymmetric cyclical developments is through an increased use of fiscal policy. When assessing the scope for this, one has to evaluate: (1) the technical effectiveness of fiscal policy as a countercyclical stabilisation tool; and (2) the political-economy possibilities of using fiscal policy for this purpose in an effective way.

larger output and employment reductions must occur there to compensate for the inflation in the booming economies (Holden, 2001).

3.1 The technical effectiveness of fiscal demand management policy

As to the technical effectiveness of fiscal demand management policy, there exists a large literature questioning its impact based on the notion of Ricardian equivalence (see Elmendorf and Mankiw, 1999). The argument is that deficit-financed tax reductions, raising the disposable incomes of households, will fail to increase private consumption and thus to stimulate aggregate demand: households will realise that their life-cycle incomes have not increased, as they will have to pay for the deficits through higher taxes in the future. However, it is well-known that the Ricardian equivalence results hold only under very restrictive assumptions. Empirical analysis seems also to indicate positive tax multipliers, although they may be smaller than believed earlier (around one or slightly below; see, for example, Blanchard and Perotti, 1999).

Still, the Ricardian equivalence debate points to the importance of finding fiscal policy instruments that are as effective as possible. One would, of course, always expect tax and transfer changes targeted on low-income groups, which to a large extent are credit-constrained, to be more effective than measures targeted on high-income groups with better access to capital markets (Wren-Lewis, 2000). Also, temporary changes in government consumption should be more effective in affecting aggregate demand than general income tax changes. This is obvious if an increase in current government consumption is financed through a reduction in future government consumption, as this does not involve any changes in the taxes paid by households and hence no changes in private consumption if that is based on life-time income. But a similar conclusion holds also if a temporary increase in government consumption is financed through future taxes. The explanation is that the short-run direct demand effects are larger than the short-run changes in private consumption due to perceived future tax changes: this is so because the changes in private consumption resulting from the changes in life-time incomes will be spread over the whole future, as households want to smooth consumption over time, whereas the whole change in government consumption occurs in the short run (EEAG, 2003).

According to the textbook Mundell-Fleming model, fiscal policy becomes more effective as a stabilisation tool for an individual country with membership in a monetary

⁵ See *Economic Survey of Spain* (2001) and *Inkomstpolitiskt avtal för åren 2001-02*.

union than with a flexible exchange rate, as the demand effects in the latter case tend to be offset through exchange rate movements (see, for example, Krugman and Obstfeld, 2002, Chs 16-17). This is sometimes taken to imply that there would be no stabilisation policy cost of EMU membership. This argument is incorrect. The reason is that it is in principle possible to achieve the same mix of monetary and fiscal policy with non-membership as with membership. The only reasonable interpretation of the fact that most countries with a flexible exchange rate have chosen to use monetary, and not fiscal, policy as the primary stabilisation tool is that this assignment has been judged to be superior (Commission on Stabilisation Policy, 2002).

3.2. Fiscal stabilisation policy to affect relative prices

One type of fiscal policy that has received too little attention in my view is measures that work by changing *relative prices*. A first such policy is temporary changes in the VAT, which affect private consumption in a similar way as changes in the real interest rate: by changing the relative price between consumption in different time periods, households are induced to re-allocate spending intertemporally (Commission on Stabilisation Policy, 2002). One could also conceive of a similar use of investment taxes or subsidies to affect the timing of private investment. The possibility of cross-border trade is usually seen as a limitation on the possibilities to set VAT rates according to national priorities in the long term. But this does not apply in the same way to temporary VAT changes as a stabilisation tool in the case of country-specific cyclical developments. On the contrary, if a temporary rise in the national VAT in a boom shifts consumption purchases abroad, this, too tends to reduce demand domestically. An alternative way of changing the (after-tax) intertemporal terms of trade for households might be to vary the rate of capital income taxation over the business cycle.⁶

⁶ This has been suggested by Boije and Shahnazarian (2002), who note that a given change in the after-tax interest rate can be achieved either through a change in the pre-tax interest rate or a change in the tax rate. However, there are several differences in effects between the two policies. A change in the rate of capital income taxation affects the whole spectrum of after-tax interest rates and returns, whereas a change in the central bank's repo rate only affects short-term interest rates. This difference tends to make changes in capital income taxation a more powerful stabilisation tool than central bank interest rate changes. One should also note that the income effects on consumption of a pre-tax interest rate change and of a tax rate change work in opposite directions: the after-tax interest rate can be raised through either a pre-tax interest rate increase (which has a negative income effect on borrowers) or a tax rate reduction (which has a

Another possibility, which has also been overlooked in much of the international discussion, is to use temporary variations in the payroll taxes levied on employers as a stabilisation tool. By changing domestic wage costs, such a policy directly affects the real labour cost and the real exchange rate vis-à-vis other euro countries. It is not only temporary reductions in payroll taxes in downswings that may be of interest. In fact, temporary rises in employers' payroll taxes may be an appropriate policy if an individual euro country experiences a boom. The reason is that higher payroll taxes for employers raise domestic wage costs and output prices, but not domestic wages. On the contrary, wage increases are likely to be held back to the extent that the demand for domestic output falls and the tax is shifted backward on to employees because "the room for wage increases" is reduced.⁷ A temporary increase in payroll taxes may therefore be a desirable way of dampening a boom, because wage costs are raised temporarily at the same time as the risk that wages are bid up more permanently (see the discussion on asymmetric nominal wage rigidity on p 5) is reduced.

The idea of using cyclical variations in employers' payroll taxes as a countercyclical tool has large similarities with the system of so-called *buffer funds* that was set up in Finland in connection with the entry into the EMU. According to this system, funds have been built up through temporary increases in employer contributions to the social security system and the intention is to use these funds to hold down contributions in downswings (Holm *et al.*, 1999).

Fiscal policies working through changes in relative prices do not have to involve variations in the budget balance. One example is to combine a reduction of payroll taxes with an increase of other taxes falling on employees (income taxes, employee contributions to the social security system or the VAT) or reductions in government transfers to households. Such a tax shift is often labelled *an internal exchange rate change*, because it can be shown to have short-run effects that are equivalent to those of a nominal exchange rate change, as discussed in Calmfors (1998). Such internal

positive income effect on borrowers). A side effect of variations in the capital income tax rate is that they may affect the incentives to reclassify labour incomes as capital incomes.

⁷ This latter tax-shifting effect has been shown empirically to be strong in the Nordic countries (Nymoén and Rødseth, 1999; Calmfors and Uddén Sonnegård, 2001). The wage-reducing effects mentioned in the text would be counteracted to the extent that compensating wage claims are triggered by the CPI rises

devaluations were made in Denmark in the late 1980s and in Sweden in the early 1990s. There are, however, some problems with this measure. One is that it requires complex decisions on several fiscal policy parameters, which is likely to result in a slow decision process. Another problem is that real exchange rate changes are known to affect trade volumes with substantial lags. This is an argument for using an internal devaluation mainly as a measure of last resort in situations when there is no scope for increasing budget deficits and when a recession is likely to be drawn-out. A good example of such a situation could be the present German one, where a budget deficit in excess of the three-percent-of-GDP ceiling in the Stability and Growth Pact necessitates fiscal restraint, at the same time as there may be a persistent misalignment of the real exchange rate (because the D-mark was converted to the euro at an overvalued nominal exchange rate).

3.3. The political economy of fiscal stabilisation policy measures

The most fundamental problems of using fiscal policy as a stabilisation policy tool are political-economy ones. There are a number of reasons why discretionary fiscal policy is likely in practice to be used in a less effective way than monetary policy.

- Decision lags are long, as tax and government expenditure changes have to go through a lengthy parliamentary decision-making process.
- The political character of fiscal policy decisions makes it hard to reverse decisions when circumstances change (Taylor, 2000).
- Fiscal policy has also other central objectives than stabilisation, viz. income distribution and an efficient resource allocation. In addition, the timing of fiscal policy measures is often influenced by attempts of incumbent governments to enhance their re-election chances. Hence, there is a serious risk that stabilisation policy aspects will carry a low weight (Commission on Stabilisation Policy, 2002).
- A voluminous political-economy literature has highlighted the risk of a systematic *deficit bias* for fiscal policy, because it is run by policy-makers engaged in day-to-day politics where a short-run perspective tends to dominate (see, for example, Alesina and Perotti, 1995; or von Hagen *et al*, 2002).

associated with higher output prices when pay-roll taxes are raised, but this effect is likely to be small compared to the other effects.

Considerations of this type have led many economists to the conclusion that discretionary fiscal stabilisation measures are likely to be badly timed and conducive to fiscal laxity in general. The prevailing conventional wisdom is that fiscal policy should mainly be confined to let the automatic stabilisers, that is the automatic cyclical variations in tax receipts and some government expenditures, dampen output and employment fluctuations (see, for example, Taylor, 2000; or European Commission, 2002). This is, however, a problematic conclusion as automatic stabilisers can by their very nature only cushion macroeconomic shocks, but not fully offset them. Moreover, there is no reason to believe that the automatic stabilisers give the optimal degree of stabilisation, as their size is a by-product of decisions that have nothing to do with macroeconomic stabilisation (mainly the ratio of overall government expenditures to GDP). This raises the question whether it might be possible to improve the workings of fiscal policy through institutional reforms that mitigate the political-economy problems.

A natural question is whether some lessons for the fiscal-policy decision-making process can be learnt from the institutional set-up adopted in the field of monetary policy in many countries, for example the UK and Sweden. This set-up involves a well-defined policy framework with the setting of clear objectives, a transparent decision-making process, and delegation of decisions to an independent central bank. In my view, there exist several more or less radical options for improving the decision-making process for fiscal stabilisation policy measures along such lines.

The most conventional approach would be to build on the recent reforms in many countries that have introduced more fiscal discipline through procedural changes in the budget process strengthening the position of the ministry of finance (see von Hagen *et al.*, 2002) and greater transparency (like with the Code for Fiscal Stability in the UK and the Fiscal Responsibility Act in New Zealand). One aim would then be to increase the importance attached to stabilisation objectives and avoid that they are confounded with income distribution, social-efficiency and re-election objectives. Another aim would be to shorten decision lags. One way of doing this could be to adopt a “*Fiscal Stabilisation Policy Act*”, which complements long-run budget balance (or government debt) goals for fiscal policy with clear stabilisation objectives. In the case of EMU membership, when

the long-run national inflation rate is tied down by the common euro area inflation rate, the natural primary objective for national fiscal policy is to stabilise output around its equilibrium (potential) level. Since the output level cannot be affected in the short term without excessive variability in the fiscal parameters, the goal should be forward-looking and apply to the medium term (Commission on Stabilisation Policy, 2002).⁸

A Fiscal Stabilisation Policy Act could also give guidelines for under which circumstances one should rely only on the automatic stabilisers and under which circumstances one should resort to discretionary action (for example, when predicted output gaps are judged to exceed some critical levels). Like in the Australian Charter of Budget Honesty, the government could be obliged to indicate which tax and expenditure changes are temporary (because they are undertaken for stabilisation purposes) and “the process for their reversal” (Business Council of Australia, 1999). To shorten decision lags and reduce the risk that income distribution or re-election considerations come to dominate stabilisation considerations in concrete situations, a Fiscal Stabilisation Policy Act could also specify in advance a small number of fiscal policy instruments to choose from if the need for discretionary action would arise (Commission on Stabilisation Policy, 2002).

A somewhat more radical approach would be to establish an *independent advisory Fiscal Policy Committee*, which could be entrusted with the task of providing a regular input into the budget process, serving as a basis for fiscal policy decisions with the aim of stabilising the economy (Wren-Lewis, 1996; Commission on Stabilisation Policy, 2002). The Committee could be required to publish regular stabilisation reports (corresponding to the present inflation reports of, for example, the Bank of England and the Riksbank in Sweden) assessing the state of the economy. The Committee could also give recommendations to the government and the parliament on how much the budget target in a given year should deviate from the budget target over the cycle and on specific tax and expenditure changes to stabilise aggregate demand (Commission on Stabilisation Policy,

⁸ The argument is similar to the one for monetary policy. Note also that an output stabilisation goal for fiscal policy does not mean that an inflation differential vis-à-vis other euro countries should be neglected. On the contrary, for example a higher inflation rate than in the rest of the euro area could mean an erosion of international competitiveness, which would make it harder to stabilise output in the future. Hence, the relative rate of inflation is likely to be a key intermediate target in a fiscal regime aiming at output stabilisation in the medium term (EEAG, 2002 and 2003).

2002). The idea is then to increase the reputational costs for the government of attaching a low weight to considerations about stabilisation and long-run fiscal sustainability. Such a Fiscal Policy Committee could be given more teeth by requiring the government to give a formal explanation to the parliament if it chooses not to heed the recommendations. One might also require the government to base its budget calculations on the Committee's estimates of output gaps as well as of tax and expenditure developments.

A more far-reaching reform would be to *delegate the actual decisions* on fiscal policy measures to stabilise the economy to an independent Fiscal Policy Committee in much the same way as monetary policy has been delegated to independent central banks.⁹ One option, which has been proposed by, for example, Ball (1997) is to delegate the power to vary certain tax rates (and/or possibly government expenditure levels) around some base values within predetermined margins.¹⁰ Another possibility, which has been advocated by Wyplosz (2002), is to let the Committee decide how much the annual budget target should be allowed to deviate from the budget target over the cycle, which would continue to be determined by the parliament. According to this model, the parliament would also decide through which tax and expenditure changes the annual budget target in a given situation should be achieved. The underlying idea behind the delegation proposals is that stabilisation of the business cycle is a commonly shared objective, which requires more of technical expertise, but less of political value judgements, than other fiscal policy decisions, such as those on the size and structure of government expenditures and taxes and on long-run government debt accumulation.

Most people probably view the idea of delegation of fiscal stabilisation policy decisions as unrealistic, because it would seem to interfere with traditional principles of parliamentary control over taxes and government expenditures, which are often regarded as a centrepiece of democratic governance. Provided that fiscal policy decisions with the aim of stabilisation can be delineated from other fiscal policy decisions, it is, however, difficult on a purely intellectual level to see why there should be weaker arguments for

⁹ This possibility has been analysed by, for example, Ball (1997), Business Council of Australia (1999), Seidman (2001), Wyplosz (2002) and EEAG (2003).

¹⁰ One way of doing this could be to give the Committee control over a "rainy-day stabilisation fund" for this purpose. The Finnish buffer funds (see p 8) play such a role, although they are controlled jointly by the government and the central labour-market organisations in a corporatist fashion.

delegation in this case than for monetary policy (which has become generally accepted).¹¹ Such delegation would also conform to more general trends in many other areas of economic policy, such as competition policy and regulation of financial markets, where politicians have chosen to focus on setting general priorities and to delegate the operational policy making to professional bodies. Successful delegation of this type does, however, require well thought-through mechanisms to hold decision makers accountable. This could include ex-post public evaluation of policies, possibilities of dismissal in the case of significant deviations from targets and possibilities of overriding the decisions (the last two possibilities preferably requiring a qualified majority in the parliament to protect against misuse) (see, for example, EEAG, 2003).

4. Overall conclusions

One cannot expect increased nominal wage flexibility in the EMU to act as a good substitute for the loss of national monetary policy in the event of country-specific cyclical developments. This puts a heavy burden on national fiscal policy. The technical potential of fiscal policy to work as an effective stabilisation policy tool has probably been underestimated in recent years: especially policies that change relative prices (such as temporary VAT changes affecting the intertemporal terms of trade or temporary changes in payroll taxes affecting real labour costs and real exchange rates) are likely to have substantial effects.

The main obstacle to efficient fiscal stabilisation policy is problems of political economy: long decision lags, irreversibility of decisions, deficit bias, confounding of stabilisation policy objectives with income distribution and resource allocation objectives, and the use of fiscal policy to secure the re-election of incumbent governments. This makes it unlikely that an increased use of fiscal policy can compensate for the loss of national monetary policy in the case of EMU membership. But the effectiveness of fiscal policy as a stabilisation tool can probably be raised significantly

¹¹ A relevant counterargument might, however, be that one regards delegation of both monetary policy and some fiscal policy decisions to “technocrats” as giving too much delegation in total. An alternative, which has been proposed by Sveriges Riksbank (2002), is that the parliament should instead delegate some fiscal policy decisions of a stabilisation character to the government. This might mitigate the problem of long decision lags, but might on the other hand exacerbate political-economy problems relating to the risk of procyclical policies pursued by governments in order to secure re-election.

through various institutional reforms establishing a more well-defined and transparent policy framework that borrow from the experiences of monetary policy making.

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