Stability, Subsidiarity and Sustainability – Cornerstones of a European Fiscal Policy for tomorrow –

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Fiscal Policy in a complex environment

The world in which we live is a world of rapid change. New technologies and the ever faster world-wide integration of economies increasingly touch on the life of each individual. The multitude of products is growing just as is the multitude of life models. This implies big challenges not only of an economic but also of a social nature – for each individual citizen and for entire nation states. In order to take advantage of the chances connected with the epochal developments and to effectively meet the risks involved, the public authorities have to assume responsibility, too. Mastering change means formulating national and international rules and, if necessary, the spending of money.

In formulating political strategies we must take account of a number of different general conditions.

- *Borders lose significance*
  Our future lies in Europe. The introduction of euro notes and coins on 1 January 2002 is a clearly visible sign for the increasing integration of Europe. The smooth process has shown impressively how much the people in the member countries have already accepted the thought of a common Europe. At the beginning of the last century this would have been unthinkable. Its early decades were characterised by terrible wars and animosity. Today many vacationers from European neighbouring countries provide for a lively exchange of views and customs. Furthermore, a tight economic network has developed for the benefit of all involved. The enlargement of the European Union will increase this sphere. Higher mobility of consumers and products as well as increased price transparency contribute – not only in Europe – to the growing competition of economies.
  Fiscal policy must do both, contribute to a stable currency and improve the locational attractiveness. In the Euro area this no longer happens exclusively in the national context; rather, national and European aspects of fiscal policy are discussed in the framework of fiscal and economic co-ordination with the partner countries and the European Commission.
- *Population ageing is progressing in the Western industrial countries*
  More and more people are reaching old age. Low birth rates and rising life expectancy result in serious changes in the age composition of the population. This demographic development puts the spotlight especially on the question of the required measures of social security. It is necessary to guarantee the long-term capability of these systems. Reforms of the social security system must coincide with the provision of the necessary financial resources.
- *Protection of the natural environment continues to gain in significance*
  Nothing can replace unmarred nature. The welfare of present and future generations depends in especially large measure on a most careful interface with the environment. In particular, environmental problems do not stop at national borders. Despite all successes to date, additional efforts are required to reduce environmental damage. Here, fiscal policy can make a contribution by providing the appropriate incentives for environmentally correct behaviour. Germany's ecological tax reform serves as an example.
- *The knowledge and information society must be furthered*
  When natural resources become scarcer, know-how becomes ever more important. Education and science are irreplaceable resources. They are increasingly gaining in significance especially against the background of accelerating technological competition. In March 2000 the European heads of states and government therefore set the strategic goal of making the European Union the most competitive economic region of the world within ten years. Unlike any other process, the goal of moving to a knowledge-based society has underlined the necessity of improving the quality of the budget.

Unlike any other policy, fiscal policy is called on to create the prerequisites for a secure future and to contribute to the welfare of present and future generations. It reflects the economic develop-

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ments, the major political decisions and social issues of an economy. It must not only provide the funds, it must at the same time help to shape the future.

Securing stability – creating growth and employment

Even a cursory review of the major determinants of modern politics clarifies the necessary direction of fiscal policy. It is become more and more necessary to think and act in a cross-border way in order to guarantee a stable development. In an increasingly global world, fiscal policy can no longer gear itself to national circumstances. Therefore the EU member states took measures some time ago to co-ordinate their fiscal and economic policies more closely. All of them agree: solid state budgets are a major prerequisite for sustained non-inflationary growth and more employment. Solid fiscal policy thus simultaneously makes a contribution to the stability of the common European currency.

Successful consolidation of the public finances is the essential pillar for a stable economic environment in the future. Low government deficits or the renunciation of government borrowing, are the contribution fiscal policy can make to low prices and interest rates. They therefore contribute not only in the short term but also in the long term to an improvement of the supply and the demand sides of the economy. A growing scope for fiscal spending may be utilised in the long term for important investments and can thus add to the growth potential of the economy. Furthermore, reducing the public debt is the most important contribution of fiscal policy to generational solidarity. We must not overburden future generations with our debts, but must leave them scope for their own creativity. For these reasons, too, budget discipline was firmly anchored in the EC Treaty of Maastricht. The rules of the EC Treaty were supplemented and clarified by the Stability and Growth Pact.

In a federally organised state, all levels of government must help to meet the EU demands. About this there is agreement in Germany among the federal, state and local governments.

Individually and jointly we must help to honour the agreement at the European level. In Germany, fixing a strict spending target is an important component of the intra governmental rules.

According to experience to date, the existing rules and regulations have proved worthwhile at the European level. Since the early 1990s, EU member states have succeeded in markedly reducing their budget deficits. Many member states already achieve surpluses. The scope for financial action is increasing.

A one-sided orientation towards consolidation, however, would not meet the complex demands on a modern fiscal policy. An important task is the stabilisation of the business cycle. The so-called automatic stabilisers must be allowed to even out cyclical fluctuations. This means in principle that in a downturn the cyclical increase in the budget deficit must be tolerated and must not be prevented by raising taxes or cutting expenditures. Correspondingly, in an upswing the cyclical improvement in the government budget must not be erased by higher expenditures or tax reductions.

The European agreements put limits on this process. The commitment to the goal of producing a balanced budget in the medium term prescribes the scope for policy action. This is especially true if in the preceding upswing the corresponding scope for letting the automatic stabilisers work was not increased.

This has primarily two causes. It is not always easy to differentiate in each situation between cyclical and non-cyclical effects on the government budget. In addition, the impetus of comprehensive tax reductions is an important instrument of a fiscal policy that supports growth and employment. This is especially true against the background of increasing global competition among companies and locations. The challenge therefore is to find a balanced mix between the demands of the Stability and Growth Pact and the growth and cyclical needs. In order not to jeopardise the basic stability orientation of fiscal policy, strict spending discipline must therefore be the basis of all plans for tax reform.

The Federal Government has taken account of this in formulating its fiscal policy. The important pillars of German fiscal policy are a comprehensive reduction of government debt on the one hand and the promotion of growth and employment by a corresponding design of the tax system on the other.

The tax system must be effective and fair. This implies that tax policy must guarantee that the funds for the necessary government tasks are available in the long term in order to promote stability. In addition it must and can set the appropriate signals, not only for a growth and employment promoting development but also e.g. for dealing responsibly with our natural resources. Europe-wide harmonisation of energy taxation would be an important step towards reducing cross-border environmental problems. Tax policy which is to meet the demand for fairness is strictly orientated towards the principle of capability, closes tax loopholes, fights illegal employment, promotes the family and supports the creation of a fully funded pension system.

Safeguarding subsidiarity – taking account of national and regional differences

One of Europe's greatest strengths is its diversity. Besides uniform rules like those entailed in the Growth and Stability Pact, the competition for ideas and problem solutions benefits everybody. Here it is important to realise that different problems require different answers. It is not only the special factor of German unification which for Germany requires different approaches in certain areas than in other European countries. The continuing challenges posed by German unification are an essential difference, however.

In eastern Germany the results to date are good: labour productivity and per capita income have more than doubled since the early 1990s. The infrastructure has been improved and brought up to the latest technical standard. Close to 350,000 newly founded firms have withstood the market test. Despite all of the successes achieved, the economic reconstruction is far from complete. This is shown, for example, by the very different economic structure and the high unemployment rate, which is twice that of western Germany.

The main goal is and continues to be to strengthen the inherent dynamics of the east German economy so that modern innovative and competitive economic regions may develop. This was the major motivation for the design of the Solidarity Pact II between the federal and state governments that extends the Solidarity Pact I, which will expire in 2004, and puts the support of eastern Germany on a reliable footing up to 2019.

Other European countries, too, have their very specific problems. Different economic structures, different traditions, different age structures or different levels of infrastructure in the European member states will not make uniform policy approaches desirable or possible in the future. Common institutions and binding rules will have to take account of this circumstance just like "soft" types of co-ordination in the form of political dialogue or pure information exchange. In the future, too, fiscal policy in Europe must entail the possibility to react adequately – together or individually – to specific challenges.

Differences alone in size and structure of economies may require different measures. Thus the ability of the automatic stabilisers to even out cyclical fluctuations also depends, besides the cyclical sensitivity of the budget, on the size and structure of the economy. The more open an economy, for example, the more government stability measures are likely to fall flat, because the additional demand can be met to a large degree by higher imports. In the course of continuing European integration and growing globalisation, the degree of openness of economies will tend to increase further – and the cyclical effectiveness of automatic stabilisers is likely to decline further. Sustained growth will therefore always require a full set of various measures that will differ from country to country.

Achieving sustainability – improving the quality of the budget

Sustainability has many aspects. It cannot be reduced to economic, social or ecological questions. A common European goal is, therefore, an economically efficient, socially fair, and ecologically sustainable development. In Germany, the continuation of budget consolidation and a reduction of taxes are important components of the strategy to achieve this goal. They must be supplemented by a strengthening of future-oriented areas of fiscal policy and the formulation of approaches to coping with the burdens of population ageing.

For intensifying an economy's competitiveness and ability to meet future challenges, the transition to a knowledge-based society is of central importance. Expenditures for conserving old structures must be reduced in favour of future-oriented spending. This does not only apply to physical investment. Just as important is spending on human capital and measures for the promotion of the family. School buildings become an expenditure of relevance for the future only through teachers. Improved childcare possibilities improve the compatibility of family and job and thus contribute to higher growth. Responsibility for education rests with government at all levels. Future-oriented fiscal policy also encompasses inducements for environmentally desirable behaviour. Placing taxes and fees on the consumption of environmental resources creates signals for dealing carefully with natural resources. Future-oriented expenditures which can no longer be classified by the old dualism of "good investment spending" and "bad consumption spending" may also be found in the area of research.

On the European level, the topic of "generational fairness" in particular is closely linked to the discussion of sustainability. All Western industrialised countries are – to a lesser of greater degree – affected by the same problem. The data on shrinking populations are already known. Nothing will change that in the short term. The effects of this development depend on the evolution of many other variables like growth, immigration, women's labour force participation rate, working life, to mention just a few. At present the baby-boom age-groups make up the centre of the labour force. When, in 20 to 30 years' time, these cohorts reache retirement age, the effects of the demographic change will become clearly visible. This does not mean, of course, that policy can wait until then. It is today that the necessary strategic decisions must be made.

Pensions are only one, albeit important, example of the problems facing us. Similar problems are emerging with respect to statutory health insurance or civil service pensions.

Welfare and other government transfers are also used to meet daily needs. They, too, will not be untouched by the demographic developments. Besides the provision of financial public resources through budget consolidation or an increase in the labour force, further routes to an appropriate reform of the social security systems must be sought and must be travelled. In this context, appropriate instruments for increasing self-provision, in particular, must be developed.

The interest of present and future generations must be balanced in an adequate way. In a world in which borders lose significance, here, too, we cannot consider exclusively national circumstances. Against this background, the reduction of the public debt and the creation of an adequate scope for self-provision are only two elements of the required answer to the demographic question. Increasing immigration of qualified workers also contributes to the growth of the labour force, and foreign investment promotes the creation of the necessary jobs. In this way, too, the capability of the social security systems can be safeguarded. In this sense, an improvement of the attractiveness for employees and entrepreneurs of their respective locations represents also a major contribution to the sustainability of fiscal policy. To maintain good neighbourliness, however, unfair methods must be prevented, as is already the case on the European level with the prevention of unfair tax competition.

Concluding remarks

A modern fiscal policy must meet a multitude of demands. It is much more than the mere administration of the revenues and expenditures of the economy. Fast-paced times are beset by high uncertainties. Predictability is therefore also of great importance to fiscal policy. This is especially true against the background of a common European currency. Wrong developments of fiscal and structural policies in individual countries can directly affect developments in other countries. In order to prevent that, the agreements on the European level must be adhered to. The European rules and regulations and the common institutions must, however, retain enough flexibility in the future to take account of the prevailing differences among individual states and regions. In this way we may succeed in safeguarding a sustainable development, which combines economic growth with social security and ecological compatibility. For the benefit of all Europeans.