Financial Times, 18 November 2008

Europe needs a concerted fiscal stimulus

Jean Pisani-Ferry, André Sapir and Jakob von Weizsäcker

The Group of 20 communiqué calls for "fiscal measures to stimulate domestic demand to rapid effect" and underlines the needs to maintain "a policy framework conducive to fiscal sustainability". The European Union should heed the G20's advice. Without a budgetary stimulus the recession will lead to a second round of credit stress. However, structural deficits in many EU member states were high even in good times, so fiscal sustainability is also a concern.

But can Europe deliver? The obstacles are daunting. The fiscal room for manoeuvre varies greatly among the member states. The political weights attached to a fiscal stimulus and to fiscal sustainability clearly differ among the core countries, France and Germany in particular. The high degree of economic integration implies strong incentives to free-ride. Reaching a differentiated agreement on who does what could take months if not years, while the urgency is to act now. We therefore propose a three-part European recovery programme.

First, EU member states would all pledge to implement the same quantum of fiscal stimulus next year so that the burden of supporting the recovery would be shared equally. Specifically, we propose that all European countries deliver a boost amounting to 1 per cent of gross domestic product in 2009. This is at the high end of the range of the German budgetary stimulus proposed last week by its Council of Economic Experts. Although it may not be ideal for all countries, it is better for everyone to ensure that all of Europe is on board. In order to send a co-ordinated and unambiguous signal and to ensure that the boost is timely and effective,

VAT is not the best possible instrument to support growth, but it is the one Europeans can implement jointly

we advocate that a portion of the stimulus be delivered through a uniform 1 percentage point cut in value added tax rates on January 1 2009. VAT is not the best possible instrument to support growth, but it is the one Europeans can implement jointly. The remainder of the fiscal boost could be delivered through measures tailored to country-specific circumstances, such as relief for the working poor and incentives to improve carbon dioxide efficiency.

Second, this budgetary boost needs to be accompanied by an agreement to strengthen the EU's fiscal framework. The fall in tax revenues and increase in spending during the downturn, plus the additional fiscal boost we propose, will lead to a number of countries substantially exceeding the 3 per cent deficit limit of the stability and growth pact in 2009. While this would trigger an "excessive deficit procedure" by the EU, that process would start biting only in 2012. By then, countries that already have high structural deficits could be in hopeless budgetary situations. Government bond spreads, which have widened markedly in recent weeks, could reach alarming levels.

To prevent such an outcome, and to reassure countries such as Germany that might not otherwise agree to take part in co-ordinated action, we propose that countries expected to exceed the 3 per cent deficit limit in 2009 commit to immediate reforms to improve budgetary sustainability, offsetting the short-term overrun. Although this would cut the deficit only in the medium term, these measures would need to be adopted in 2009 and certified by the European Commission. Pension reforms are a good example of such measures. If countries failed to take action, they would have to submit to an accelerated excessive deficit procedure that would bring forward corrective measures from 2012 to 2010.

Third, to guarantee sustainability, member states should commit not to borrow at abnormally high interest rates. We propose that all eurozone countries commit not to borrow at an interest rate of more than 200 basis points above the lowest government bond yield within the euro area. If this proposed limit is exceeded, it should trigger an emergency and temporary procedure where the member state would need its budget and borrowing plans to be approved by the EU Council before they are enacted.

These ideas should be among the proposals the European Commission will consider on November 26 and should be endorsed by the European Council on December 11 with immediate effect. We are aware that our proposal amounts to turning the traditional EU logic upside down. But if the EU chooses instead to follow its instincts and muddle through, it risks paying a high economic and political price.

The writers are resident scholars at Bruegel, the European think-tank. The piece is based on a policy brief available on www.bruegel.org