

# MACROECONOMIC POLICIES AND INSTITUTIONS

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*Why since at least two decades macroeconomic policies have been so active in the US and so passive in Europe? I contend that social norms have changed and that the new norms call for a greater degree of inequality. Then macroeconomic policies have to be active in the United States and passive in Europe. The change in the social norm was mainly led by the new generation of elites born after WW2 educated in a context where individual successes were more affected to individuals than to the collective action which has contributed to build the public goods they have benefited from.*

## 1. Prolegomena: The European macroeconomic policy puzzle

The theme of this lecture came out as an effort to understand the difference in economic policy strategies on both sides of the Atlantic. Why since at least two decades macroeconomic policies have been so active in the US and so passive in Europe? Why governments in Europe do accept rather passively a persistent high level of unemployment? What explains their apparent resignation to a slow growth trend? Is there a fundamental difference in institutions that can explain such a prolonged difference in growth performance? My answer to these questions has varied through time.

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In the 1980s I developed with Edmund Phelps (Fitoussi and Phelps, 1988) an explanation of the slump in Europe. The radical change of the US policy mix in the first half of the eighties led to a large increase in both the world long term interest rate and the real exchange rate of the dollar; for the European countries this magnified the inflationary consequences of the second oil shock and forced a tighter monetary policy. The interest rate and the exchange rate channel of the transmission mechanism dominated the trade channel and as a result the expansion in the United States did not lift the European rate of growth.

In the 1990s the story was not quite the same. The American policy mix was reversed – expansionary monetary policy and (weakly) restrictive fiscal policy – and it was no more possible to refer to an external shock to explain the poor European performance in terms of growth as well as in term of unemployment. But an internal shock, German unification, played the same role, as it led in Germany to an expansionary fiscal policy and a monetary restriction. The only important difference was that the inflation situation was not at all the same at the beginning of the eighties and at the beginning of the nineties. By and large, the battle against inflation had been won in the preceding decade, and the German unification shock should not have led to such an increase in the restrictivity of monetary policy in non German countries of the European Union. One has to recall that the average short term real rate of interest in the EU during the period 1991-1996 was about 5% for an average rate of growth of 1.5%: the critical gap was thus as high as 3.5%, which by historical standard is extraordinary high. We have thus to refer to a complementary phenomena to explain the course of macroeconomic policy in Europe during the nineties, namely the deflationary bias of decentralised monetary union (Fitoussi and Flandreau, 1994). A partial proof of this assertion is that this deflationary bias came to an end with the launching of the euro. Moreover an alternative explanation of the high level of interest rates during this period does not exist.

When it comes to the current decade the passivity of European economic policy facing a series of adverse shocks needs a complementary explanation. The main suspect this time is institutional: the missions and structure of the European government. Monetary policy is in the hands of an independent federal agency whose only mandate fixed by an international treaty is to keep price stability. It is important to underline that the European Central Bank (ECB) has both independ-

ence of means and goal and is not accountable to any political institution. It has thus no legitimacy to react to shocks but those which affect the current and expected inflation rate. In such a setting it is no wonder that the responsibility of exchange rate policy is all but clear and relies *de facto* on the ECB. When it comes to fiscal policy, the picture is even gloomier, as it is in the hands of twelve national authorities, constrained by the Stability and Growth Pact. In a nutshell the structure of power is such in Europe that those institutions which have the instruments to react have not the legitimacy to do so while those which have the legitimacy have no more the instruments. Hence the passivity of European policy reaction.

So far so good. The naïve could nevertheless have something to object: “the story for each decade seems to be convincing. You can always refer to an exogenous factor – different from decade to decade – to explain the poor performance of the European economy; but how to make sense of the fact that economic policies are consistently wrong in Europe and consistently right in the US?”. And indeed the naïve is right: how to make sense of that?

I have no articulated answer to that query. I will rather use a working hypothesis which may be put in the following way: assume that over the past decades social norms have changed and that the new norms call for a greater degree of inequality. Then macroeconomic policies have to be active where this higher degree of inequality has been achieved – in the United States – and passive where it has not, so as to achieve it. That is admittedly a crude way of putting the hypothesis, but as we shall see later it may be arrived at in a more sophisticated way. It is not a conspiracy theory. A change in social norm may have deep roots and be the reflection of a collective belief to which policy makers may find hard to resist. It may come from the achievement of democracy itself, which by freeing people may lead to more individualistic behaviour. It may also come from a change in the doctrinal credo of the European elites: After WW2, the then existing elites fell into disrepute for obvious reasons, and most of them were changed. The new generation had a strong sense of the public good, as normal after a war, and a weak confidence on the smooth functioning of a market economy as their memory of the thirties were still vivid. John R. Hicks (1982) explained the succes of the “French model of the mix economy” in the sixties by the coming into power of this new class of elites. Because of the very success of the strategies they

have lead (the golden thirty, i.e. the huge increase in per capita income in Europe) those beliefs progressively faded under the doctrinal influence of the theory of the market economy. The change in the social norm was mainly led by the new-new generation of elites born after WW2 and educated in a context where individual successes and personal merit were more affected to individuals than to the collective action which has contributed to build the public goods they have benefited from. To understand the consequence of a change in social norm some theoretical reflections are in order.

## 2. Social Norms and Inequality: Theoretical Notes

In what follows, I will try to demonstrate how a change in social norm leading to a more individualistic evaluation of the workers (i.e. changing the weight between the evaluation of the productivity of a team and the productivity of the workers composing a team) may lead to a greater degree of inequality between the workers.

I will first use a completely individualistic framework, the theory of a pure market economy, to show how a collective action imposed through law may mitigate the degree of inequality achieved spontaneously. I will then show how a social norm may substitute for this collective action through an implicit system of subsidies between workers. Eventually I will study the consequence of the ending of this social convention, what will happen if it is no more obeyed.

If we reason in the framework of a competitive general equilibrium model, full employment is achieved when the wage distribution corresponds to the distribution of marginal productivities of labour. Shocks on relative marginal productivities of labour as those which are routinely emphasized – the impact of globalisation on the demand for low skilled labour, the non-neutrality of technical progress – have the effect of widening the distribution of wages, i.e. of increasing inequality in countries where such an increase is allowed for, say in the US. In countries characterised by a generous social protection system such an adjustment may be prevented. For example, the level and the duration of unemployment benefits may raise the reservation wage. Besides, minimum wage legislation may cause workers whose marginal product is valued less than the minimum wage to be permanently unemployed.

Under these circumstances a trade-off can arise between wages and employment when the demand for unskilled workers falls. This trade-off seems to be well grounded in General Equilibrium Theory. However in such a framework, absent heroic assumptions on endowments, redistributive schemes have to be devised to obtain equilibrium wages above (social) subsistence level. Minimum wage *cum* unemployment benefits and/or minimum income is an example of such a scheme. Dehez and Fitoussi (1996, 1997) present a general equilibrium model with different categories of labour, each characterised by an inelastic supply and a specific level of productivity; they study the effect on employment and wages of introducing a minimum real income, while prices and nominal wages are otherwise perfectly flexible. Compensations are paid to unemployed workers and financed by an income tax. Together with the minimum real income, this induces a minimum real wage. The fact that individuals differ in terms of their skill is an important feature of the model. The distribution of skills is relatively rigid in the short term because the acquisition of new skills takes time. However there is always a certain degree of flexibility because workers are often qualified for a variety of jobs. Skill and qualification are thus distinguished: the skill structure is rather rigid while the qualification structure offers some flexibility. This flexibility is allowed for by assuming that the structure of qualifications is pyramidal in the sense that workers with a given skill are qualified for jobs corresponding to lower skill levels.

A simple characterisation of an equilibrium with unemployment is given in real terms. The emerging wage scale is such that wages in two successive categories are equal whenever unemployment prevails in the most qualified type<sup>1</sup>. The equilibrium distribution of employment may be characterised by under-employment because some workers may have to accept jobs corresponding to lower qualifications. It is then shown that the existence of a (short run) equilibrium depends on the capacity of the economy to finance the unemployment compensations from income taxes, without the creation of money.

Alternative institutional arrangements, like employment subsidies, perform better in such a framework. Firms receive a subsidy such that workers in category  $j$  cost their marginal productivity, even if they receive a net real wage equal to the minimum income. In this setting,

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1. See Fitoussi J.-P. (1994) for a comparative study on wage distributions in United States, United Kingdom and France.

there is full employment and the authors show that it is actually possible to cover the subsidies from taxes. The employment subsidies regime is thus compatible with full employment and a balanced budget under minimal assumptions. Full employment can be obtained through a wage subsidy scheme if, and only if, the minimum net income of the wage earner is strictly less than the weighted average of marginal productivities. However, it may also be explicitly imposed through taxation if the high skilled workers do not reduce their supply of labour – as assumed in that model – because of the increased taxation. In effect, the scheme has the consequence of narrowing the after tax wage distribution relatively to the productivity distribution.

To sum up, the introduction of a wage subsidy scheme will have two effects: in a country characterised by a relatively high level of the minimum wage (say France), it will “force” full employment, because the “high” minimum wage perceived by the worker is greater than the cost of labour paid by firms. In a country where the minimum wage is not binding but the problem arises from a too high level of the reservation wage – which amounts to saying that the wage effectively paid to the less skilled is too low – it will lead to an increase in the net real wage perceived by the workers and thus reduce the propensity to quit of these workers. In both situations, it will lead to an increase of in-work benefits.

But individual marginal productivities are hard to measure as most productions are arrived at through team working. For this reason, there is some arbitrary element in assigning to each member of a team a given figure for his productivity and thus for his wage. In other words wage distribution is also arrived at through social norms. For example, in the preceding case, the full employment solution may be spontaneously achieved if social norms impose a wage structure such that the degree of inequality in the wage distribution is smaller than the degree of inequality of marginal productivities. Social norms may impose such implicit systems of subsidies (from workers with a high level of productivity to workers at the low end of the productivity scale).

But it is the converse case that we want to study. Assume then that the *primum movens* of the change in wage distribution, and more generally, income distribution, is neither globalisation nor technical progress, but a change in attitude in society towards inequality. In 1992 I showed how a greater tolerance towards inequality is likely to lead to mounting unemployment in European countries (Fitoussi,

1992). It is easy to understand the reasons if we use the preceding framework. This change in attitude can be seen as an exogenous shock – every thing being equal – on the wage distribution, which becomes wider to the point that say the minimum wage becomes again binding (leading to unemployment) and/or to the point where the system of subsidies becomes unfeasible (leading to a burst in the degree of inequality). One may even think to the case where the new social norm leads to a wage distribution wider than the distribution of marginal productivities (“the winner takes it almost all”). In this latter case full employment can still be sustained if relative wages adapt to the new social norms. Otherwise unemployment will increase among the workers at the lower end of the wage distribution. In effect to meet this change reverse subsidies are called for – from the poor to the rich – to avoid adverse consequences on employment. It is as if low skilled workers accept a real wage lower than their marginal product to allow high skilled workers to get real wages higher than their marginal product. Admittedly this is an extreme case. But even if we consider the general case where the new social norms call for a widening of the wage distribution, it implies on impact reverse subsidies *vis-à-vis* the former. In countries where the social protection system does not allow for such reverse subsidies – because say of a “too” high level of the minimum wage – unemployment will increase. Of course, to avoid such an outcome a fiscal scheme may be devised to subsidize the employment of these workers – as in the preceding model, but it will unlikely be financed by high wage workers; the impossibility to cover subsidies with tax receipts will thus lead to budget deficits. In effect the high skilled workers are asking for an increase in their net income, and for this reason will oppose an increase in income taxes. (Fiscal and social competition between European countries becomes the common wisdom through which they legitimate their behaviour). The employment subsidies regime becomes thus incompatible with full employment and a balanced budget. Notice that the change in social norms has in this case the effect of increasing the NAIRU. In such an environment, macroeconomic policies (in a very strict regime of inflation targeting at a very low rate) become ineffective to combat unemployment and the situation seems to call clearly for “structural reforms”. I will come back to this point later.

Is there evidence of a change in social norms? Actually there is. The country where this change seems to have worked all its way is the United States. Paul Krugman (2002) clarifies the concept: since 1975,

the average annual salary in America increased by 10%. Over the same period the average annual compensation of the top 100 CEOs went from 39 to 1000 times the pay of an average worker. Between 1979 and 1997, the after tax income of the top 1% family rose 157% compared with only a 10% gain for families near the middle of the income distribution. It is no wonder then that the share of the rich is no longer trivial: the top 1% receives nowadays 14% of after-tax income, a share which has doubled over the past 30 years and which is now about as large as the share of the bottom 40% of the population. "And here is a radical thought: if the rich gets more, that leaves less for everyone else" (Krugman, 2002). The usual explanations – globalization, skill-biased technology, or "the superstar" explanation – cannot help to understand an increase in inequality of such a magnitude. Income seems to have evolved out of relation with any measure of productivity. "The more pessimistic view – which I find more plausible – is that competition for talent is a minor factor. Yes a great executive can make a big difference – but those huge pay packages have been going as often as not to executives whose performance is mediocre at best." (*ibid.*).

### 3. The effectiveness of macroeconomic policies

#### *Macroeconomic policies and social norms*

Against this background, the difference in the use of macroeconomic policies between the United States and Europe may be more easily understood. Macroeconomic policies have to be active where the social protection system is weak or equivalently where the degree of inequality has reached the level required by the new social norms. Otherwise a slowdown of growth, not to say a recession, would have such far reaching consequences, that it would endanger the legitimacy of the economic system. Mass unemployment in the US is simply unbearable in view of its potentially destructive social consequences. (To fix ideas, life expectancy is in the US three years lower than in Sweden; infant mortality twice as high. The median Swedish family has a standard of living roughly comparable with that of the median US family, but Swedish families with children which are at the 10th percentile have income 60% higher than their US counterpart).

In Europe macroeconomic policies may be passive, or even structurally restrictive, as the social protection system can take care up to a certain point of the unemployed. But the resulting slow growth path of the economy will put the social protection system and public finance under pressure, as fiscal and social receipts will slowdown at the very moment where social expenditures are increasing.

The responsibility of bad macroeconomic management in the soft growth regime which characterises Europe since at least fifteen years has for long been recognized: the abnormally high level of real interest rates in the nineties, the procyclical evolution of the real exchange rate, the absence of reactions of fiscal policy to the succession of shocks in the present decade, etc. So absent macroeconomic policies and growth policies, the only apparent way out would then be structural reforms, a leaner welfare state and a lower level of public spending. The course of European macroeconomic policies can be seen as a way to force structural reforms so as to achieve the required increase in inequality. European economies would need greater labour flexibility and this in turn would imply the reduction of the artificially introduced imperfections that hamper its free and efficient functioning. Among these institutional obstacles the most frequently named ones are the minimum wage, unemployment benefits, employment protection, and more generally a labour market legislation which imposes structural rigidities. The conclusion seems clear: our society can keep its level of affluence and full employment can be reached by making workers depend more on low-pay precarious jobs.

Regardless of the theoretical justification of the Welfare State whose function should be that of alleviating the inefficiencies resulting from the real-world market failures, it is undeniable that the European experience has shown how welfare programs increase the size of governments: the need of larger revenues to finance various programs may lead to increase the magnitude of tax distortions. In the presence of lasting soft growth periods welfare programs may lead to a mounting public debt and/or to increased taxation of labour income. The welfare state may then be considered as unsustainable in times of unemployment because it leads to an increase in the cost of labour at the very moment a decrease of this cost is called for. Hence, by making the burden of adjustment fall on the social protection system, restrictive macroeconomic policy show its effectiveness, once its implicit goal

of increasing the degree of inequality – i.e. to adapt to the new social norm – has been recognized.

***The mechanics of active decentralised structural reforms in a space characterized by rules oriented macroeconomic policies***

Notice that the same story can be told in a different, less awkward way. One of the main justifications of the European construction is to build a big economy so as to benefit from the fruit of a single, large market. But to arrive at such an outcome, member States have agreed to obey to rules designed to safeguard the public good “financial stability”. In so doing they have collectively accepted to at least partially sterilize the instruments for managing a big economy, i.e. monetary policy and fiscal policy without speaking of exchange rate policy and industrial policy. Is it a pure chance if among the big countries of the OECD, the euro area is the one which has the smallest (consolidated) budget deficit and the lower growth rate? But if the “European government” is constrained by rules, national governments have to find their way to alleviate the burden of shocks on their citizens.

In principle in a common currency area where exchange rates are irrevocably fixed, relative deflation translate one for one into real depreciation. Price and wage flexibility may thus be very effective for a country which is subject to a contractionary demand shock. In a large unified market any single country comes close to being a text-book small economy whose price elasticity of exports is very large. Hence a modicum of relative deflation could translate into a large gain in net export. Admittedly this kind of adjustment may have adverse effect on the net export of other countries, which could be tolerated if it is a reaction to a specific shock hurting a given country. But what if the whole area is subject to a contractionary demand shock? For reasons already mentioned (the one-sided mandate of the ECB, the Stability Pact), macroeconomic policies have a limited scope to react. But national governments cannot stay passive when confronted to mounting unemployment. But their capacity to react is severely limited as they have no more at their disposal the instruments of macro policies. They are left with only one strategy, namely competitive disinflation which implies structural reforms, i.e. a partial dismantling of the social protection system and of labour protection. In the context of a common contractionary shock, this type of national strategies will obviously lead to much more perversities than in the context of a

specific shock. When cross border effects and likely policy responses are taken into account they will most probably be destabilizing. Even more, the fiction of Europe being a collection of textbook small open economies cannot be pushed too far. Some are much bigger than others (i.e. Germany versus Ireland) which imply that the payoff of real depreciation is unevenly distributed. To say the same thing differently, for a given shock the size of the real depreciation needed is much bigger for Italy than for, say Denmark. This amounts to recognize that if it is rational and profitable for a small economy to play small, it is not rational, nor profitable for a big economy to do the same. It should not come as a surprise then if when we look at the European Union we get the impression that small countries are doing much better than big ones. There are certainly lessons to be learnt in observing the Danish way, but for France, Germany or Italy, it will far from suffice to import the Danish model!

The conclusion is simple: the European separation model – federal monetary policy and federal rules constraining national fiscal policies on the one hand and “unconstrained” national structural policies on the other – leads to an uncooperative game whose outcomes are a soft growth path and an increase in the degree of inequalities. Absent an active macroeconomic policy at the European level, each country whatever its size has the incentive of using the instruments of a small economy, or is constrained to do so, *faute de mieux*. It is as if the aim of building a big economy was conditional on the giving up of the instruments necessary to rule a big economy!

#### 4. Is there an independent rationale for structural reforms?

In what precedes I advanced a strong and provocative hypothesis: the inertia of European governments in the past decades is due to a “hidden agenda”, namely the tentative to bring the European social system to a lower degree of protection, and hence to prove the ineluctability of structural reforms. These, in turn, should push Europe towards the situation required by the new social norms. But wouldn't it be more straightforward, and more intuitive, to admit that structural reforms simply smoothen the working of the economy, and hence are conducive to higher growth and welfare for all? After all the NAIRU could have increased as a consequence of the inadaptation of the social system to a new environment – the thesis of the interaction between

shocks and institutions – rather than as a consequence of an exogenous move in the desired wage distribution. Independently of the truth of this diagnosis itself, I want to emphasize that the need for structural reform is not an excuse for bad macroeconomic policies! One may even argue the contrary: the more needed are structural reform, the smartest should be the policy mix. Otherwise the cost to present generations of the adaptation to the new social protection system would be so high that it will entail the political capital of the government. The cost of the mounting conflicts in the economy would add up to the one associated with bad macroeconomic management producing an even slower growth path.

The reference model, in the plea for structural reforms, is centred on an economy with perfect competition and rational expectations. In such a model full employment is always assured absent rigidities, and policy is ineffective. This framework emphasizes the role of institutions in economic performance, especially labour market institutions: any rigidity leads to departures from the reference model and hence to bad economic outcomes. Redistributive schemes may be devised, as shown before, but up to a point only, when they enter into conflict with work incentive.

This vision has two major (and related) flaws: The first, theoretical, is that it is based on a simplistic application of the welfare theorems, by which a perfectly competitive market will always reach the most efficient price/quantity allocation. It is simplistic because the step from the theoretical result to the policy prescription is wider than one could think, and has to be taken cautiously (as was done by the founders of general equilibrium theory). In fact, the efficiency of the market outcome strongly depends on a number of assumptions that are rarely observed in the real world, from perfect competition to complete markets and information. At any rate, even assuming that market forces were able to attain the maximum efficiency, there would still exist a problem of equity in the distribution of the resources. A democratic society may have a legitimate taste for redistribution and for the implementation of a costly system of safety nets; in this case the strict optimality notion delivered by the free market ideology may not coincide with a broader notion of social welfare.

But once we admit, because of “market failures”, the impossibility to attain the first best equilibrium, the theory is incapable of establishing an unique ranking of alternative institutional arrangements. In

other words, it has still to be proven that efficiency is monotonically related to flexibility, so that the closer we get to the benchmark, the better; and unless this is proven, “more reforms are good” may not be seen as an unconditionally true statement. Thus we have a first dismissal, on theoretical grounds, of the argument in favour of structural reforms.

If we broaden the perspective, things become even more complex. I have argued elsewhere (Fitoussi, 2002, 2004) that democracy and political adhesion of the population to the economic government of a society can actually enhance efficiency, guaranteeing the flexibility, transparency and consensus that would be missing when ruling according to the strict application of a doctrine<sup>2</sup>. Take as an example the different bargaining power of workers and entrepreneurs. In its “Wealth of Nations” Smith had already highlighted the problems that this asymmetry could cause. The norms on labour protection can then be seen as a legitimate outcome of the democratic process, aimed at re-establishing some fairness in the bargaining process.

The only candidate left, for arguing in favour of structural reforms, is then empirical analysis. Nickell *et al.* (2003) who are rather representative of the current consensus on the issue claim that “the equilibrium level of unemployment is affected first by any variables which influences the ease with which unemployed individuals can be matched to available job vacancies, and second, by any variable which tend to raise wages in a direct fashion despite excess supply in the labour market”. These variables include the unemployment benefit system, the real interest rate, employment protection, active labour market policy, union structures, the extent of coordination in wage bargaining, labour taxes etc. But in fact what is striking is the weak, to say the least, explanatory power of the institutional variables, especially those supposedly more important, as the benefit replacement rate and employment protection. That the latter may have ambiguous effects has long been recognized in the literature: the fact that firms are more cautious about hiring, because of strong labour protection, may increase the efficiency of the matching process. But what has not been recognized is that the same may be said for the workers. The fact that unemployment benefit allows the unemployed to search for a job better suited to their skills and expectations, may also increase the efficiency of the matching process. Certainly labour productivity could be

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2. The path breaking research on the subject is Usher D. (1981).

greater if the worker has the feeling that his job better corresponds to his desire (Fitoussi, 2003).

At best, empirical studies are able to find robust second order effects of institutions: “The estimated coefficients on labour institutions disappear or becomes statistically insignificant when the researchers make modest changes in the measures of institutions, countries covered, and time periods of analysis” (Freeman, 2005, p. 9). Economic outcomes are more easily explained by the large shocks that OECD countries have suffered: changing trend in productivity growth, the oil shocks, the important increase in the real rate of interest. Besides, structural reforms in the countries which implemented them, do not appear to have played an important role either (Fitoussi *et al.*, 2000). There is thus a hiatus between usual recommendations and the weaknesses of the evidence to support them.

This hiatus has been recognized in a recent, fascinating book by the World Bank – *Economic Growth in the 1990s: Learning from a Decade of Reform* (2005). This book is a plea for modesty about what we know and what we do not, about the absence of a unique universal set of rules, about the fallacy of the search for elusive best practices, etc.

To sum up, the assumption that the market paradigm is always superior to any other institutional arrangement, is not supported by a strong theoretical argument, nor by the data. As Solow remarks at the end of his Keynes Lectures: “If pure unadulterated labour-market reform is unlikely to create a substantial increase in employment, then the main reason for doing it is anticipated gain in productive efficiency, however large that may be. But if we respect the wage earner’s desire for job security, and it seems at least as respectable as anyone’s desire for fast cars or fat-free desserts, then an improvement in productive efficiency gained that way is not a Pareto-improvement. More labour market flexibility may still be worth having – and I think it is – but then the losers have a claim in equity to some compensation. The trick is to find a form of compensation that does not cancel the initial gain in labour-market flexibility”. (Solow, 2002). On the empirical front, two recent studies independently conducted on the subject<sup>3</sup>, reached the same conclusion out of a sample of 19 OECD countries. In market democracies, the institutional structure is not a powerful factor in explaining economic performance. Capitalism is sufficiently robust to

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3. See Fitoussi J.P. Passet O. (2000) and Freeman R.B. (2000).

accommodate rather different institutional settings (Freeman, 2000). If we had in each decade followed a common wisdom saying that there is one institutional arrangement that is best, we would have recommended to follow the French institutional model in the '60s, the Japanese one in the '70s, the German one in the '80s, and the US one in the '90s. The nationality of the model of the present decade is still unknown, although the Danish one is gaining voices.

The diversity of the institutional framework in OECD countries shows that institutions are the outcome of a political process anchored in the specific history, culture and anthropology of the country, rather than a way to increase efficiency. If for example, the typical labour contract which emerged after the World War II was almost everywhere of long duration, it may be just because after a war, the solidarity between social groups had to be reassessed. It may well be that, as I suggested before, the social norm has since then evolved; but this only adds to the evidence that the notion of "best" institution is endogenous<sup>4</sup>.

## 5. A complementary explanation: "Public social custom" as a determinant of macroeconomic policy in Europe

Before concluding we are left with another question that we need to answer, in order to validate our hypothesis. In fact the policy inertia and the push towards structural reforms were a common characteristic of European policy-making, regardless of the political side of the government involved. Is it possible that any government in Europe has pushed an agenda aimed at reducing the generosity of the social system? Why would governments that had programs centred on growth and social solidarity take a different course once elected, even when they had a reasonable expectation of being punished by their electorate? Unless this paradox is accounted for, our working hypothesis will not hold. Fitoussi and Saraceno (2002) discuss this issue in relation with the Stability and Growth Pact. The question they ask is why governments have accepted restrictions to their fiscal behaviour, when the economic debate on the rationale of restrictions is still

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4. Take an example closer in time. The increased generosity of unemployment benefits, after the attacks of September 11th, was quite obviously an adaptation of institutions to the changed economic conditions. Yet, a supporter of structural reforms could argue ten years from now that unemployment had risen in response to the increased rigidity of the system!

unsettled both theoretically and empirically. In the framework of EMU, the question is all the more important because national governments in the Union have few instruments left, having already given up monetary sovereignty, i.e. the manipulation of the exchange rate and the short term rate of interest. A common monetary policy has differentiated effects on the dynamics of public debt: countries “enjoying” the lowest rate of inflation will suffer from the highest level of real interest rate; as a consequence, it is particularly difficult to understand the rationale of the policy mix which will be imposed by a strict obedience to the Stability Pact. And even harder it is proving, nowadays, to explain to the electorate and to public opinion why the generalized stagnation of these years is not being dealt with by means of a robust active fiscal policy.

There is for sure a path dependency in the building of Europe which may explain why rules devised at a certain moment of time under special circumstances – for example to convince the German government to give up its monetary leadership in exchange of an insurance of prudent fiscal behaviour – may persist even when these special circumstances have disappeared. It is important to underline that, whatever the context in which they are designed, these kinds of rules, because they have to be explained to an internal political audience and to be agreed upon by other governments should have at least two properties: to be simple and to be associated with a principle of good government. Hence whence they are (loudly) legislated, it becomes very difficult to call for their change without appearing as derogating to a principle of good government. This is especially true of fiscal rules because of the common wisdom according to which fiscal discipline, whichever the expression means, is always the sign of a good management. If the rule enters into force at a moment where it is not binding – because growth is resuming as it was the case in Europe – it acquires more strength and legitimacy. That would not have been the case if the rule were impossible to implement from the outset. Then any departure from the rule, provided it is not unanimous, conveys the idea of bad government, lack of courage, demagoguery, etc. Graders are given to the members’ state in the European class room and the *mauvais élèves* are publicly designed (early warning, etc.). What is then at stake is the reputation of the different governments both *vis-à-vis* their electorate (and the opposition being in the left or in the right side is prompt to denounce deviations from the rule in the public debate) and their alter ego.

Hence we argue that the consideration of reputation issues may go a long way to solve this puzzle. First, decisions concerning the Union are the outcome of a bargaining process between the different governments of Europe. Each government may believe that its weight in the negotiations depends on its reputation. In a similar vein, one may consider the European Union as a Club where members obey a social norm because they believe that failing in doing so will result in exclusion by the others; then, the obedience to the norm may emerge as a self fulfilling equilibrium void of any economic premise (but with serious consequences). The paper extends to public behaviour a model originally written by Akerlof (1980), and shows that the fear for reputation loss may be enough to yield an inefficient equilibrium<sup>5</sup>.

In a broader sense, this argument can also be used for the purpose of this paper. A newly elected government, regardless of its political colour and mandate, must show to its EU partners that it is in fact worthy of sitting at the table. As a consequence, it will adhere to the mainstream agenda regardless of its convenience and of the electorate preferences. Paradoxically, governments whose constituencies care more about the social contract, will be those who must work harder to convince the partners, pushing the reforms aimed at dismantling the contract itself.

Of course, one may wonder why reputation is founded on criteria of budget balance, and not on criteria of low unemployment or high GDP growth. And the answer is most probably to be traced to a sort of path dependency. The transition towards the EMU has been dominated by the Maastricht criteria; it is now plainly admitted, even by high rank officials, that the criteria were motivated, among other things, by the attempt (failed) to exclude from the Euro the so called "Club Med" countries (Italy, Spain, Greece, Portugal). The norm that emerged with non economical motivations is now trapping those who wanted it, and has heavy welfare consequences for the Club as a whole.

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5. The Stability Pact is not the only instance of a norm constraining public behaviour in recent European history. In the 1990s, the obedience to the theoretically dubious requirement of maintaining exchange rate parities vis-à-vis the German Mark had most of the features of a social norm. It led to a strongly procyclical monetary policy, similar in many respects to the widely studied (Clarke S., 1967) British experience of the 1920s. As a result, Europe entered a period of slow growth and mounting unemployment that lasted almost six years.

## 6. Conclusion

The main purpose of this paper was to understand the course of macroeconomic policy in Europe in the light of several analyses which have shown that it has barely adapted to the different shocks which have hit the European economy in the last two decades. As a result the performance of the EU economy in the last 15 years and in particular the euro area have been poor, slightly but just slightly better than the Japanese economy (almost the same real growth per capita during this period in the two regions). The usual diagnosis of this situation is the structural sickness of the European economy in general and of its big continental countries in particular: too high a level of redistribution through both the social protection system and the fiscal system; too high a level of labour protection; too many obstacles to a smooth functioning of a market economy both in the labour and the good markets. It is nearly obvious that if all these reforms are implemented the most likely outcome would be an increase in the degree of inequality in European societies. This increase would be the social cost to pay for adapting to a new context, and notably to globalisation and the new information and communication technology. This adaptation will deliver great economic benefits even if unevenly distributed.

This diagnosis contains certainly a part of truth – a social system has to be adapted to change in its environment. But it contains also a lot of rhetoric at least for two reasons. The first is that, despite the numerous efforts deployed to prove it empirically, there still does not exist strong empirical evidence to validate it. The second is that it has been possible to prove that the most globalised economies (i.e. small countries) have, contrary to common wisdom, big government.

But common beliefs, whatever their theoretical and empirical underpinning, act as social norms. It is why I have advanced the working hypothesis that a change in social norms may explain the course of macroeconomic policies in Europe – their non reactivity to unemployment and/or soft growth – if we admit that their implicit aim is to show that the only way out are structural reforms to adapt to the new social norm. Otherwise we would have been left with the puzzle that the need for structural reforms is an excuse for bad macroeconomic policies.

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