COMMENTS ON SESSION 2
FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

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Discussion of "The Importance of Fiscal Policy Frameworks – Swedish Experience of the Crisis" by Robert Boije and Albin Kainelainen (Ministry of Finance, Sweden), "Implementing Germany's New Constitutional Fiscal Rules" by Jürgen Hamker (Bundesbank) and "Fiscal Performance and Decentralisation in European Union Countries" by Julio Escolano, Luc Eyraud, Marialuz Moreno Badia, Juliane Sarnes and Anita Tuladhar (IMF)

The three papers share a favourable characteristic, which is that they are well-written and highly informative for the discussion of the importance of fiscal rules for fiscal performance at the national level. The following discussion is structured by three questions that are addressed in the papers: What can fiscal policies do? How can fiscal rules help? What can we learn for other countries?

What can fiscal policies do?

Looking at the first question, history provides interesting examples of how the correction of fiscal imbalances can contribute to macroeconomic stabilisation. For 1993, fiscal data for Sweden point to severe imbalances. The deficit ratio amounted to 11.2 per cent of GDP, the expenditure ratio was close to 20 percentage points of GDP above the average of the current euro area countries and the debt ratio had risen by almost 39 percentage points of GDP over the preceding three years. This had happened in an adverse economic environment of a financial crisis requiring substantial government intervention in the financial sector and with real GDP contracting by more than 4 per cent over the same period. According to these parameters, the situation in Sweden in 1993 was not much different from that of today's crisis countries in the euro area.

A look at the current situation in Sweden shows how much appropriate fiscal policies, in combination with wide ranging structural and institutional reforms, can achieve. According to the European Commission Spring 2011 forecast, Sweden will be the only EU country showing a fiscal surplus (excluding one-off measures) and rank fifth in terms of its debt ratio. It achieved primary fiscal surpluses in excess of 5 per cent of GDP over the period 1997-2001. These remarkable achievements rest on the foundation of a sound and comprehensive set of fiscal rules that is constantly being adapted.

How can national fiscal rules help?

The paper by Boije and Kainelainen provides and excellent overview of the beneficial impact that sound and well-implemented fiscal rules can have on the fiscal situation. In this regard, three elements appear of particular importance.

- First, such rules can ensure the conduct of sound fiscal policies in economic good times, leading to a safer starting position in terms of fiscal balance and debt when the economic cycle turns. And, indeed, the recent crisis has shown that many of the fiscal problems were caused not only by the sharp downturn of fiscal balances in response to the economic and financial crisis, but importantly also by weak fiscal positions at the start of the crisis, reflecting inappropriate policies during the preceding boom. Somewhat differently from the paper, I would not see a major impact of fiscal rules on the performance of public finances during the crisis. The data

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suggest that the existence of fiscal rules does not explain to a major extent differences in the increases in deficits in the crisis. Moreover, it should be noted that several countries effectively suspended (parts of) their fiscal rules during the crisis to give government more flexibility to react on the crisis.

- Second, appropriate rules instil a political cost for policy makers planning to deviate from the given guidance. In this regard, while the paper clearly lays out the implications of Sweden's rules-based framework for the considerations of decision makers, it would be interesting to learn more about the reasoning behind the envisaged greater formalisation of the rules. Intuitively, while a greater formalisation of fiscal rules (e.g., putting them in the constitution instead of in conventional laws; setting up legally binding sanctions) should be expected to ensure greater compliance, experience suggests that some of the countries with successful fiscal rules had a framework of a relatively vague and legally non-binding nature.
- Third, and in my view importantly, transparent rules invite outside scrutiny of the government's behaviour. While this additional effect may be relatively small in countries where transparency of the public accounts is well enshrined, the effect may indeed be quite important where this is not the case. Eventually, policy makers can be held to account only if there is transparent information on the costs and benefits of their actions complementing fiscal rules with accounting and reporting obligations, possibly combined with independent monitoring agencies.

One question arising from this paper is whether fiscal rules should stay unchanged over time or whether they need to be adapted on an ongoing basis. The experience described in the paper suggests in the case of Sweden a constant adaptation of the rules was useful and perhaps even necessary to ensure their effectiveness. Further research could investigate if these ongoing changes reflect a process of convergence towards an optimal set of rules or if a constant evolution of rules is a necessary ingredient for a successful rules-based fiscal framework.

What can we learn for other countries?

The paper by Hamker may serve as a very detailed and comprehensive reminder that even when fiscal rules are established with the best intentions and with broad political support loopholes will always remain and risk to be exploited. Overall, the paper gives a wide-ranging overview of the new set of fiscal rules in Germany, which are enshrined in the constitution and apply at the federal as well as the state level. It is indeed most interesting to read about all the possible ways to circumvent the spirit of the rules while remaining nominally in compliance. Of note, such manoeuvring will most likely generally precede any outright violation of the rules, which can eventually not completely be ruled out.

These considerations lend support to one of the key findings of the fiscal rules literature that is also reflected in the paper by Boije and Kainelainen: to be of value, fiscal rules need to be simple enough to allow the general public (including the media) real time monitoring of the government's performance relative to the rules. Given that enforcement of the rules via the legal channel is generally difficult and certainly in most countries very time-consuming, an immediate sanction for divergent government behaviour can most likely come only via public opinion. In this regard, a possible lesson from the German approach is that setting up an effective framework may be more difficult the more dispersed is the implementation of fiscal policies across different layers of government.

With regard to learning from country experiences, in particular regarding the impact of expenditure decentralization to lower levels of government, the paper by Escolano *et al.* provides further food for thought. Based on an empirical analysis for the EU member states, the paper finds that (i) a higher share of spending decentralisation is associated with higher general government primary balances whereas revenue decentralisation has a negative impact on general government fiscal positions; (ii) higher transfer dependency tends to reduce the positive effect of expenditure decentralisation (interaction term) and (iii) neither the central government fiscal rules index nor the subnational fiscal rules index have a statistically significant effect on the primary balance whereas a higher score in the overall rules index tends to improve the primary balance.

These results suggest that fiscal rules at the subnational level seem to contribute little to overall fiscal performance, while the arrangements on the (non-) devolution of revenues and expenditures play an important role. Looking ahead, the paper interprets the findings as pointing to an unsustainable trend in fiscal decentralisation as the transfer of expenditure obligations without commensurate revenue sources will hit limits.

From an econometric angle some issues could be addressed in more detail in the paper. Most notably, the issue of endogeneity and possible reverse causality in the regression would deserve some attention. Governments with strong fiscal positions may find it easier to devolve expenditure to lower levels of government which could enable them to cater better for local preferences. Thus, the strength of the general government fiscal position would drive the amount of expenditure decentralisation and not vice versa as conjectured in the paper. More on the technical side, the coefficient on the interaction term of spending decentralisation with transfer dependency, while statistically significant, appears to be very small. Here, an economic interpretation of the size of the impact of the coefficient on overall fiscal outcomes would be useful.

From a policy perspective, the results seem to support the old wisdom of "divide and rule": with expenditure devolution, a strong central finance minister faces a potentially wide range of spending ministers who may find it difficult to form coalitions among themselves and thus have relatively weak negotiating power. In such an environment, rules at the subnational level may indeed be unnecessary. In this regard, an interesting direction for further research could be the question to what extent revenue devolution combined with encouraging tax competition at the subnational level could bring further economic benefits. After all, regional and local authorities could compete with each other not only with respect to expenditure policies but also with regard to taxation with a possibly overall beneficial effect on the economy.