INTRODUCTION

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Fiscal rules are one of the building blocks of European Monetary Union (EMU). The Treaty of Maastricht and the Stability and Growth Pact set rules and monitoring procedures geared at restraining deficit and debt levels while allowing room for fiscal stabilisation. This fact alone provides sufficient reason for a workshop on fiscal rules. However, further motivation is to be found in the recent debates taking place in several countries about the introduction of rules at the national or decentralised level and in the extensive literature about the rationale of rules.

This volume aims at providing an overview of the theoretical and empirical problems involved in the design and in the implementation of fiscal rules. It examines the role of rules at different levels of government and offers indications about the experiences of some countries. The analysis is particularly relevant as the policy debate is gradually moving from how to achieve fiscal consolidation to defining suitable medium and long-term objectives and also to designing institutions and rules that ensure the durability of sound fiscal positions.

The papers presented at the workshop were allocated in four sessions. The first session examines the pros and cons of fiscal rules from a general point of view. In the second session, the focus narrows to the rules introduced in the European Union. In the third session, the analysis is broadened to encompass not only numerical rules but also budgetary procedures and institutions. In the fourth, the solutions experimented in different countries are analysed with reference to the specific institutional setting of fiscal federalism.

The pros and cons of fiscal rules

In the opening paper Balassone and Franco review the literature on budgetary rules from its very beginning to the years immediately before the Treaty of Maastricht. In so doing, they highlight how the rules developed within the European Union draw heavily on ideas that were central in the

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earlier debate on fiscal rules but, at the same time, reflect the novel feature of the EMU. Specifically, the new rules reflect the interaction between the multinational nature of EMU and the lack of a political authority of federal rank. The highly decentralised setting of fiscal policy in EMU gave prominence to moral hazard issues. It was at the root of the rejection of both the dual budget approach and the distinction between ordinary and extraordinary finance. It lay behind the adoption of a detailed multilateral surveillance procedure. It also led to the introduction of a predetermined limit for the annual deficit in a framework that envisages the targeting of a balanced budget over the cycle.

Kopits draws a parallel between rule-based monetary and fiscal policies and points to their common denominator: the attempt to confer credibility on policy action by removing discretionary intervention. He outlines the evolution of fiscal rules and notes that the last generation of rules, those introduced in the 1990s, emphasises very much the need for transparency standards. Kopits notes that fiscal rules are sometimes characterised as a fig leaf and that they are criticised for reducing budgetary flexibility and inviting abuse. Kopits finds support for a rules-based fiscal policy framework in political economy arguments. For example, rules can restrain rational policymakers who are facing an electorate which underestimates the future implications of current policies. He considers different approaches at the national and subnational levels and draws some conclusions about the desirable features of rules. He concludes that rules are mostly useful in countries where a reputation of fiscal prudence is lacking and that their effectiveness is enhanced if they rely on a comprehensive framework applied in a consistent and transparent manner at all levels of government.

Van den Noord and Atkinson focus their analysis on public expenditure. They review public expenditure trends and examine public expenditure policies from three points of view (macroeconomic sustainability, allocative efficiency and technical efficiency). They discuss the experiences of OECD countries with reforms aimed at improving the cost-effectiveness of public expenditure. They acknowledge the important role of fiscal transparency in improving the quality of the policy debate and examine the OECD’s effort in this area. Van den Noord and Atkinson note that transparency can strengthen fiscal rules. While a government cannot commit itself or a successor to respecting the rules it has introduced, it can create a policy environment that pushes future governments to respect sound fiscal criteria. They also point to the usefulness of medium-term fiscal frameworks and to the need to monitor public bodies outside the budgetary process and to apply a hard budget constraint to lower levels of government.

Perez and Hiebert discuss the role of fiscal policy rules in macroeconomic models. They note that rules are designed to guarantee that the intertemporal budget constraint of the government is satisfied. Rules avoid explosive paths for the debt ratio and influence the adjustment of policy variables against shocks and policy changes. Perez and Hiebert note that rules are generally imposed exogenously and that there is little consensus on their most appropriate formulation. Exogenous rules involve backward-looking behaviour on the part of government, may not take into account the specific features of the shocks, and may not be fully consistent with other sectors of the model. The authors offer an alternative specification in the form of an endogenous fiscal rule which requires the presence of forward-looking agents. The rule is forward-looking and consistent with the set-up of the model. It allows shock-specific fiscal policy responses. Only counter-cyclical automatic adjustments are envisaged.

Kilpatrick examines UK past economic policy and notes its problems in terms of instability, imprecise objectives and poor co-ordination of policies. He describes the recent reforms aimed at increasing transparency and accountability of fiscal policy, introducing firm fiscal rules and establishing an independent monetary policy. He points to the crucial role of the Code for Fiscal Stability introduced in 1998 which specifies principles of fiscal management and transparency standards. Kilpatrick emphasises the joint roles of transparency and rules in promoting fiscal discipline and better policies in a democracy. Rules can offset political pressures towards higher deficit levels and improve the credibility of government’s commitments. Transparency can obviate to one of the main problems of rules, that is the potential lack of flexibility. He notes that there is a trade off between the credibility of policies and the flexibility in their implementation. Transparency can allow more of the latter without losing the former. He states that capital spending ought to be financed through borrowing but within limits set by the need to restrain debt levels. Finally, he stresses the inherent uncertainty of budgetary projections and trends and points to the need for a cautious approach in setting targets and implementing rules.

Peach discusses the role of the fiscal rules introduced in the United States at the federal level from the mid-80s. He notes that the first generation of rules, which focused on numerical targets for the deficit, did not prove very effective. The second generation was more successful: it established ceilings on some expenditure items and modified budgetary procedures. In particular, changes in the tax code and in expenditure enacted in a session of the Congress were expected to be deficit neutral over a certain number of years. Peach argues that rules, although not always adhered to, substantially affected the policy debate in the United States. Rules were particularly effective when they were supported by the political will to avoid large deficits and debts. He notes that also simple rules can be instrumental in improving the fiscal balance. In particular, the requirement to formally raise the debt ceiling introduced in the US in 1917 contributed to the enactment of legislation aimed at avoiding debt expansion. He concludes that rules are particularly effective when the majority of voters are convinced that compliance with them is in their interest.

The final paper of the session, by Kennedy, Robbins and Delorme, examines the importance of fiscal rules in determining budgetary outcomes. After briefly reviewing the rationale for rules, the paper compares the rules introduced in several countries at the national and subnational levels. It notes that while several countries have introduced restrictions on deficit, debt, tax and expenditure levels, some countries have focused their efforts on increasing transparency and accountability in the conduct of fiscal policy. Kennedy, Robbins and Delorme also evaluate the evidence about the impact of rules in terms of budgetary consolidation in the 1990s. The evidence indicates that both countries with rules and countries without rules implemented successful fiscal adjustments. From this, the authors conclude that rules may be helpful in achieving fiscal consolidation and may even be necessary in certain countries, but they are clearly not necessary in all countries. They also find that empirical studies of fiscal rules generally support this conclusion. However, determining the conditions under which fiscal rules are indeed necessary to ensure fiscal discipline remains an area for further research.

From the papers in this session Schucknecht draws three main precepts for the design of successful fiscal rules: a) rules and their objectives must be clear and simple and the outcome measurable in terms of the target; b) transparency, monitoring and enforcement must be secured, and rules must be hard to change; c) the institutional framework in which rules are imbedded is crucial. He also identifies one main risk for fiscal rules: that if the three precepts are not followed, rules may be eroded and circumvented. Schucknecht considers the possible substitutability of rules and reputation in safeguarding fiscal discipline. He disagrees with Kopits' view that reputation may make rules unnecessary and notes that past experience shows that governments can easily squander their reputation for political short-term benefits. He highlights the need to take implicit and contingent liabilities into account and points to the introduction of rules prohibiting government guarantees and off-budget accounts.

Langenus focuses his comments on two issues: whether rules are required and how rules should be designed and implemented. He agrees with Kilpatrick that the empirical literature is neither rich nor convincing. Most studies evaluates the impact of rules on fiscal outcomes on the basis of State finances in the US. He notes that the perceived causality may reflect voter preferences: voters introduce tight rules because they want fiscal discipline. With this note of caution about the endogeneity of results, Langenus states that the need for rules should be primarily assessed taking into consideration their effects on the conduct of fiscal policy. Do rules constrain fiscal flexibility and limit tax smoothing? Available evidence, albeit limited, seems to point to the fact that rules not only improve fiscal outcomes in accounting terms (better balances), but also limit the scope for destabilising fiscal policy. Langenus also suggests that rules can improve fiscal outcomes by increasing media attention on fiscal policy. When predetermined targets are available, the media can more easily monitor fiscal policy. As to the issue of rule design, he argues that procedural rules may in the future become more important than numerical rules. Transparency may become one of the core issues. However, this shift in emphasis, which may imply losses in terms of simplicity, requires additional efforts to develop adequate indicators.

European Fiscal Rules

The paper by Buti, In'tVeld and Roeger focuses on the interaction between monetary and fiscal authorities when the latter are subject to upper limits on budget deficits. The authors analyse a stylised version of the European Monetary Union institutional set-up in a game theoretic format where an inflation-conservative central bank interacts with a fiscal authority pursuing output stabilisation around a preferred output gap subject to a deficit ceiling. They show that complementarity or substitutability between the policies and the preference of each authority for the other authority's behaviour crucially depends on the type of shock hitting the economy. In the event of supply shocks, the two policies move in opposite directions, a loosening (tightening) of fiscal policy matching a tightening (loosening) of monetary policy. Under demand shocks, the two policies move in the same direction. As the authors point out, the presence of a single fiscal authority in their model suggests caution in deriving direct policy conclusions for the European Monetary Union. However, the model suggests positive gains from co-ordinating the policy responses to shocks if the government's sole objective is cyclical stabilisation (a zero output gap is preferred). On the contrary, co-ordination would imply an inflation bias if the fiscal authorities target an output level beyond its natural level. The authors suggest that this result may provide a rationale for the traditional central banks' aversion for ex-ante co-ordination of macroeconomic policies.

Quinet and Mills share the interpretation of the "close to balance or in surplus" medium-term target set by the Stability and Growth Pact as applying to the cyclically-adjusted fiscal balance. They argue that this target is to be regarded more as setting a guideline than a rule since there is no process to sanction deviations. They point out how the multi-year planning framework complementing the "close to balance or in surplus" guideline is designed to bring more discipline to fiscal policy-making during "good times" and to ensure consistency between the guideline and the objectives set for the debt to GDP ratio and the government share in the economy. Quinet and Mills stress that while it is widely recognised that expenditure-based fiscal retrenchments are more successful than tax-based consolidations, permanent spending rules have not obtained much attention in the economic literature. They suggest that a spending rule may curb the tendency to relax fiscal policy during "good times", hence preserving the free operation of automatic stabilisers on the revenue side. In their opinion, the difficulty met in adjusting for the cycle in real time also makes a spending rule more transparent and more operationally targeted than a cyclically-adjusted balance. The authors recognise that controlling expenditures does not guard against deficits being created through excessive tax cuts. In this respect, they support contingent rules determining the allocation of growth dividends or revenue overshoots to tax and deficit cuts.

The paper by Föttinger tackles the issue of proper budgetary rules and reporting requirements to ensure fiscal sustainability. The author points out that comparisons between alternative rules should be made with reference to their actual features, as determined by feasibility constraints, rather than to their theoretical properties. He argues that simple rules with modest informational requirements may be more effective in constraining opportunistic behaviour by politicians than more complex instruments with high informational requirements which would only deliver efficiency gains in a world without agency costs. Building on the correlation between the degree of transparency and the potential for creative accounting, Föttinger contrasts the potential merits of government balance sheets in increasing transparency about government net worth with the risks of using such accounts in the context of binding fiscal rules. He considers that the possibility of underinvestment determined by present EMU fiscal rules are not a convincing argument for the introduction of a "golden rule amendment" when compared with the high agency costs in terms of over-investment that such an amendment may entail. He argues that the benefits of accrual accounting in terms of transparency cannot be fully exploited because the primary source of national statistical offices accounting is still cash based. He notes that national accounts methodology was not developed with a view to control governments budgetary policy and finally supports the drafting of accounting standards specifically designed for the public sector.

Berndsen examines the different fiscal rules that have been applied in the Netherlands in the post war period. These rules display a high degree of heterogeneity. They include a golden rule, rules based on the concept of cyclical adjustment, limits to increases in the fiscal burden, ad hoc ceilings for the nominal deficit, and ceilings for public expenditure in real terms. He finds that all these rules tend to be gradually eroded by both political factors (changes in government) and economic climate (low trend growth or recessions). This evidence supports the idea that rules, however carefully drafted, gradually lose their binding power. Berndsen argues that in the case of EMU, where countries have willingly given up a degree of freedom in the design of fiscal rules, the problem may be somewhat less relevant. However, while there is evidence that the 3% of GDP threshold for the overall deficit is perceived as a "hard ceiling" (Buti et alii), the medium-term target of a budgetary position "close to balance or in surplus" may still suffer from rule erosion as it needs to be complemented by national legislation (Quinet and Mills).

The discussion by Brunila shares Berndsen's view that European rules represent a device through which commitment shortcomings affecting national fiscal rules can be overcome. As to the need for national fiscal rules, Brunila points out that they may not only serve the objective of fiscal stabilisation, as pointed out by Quinet and Mills and by Berndsen, but also the need for better co-ordination among different levels of government. Concerning the former, she argues that an important challenge for a proper implementation of EMU fiscal rules is related to the measurement of structural or cyclically adjusted balances. As to national level co-ordination of fiscal policy, she points out that, in countries where lower levels of government have substantial financial autonomy, national budgetary rules can represent a co-ordination device that improves accountability and the commitment of all budgetary players to the targets set in the framework of the Stability and Growth Pact (see also the papers in the fourth section). Brunila shares Fottinger's view that the golden rule is not a feasible alternative to present European rules. To this effect, she points out that the golden rule would involve considerable practical difficulties, complicate the multilateral surveillance process and reduce transparency by providing leeway for opportunistic behaviour and "creative accounting". Concerning the issue of the desirability of more co-ordination between fiscal and monetary authorities, raised by Buti et alii, she sees supranational co-ordination as beneficial. Although the adherence of fiscal authorities to the "close-to balance or in surplus" rule should significantly lessen the probability of policy conflicts in EMU, the sanctioning structure of the Pact still need to be stress-tested.

Hagemann focuses his comments on the issue of whether there is a need for national budgetary rules to supplement the rule framework designed at the European level. From the papers in the session, he finds at least two reasons supporting the adoption of such rules. First, well designed and effectively implemented rules can enhance the transparency and predictability of fiscal policy, thereby allowing economic agents to anticipate the national stance of fiscal policy. Second, rules that help achieve budgetary position of "close to balance or in surplus" allow countries to use fiscal policy to smooth output fluctuations in the event of asymmetric shocks. As to the choice of rules, he argues that it is unlikely that a "one size fits all" operational rule for all countries or all times can be identified. Concerning the issue of co-ordination at the supranational level, Hagemann notes that, in addition to the issue of monetary and fiscal policy co-ordination, in the European Monetary Union there is a problem of national fiscal policy co-ordination. He argues that the adoption of national fiscal rules does not answer the need for such co-ordination, and suggests that the creation of a supranational stabilisation fund at EU level may need to be considered. In view of the difficulties surrounding the estimate of cyclically adjusted budgets, he suggests the use of prudent underlying assumptions in the drafting of multi-year budgetary plans.

According to Denis, the most prominent common feature of the papers in this session is the critical assessment of the Stability and Growth Pact. The Pact appears an imperfect tool to achieve fiscal discipline. In some respects, it could even be counterproductive. The papers stress the lack of sanctions to support the medium-term target of close to balance or in surplus, the difficulty met in estimating the cyclically adjusted budget balances, and the need for supranational policy co-ordination. In line with Föttinger's reasoning, Denis tries to rebalance this assessment. He recalls that the 3% deficit ratio ceiling and the 60% debt ratio, combined with the close to balance provision of the Stability and Growth Pact have been designed to avoid free-riding behaviours but are also a pedagogical tool towards the public. In Denis' view, these rules have been successful in widening political support in favour of sound fiscal strategies. He shares the idea that a golden rule would not represent a useful alternative as it would unduly penalise some outlays, such as those on education, that may have an even stronger impact on growth than some capital expenditure. However, Denis argues that tighter co-ordination within EMU may be necessary to improve the macroeconomic impact of economic policies.

Fiscal rules and budgetary procedures

Fisher points out that while the Excessive Deficit Procedure and the Stability and Growth Pact introduce a framework of numerical rules and surveillance procedures to be conducted at the supranational EU level, it is up to each Member State to ensure the necessary conditions allowing the fulfilment of its EU obligations. In compliance with the subsidiarity principle, the EU framework does not give any indication on the set-up of national budgetary institutions. The author provides a broad overview on the interactions between the EU framework and national budgetary institutions and assesses if and how they are adapting and what are the areas of "friction". Fisher notes that while institutional change takes time and the Pact is still very young, nevertheless the demands from the EU setting are gradually feeding into national budgetary frameworks. The major developments are identified in the evolution of medium-term budgeting mechanisms and in improved co-ordination within the general government. Additional pressures for change are expected as the focus at EMU level shifts away from budgetary consolidation towards the quality and sustainability of public finances and towards the co-ordination of economic policies in the euro area.

Hemming and Kell explore the link between fiscal adjustments that took place in OECD countries during the 1990s and changes introduced in budgetary frameworks with a view to promoting fiscal responsibility. They review the reforms that have tried to counter the deficit bias by improving transparency and accountability of policy makers and by introducing fiscal rules. They emphasize that efforts to increase transparency are particularly important both in their own right and as a precondition for other lines of action and that public opinion should be informed about fiscal policy objectives, assumptions and projections and public sector accounts. Hemming and Kell highlight the pros and cons of different rules and conclude that a combination of expenditure ceilings to constrain short-term pressures and a medium-term debt ceiling can be a valuable solution. The creation of an independent fiscal authority, with some powers to set fiscal policy independent of government, would be highly controversial. This depends on the multiple objectives and instruments of fiscal policy and the redistributive and political implications of fiscal decisions.

Against the commonly accepted view that in the run-up to EMU the Maastricht fiscal restraints were quite effective in re-aligning public finances in Member States that were showing large excessive deficits, Strauch and von Hagen stress that there are some objections concerning this initial sign of institutional effectiveness. They note that the restraining effect is much less apparent in the early stages of the post-1992 period for some larger countries. Moreover, some countries might have consolidated their public finance position even without the Maastricht fiscal criteria, given their debt level and the macro-economic environment. The authors argue that formal fiscal restraints may be an effective instrument for avoiding excessive deficits, provided they incorporate certain institutional features: the fiscal target must be clear-cut and comprehensive, enforcement should rely on independent agents, and the formal restraints involved should be difficult to amend. They find that EMU fiscal rules show some weaknesses with respect to these guidelines. The authors also stress that the budget process can be an effective instrument for solving the problem posed by a “deficit and spending bias” in public finance. In their opinion this holds also if strict fiscal rules already exist.

Heeringa and Lindh compare the experience of the Netherlands and Sweden with fiscal rules and procedures. They note that the two countries are relatively small open economies vulnerable to negative external economic developments and have remarkably similar budgetary experience. In both countries, the introduction of budgetary rules has contributed significantly to the recent improvements of the fiscal situation. The Netherlands adopted a trend-based budgetary policy in 1994, after a period of budgetary consolidation which had started in the early 1980s. Sweden implemented new budgetary procedures in 1997, after having suffered the most severe fiscal crisis in the 20th century. In both countries, the introduction of multi-year expenditure ceilings was an important feature of the reforms; they contributed significantly to the recent favourable budgetary developments by strenghtening awareness of the long-term. However, some problems of pro-cyclical behaviour have emerged.

The paper by Janssen discusses New Zealand's fiscal policy framework. The author points out that over the past 15 years New Zealand has been paying considerable attention to the "rules of the game" for monetary, fiscal and regulatory policies and that this new focus has been an integral part of New Zealand's economic reforms. For fiscal policy, significant changes to the institutional framework have accompanied the consolidation of the Government's position. Especially important was the introduction of the Fiscal Responsibility Act in 1994. Janssen notes that the framework for fiscal policy adopted in New Zealand differs from that used elsewhere, especially in its use of legislated "principles of responsible fiscal management" as opposed to mandatory targets. However, New Zealand Governments are still required to set short-term fiscal targets and long-term objectives for a range of fiscal aggregates. According to Janssen, New Zealand's fiscal policy framework faces a number of challenges and is subject to ongoing developments. He indicates the potential benefits of a more explicit institutional framework and stresses the relevance of long-term fiscal issues for the formulation of fiscal policy.

Reininga analyses the features of the fiscal policy regime adopted in the Netherlands since the mid-90s and places them in the historical perspective of Dutch fiscal policy after 1945. He points out that at an earlier stage it was the urgency of consolidating public finances that reduced disagreement among political parties in the Netherlands over priorities in public finance. This enabled Governments in the 80s to embark on tighter fiscal policies than their predecessors, aiming at a considerable reduction in the budget deficit. Concerning more recent developments, Reininga suggests that the increased significance of coalition agreements as a commitment device for participating political parties may have facilitated the formation of coalition governments with programmes targeted at deficit reduction. Consequently, when public finances appeared to be under control again, the Dutch government was able to introduce a trend-based budgetary policy, featuring medium-term ceilings for government expenditures, a transparent and orderly budgetary process, automatic stabilisation with regard to the business cycle and - to some extent - tax smoothing on the revenue side.

In commenting on the papers in this session, Cabral argues that, as far as fiscal consolidation is concerned, the EU can be considered a success story from 1995 and that this success owes a lot to fiscal rules and budgetary procedures. He acknowledges that procedures can be improved but also stresses that the scheme of incentives provided by EMU fiscal rules is, by and large, proving to be right as the fiscal position of EU countries in 2000 was clearly better than in 1995. First, he stresses that the first two years of implementation of the Stability and Growth Pact have provided clear evidence of the transparency of EMU fiscal framework. Stability and convergence programmes were made public annually by the Member States. The Council gave an Opinion on each of them, which was also made public. According to Cabral this has allowed the build-up of a Commission/Council doctrine, a kind of benchmark against which each Member State knows it is going to be judged. Second, he points to the importance of the multi-annual framework for controlling public finances. Third, Cabral sees the role of the European Commission increasingly as that of an independent fiscal authority, which can be very helpful in ensuring fiscal discipline. He concludes by arguing against the view that EMU fiscal rules display little flexibility. The Stability and Growth Pact objective of a “medium-term budgetary position of close to balance or in surplus” is to be interpreted in terms of structural, or cyclically-adjusted, budgetary balance, so that once such a structural balance has been reached fiscal policy can play a stabilising function.

Marè focuses on the effectiveness of fiscal rules as the main theme of the papers in the session. He draws the distinction between numerical and procedural rules. The former may be sub-optimal in that they do not allow sufficient flexibility for tax-smoothing and may induce creative accounting; these shortcomings may be lessened if numerical rules are coupled with procedural rules which are both “authoritarian” and transparent. By “authoritarian” Marè means those rules which give strong prerogative to the prime minister or the finance minister and, in the words of Von Hagen “limit universalism, reciprocity and parliamentary amendments", thereby facilitating strict execution of the budget law. Transparency and simplicity are values *per se*: the complexity of modern public sector budgets allows politicians to overemphasise the benefits of spending and to hide future liabilities. Marè welcomes recent reforms that in many countries aim at increasing transparency. While he is relatively sceptical about the actual effect of some of these reforms (such as the use of multi-year budgeting), he is quite confident that others (such as the use of independent bodies for a formal assessment of both forecasts and policy evaluation formulated by the Government) might prove extremely useful.

Delorme complements the analysis in the paper by Hemming and Kell by a discussion of the relative merits of legislated and unlegislated rules. Starting from the idea that countries with a credibility problem may best benefit from the adoption of rules, he then explores the issue of whether these rules should only concern the transparency of the budgetary process or should also set numerical targets. He finds that no clear cut conclusion can be reached. He analyses three cases that can all be deemed successful and are characterised by different choices over the trade-off between stringency and flexibility, between legislated and unlegislated rules. First, Canada provides a good example of a situation where legislated rules were not necessary to implement a fiscal turnaround. Delorme links this feature to the fact that the turnaround took place under a Government were the Finance Minister was highly influential, with a strong reputation for the management of public finances. Second, New Zealand took an intermediate position by opting for legislated principles for sound fiscal policy, as described in the paper by Janssen, while rejecting the use of mandatory targets. Third, the Netherlands, as discussed by Reininga, strongly relied on numerical targets.

Fiscal rules in a decentralised framework

Balassone and Franco note that while the budget rules that frame EMU apply to national States, several EMU member nations are already organised on a federal basis and others, pressed by political and economic needs, have started to enact reforms aimed at increasing the degree of decentralisation. They highlight several critical areas in the interaction of fiscal decentralisation and the Stability and Growth Pact. Balassone and Franco point to the reduced flexibility of the European approach compared with solutions adopted in federally structured countries and to the asymmetry between the responsibilities laid on national and local governments by European rules (compliance with the rules depends on the conduct of all levels of government, but *de facto* it is the central government that is answerable to the EU and that must pay the price for non-compliance). This calls for strict controls over local governments to prevent free-riding. The authors examine alternative solutions to deal with these problems, such as the mechanical extension of the Stability and Growth Pact, the introduction of a golden rule for decentralised governments, also in the form of a market for deficit permits, and the use of reserve funds. Finally, Balassone and Franco analyse how the issue has been addressed in Italy through the introduction of the Domestic Stability Pact and stress the need for further significant refinements of these domestic rules.

Gordo and Hernandez argue that fiscal decentralisation has been one of the key features of the development of the Spanish public sector over recent decades. They examine the gradual shift of responsibilities for the management of certain services from the State to regional governments along with development of the arrangements for financing these responsibilities. They note the substantial differences in the responsibilities assigned to the regional governments. This aspect makes the Spanish decentralisation process rather different from that of other countries. The regions with a special status have full fiscal autonomy. Those with ordinary status rely on transfers, mostly from the central government, for about 75 per cent of their total revenues. Some of the latter regions manage health care: others do not. Gordo and Hernandez provide a detailed analysis of the tax revenues assigned to regional governments and of the transfer mechanisms. They note that there are rules guaranteeing regions that the growth of their resources will be basically in line with that of nominal GDP. Borrowing is allowed only for investments.

Wendorff analyses the German experience in reconciling European fiscal rules and a federal organisation. He highlights the main features of German decentralisation: the emphasis on uniformity of conditions throughout the country, the co-operation of federal and regional governments in shaping budgetary rules and the consequent implicit bail-out provision, and the important roles of shared taxes and intergovernmental transfers. He notes the unsatisfactory results of German budgetary rules, based on the golden rule approach, in terms of deficit control. The effectiveness of the rules was weakened by the broad definition of investment and the failure to consider depreciation. Wendorff recalls that the approval of the Stability and Growth Pact gave rise to an intense debate in Germany on the benefits of a so-called "national stability pact". The discussion focused on the legal status of the pact, the distribution of deficit between federal and regional/local governments, its distribution within regional/local governments, and the structure and distribution of sanctions. In the end, it proved difficult to reach a consensus on major issues, with the result that no national stability pact has so far been adopted. Wendorff suggests the introduction of a rule prescribing federal and regional governments to balance their budgets over the cycle and notes that this rule should be introduced in the context of a reform disentangling the fiscal responsibilities of the different levels of governments and increasing the revenue responsibility of each public authority.

Robinson notes that since the late 1980s deficits and public debt have been the major preoccupation of Australian fiscal policy. There was a widespread public perception that a number of States, and subsequently the national government, were experiencing debt crises. As a reaction, in the 1990s, most federal governments adopted explicit fiscal rules requiring balanced cash budgets. Governments aimed at reducing debt and usually targeted structural cash surpluses. At a later stage, some governments introduced accrual accounting which distinguishes between consumption and investment. Robinson argues that the golden rule can best be expressed as a rule requiring the accrual operating balance (i.e. the gap between revenues and consumption including capital amortisation) to average zero over the business cycle. He notes that this result may represent the best practicable approximation of the intergenerational equity principle: each time period should pay for itself. The net worth of the public sector would remain constant. While some States adopted the golden rule, the federal government went for a zero "fiscal balance" (i.e., the operating balance minus net non-financial investment) over the cycle. Net financial worth would remain constant in nominal terms. This approach is tighter than that required for fiscal sustainability.

The paper by Tannenwald examines the recent debate on devolution of fiscal responsibilities from the U.S. federal government to the States. Over the last 70 years, the share of federal spending out of total government outlays doubled, reaching 61 per cent. This trend appears inconsistent with the important role that the Constitution assigns to States. Since the 1990s, a rebalancing of responsibilities has been widely discussed. A "devolution revolution" has been considered. Several economists have highlighted the efficiency benefits of devolution and suggested several policy changes, such as the reduction in federal aid to state and local government, the substitution of block grants for matching entitlements and greater flexibility for states in making use of federal grants. Tannenwald notes that the political support for devolution has not actually been very strong and that the federal government has mostly retained its dominant role. He illustrates this point by analysing the policies concerning health care for children, health care for low-income households (the Medicaid program), and federal assistance for primary and secondary education. He shows that matching requirements and constraints on the use of federal funds still have an important role.

Bogaert and Père examine the institutional reforms introduced in Belgian public finances over the 1990s. During this period, the process of the federalisation of Belgium, which had been started in the 1970s, moved forward in a context of fiscal consolidation. The regions and the linguistic communities were attributed the responsibility for managing a wider range of public services. The federal government remained responsible for raising most of public revenues, but a larger share was transferred to regions and communities. The Higher Financial Council had an important role in the co-ordination of the budgetary policies of the different entities. It recommended budgetary balances and primary expenditure targets. The authors note that the federal and social security authorities largely contributed to fiscal consolidation. Finally, Bogaert and Père consider some problematic issues. They note that net public investment has been negative or close to zero in recent years and that most investment projects are the responsibility of regions. At present, regions are recommended to reach structural budget balance. Bogaert and Père note that, if regions were allowed to fund capital projects via borrowing, the federal government would have to achieve a structural surplus to offset the regional deficits. A uniform deficit threshold for all regions would probably be required.

Monacelli notes that the papers included in the last session focus on three issues: the relationship of decentralisation with the European Stability and Growth Pact, the indicators to be used in assessing compliance of regional and local authorities to national fiscal rules, and the role and design of sanctions. As to the first issue, she notes that promoting efficiency in the provision of public goods through decentralisation is not necessarily inconsistent with compliance with fiscal rules at the national level. In EMU problems can arise from the shift from the old domestic rules, often based on the golden rule, to the new balanced-budget rule. As to the second issue, Monacelli stresses the need for good proxies for evaluating the policy action of decentralised governments and suggests that central government should make use of a wide range of indicators. Finally, she notes that ex-post monetary sanctions are only one possible option. Non-monetary sanctions, such as the exclusion from the decision-making process, can also be considered. Mechanisms operating ex-ante, providing incentives to comply with rules, can also be effective.